Value Fund
Quarterly Update

INTELLIGENT INVESTOR
FUNDS MANAGEMENT

31 MARCH 2010

Portfolio performance

Underneath a seemingly benign surface, it's been an action-packed quarter for the Intelligent Investor Value Fund.

During the quarter ended 31 March 2010, the All Ordinaries Accumulation Index fluctuated between a high of 34,380 and a low of 31,234, a range of more than 10%. All the while, the Value Fund's unit price hardly budged from the $1 initial issue price, despite us increasing the percentage of the portfolio invested in stocks from 48% at 31 December to 89% at the end of the quarter.

SUMMARY OF RETURNS	
3 month return	–1.99%
1 month return	–0.34%
Return since inception (2 November 2009)	–0.14%
Number of stocks in portfolio	14

I have no explanation for this other than pure coincidence. The underlying stocks in the portfolio have been quite volatile—in some cases enabling us to add substantially to our position—but the ups on any given day have typically been offset by the downs. The net result for the quarter was a 1.99% decline in the Value Fund unit price, taking the return since inception to –0.14%. In comparison, the All Ordinaries Accumulation Index is up 1.5% for the quarter and 7.2% since we started investing on 2 November 2009. »

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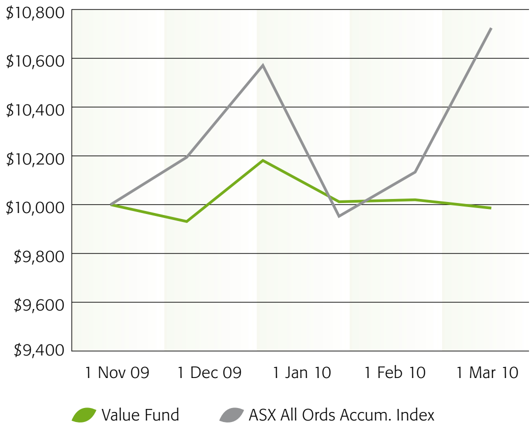
INTELLIGENT INVESTOR

VALUE FUND VS ASX ALL ORDS ACCUM. INDEX



PORTFOLIO DISTRIBUTION*

- Less than $100m **10%**
- $100m–$200m **40%**
- $200m–$1bn **21%**
- $1bn+ **18%**
- Cash **11%**

*according to market cap

The good news is that we've been able to establish substantial positions in stocks that we expect to provide excellent returns over the next few years. The fund is now 89% invested and, while our preference is to be fully invested as long as we can find enough opportunities to justify it, that's an excellent position to be in after just five months.

The quarter also involved us participating in a few shorter-term opportunities—one which we have already exited and one which we expect to exit relatively soon. To these and the rest of the portfolio we will now turn.

WDS and Centrebet

On 2 February, mining engineering firm **WDS** announced a profit downgrade and the share price fell off a cliff. The company had raised $45.7m from shareholders at $1.70 per share in September 2009 and was trading around $1.50 when the downgrade was announced (a revised forecast profit of $7m versus previous guidance of $22m–$24m). When trading resumed the opening price was $0.77 and it went straight down from there, hitting a low of $0.505. We started buying at $0.56 and finished the day with a touch over 2% of the fund invested in the stock at an average of $0.55.

The very next day the stock rallied to more than $0.80. We sold about half the holding at $0.80 and the rest over the following month, giving us an average sale price of $0.77, a 40% gain. We bought WDS with the intention of holding it longer-term and potentially buying more as we got to know it better. Mr Market's wild gyrations gave us a chance to take our profit and run.

Another idea that looks like reaching fruition in a short time frame is our current investment in **Centrebet**, an online bookmaker run by Con Kafataris. This rapidly growing sector has been in consolidation mode for a number of years. With high fixed costs and low marginal costs, the biggest players by revenue have a distinct advantage over the rest of the field—hence the rush to acquire competitors (The Intelligent Investor's Research Director, Greg Hoffman, highlighted the changing landscape and a potential opportunity in The Ideas Lab: International All Sports). Centrebet is the last remaining listed online play (both **Tabcorp** and **Tatts Group** have online bookmaking operations but they are dwarfed by the traditional bricks and mortar TABs). We began buying in January and have ended up with about 5% of the fund invested at an average of $1.46 per share. The stock looked reasonably priced in its own right but we were confident that it was going to be a major participant in any further consolidation, either acquiring or being acquired.

