Funds Management Quarterly Report

December 2013

INTELLIGENT INVESTOR INTERNATIONAL FUND | INTELLIGENT INVESTOR VALUE FUND

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Lessons from 2013, thoughts for 2014

In the movie Groundhog Day, Phil Connors (played by Bill Murray) enters a time loop, waking up to find himself beginning the same day over and over again. I woke on the first of January hoping 2013 was a groundhog year for us; it doesn't get much better than that.

The vast bulk of our 44.2% return for the year in the Value Fund came from stocks we have owned for several years (**Ingenia**, **Enero** and **RNY** the most significant). Stocks were bought cheap and held for years while we waited for value to be realised. Our valuations turned out to be justified and the value identified has been reflected in the stock price or the company has been taken over. Value investing 101. But in 2013 these hard earned returns have been augmented with a healthy dose of luck, something which was in short supply in 2010.

An unhedged international fund was launched three months before the Australian dollar fell out of bed. Sure, we worked with a sense of urgency to get the fund launched but we could easily have been a few years early or, worse, a few months late.

> ***We've made a lot of money over the past couple of years by playing the other side of the market's obsession with extrapolation, and expect to continue doing so.***

PERFORMANCE (%)

	1 QUARTER	1 YEAR	3 YEAR	SINCE INCEPTION
VALUE FUND	2.77	44.21	20.05 p.a.	14.87 p.a.
ASX ALL ORDS. ACCUM. INDEX	3.42	19.66	7.99 p.a.	7.94 p.a.
INTERNATIONAL FUND	14.63			36.01
MSCI ACWI IMI	12.09			35.70

Of a number of new stocks purchased during the year, three promptly doubled within three months of purchase. The last of these three gifts was **Forge Group**, which almost tripled within a month of its addition to the portfolio (see page 10).

We will not know for several years whether our valuation of Forge was correct or not – that will depend on future profitability, cashflow and dividends. But the share price appreciation has allowed us to bank the profits without having to wait to find out whether we are right or not. That's called luck, plain and simple, and we had more than our fair share in 2013.

Alas, when I woke up on the 1st of January, the Australian cricket team was leading England 4-0 in an Ashes series. Quite clearly we are not reliving 2013.

Which makes it prudent to focus on making returns the old fashioned way.

(For the record, the 14.9% annual return since inception feels a fair reflection of our efforts over the past four and a bit years. Some good luck, some bad luck, some dumb decisions and a lot of good ones.)

So what can we learn from 2013 to help us in the years ahead?

EXTRAPOLATION DOMINATES

We added a few tools to the kit and reinforced some important principles that have been around for decades. The first was that human beings have an inherent bias that causes them to assume that recent trends will be future trends.

In the September Quarterly Letter from GMO, Jeremy Grantham says there is one thing compatible with everything he knows about investing: 'extrapolation dominates the workings of the market'.

'The 30-year U.S. government bond peaked in 1982 at a 16% yield, because inflation had spiked for a second to 13% (even though Paul Volcker was already on the anti- inflation warpath). Yes, you might expect the T-Bill to be 14% or so, which it was. But a 30-year bond! To extrapolate a full 13% inflation – a complete outlier event, by its very nature bound, kill or cure, to be temporary – for a full 30 years! More recently, of course, we extrapolate currently very low inflation for 30 years. My case rests.'

When the Aussie dollar has risen, it will apparently keep rising forever. Now that it has fallen, everyone is telling us it is certain to go to US$0.80. The same principle applies to sectors, asset classes and individual stocks. Eighteen months ago mining services businesses were priced as perpetual growth stocks. Now that they are not winning many new contracts, they are priced as if they will never win another contract again.

We've made a lot of money over the past couple of years by playing the other side of the market's obsession with extrapolation, and expect to continue doing so. But we also need to be very careful about the risks of extrapolation in our own valuations (see the commentary on profit margins below). Unless you have a very good reason to think otherwise, the words of Horace should haunt you:

'Many shall be restored that now are fallen, and many shall fall that now are in honor'[1] .

1. Don't worry, I haven't read Ars Poetica. The quote is on the first page of Ben Graham's Security Analysis

BUY VALUE, NOT THEMES

Do you know what the best performing sector was on the Australian stock market last year? The healthcare sector benefited a lot from a lower Australian dollar. Infrastructure benefited from lower interest rates. And property was also boosted by lower interest rates and a resurgent residential property market. But the answer is not healthcare, not infrastructure, not property. The best performing sector was discretionary retail.

You'll notice that the media commentary doesn't come with much explanation.

