Value Fund
Quarterly Update

31 DECEMBER 2010

Portfolio leaps into Year of the Rabbit

Photon Group and RHG have delivered a stellar quarter for the Value Fund.

The December quarter of 2010 represented an excellent three months for the Value Fund. The unit price increased 8.22% for the quarter, outperforming the All Ordinaries Accumulation Index by 2.91%.

The Fund is a concentrated portfolio of stocks, many of them illiquid, and the unit price can move around from month to month, often without good reason. But there has been meaningful positive news in the December quarter.

Review of quarter

RHG returns the cash

Today's **RHG Group** owns the right to service a $5bn portfolio of mortgage loans, down from $15bn when the company, known as Rams Home Loans at the time, was caught up in the financial crisis of 2007.

SUMMARY OF RETURNS AS AT 31 DECEMBER 2010

	IIVF	ALL ORDS. ACCUM. INDEX
3 month return	8.22%	5.31%
6 month return	7.78%	14.46%
Since inception (31 Oct 2009)	2.59% p.a.	7.84% p.a.
Stocks in portfolio	15	

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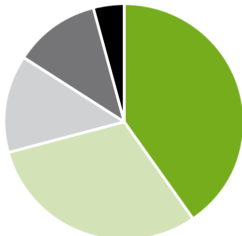
PORTFOLIO DISTRIBUTION (by market capitalisation)

- Less than $100m **40.3%**
- $100m–$200m **30.7%**
- $200m–$1bn **13.4%**
- Over $1bn **11.7%**
- Cash **3.9%**



» Although it hasn't been able to make any new loans, the company has amassed almost $300m in cash and other assets from managing the old portfolio in the three years since. These assets are the reason we bought the shares and the reason RHG was recommended for several years in *The Intelligent Investor*. Until now, however, it remained uncertain what the fate of these assets would be.

We were ecstatic to hear at its November annual meeting that the board will be returning these assets to shareholders in the not-too-distant future.

If management can sell the illiquid assets and the right to service the remaining loan portfolio for a reasonable price, the company will effectively be wound up and a minimum of $0.88 will be returned to shareholders ($0.70 will be in the form of a fully franked dividend).

If those assets can't be sold for a satisfactory price, shareholders will be given the option to take $0.88 per share early in 2011. Those who take up the option will be paid out of existing cash reserves and those who hang around, which will include founder, chairman and significant shareholder John Kinghorn, will wait for the rest of the assets to be liquidated.

We will make our decision once the details are known and the half-year results are out but, either way, it is going to represent an excellent return on our $0.58 average purchase price.

Photon shows its positive side

After the trauma of the September quarter, marketing conglomerate **Photon Group** announced some welcome positive news in November and December.

Prior to the company's annual meeting, Photon told the market that its results for the first four months of the financial year were almost identical to those for the same period in 2009.

This would not normally be significant news. But at the time, with the shares trading at less than three times last year's underlying post-tax earnings, it was being priced for a substantial deterioration. Anything close to last year's result would be a massive positive and the first four months are encouraging.

More importantly, however, the company made a second announcement, just days before Christmas, that it had sold four of its digital marketing businesses to **Salmat**. The companies contributed $8.2m of last year's $75m in underlying operating earnings and were sold for $75m, plus an additional $15m if certain unspecified earnings targets are met by 30 June 2011.

The price paid is significantly higher than the multiple we have used to value the overall business. Given our estimate is well in excess of the current share price, the sale not only gives the company a meaningful pile of cash but reinforces our view of the excellent value on offer.

The cash will be used to pay Photon's debt down to $122m. This level of debt, down from almost $300m prior to August's recapitalisation, is conservative, manageable and means the company is now highly unlikely to go broke.