It looks like it's going to be the latter. On 9 March Centrebet announced it had received a number of 'indicative, non-binding and conditional proposals from parties expressing an interest in the possible

Selection of holdings

STOCK	BUSINESS	PORTFOLIO WEIGHTING
31 MARCH 2010		
Prime Infrastructure Holdings	A diversified infrastructure fund. The main investments are Northern Gas Pipeline in the US, Queensland's Dalrymple Bay Coal Terminal and WestNet Rail — a rail network in Western Australia.	12%
MAp Group	Owns a majority stake in Sydney Airport and several other smaller airport investments including stakes in Brussels and Copenhagen Airports.	9%
Photon Group	Photon Group owns a diversified collection of marketing businesses with particular strengths in the area of field marketing (product testing, demonstrations and merchandising, mostly on behalf of large consumer companies like Vodafone and Coca-Cola).	8%
RHG Group	An asset play with a 84 cents of net tangible assets, plus the rights to income from a $5bn mortgage book.	7%
Spark Infrastructure	Has an effective 49% interest in the electricity distribution networks in Melbourne's CBD, Western Victoria and South Australia.	6%

acquisition of the Company'. We expect Kafataris, who controls some 60% of the company, to hold out for something in the order of $200m, or more than $2 per share. If it plays out as planned, it will be a nice return in a relatively short period of time.

Still hooked on infrastructure

Approximately 30% of the fund is invested in infrastructure stocks. We've bought more **Prime Infrastructure**, maintaining our percentage weighting as the fund has grown, and these additional purchases enabled us to get the average cost down to about $4 per security. Much will depend on the outcome of Natural Gas Pipeline Company of America's (NGPL) ongoing stoush with the US energy regulator. NGPL is Prime's largest investment and, if NGPL wins the argument and can maintain current access prices to its gas pipelines, we're going to do very well. If it loses and, in the absolute worst case, the equity in NGPL is worthless, the current security price would still look reasonable on the basis of Prime's remaining investments. At the half-yearly results briefing, Prime management didn't provide any insight into which outcome is most likely, but did indicate that a 'settlement' should occur before the end of the year.

MAp Group, the former Macquarie Airports, is our second largest infrastructure investment at 9% of the portfolio (up from 5% at 31 December). The group's main investment is a 73% stake in Sydney Airport, an asset we consider the crème de la crème of infrastructure investments, and it also owns significant stakes in Brussels and Copenhagen Airports. MAp's management team recognised many years ago that the airlines and the airports want the same thing: more passengers. The model—surprisingly novel until you consider that most of the world's airports are government owned—is to get as many passengers as possible through the doors by offering airlines attractive deals. MAp knows only too well that it can then convert these passengers into highly profitable customers of its retail and car parking operations.

The underlying airports' earnings equated to about 21 cents per security in 2009, so the current security price, north of $3 per security, doesn't look like a screaming bargain. But we expect a substantial boost to earnings this year from a recovery in traffic growth (Sydney Airport reported a double digit increase for the month of February) and this is a business that should provide positive surprises for many years to come. As long as the price doesn't get too high, we'll maintain the current weighting and let the airports do their work.

The final infrastructure investment is a 6% weighting to **Spark Infrastructure**. At the end of last quarter we had almost equal investments in Spark Infrastructure and SP Ausnet. These two businesses operate under the same regulatory framework and we view them as equivalent from an investment perspective. But relative movements in the stock prices of both led us to sell SP Ausnet and double up on Spark.

Spark owns a 49% interest in electricity distribution networks in Victoria and South Australia. As these assets are monopolies, they are regulated by the Australian Energy Regulator (AER), which is part of the ACCC. The AER stipulates what investment the distributors are allowed to make in their networks and, commensurately, what tariffs they are allowed to charge for usage of their networks. The regime for the next five years will be set for Victoria and South Australia later in 2010 but one thing is already clear; Spark's entities, needing to upgrade their 50-year-old electricity networks, are asking for substantial increases in allowable capital expenditure and they are likely to get it. This means shareholders are going to have to find billions of dollars in capital and, if you live in either of these states, you're going to be slugged with substantially higher electricity bills so that the owners of that capital can earn a return.

> **"The good news is that we've been able to establish substantial positions in stocks that we expect to provide excellent returns over the next few years."**

As partial owners of this business, we would be more than happy to contribute more capital in the knowledge that we're going to earn a secure, regulated return. But it seems not all securityholders think this way, with management deciding that a listed entity is perhaps not the best structure for funding substantial future capital commitments. The company is undertaking a 'Strategic Review' to explore options for meeting the capital needs of the business including 'changes in corporate structure, changes in capital structure, capital raisings and proposals that involve asset sales or a change of control of Spark Infrastructure'.