'Discretionary retail surged on the back of higher unemployment, consumers maintaining a tight lid on expenses and an acceleration in the shift from bricks and mortar to online retailing'? Doesn't really make a lot of sense, does it?

Discretionary retail was the best performing sector because it had been sold off to very cheap levels during the prior year. Investors were too focused on their future-of-retail crystal balls to realise that there were some good business trading at attractive prices. And that includes us. We took a long look at **JB Hi-Fi**, **Specialty Fashion** and **Kathmandu** and let our fear of the theme scare us away from what would have been very attractive investments.

The best time to buy a stock is often when the consensus view is that the outlook is horrible, even if your own view is consistent with the consensus. If the future is indeed as bad as everyone expects, at least you didn't pay for it. If it turns out that things aren't quite that bad, then there is often a lot of money to be made.

> ***Losing money every now and then is inevitable when investing. If we try and eliminate risk, we will almost certainly eliminate return.***

DISCIPLINE AND FLEXIBILITY

Ed Cowan, former opening batsman for the Australian test cricket team, did some guest commentary for ABC radio during the Sydney test match. Asked how his batting style had evolved over time, the notoriously slow scoring Cowan responded that he had actually been something of a 'dasher' in his younger days. As his career progressed and aggressive strokes led to his dismissal, the flashy shots were retired one by one. By the time of his test debut, Cowan's repertoire consisted of forward defence and the cut shot.

Our investing approach often evolves along a similar path. Each mistake results in the swearing off of a particular type of investment or a reduction in the amount of risk we are prepared to take. In the last five years alone, you could have sworn off companies with debt, mining exploration companies, gold stocks and insurance companies.

And you end up like the Ed Cowan of investing. No mistakes, but no runs either. Many investors have missed out on the super returns of the past two years because they decided to stop taking risk at the worst possible time.

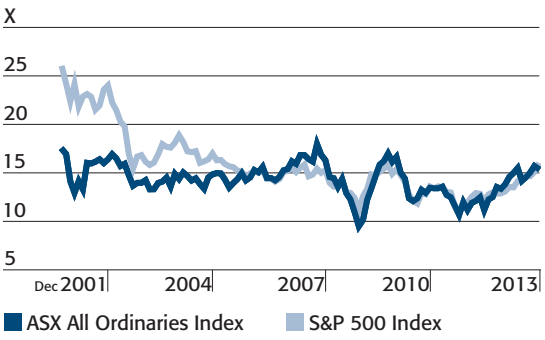
It's something we are very conscious of as our own business evolves. We've gone from a one man show to a team of five. From an investment process that could be executed in 24 hours to one that often runs to 30 pages of research. Our position sizes are generally smaller and our risk management processes much more sophisticated. Net this is undoubtedly good. You will have noticed significantly less mistakes over the past two years, and those mistakes we have made have been contained. But we need to make sure we keep our flexibility, our responsiveness and aggressiveness when the right opportunities arise. Losing money every now and then is inevitable when investing. If we try and eliminate risk, we will almost certainly eliminate return.

2014'S BIG ISSUE: PROFIT MARGINS AND MEAN REVERSION

In the past two calendar years, the All Ordinaries Accumulation Index has risen 42.2%. The United States S&P 500 is up 53.6% and 202.8% since the bottom of the 2008–9 bear market. Obviously rises of this nature should temper our expectations of future returns. But to what extent should we be worried about the potential for a serious correction or long-term bear market?

Many investors (us included – see *Don't sell your stocks just yet*), have suggested that the market is at worst mildly overvalued. We will repeat the argument with the assistance of the charts below. The most commonly used valuation short cut – the price to earnings ratio (PE ratio) – is not out of whack with historical levels. Using 2014 estimated earnings it is 15.4 for the S&P 500 and 14.6 for the All Ordinaries Index, versus averages of 15.5 and 14.2 respectively over the past 13 years.

CHART 1: PE RATIOS



Source: Capital IQ, Dec 13

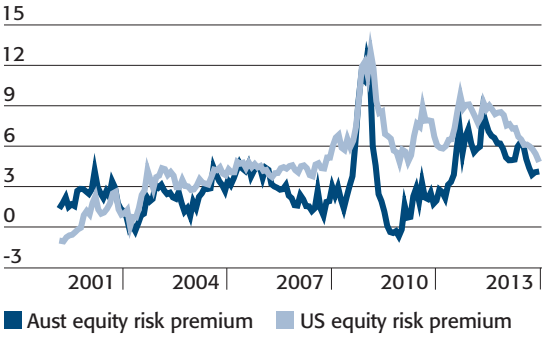
Relative to long term interest rates, you could argue equities are not overvalued at all. Equity risk premiums represent the difference between the earnings yield on equities and the yield on long-term government bonds. In both the US and Australia, according to this measure, equities are priced to deliver better than historical returns (see Chart 3).