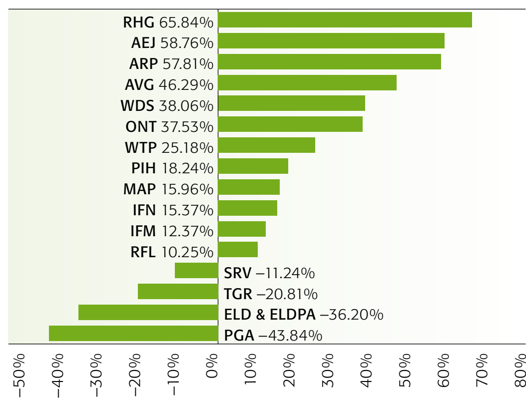
In another tick for new CEO Jeremy Philips, this transaction has increased the value of Photon and substantially reduced the risk.

Review since inception

Far from stellar beginnings

Despite a strong last quarter, our results since inception are well short of the All Ordinaries Accumulation Index, our 8% per annum performance fee benchmark and our long-term expectations.

PERFORMANCE BY STOCK (ABSOLUTE RETURN > 10%)



Data from Praemium 4 November 2009–31 December 2010

The underperformance is not for a lack of outperforming stocks. As you can see in the figure above, 12 stocks have contributed returns of more than 10%, versus only four stocks contributing returns of less than –10%.

The overall underperformance has come about because we had more money invested in the stocks that performed poorly than we did in the ones that performed well. Photon Group, the main culprit, is responsible for a 10.5% detraction from overall performance, whereas RHG contributed 4.2% on the positive side of the ledger.

This is an explanation, not an excuse. Portfolio allocation is as important as stock selection and it is a fund manager's job to get both right.

Over time, we expect our larger positions to perform better than our smaller ones—that is why we have made them large positions. To date the market has delivered exactly the opposite but we expect that to change given time. (As an aside, assuming our estimate of value does not change, we will tend to stop buying stocks when the price rises and buy more of those that fall. It is not surprising that we have ended up with the largest positions in underperformers after only one year of operation.)

Assessing performance (where possible)

Value investors have a bad habit of ignoring price falls because 'the stock will show its value over time', while using price rises as vindication of their investing decision. The market is right when it agrees with you, the theory goes, but wrong when it doesn't.

When reflecting on our performance over the past 14 months, we can avoid such a mistake by splitting our selections into two categories: those where the value has been clarified, in agreement or otherwise with our original assessment; and those where the jury is still out, irrespective of the share price movement.

Our average purchase price for RHG was $0.58 per share. The company is going to return a minimum of $0.88 to shareholders, $0.70 of which will be a fully franked dividend (see page 2). It is clear we bought the stock cheap.

Alinta Energy is also returning cash to securityholders–$0.10. That represents an excellent return on our $0.052 purchase price and is confirmation of our thesis that the cash held by the parent company (and not available to banks as security) was of substantial value to Alinta's owners.

Finally on the positive side of the ledger, we received a takeover offer for Prime Infrastructure at a decent premium to our average purchase price. A takeover is not the same level of confirmation as a capital return. Just because someone else was prepared to pay a higher price does not mean our original estimate of value was accurate. »

UNIT PRICE SUMMARY

DATE
31 Dec 10

BUY PRICE
$1.0146

REDEMPTION PRICE
$1.0065

MID PRICE
$1.0106

» That the acquirer in this case was Brookfield, however, a well regarded and canny Canadian investment outfit, suggests that, if anything, the underlying assets are worth more than Brookfield paid.

CONFIRMED PERFORMANCE		
STOCK	CONFIRMATION EVENT	RETURN
RHG Group	Proposed return of capital of at least $0.88 per share	65.8%
Alinta Energy	Proposed $0.10 distribution to unitholders	58.8%
Prime Infrastructure	Takeover from Brookfield Infrastructure	18.2%
Photon Group	$100m blowout in deferred consideration payments owed	–43.8%

As for stocks where we received confirmation that we were wrong, Photon is the sole contender so far. At the very least, our estimate of value was out by the $100m increase in deferred consideration payments. Despite recent good news (see page 2) it is likely we were also too optimistic with regard to our estimate of sustainable earnings. Adjusted for the 7-for-2 rights issue made to all shareholders in the September quarter, our average (pre-recapitalisation) purchase price was $0.32 per share.

