Value Fund

Quarterly Update

INTELLIGENT INVESTOR
FUNDS MANAGEMENT

30 SEPTEMBER 2011

The whole world sinks in the same boat

Fears of another global recession sent stockmarkets sharply lower in the last quarter. The Value Fund wasn't immune.

The Value Fund is well positioned for a lower Aussie dollar. We don't own any consumer discretionary stocks (yet). We're prepared for the Chinese economy to hit the skids and don't own any resources stocks, some of the worst performers on the market over the past three months.

Yet the Fund's performance was almost as bad as the market over the period. The Value Fund unit price fell by a fraction less than 11%, compared with a fall of slightly more than 11% for the All Ordinaries Accumulation Index.

One of the reasons for this is the increase in correlation amongst markets and asset classes around the world. *The Economist* recently pointed out that »

SUMMARY OF RETURNS AS AT 30 SEPTEMBER 2011

	IIVF	ALL ORDS. ACCUM. INDEX
1-month return	–7.20%	–6.27%
3-month return	–10.52%	–11.28%
6-month return	–13.19%	–15.52%
1-year return	–5.55%	–8.43%
Since inception (31 Oct 2009)	–5.40% p.a.	–2.67% p.a.
Stocks in portfolio	16	

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UNIT PRICE SUMMARY

DATE
30 September 11

BUY PRICE
$0.8272

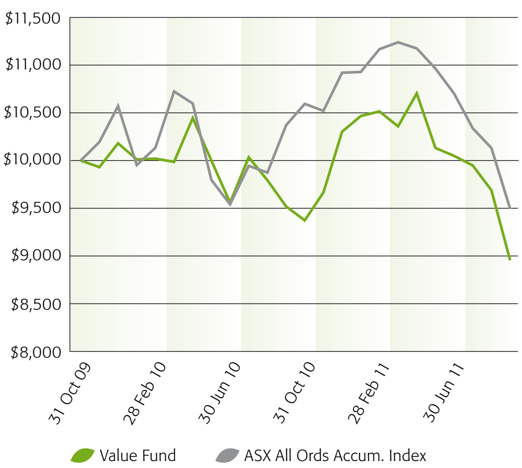
REDEMPTION PRICE
$0.8206

MID PRICE
$0.8239

» global stock markets are now all in the same boat. The correlation between returns has increased from about 0.5 in 2000, to 0.8 of late (meaning 80% of the returns in one market can be explained simply by looking at the returns in other markets). Particularly in times of panic, investors are selling anything they can. If that means selling stocks with US Dollar exposure even while the Aussie Dollar is itself tumbling, then so be it.

Of course, our ultimate returns will be determined by the businesses we own, not stock price movements over the course of three months. With that in mind, we'll begin this Quarterly Update with a look at the Centrebet takeover, then review a couple of new additions to the portfolio and explain why the world economy is the least of China's worries.

VALUE FUND VS ASX ALL ORDS ACCUM. INDEX



Centrebet comes good

The Value Fund has owned Centrebet since early 2010. As we said in the March Quarterly Update of that year:

> *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 [industry] consolidation, either acquiring or being acquired.*

The average purchase price was a touch more than $1.50 during the initial period of accumulation.

It took longer than expected but we collected some healthy dividends along the way and the final outcome was more than we could have hoped for. UK operator Sportingbet Plc offered Centrebet shareholders $2.00 per share in May of this year and, with Con Kafataris pledging the support of his family's 60% holding, the deal was as good as done.

Kafataris, though, had structured the deal so that he and the rest of the company's shareholders keep 90% of the proceeds, if any, from a legal case the company has running against the Australian Taxation Office. Centrebet is claiming it is entitled to an immediate refund of $10m and credits which may enable it to recover a further $80m, relating to GST incorrectly paid between 2006 and 2010.

The Value Fund has already received its $2.00 per share but still owns the Litigation Claim Rights and Litigation Claim Units (they are unlisted). With IASbet winning an almost identical case in July, it's looking increasingly likely that they're going to be valuable. Although it could take up to 10 years to get the last dollar (as Centrebet uses the credits, it will pay 90% of the cash it would otherwise have paid across to the old shareholders), it adds a potential $1 per share to the takeover price.

INTELLIGENT INVESTOR

Reporting season wrap-up

STOCK	SUMMARY
AS AT 30 SEPTEMBER 2011	
UXC	The full-year result was full of write-downs relating to Field Services Group, which recently sold for $60m. The numbers from the remaining business were reasonable—revenue of $518m and pre-tax, pre-impairment profit of $17m—although the margins are well below where they should be relative to competitors.
Photon Group	Reported a loss of $60m for the year to June thanks to intangible writedowns of $87m. The underlying result was a profit of approximately $20m, backed up by $26m of operating cashflow. The company has reduced its debt from $450m to $140m, which could come down further yet. If management continues offloading assets at attractive prices, debt won't be a problem this time next year.
1300 Smiles	Increased net profit by 19% and earnings per share by 15%. There is a lot of organic growth in the existing business, but MD Daryl Holmes also has his eye on a couple of acquisitions and raised $8m from institutional shareholders (including us) at the start of September. We're less enthusiastic about acquisitions than the organic growth opportunities, but are sure Holmes will maintain his unwavering focus on earnings per share.
Australian Vintage Group	Generated a $10.2m profit before significant items and declared a dividend of 2.5 cents per share—another remarkably strong result in very difficult conditions. Management estimate that the strong Australian dollar knocked $13m off the pre-tax profit. If they get any relief on the currency front, Australian Vintage's profit can be a lot higher yet.