All of this analysis is based on one crucial assumption: that the earnings estimated for 2014 are representative of long-term sustainable earnings. The PE ratio is a crude valuation tool for exactly this reason. In a proper valuation model we would estimate all future cashflows and discount them back to today. The PE ratio uses one year's earnings (either last year's or the expected current year's) as representative of all future cashflows. If it's not an accurate estimate, your valuation model is useless.

Several prominent value investors argue that today's level of corporate profitability – the E part of the PE ratio – are not only not representative of future earnings power but substantially overstate it, leading to market overvaluation of as much as 70%.

We have referred to Jeremy Grantham's thoughts on the topic before. Profit margins are, he says, "one of the most mean-reverting series in finance". And they are currently several standard deviations above historical levels.

CHART 2: EQUITY RISK PREMIUM



Source: Capital IQ, Dec 13

More recently, John Hussman of Hussman Funds added more meat to the Grantham argument. In an open letter to the Federal Reserve, he makes three key points:

"We can demonstrate in a century of evidence that:
a) profit margins are mean-reverting and inversely related to subsequent earnings growth;
b) margin fluctuations are largely driven by cyclical variations in the combined savings of households and government, and importantly;
c) valuation measures that normalize or otherwise dampen cyclical variation in profit margins are dramatically better correlated with actual subsequent outcomes in the equity markets."

The whole letter is well worth a read. Or if you are after a short-cut version try *The Coming Retreat in Corporate Earnings*. But there are a couple of crucial points.
First, a simple PE ratio has historically had poor predictive power when it comes to forecasting subsequent equity market returns. A measure as simple as price to revenue is much more effective when predicting future 10-year returns, because revenue is significantly less cyclical than profits. The evidence he presents suggests we shouldn't be placing too much faith in market PE ratios or equity risk premiums.
Second, corporate profits have been high for the past decade because consumer and government savings rates have been exceptionally low. After running through some national accounts equations, he shows that:

'***Corporate profits as a share of GDP are nearly the mirror image of deficits in the household and government sectors***. *A simple way to think about this is that dissaving in both sectors helps to support corporate revenues and limit the need for competition, even when wages and salaries are depressed. It follows that most of the variability in corporate profits over time is driven by mirror image variations in the household and government sectors. As it happens, this relationship turns out to be strongest with a lag of roughly 4–6 quarters. Given the general improvement in combined government and household savings that began just over a year ago, it follows that current-year or even higher year-ahead earnings estimates may not be particularly useful "sufficient statistics" for the purpose of valuing equities.'*

It's the most compelling explanation I've seen as to why US profit margins are elevated and why they are likely to revert to average, perhaps soon.
We are stock pickers, not market forecasters. And we have seen historical data correlations used to justify all sorts of weird and wacky theories. But there is some compelling logic to the Hussman and Grantham arguments and it corresponds with the low number of opportunities we are finding, particularly in the US and the industrials side of the Australian market. If there is a bear market coming, it will be driven by profit compression rather than multiple compression.
If profit margins do revert to average over the next five or so years, we would expect wildly divergent performance from stock to stock. Those that are earning above average profit margins because they have a sustainable competitive advantage should be relatively immune, while those that look like great businesses today but have little or no competitive advantage would bear the brunt of a correction.
With the exception of US markets and the industrials side of the Australian market, we are finding plenty of interesting ideas to invest in. But those two exceptions are in the middle of our circle of competence. With significant amounts of cash in both portfolios, a correction of any sort would be welcome.

With significant amounts of cash in both portfolios, a correction of any sort would be welcome.

ROADSHOW FEEDBACK AND 2014 PLANNING

Many thanks to those who attended our Sydney and Melbourne roadshows. Both nights were a great success and it's always wonderful spending time with those who entrust us with their money. We have had plenty of suggestions for improvement and will try and incorporate those into future events. You can still watch the Sydney event online if you missed it.
We'll be doing something similar in late 2014 and will try and lock down dates as soon as possible. We're also visiting Perth in early March and will be presenting to existing and potential investors. Further details will be available soon.