Given our estimate of value is now in the order of $0.15–$0.20, we can chalk the initial investment up as a mistake, paying something in the order of two times too much.

We made a subsequent and separate decision to purchase more Photon shares, both in the institutional placement at $0.10 each and since at prices ranging from a low of $0.0551 to a high of $0.0711. This second investment belongs in the 'jury still out' category (see opposite) although a positive outcome is looking increasingly likely.

Jury still out

Regarding the rest of the stocks in the portfolio (a selection of which can be seen in the table below), it is not clear yet whether the investment thesis was correct or not.

To date we have made a positive return on most of these holdings but it is hard to say conclusively whether the businesses are worth our original estimate of value.

The share price of wine company **Australian Vintage Group**, for example, has risen 42.2% on the $0.24 average we managed to buy the shares for.

It has produced one good result—a profit of $8.1m for the year ended June 30 2010, which stacks up well against our purchase price (equating to a market capitalisation of $31m). But this business operates in an extremely tough industry, is being hammered by the high Australian dollar and owes $144m to the banks. Australian Vintage still has some work to do before we can regard it as a success.

Often it takes longer to assess performance on higher quality businesses. The price we paid for **1300 Smiles**, for example, anticipates a decade

JURY STILL OUT	
STOCK	RETURN ON AVERAGE PURCHASE PRICE
1300 Smiles	37.5%
Australian Vintage Group	42.2%
UXC	–7.7%
RNY	–5.1%
Real Estate Capital Partners USA Property Trust	5.7%
MAp Group	16.0%

of healthy profit growth. If the profit increases 10% per year for the next three years, that will be encouraging but it will not be conclusive proof that we are correct. For that we will have to hang around, as we will with other highly rated businesses like **MAp Group**.

This is the reason we ask our investors to take a long term approach and give us at least three years, and preferably five, before assessing our performance. Over time, more stocks will move from the 'jury still out' category into the confirmed category and it is these results, not short term price movements, that will determine whether we are doing our job properly or not.

Positioning us for the Year of the Rabbit

It's time to buy in the US

In the past 12 months I've been to Johannesburg, London, Vienna, Istanbul and Hong Kong. Based on what I've seen, Sydney is now one of the most expensive cities in the world.

Food, accommodation, property prices, transport—you name it, it costs more here than almost anywhere else. Even the London Tube, which in 2002 cost me an hour's Australian salary for one round trip, now costs roughly the same as Sydney's vastly inferior CityRail network.

Most of us get paid Australian dollars and spend Australian dollars, so we don't notice how expensive it is here until we travel overseas, meet a tourist or converse with an expat. A few weeks ago I met a new recruit at the University of New South Wales who had transferred from the US in June. He sold his house in Houston—four bedrooms, two bathrooms, double lock-up garage and hardwood floorboards for US$175,000. "It was ON LAND Steve".

He was somewhat shocked that his pile of Greenbacks won't buy him a shoe box in Sydney.

So is the Aussie Dollar overvalued?

Probably. Currencies are impossible to value with any degree of certainty but some form of purchasing power parity should hold. In two relatively open economies with floating exchange rates, the comparative cost of tradeable items should be somewhat similar.

Whether the Aussie is overvalued or not, however, there are a number of good reasons for getting a decent chunk of our assets out of Australian dollars. More specifically, there are even better reasons for shifting your portfolio from being fully hitched to the Australian economy to a more balanced exposure between Australia and the US.

We're all on the China bandwagon

There is an argument that, if you have Aussie dollars to invest and need Aussie dollars to live off when you retire, there is no reason to complicate the situation by exposing yourself to foreign currencies.

If you are buying government bonds, I have some sympathy for this argument. If you are buying equities, I do not. The problem is that it's difficult to find a corner of the Australian market that is not impacted by the Chinese economy. More specifically, it's almost impossible to construct a portfolio of Australian stocks not influenced by Chinese demand for Australian resources.

The two do not necessarily go hand in hand. China's past decade of growth has been generated by devoting an extraordinarily high percentage of GDP to investment.

