

Value Fund

Quarterly Update



INTELLIGENT
INVESTOR
FUNDS MANAGEMENT

30 JUNE 2011

Stockpicking for grownups

Performance analysis

A lot went right in the past year. **Prime Infrastructure** was taken over by Brookfield in November. **Alinta Energy** was bought by its lenders in March at double our purchase price. Shareholder action on **RHG** was successful, resulting in a 122% return on our purchase price. And towards the end of the year, **Centrebet** also locked in a takeover offer from UK company Sportingbet.

MAp Group and **Spark Infrastructure** did what they are supposed to do as 'defensives' and performed well when the market performed poorly over the past few months. For the year, MAp returned 37% including distributions and Spark returned 25%.

Unfortunately all of that good work has been undone by the poor performance »

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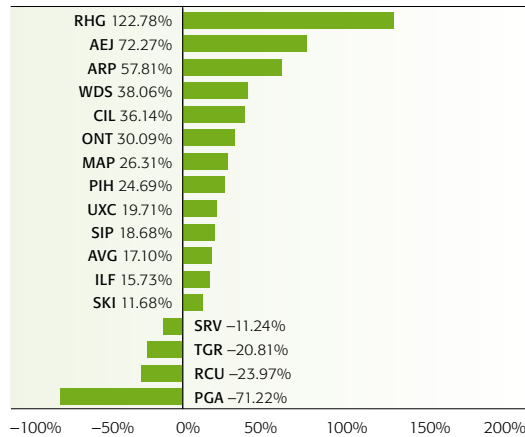
SUMMARY OF RETURNS AS AT 30 JUNE 2011

	IIVF	ALL ORDS. ACCUM. INDEX
1 month return	-0.83%	-2.39%
3 month return	-2.98%	-4.78%
6 month return	-2.46%	-2.00%
1 year return	5.12%	12.17%
Since inception (31 Oct 2009)	0.29% p.a.	4.16% p.a.
Stocks in portfolio	14	

» of one stock, **Photon Group**. We discuss the current situation at Photon on page 4. Suffice to say for now that we have made two meaningful investments in this stock, one prior to its recapitalisation and one as part of the recapitalisation process, and both are performing disastrously. Photon was the worst performing stock in the All Ordinaries Index for the 2011 year.

Which is why, despite much success, we have not made you any money yet. The Value Fund's return for the year was 5.12%, 7% less than the All Ordinaries Accumulation Index's 12.17% return.

PERFORMANCE BY STOCK (ABSOLUTE RETURN > 10%)



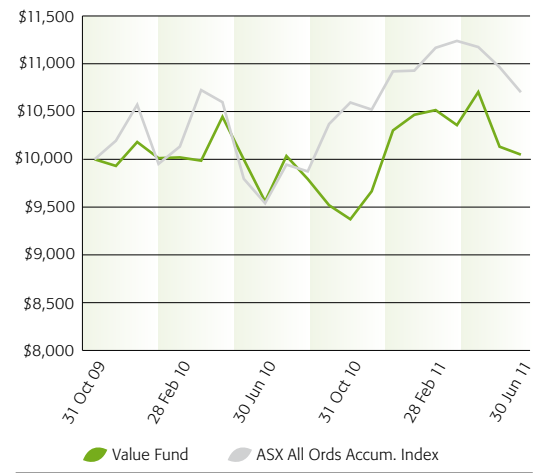
Since inception, we are barely breaking even (0.29%p.a. versus 4.16%p.a. for the Index).

Twenty months in, this might seem a disappointing start, but it is nothing out of the ordinary. We have a concentrated portfolio of stocks, many of them illiquid. Our returns will not come smoothly and neither will they be closely correlated with the Index.

Charlie Munger, one of the world's most respected value investors, has labelled the current environment 'stockpicking for grownups'. It's not meant to be easy.

We have no idea when the big positive returns will arrive—we asked for an investment timeframe of three to five years and might well need them—but we have a cheaper portfolio today than at any other time since we started the fund.