Steve Johnson
Chief Investment Officer
Intelligent Investor Funds Management

International Fund

The cash-laden Intelligent Investor International Fund has been racing to keep up with rampant global stockmarkets. So far the returns are neck and neck, but a retraction in markets would leave the Fund well placed.

FUND FACTS

Fund commenced	8 Feb 13
Minimum investment	$20,000
Monthly investment	Min. $200/mth
Income distribution	Annual, 30 June
Applications/ redemption	Weekly

UNIT PRICE SUMMARY

Date	31 Dec 13
Buy Price	$1.3588
Redemption Price	$1.3479
Mid Price	$1.3533
Portfolio Value	$43.2m

The International Fund launched in February 2013. If a crystal ball had revealed that, ten months later, global equity markets (as represented by the MSCI All Country World Index) would be up 35.7% and that the International Fund – weighed down by average cash balances of more than 50% over the course of the year – would have marginally outperformed the index, up 36%, we'd have demanded a second opinion. It's been a fortuitous start indeed.

Much of it is luck, no doubt. Hopefully, it also partly represents early proof of concept – that with diligent analysis and careful, often-contrarian execution, the Fund can add value to the portfolios of many Australian investors. Thank you for your support and trust.

The source of the benchmark's large return this year has been booming stockmarkets around the globe, accentuated by the significant fall in the Australian dollar against all major currencies.

SUMMARY OF RETURNS AS AT 31 DEC 13

	INT' FUND (%)	MSCI ACWI IMI (%)
1 MONTH RETURN	2.82	3.96
3 MONTH RETURN	14.63	12.09
6 MONTH RETURN	18.55	18.81
SINCE INCEPTION*	36.01	35.70

**8 Feb 2013*

> ***Considering the large average cash balances over the year, the Fund's share investments clearly outperformed. Much of that came in the last quarter and much of it came from outsized returns from a handful of stocks.***

From the Fund's inception in February until 31 December 2013, the S&P 500 index of large capitalisation American stocks rose nearly 22% in US dollar terms. Other major indices also rallied, with the German DAX up nearly 25%, UK's FTSE 100 up 7.7%, and the Japanese Abenomics-influenced Nikkei 225 index up more than 45% in local currency terms.

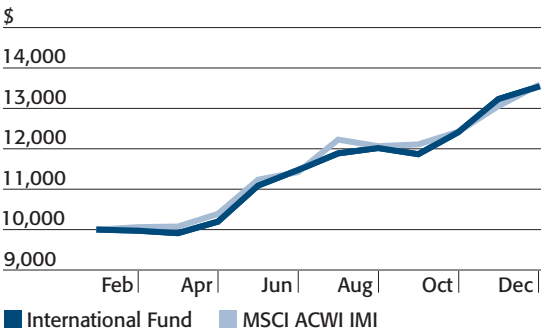
The falling Australian dollar was also a substantial tailwind. At inception in February, one Australian dollar bought US$1.03, €0.77 and £0.65. By 31 December 2013, the same dollar could only buy US$0.89, €0.65 and £0.54. A decent chunk of the index's overall performance (from a local investor's point of view) came from a falling Australian dollar. Protection against such an event was the key reasons for the Fund's fast-tracked launch in early 2013. That explains the index's 35.7% return. What about the Fund's 36% return?

PERFORMANCE DRIVERS

Considering the large average cash balances over the year, the Fund's share investments clearly outperformed. Much of that came in the last quarter and much of it came from outsized returns from a handful of stocks. These stocks have been mentioned frequently in recent monthly letters, so this summary will be brief.

Veripos (OB:VPOS) was acquired in June. It was the GPS systems provider outlined (but left nameless) in the September quarter letter (see 'Three niche oil services companies'). At the price acquired, the Fund expected a good outcome from the stock, but neither as good nor as fast as ultimately transpired. As outlined in Kevin Rose's presentation at the recent Intelligent Investor roadshow, the company has become a 'must-have' for several industry bidders, and a bidding war erupted. As we go to press, that process is still playing out and the Fund retains its position. The stock is up 104% in barely 6 months and this investment will soon turn into cash.