Any potential deal would involve Cheung Kong Infrastructure (CKI), a Hong Kong based investment company which owns the other 51% of Spark's investments, has four of the eight Spark board » seats and a generous management contract which involves Spark paying it a substantial amount of fees every year. Whether it's a complete takeover offer, a partial asset sale or an internalisation of the Spark management team, we'd be very happy to have the marriage unwound. It looks like all of these options are on the table and, at the right price, any of them would be good for Spark.

Of course, we didn't buy it in the expectation of corporate activity. We bought it because the underlying assets are generating $0.20 per security in cash flow and, irrespective of whether that's reinvested to generate higher future returns or paid out to securityholders, that is more than enough to justify the current $1.20 price.

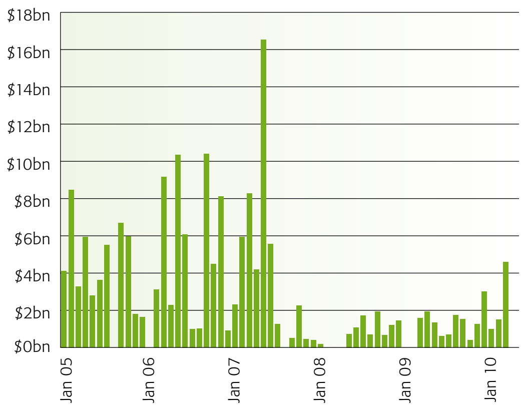
Balancing the good and bad at RHG

Conflicting signals from mortgage company **RHG Group** are making it difficult to nail down the attractiveness or otherwise of this stock. On one hand, substantial shareholders have been selling noticeable amounts of stock. There are sometimes good reasons for a director selling their shares but combined, these two events make us nervous.

The good news is that the timing may well be perfect for RHG to do what management knows best: write mortgages. The residential mortgage backed security (RMBS) market, where RHG's original Rams business sourced the majority of its funding, is showing signs of life. You can read the details of the resurgent RMBS market in my recent blog post but the accompanying graph tells the story. There were $4.6bn of RMBS issued in March (which is the most since June 2007, just before the credit crisis shut the market).

RHG signed a three-year non-compete agreement with Westpac when it sold the Rams brand in 2007. That expires in November this year and, if funding

AUSTRALIAN RMBS ISSUANCE



Source: Banking Day.

costs fall a touch further, the timing could be perfect for RHG to re-enter the mortgage market, which is crying out for a modicum of competition.

We have a strong preference for RHG's substantial cash pile to be returned via fully-franked dividends. But we've had to accept that this is unlikely ever since Greg Hoffman and I took a tilt at the RHG board and lost. The next preference is for RHG management to spend the money on something they know how to do, and that is writing mortgages.

Small stocks, large positions

We have also been able to add significant positions in two small, illiquid stocks, both of which are exactly the type of opportunity we had in mind when establishing the Value Fund. One has a market capitalisation of less than $30m and the other approximately $100m. Between them they represent about 20% of the fund and it's this portion of the portfolio that offers the potential to provide outsized returns over the next few years »

2010 ROADSHOW LOCATIONS

Tuesday 13 April	Adelaide CBD	**Monday 26 April**	Hobart CBD
Thursday 15 April	Perth CBD	**Tuesday 27 April**	Melbourne CBD
Tuesday 20 April	Canberra, Ainslie	**Wednesday 28 April**	Cairns
Wednesday 21 April	Sydney, Parramatta	**Thursday 29 April**	Townsville
Thursday 22 April	Port Macquarie	**Friday 30 April**	Sunshine Coast, Mooloolaba

(though will likely cause large fluctuations in the unit price from month to month).

We won't disclose the names of these stocks just yet, but we will hopefully have some interesting stories to tell over the next year or so.

We will, however, be talking stocks and plenty more at our upcoming roadshows. If you're interested in hearing more, or just want to meet us, hear about the fund and ask a few questions, why not join us for a night? Details are available in the table above, entry is free and we'd appreciate you bringing any friends or family who might also be interested in the fund.

Presentations will start at 6pm and finish by 8pm. Register at www.iifunds.com.au/roadshows.

I hope to see you there. If not, we'll be back with another quarterly report at the start of July. If you have any questions in the interim, email me at steve.johnson@iifunds.com.au.

Yours sincerely,

Steve Johnson

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