VALUE FUND VS ASX ALL ORDS ACCUM. INDEX



“ Our returns will not come smoothly and neither will they be closely correlated with the Index. ”

RHG delivers the goods

Mortgage company RHG was an idea that came from my days writing for *The Intelligent Investor*. Our valuation of the mortgage book was in excess of \$1 per share when the share price was less than \$0.30 in 2008. Despite almost doubling, it still looked great value when we started the Value Fund in late 2009.

The problem was always how that value was going to be realised. Chairman and major shareholder John Kinghorn seemed to have no intention of returning its growing pile of cash to shareholders.

By September 2010, despite the company's net tangible assets per share growing to \$1.02, co-founder and director Greg Jones sold all of his 4.5 million shares at less than \$0.70 each. One could be forgiven for assuming there was little prospect of shareholders seeing the cash anytime soon.

Two months later, to the surprise of most shareholders and, presumably, Greg Jones himself, the board announced an equal access buyback at \$0.88 per share.

As it turned out, this wasn't much of an improvement on no capital return at all. When the 31 December accounts came out, they showed \$1.18 per share of net tangible assets relating to past profits, and that the business would continue to be very profitable. Worse, the board was threatening to delist the company after the buyback, effectively forcing anyone who didn't want to own an unlisted share to sell into the lowly-priced buyback.

In hindsight, though, the buyback-offer set in train a sequence of events that resulted in the best possible outcome for the Value Fund.

At a special general meeting shareholders (including us) revolted. More than 120 million shares were voted against the proposal versus 18 million for. Not only did this reject the buyback, but it showed the chairman he was no longer in control of the company.

The board immediately declared a \$0.79 cent fully-franked dividend, committed to keeping the company listed and appointed a number of directors not associated with John Kinghorn. The shares are now trading at near \$0.50, ex-dividend, making a mockery of the original \$0.88 all inclusive offer.

The Fund has now sold all of its RHG shares. We have concerns about the residential property market in Australia and were able to exit at a price resembling something like fair value. There is potentially more to come for RHG shareholders—the rump could be worth \$0.70 or so in a benign economic environment—but our 122% return is more than adequate and we are finding plenty of better opportunities elsewhere.

RHG SHARE PRICE



Source: IRESS

Centrebet accepts top fluctuation

It's been the year of the takeover for the Value Fund. To a list already containing Prime Infrastructure and Alinta Energy Group, we can add online bookmaker Centrebet International.

In contrast to Alinta and Prime, we bought Centrebet in the expectation that it would be taken over. It has taken longer than originally expected but, when it came, the \$2.00 offer price from UK company Sportingbet Plc was healthy enough. Including dividends, the investment should generate a return of 36% and we retain the right to the proceeds from a court case Centrebet has running against the Australian Tax Office. This could potentially add \$0.50 to the proceeds, but we won't know the final outcome until the end of the year at the earliest.

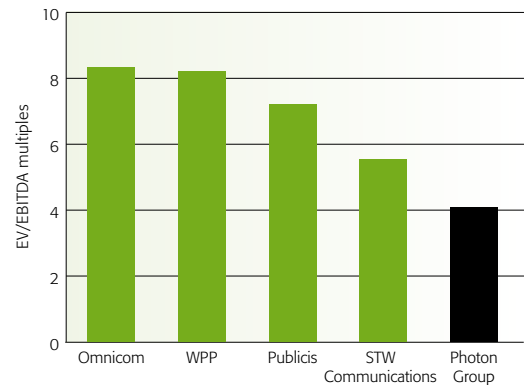
Troubled double on Photon

We've dwelt enough on the original Photon error. Although suspended at the time, it was recorded at a share price of \$1.02 in the 30 June 2010 unit price. Were it not for the recapitalisation in August last year, it would likely be worthless. In any case, at a closing price of \$0.04 this year, there isn't much difference.

The question now is whether we have added to the error with subsequent investments; at \$0.10 in the capital raising and at lower prices since.