Throughout the Japanese economy's transition to first world status, investment as a percentage of GDP »

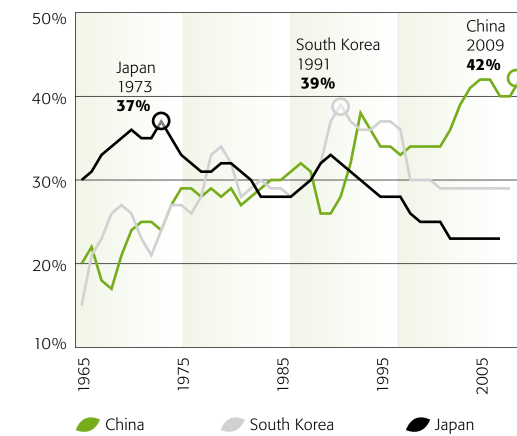
» topped out at 37% in 1973 and in South Korea it hit 39% in 1991. In China, the ratio is currently north of 40% and rising (see graph below).

There is a case for a debt-induced crisis in China but it is also quite conceivable that the Chinese economy continues to grow, just like Japan and Korea did, while its demand for resources wanes thanks to a structural shift away from investment and towards consumption. Either scenario would be bad for Australia.

The problem is not so much stocks with direct exposure to Chinese demand—that is a manageable risk in the context of a portfolio. The problem is that the whole Australian economy is hitched to the China bandwagon.

Take **McMillan Shakespeare** for example. This company provides salary packaging services to public health sector employees using a tax loophole to claim all sorts of out-of-pockets as pre-tax expenses (numerous people I know have paid for their weddings pre-tax).

GROSS FIXED CAPITAL FORMATION OF GROSS DOMESTIC PRODUCT



Source: http://data.worldbank.org/indicator/NE.GDI.FTOT.ZS?

You might think this stock is relatively China safe. But it doesn't take too much imagination to contemplate a commodities bust having a negative impact. Government finances would come under pressure and, as a consequence, the government could shut the loophole as suggested in the recent Henry review of taxation. It's a stretch, but it's not implausible.

Unemployment, the government's financial position, asset prices and consumer spending are all only one or two steps removed from the China boom.

We're not making a call on whether the resources boom is going to bust. But the risk is there and, as Australian investors, whether you think a bust is likely or not, we have too much exposure to China.

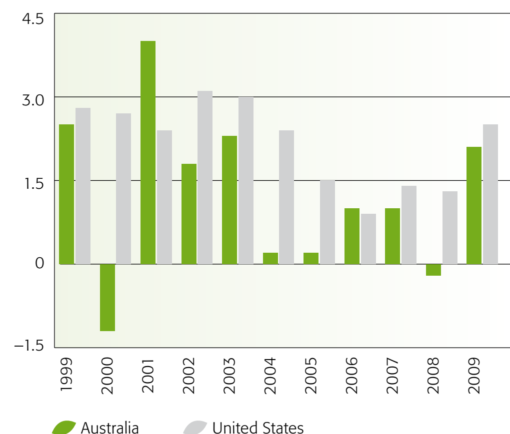
With the dollar carrying so much purchasing power, the time is perfect to do something about it.

Getting long the US

Choosing where to go outside Australia is not easy. Most potential destinations have their fair share of problems. But our preference is for the US. The country's short and long-term problems have been well documented: a fiscal deficit in excess of 10% of GDP; short-term interest rates at zero; a central bank hell bent on printing money to drive long-term interest rates down; official unemployment stuck stubbornly high; and legislated heath care obligations that make government deficits seem intractable.

What the US economy has, however, is productivity growth. If the US economy can grow, meeting its obligations will be straight forward. Monetary and fiscal policy can shift consumption and production from one period to the next but real long-term growth comes from productivity—producing more

PRODUCTIVITY GROWTH AUS VS US



Source: OECD

goods and services given the same amount of labour.

As you can see in the graph above, US productivity has increased right through the crisis. It is this, more than anything else, that sets the US economy apart from the likes of Greece, Ireland, Portugal and Spain.