CHART 1: COMPARISON OF $10,000 INVESTED IN THE INTERNATIONAL FUND AND THE MSCI ACWI IMI (FEB–DEC 2013)



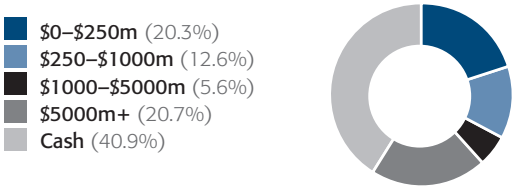
Source: Capital IQ, Dec 13

Italian small cap opportunity **B&C Speakers** (BIT:BEC) was outlined in the June quarter update, and again in Gareth Brown's presentation at the recent roadshow. The company is the global leader for the internal componentry that goes into professional audio loudspeakers, yet was out of earshot of the entire investment world when the Fund acquired stock in June and August. It's since started receiving some deserved attention. There's more to come. The stock is up 54% since our initial purchase and it's been an important contributor to results, being the single largest position in the Fund. If the stock continues rising, sensible portfolio allocation dictates that the position be trimmed. But we like the industry, the company and the management, and the stock remains fairly cheap.

Large positions in **Google** (NASDAQ:GOOG) and **American Express** (NYSE:AXP) have also been important contributors to overall returns, rising 36% and 34% respectively in US dollar terms from average purchase price. The returns to the Fund from these four (and other) investments were further boosted by the falling Australian dollar over the year.

The main headwind which brought the Fund's overall returns back closer to the index return was the large average cash weighting. As promised at inception, we took our time investing the savings you've entrusted to us. That meant, on average, that a touch over 50% of the portfolio sat in cash over the course of the year, held in a basket of different currencies. Had we foreseen the extent of the bull market of 2013, a more hurried approach investing your money might have been warranted. But, hindsight bias aside, we're very happy to have kept up with the index given the circumstances.

CHART 2: PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAP



At year end, the cash position stood at 41%. This is likely to trend down in the months ahead, although not in a straight line. In the meantime, pray for a stock market downturn—the Fund is very well placed for one.

PORTFOLIO CHANGES

The portfolio has been almost static since the last quarterly letter, so there is not much to report. As foreshadowed in the September quarter letter, the Fund has added to its basket of Japanese 'net-net' bargains. For those new to investing, net-net was a term coined by Ben Graham to describe a stock trading at less than its net working capital – ignoring long term assets like property.

As foreshadowed in the September quarter letter, the Fund has added to its basket of Japanese 'net-net' bargains.

SUMMARY OF HOLDINGS

STOCK	COUNTRY	PORTFOLIO WEIGHTING (%)
JAPANESE PORTFOLIO OF NET-NETS	Japan	7.5
B&C SPEAKERS	Italy	7.4
GOOGLE INC CLASS A SHARES	US	6.3
AMERICAN INTERNATIONAL GROUP	US	6.0
VERIPOS INC	Norway	5.9

As someone once put it, Graham wanted to buy a fully furnished house for less than the price of the furniture alone. Earlier in the year, the Fund put together a portfolio of unwanted Japanese stocks at a 35%+ discount to net working capital. In the latest quarter the size of the investment was approximately doubled, by adding to some existing positions and acquiring new stocks that had become available at similar bargain metrics. The most important variables here are statistical cheapness and diversification. There are now 29 stocks in the bargain basket and, collectively, it represents 7.5% of the portfolio.

Soon after inception, the Fund acquired shares in retailer **Coach, Inc.** (NYSE:COH) (see April 2013 monthly update). At the time, the stock was weighed down by concerns over intensifying competition within the North American accessories market. The thesis went that if the company's highly regarded management team could stabilise this part of the business, then the stock market's gaze would soon move to more promising opportunities both internationally and within its men's offering. But the results reported by the company in August and November suggest the problems are entrenched and widespread. The Fund sold its position for a small loss (1%) in US dollar terms, but a moderate profit in Australian dollar terms.

THE SEARCH CONTINUES

At 30 November 2013, the Russell 2000 index of small capitalisation US companies was trading on a price earnings ratio (PER) of 22, a dividend yield of 1.22% and a price to book ratio of 2.35 times. Meanwhile, the Russell Developed Europe Small Cap Index was trading on a PER of 16.7, a dividend yield of 2.36% and a price to book ratio of 1.75 times. In a broad brush, this explains why more of the Fund's analytical efforts are currently being focused on Europe rather than the US. Numerous European small and mid-sized companies are being subjected to our analytical framework, with a few likely to become new investments over the next month or two.

CURRENCY EXPOSURE

CURRENCY	EXPOSURE (% OF PORTFOLIO)
USD	45.5
EUR	17.0
NOK	10.0
JPY	7.5
GBP	7.3

More resources are also being dedicated to Asia. Korea, in particularly, looks like fertile ground for value investors. The Korean market is more foreign to us than, say, the German or Italian markets, so we are treading cautiously and seeking specific local advice. If we're able to get our heads around the cultural nuances, though, expect more Asian positions in the Fund over the coming months.