Our investment case was based on an estimate that Photon could earn between \$60m and \$70m of earnings before interest, tax, depreciation and amortisation (EBITDA) on a sustainable basis. Adjusted for the sale of its digital businesses to

EV/EBITDA MULTIPLES



Source: Capital IQ/internal estimates

Salmat, this year's earnings will likely be at the bottom end of that range.

Offsetting the disappointing earnings, Photon received \$75m from Salmat for the sale of its digital businesses which has been used to repay debt. The price, nine times EBITDA, was excellent and the risk of insolvency has been meaningfully reduced.

All in all, I'd rather be where we are now, with earnings coming in at the low end of the range but a solidified balance sheet, than where we were at the end of September. There is less potential upside, but there is also less risk of insolvency.

From here, if this year's earnings are sustainable, we are going to make a lot of money. The rest of the business now trades on an enterprise value to EBITDA multiple of four. At the current price, the shares are trading at three times our estimate of next year's earnings (excluding goodwill amortisation).

Whereas previous management's acquisition binge consumed all of the company's earnings and then some, the underlying businesses are not capital intensive. The earnings can be used to further repay debt over the next few years and, eventually, return to paying fully franked dividends.

Photon still has its fair share of problems. And until the debt is halved from its current still uncomfortable levels, this will remain a risky situation. For these reasons we are being relatively conservative regarding the percentage of the portfolio allocated to this stock.

But for now our investment thesis remains intact and, given the share price has more than halved, the opportunity looks substantially more attractive than it was.

Trouble brewing in China

In the December quarterly report we wrote at some length about our concerns for the Chinese economy and Australia's exposure to any fallout. We have a large portion of the portfolio in businesses exposed to the US dollar, particularly US commercial property, as protection.

So far, the Australian dollar has only appreciated further and this has detracted marginally from our performance (both **RNY Property Trust** and **Real Estate Capital Partners USA Property Trust** have underperformed the market since they were purchased). There are increasing signs, however, that we are well placed for the next few years.

The Wall Street Journal recently reported that 'The Great Property Bubble of China May Be Popping'; Jim Grant, highly respected editor of **»**

UNIT PRICE SUMMARY

DATE

30 Jun 11

BUY PRICE

\$0.9897

REDEMPTION PRICE

\$0.9818

MID PRICE

\$0.9857

CHINESE INFLATION



Source: Capital IQ/internal estimates

» *Grant's Interest Rate Observer*, dedicated his last two editions to a potential China derailment; and there are numerous reports of slower export growth and reduced demand for commodities in the People's Republic.

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It wasn't until the Lehman collapse, more than a year later, that the penny finally dropped.

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So is this the beginning of the end for Australia's 17-year economic miracle?

Crises are unpredictable things. We look back now and see that the sub-prime crisis led to Lehman Brothers' collapse, AIG's demise and brought the global financial system to its knees.

But even after the losses began to mount on US sub-prime mortgages and funding markets began to freeze, putting the pieces together was no easy task. John Hempton, now of Bronte Capital but at the time working for Platinum Asset Management, wrote a piece titled *A History of US Finance* in June 2007. In it, he laid bare the corrupt lending practices, perverse incentives and naïve credit agency assumptions that were the undoing of the sub-prime market. He went on to conclude that:

None of these problems will cause real issues for large regulated banks in the US. The stock price of banks with large subprime exposure (Wells Fargo, Washington Mutual) might be weak—but their subprime businesses do not threaten their solvency. We expect banks to come through this credit crisis unscathed. If the stocks get very weak we would consider buying them.

This is not a criticism of Hempton. He was further along the curve than me or almost anyone else at

the time. Global stockmarkets were hitting new all-time highs in late 2007. It wasn't until the Lehman collapse, more than a year later, that the penny finally dropped.

I quote him only to illustrate how difficult it is, nigh on impossible I should say, to know *at the time* that a crisis is unfolding. Or what the consequences of that crisis will be.