The other advantage the US has is that its electorate is not as enamoured of government as the Europeans are. The success of the Tea Party Movement in November's congressional elections reflects a deep-seated aversion to big government and big deficits. Sure, most of the policy ideas are harebrained and narrow minded. But their popularity reflects a desire among the population to do something about their long-term structural issues. That is something we don't see in Europe.

So we think the US remains one of the world's more attractive places to invest. Right now, it is going through a very typical deleveraging-induced malaise. It is not uncommon. There have been dozens of economies go through a similar period over the past 100 years (albeit on a smaller scale). The lesson from past crises is that economic growth will be below par until the excess debt from the early noughties is purged from the system.

According to a McKinsey special report on past episodes of *Debt and Deleveraging*, this process typically takes seven years. The weak US dollar is undoubtedly speeding the process and there are early signs that consumer debt reduction is coming to an end. For the first time in more than two years, total lending in the US increased in November. We expect the US to return to historical levels of growth once the deleveraging is complete and that point looks like it is now within sight.

Moreover, the big US blue chips are cheap and are the best way to protect yourself against inflation. Some of the most respected US investors have said so, including Jim Grant, Jeremy Grantham and (once respected) Bill Miller. It's hard to argue with the Walmart bulls when it's trading on 12 times earnings, and we can go one better than them by paying with our potent Aussie dollars.

Window of opportunity

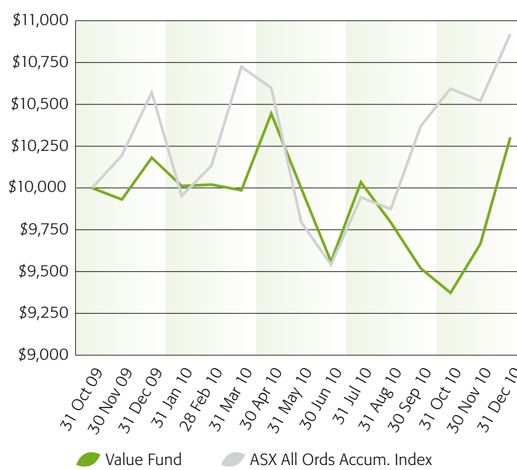
There's nothing to say the exchange rate can't go to US$1.20 or US$1.50. But we're taking the opportunity that is currently available to position the Value Fund towards US-centric businesses, both as a risk management strategy and a money making opportunity.

We are somewhat restricted because our mandate limits us to ASX-listed stocks, but there are several US focused businesses, such as **News Corporation** and **QBE Insurance** which are high on the consideration list at the moment.

Our main focus so far has been on **RNY Property Trust** and **Real Estate Capital Partners USA** »

Great new website

www.iifunds.com.au received an upgrade for Christmas. It's easier to find monthly unit prices, the Value Fund's summary of performance and the important 'How to Invest' information. With the Bristlemouth blog now integrated into the site, Steve's regular posts give you a reason to keep visiting. Take a look at www.iifunds.com.au.



Property Trust (RCU), two property trusts 100% invested in US commercial property in which we already have meaningful stakes. We're expecting a capital raising from RCU early in 2011 and, post contributing to that, we will have slightly more than 20% of the Fund invested in these two property trusts.

While these stocks are particularly attractive in their own right, the US exposure is a bonus. We would like a more diversified basket, but we would also like US-related stocks to be a higher percentage of the portfolio.

2011—The Year of the Rabbit

Between them, the two property trusts mentioned previously, Photon Group and **UXC** represent almost half of the Value Fund's investments. All four have substantial issues to deal with in 2011, the Chinese Year of the Rabbit, but also represent the stocks with the potential to provide substantial hops on the performance score sheet. It is highly likely that some or all of them will graduate from the 'jury still out' category in 2011, and provide us with confirmation of the underlying value we see in the stocks.

We look forward to providing you with updates and information about our progress. Don't forget to take a look at our new website (www.iifunds.com.au) and keep an eye on the Bristlemouth blog where you'll find regular thoughts and commentary on many of the Fund's holdings.

As always, thanks again for your continued support.

Steve Johnson

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