Value Fund

It has been a stellar two years for the Intelligent Investor Value Fund. You shouldn't expect returns of this magnitude to continue, but we are still finding value in old and new stocks alike.

FUND FACTS

Fund commenced	31 Oct 09
Min. investment	$10,000
Monthly investment	Min. $100/mth
Income distribution	Annual, 30 June
Applications/ redemption	Weekly

UNIT PRICE SUMMARY

Date	31 Dec 13
Buy Price	$1.4771
Redemption Price	$1.4654
Mid Price	$1.4713
Portfolio Value	$47.7m

The Value Fund had a moderate December quarter, the unit price rose 2.8% compared to the 3.4% return generated by the benchmark ASX All Ordinaries Accumulation Index. The last three months consolidated what was an excellent year, with the Fund returning 44% in 2013 (net of fees) compared to the benchmark's 20% return.

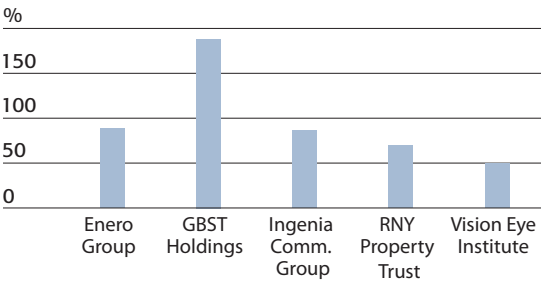
SUMMARY OF RETURNS AS AT 31 DEC 13

	VALUE FUND (%)	S&P ALL ORDS. ACCUM. INDEX (%)
1 MONTH RETURN	0.38	0.92
3 MONTH RETURN	2.77	3.42
6 MONTH RETURN	20.28	14.57
1 YEAR RETURN	44.21	19.66
2 YEAR RETURN (PA)	37.55	19.25
3 YEAR RETURN (PA)	20.05	7.99
SINCE INCEPTION*(PA)	14.87	7.94

**31 Oct 2009*

The biggest contributors in the last twelve months were **RNY Property Trust**, **Ingenia Communities Group**, **Vision Eye Institute**, **GBST Holdings** and the recovery in stock price of laggard **Enero Group**. Against the benchmark we benefited from our non-participation in mining and mining services, but also missed out on gains amongst the larger financials and the general price appreciation of dividend paying blue chip companies.

CHART 1: 2013 GAINS



Source: Capital IQ, Dec 2013

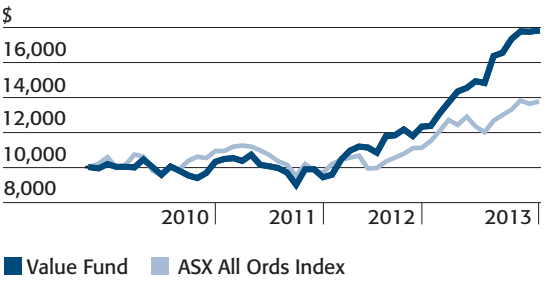
With our key positions having performed so strongly, and the sharemarket itself having rallied 20%, it's fair to say our job has become harder. The portfolio isn't as emphatically undervalued as it was this time last year. Twelve months ago we would have said 50% of the portfolio was trading at less than half our valuation. That number is probably more like 30% today, although with the underlying companies less leveraged, the portfolio is much safer than it was.

We've gone out of our way to emphasise the self evident fact that 40% returns per annum are unsustainable. But, based on conversations with a number of investors, we seem to have created the impression that we are decidedly pessimistic about future returns from the Value Fund. That was not our intention.

First, some of our old legacy positions remain excellent value. With a lower Australian dollar, an improving US economy and a tsunami of capital moving into US commercial property, both RNY Property Trust and **Mirvac Industrial Trust** are well placed for 2014. Vision Eye Institute has seen its share price fall back to attractive levels and GBST will benefit greatly from a lower Pound.

Second, we are still finding plenty of new opportunities. Most are in the mining services space and our approach has been to hold a basket of smaller positions due to their riskiness, but we have also added a significant position in the financial services space that we don't want to disclose yet.

CHART 2: COMPARISON OF $10,000 INVESTED IN THE VALUE FUND VS THE ASX ALL ORDS INDEX



Source: Capital IQ, Dec 2013

Third, there are all the opportunities we haven't discovered yet. That sounds ridiculous but some of the 2014 returns came from stocks we didn't own at the start of the year and, over a five year time frame, our ability to successfully identity new opportunities will be far more important than the existing portfolio.