I addressed my concerns with the Chinese growth story in a Value Fund presentation in April. Some of the problems outlined there—inflation, a property market bubble, reckless credit growth and an economy overly dependent on investment—seem to be coming to the fore. The property boom looks particularly scary. This from *The Wall Street Journal*:

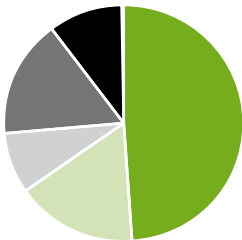
Beijing has one of the most expensive real-estate markets in the world relative to the income of its citizens. Calculations based on Soufun data show that in the opening months of 2006 an average-price new apartment in China's capital would cost around \$100,000—the equivalent of 32 years' disposable income for the average resident. By 2011, the average price had more than doubled to \$250,000, but relatively modest increases in income mean it would now take 57 years of saving for the average resident to cover the cost.

Remember that one of the reasons we're not supposed to worry about a property market correction in China is that the Chinese buy their property with at least 40% deposits, and consequently the banking sector won't be affected by a correction. Really?

Sure, savings rates are high, but how does anyone afford to buy houses at those prices without substantial amounts of leverage? Hidden leverage is showing up all over the place in China, including a recent estimate of local government debt, previously

PORTFOLIO DISTRIBUTION
(by market capitalisation)

- Less than \$100m 49.2%
- \$100m–\$200m 16.2%
- \$200m–\$1bn 8.4%
- Over \$1bn 16.2%
- Cash 10.1%



Selection of holdings

STOCK	BUSINESS	PORTFOLIO WEIGHTING
AS AT 30 JUNE 2011		
ING Real Estate Community Living Group	Retirement village owner and operator in Australia and the US.	5%
Infigen Energy	Infigen is a highly leveraged owner of windfarms in Australia and the US.	6%
UXC Limited	Provides information, communication and technology solutions to a variety of organisations, as well as asset management and environmental services to the utilities sector.	10%
1300 Smiles	A corporate dentistry business located predominately on the east coast of Queensland. Its focus is on large regional centres.	7%

These stocks are not necessarily the largest holdings in the Value Fund.

not recorded due to 'off-balance sheet financing' equating to 40% of GDP. Much of this debt has ended up financing property speculation.

Like everywhere else in the world, if the housing market collapses the banking and construction sectors will suffer with it.

Jim Grant, in the latest edition of *Grant's Interest Rate Observer*, laments his own Federal Reserve's attempts to play central planner and control asset prices and interest rates, gets to the root cause of China's problems:

Heavy duty money printing, wild and wooly lending, exchange-rate suppression, a closed capital account and price control—not the ideal combination of macroeconomic policies for a healthy and growing economy. They are, however, the policies dear to the heart of the Chinese overlords. Nemeses there will surely be, though on the gods own timetable.

The Federal Reserve's artificially low interest rates led to dramatic resource misallocation and, ultimately, a gigantic residential property bubble in the US. The Chinese authorities don't only control the interest rate but all facets of the economy. That can only lead to resource misallocation on a much grander scale. Quoting Grant again, '[m]anipulate enough prices and before you know it, the bullet trains, sans passengers, are streaking from empty city to empty city past idle steel mills and untenanted shopping malls.'

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All in to the Value Fund

Back when we started the Value Fund I told potential investors I would be investing all of my own share money in the Fund, just as soon as I sold my RHG shares. With the events of the past few months (see page 3), I've been able to sell all of my remaining RHG stock and invest the proceeds in the Value Fund. As of this month, I am 'all in' as the poker players would say.

2011 distribution

Details for the 2011 distribution can be found in the pullout box above. Apologies that we couldn't give you an estimate prior to year end but there were some significant last minute changes that made an early estimate of little use.

We'll be back in September with a host of results to report following the annual August 'reporting season'. In the meantime, if you have any questions about your investment, don't hesitate to get in touch.

Kind regards,



Steve Johnson

2011 Distributions

The 2011 distribution from the Value Fund is 6.4901 cents per unit. The distribution was paid directly to your bank account or, if you elected to reinvest some or all of your distributions, added to the number of units you own in the fund on Tuesday 12 July. Contact Fundhost on 02 8223 5400 if you have any queries about your distribution.



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