Temper your expectations, but there is no need to annihilate them.

> ***Temper your expectations, but there is no need to annihilate them.***

A BROKEN THESIS ON QBE

For many investors, selling a stock is a perfectly natural response to bad news from a company. Particularly if the share price has fallen as a result, for those (like us) with a contrarian bent, it feels unnatural, uncomfortable and the antithesis of value investing.

Whilst it hurt, it's exactly what we have done with **QBE Insurance**. Over the past two years, we have become increasingly uncomfortable with the QBE business and have let the portfolio weighting drift down from north of

8% to less than 4%. We should have sold the lot.

Our original thesis was that QBE was one of the better insurance businesses in the world. We thought its problems represented temporary hiccups and that once those problems passed the company would return to a level of profitability that would be the envy of the insurance world. We were prepared to pay a premium to book value because the franchise value was significant. After three years of relentless profit downgrades, those assumptions have to be questioned. Perhaps this business is not the quality we thought it was. Perhaps those acquisitions have been just as value destructive as most other international expansion binges. Perhaps it's just another insurance business and not one of the best in a globally competitive industry.

If that's the case, why are we prepared to pay a premium to book value to own it?

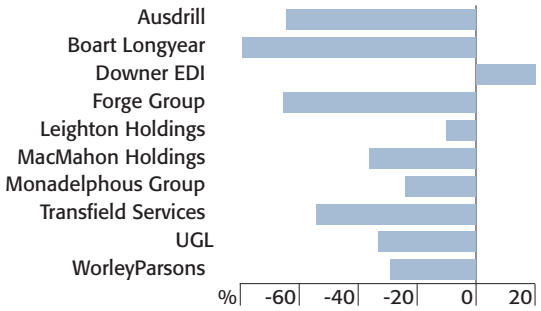
It's easy to make the case for this stock still being cheap and there's every chance we've sold out at the point of maximum pessimism. But it's a broken thesis, which means back to the drawing board for QBE. We've sold the Fund's stake in the company and will reassess with a clear mind in early 2014.

Forge's story was the most spectacular for the year, but it's certainly not been the only trouble spot in mining services.

DOWN AND OUT IN MINING SERVICES

Shareholders in Forge Group must be wondering how it all went so wrong. Forge had been one of the sharemarket's star performers in recent years, its shares rallying more than ten-fold from $0.60 in 2007 to a high of $6.91 in 2013. The company had grown revenue from $18m in 2004 to a staggering $1bn in financial year 2013, and it had just reported a record $63m net profit. Though the share price had increased, Forge still traded on a single digit earnings multiple, and as well as producing excellent returns on its capital it was a member of a rarefied breed of companies that was rapidly growing earnings while paying dividends. To top off a (usually) very attractive set of characteristics for investors, Forge also had low debt, with $93m in cash easily covering $26m in borrowings as at 30 June 2013.

CHART 3: MINING SERVICES TALE OF WOE



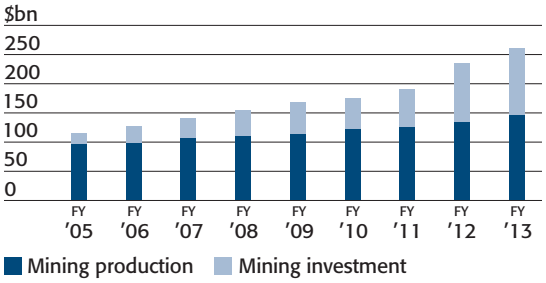
Source: Capital IQ, Dec 13

Yet in November Forge went into a trading halt citing project issues, and when it recommenced trading it was gutted. Forge unveiled a $127m profit downgrade and the stock fell a brutal 84% on the first day. It was probably lucky to have survived at all, a proposed equity raising had fallen over and only the support of lender ANZ kept it afloat.

Forge's story was the most spectacular for the year, but it's certainly not been the only trouble spot in mining services. In Chart 3 we've shown a selection of mining services companies and the treatment of their shares during 2013. It's not a pretty picture; only one ended the year positively, most had double digits falls and there are plenty that fell more than 50%:

The macro environment in mining, so long a tailwind for these businesses, has turned ugly. Commodity prices, with the notable exception of iron ore, have fallen and as a result new investments in mining projects have died out. Chart 4 shows the contribution to gross domestic product of mining (dark blue) and the investment in new mining projects (light blue). Investment has grown explosively in recent years, from $17bn in 2005 to $115bn in 2013, and now accounts for a huge part of overall expenditure. Once the current crop of projects are completed, total resources spend is likely to fall considerably.

CHART 4: MINING CONTRIBUTION TO GDP



Source: ABS, Dec 13

That's if current conditions continue, but things could certainly get worse. If our concerns about the sustainability of China's growth model are validated, iron ore our biggest export is likely to come under price pressure and coal and other metals could certainly fall further leading to more extensive damage than what we've seen to date.

In a good environment mining services companies can masquerade as high quality businesses, but challenging conditions reveal their true nature. They are acutely leveraged to the commodity cycle; miners usually outsource their more discretionary and lumpy expenditure and contractors are therefore stung hardest in a downturn. A rough industry rule of thumb is that when headcounts are reduced, ten contractors exit for every staff member of the client made redundant.

Most contractors operate in competitive conditions where margins are thin, have volatile turnover with very little visibility, and have weak negotiating positions with their clients (and often also their own workers). Some produce a high return on equity but it is often the result of off balance sheet financing (project guarantees), insufficient cash and too much debt.

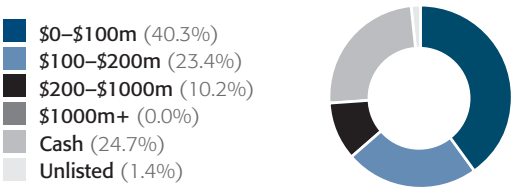
They also have a shocking tendency for blow-ups and writedowns, as was the case with Forge, and when they are vulnerable the rot can become self-fulfilling and

fatal. New work becomes difficult to win, clients refuse to pay their bills and suppliers demand cash payment upfront. This stresses the balance sheet, making the banks nervous and threatening solvency.

STILL READING?

Despite their flaws, the carnage in the mining services sector has created interesting opportunities for value seekers. The sell-off has been deep, frenzied and in some cases overdone. As is often the case, the occasional gem is hammered in the stampede. Not all mining services companies are born equal, and some are likely to show considerably more resilience through the downturn.

CHART 5: PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAP



Other than Forge, we're not yet ready to disclose specific ideas because we are still buying. But we're happy to outline a couple of themes of interest. Firstly, production in mining, in contrast to investment, continues to hit record highs thanks to the investments of the past decade. Companies that provide production critical services, which can't be easily deferred, and aren't vulnerable to new competition from other work-starved contractors moving in on their dirt, look prospective. For companies in this advantageous position, the supply of work is still strong and margins aren't under as much pressure.

Secondly, some of these beaten down mining services businesses can be purchased for significantly less than net tangible assets. This can be attractive, particularly those where the assets are liquid, or in the case of plant and equipment, of such short life such that the chances of prolonged industry oversupply of the asset is minimised. Such a position should protect margins through a downturn as the company involved, and its competitors, have the option of reducing their assets bases, through liquidation or natural depreciation, if adequate returns are not generated. This helps keep margins healthy and provides an addition level of protection for investors, because free cash flow can be generated either through ongoing operations or the wind-down of activities.

And what of Forge Group? In a demonstration that for every stock there is a price that's good value, even in disgraced mining services providers, the stock fell to $0.48 in mid-December and then staged an extraordinary rally to finish the year at $1.74. No relevant news was announced other than a short confirmation that an already disclosed project on the giant Roy Hill project would go ahead. The gains were small commiseration for long time shareholders, but a lucky break for those, like us, who bought in after the trading halt (see excerpt). Perhaps Forge, the poster child for 2013's meltdown, will be the poster child for a 2014 recovery in mining services? It remains to be seen but in our view there is plenty of value in the sector.

A SELECTION OF STOCK HOLDINGS

STOCK	DESCRIPTION (WEIGHTING)
VEI	Ophthalmology clinics around Australia recovering from historical debt burden. **(7.1%)**
GBT	Financial industry software provider in the UK and Australia. **(6.0%)**
MIX	US industrial property owner in the process of liquidating its assets. **(5.1%)**

We familiarised ourselves with Forge Group during the trading halt, and purchased some shares at $0.57 on the day trading recommenced. The price rose 20% in subsequent days and with the price higher we took our gains pending more detailed research. Having completed our research we were fortunate that the price had fallen back down, and prior to Christmas we purchased again at $0.61. We were expecting to be in for a long arduous haul as the company sought to re-establish credibility. A little over a week later we sold out at an average of $1.52. Forge was too risky to ever be a large part of the portfolio, but it added a meaningful 1.75% to the Value Fund's performance for the quarter. We'll attribute that to luck for now and let you know in a few years time whether the decision to invest was right or wrong.

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