The shares last traded at $2.24 before delisting, implying a value of $0.24 for the Litigation Claim Rights and Units combined. We are including them at this value in the unit price for now, but anticipate they are worth a lot more than that.

Stocks in focus

ING Real Estate Community Living Group

ING Real Estate Community Living Group (ILF) is a listed property trust with an investment portfolio of retirement villages in Australia and the US. One of six property funds originally managed by the Australian arm of ING Group, ILF was over-leveraged when the global financial crisis hit and has spent the years since selling assets to reduce debt.

That process is largely complete. ILF has announced the sale of most of its US assets, the proceeds from which will be used to reduce debt in the Australian portfolio. Upon settlement, the Australian portfolio will have a more sensible loan to value ratio of approximately 40%, and will represent around 88% of the $0.26 net asset value (NTA) per unit. The remainder consists of six remaining US retirement villages and a portfolio of New Zealand student accommodation. Both are highly leveraged but provide interesting upside potential—the debt is non-recourse so the downside is zero.

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Even without the overseas assets, ILF's NTA should grow from here. Simon Owen was appointed as Chief Executive Officer of ILF in 2009 and has made excellent progress already. Owen was formerly CEO of Aevum, an ASX-listed retirement village operator bought by **Stockland** in 2010. Occupancy has improved from 73% to 81% since his arrival, and debt has been dramatically reduced. His target occupancy is 89% over the medium term which, if he can achieve it, will justify meaningfully higher earnings, cashflow and NTA.

ILF SHARE PRICE VS NET TANGIBLE ASSETS

Owen also sees plenty of opportunity to add to the Australian portfolio. Much of the cost of a retirement village arises from building and maintaining the communal areas, including kitchens, dining halls and recreational areas. The cost of adding a marginal unit to the existing infrastructure is much less than the average cost of building a new village. Owen sees plenty of opportunity to add these low cost extensions to ILF's existing portfolio and purchase distressed assets where the owner has built the communal areas but can't afford to complete the village.

Finally, ING has announced its exit from the listed property management business in Australia, so there is likely to be a restructure of the trust in the near future. The end result should be a management team better aligned with the interests of unitholders.

We are conscious of the potential flow on effects from a weak residential property market. But we've been able to establish a meaningful position at a 60% discount to the NTA (an average purchase price of just over $0.10) and, given we expect that NTA to grow, have high expectations for the investment.

QBE Insurance

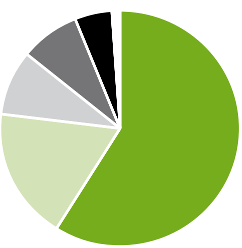
The fund also established a position in **QBE Insurance** during the quarter. With a market cap of $14 billion, QBE is larger than the rest of the companies in the Value Fund combined; we don't often find opportunities in stocks this size.

The market, however, has become obsessed with the impact low interest rates will have on QBE's profitability. The share price has fallen more than 60%, from north of $30 in late-2007, to less than $13 at the end of September, during which time the company's net earned premium has grown from US$8.5 billion to US$12.9 billion.

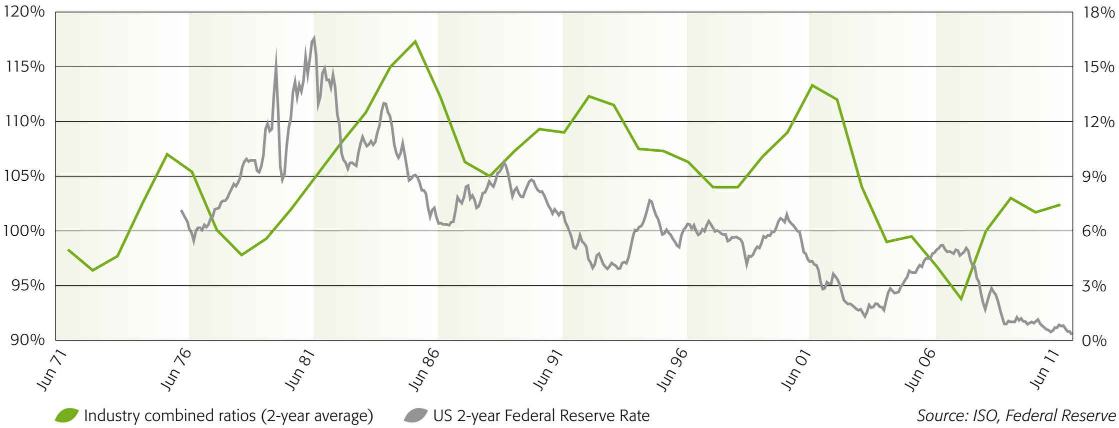
Low rates will obviously have an impact on QBE's short-term profitability. It has US$29 billion of insurance premiums and shareholders' equity invested in highly rated debt securities. Low rates mean less income on those investments and, with 30-year US government debt securities yielding just 3%, it could be a long time before that changes for the better.

PORTFOLIO DISTRIBUTION (by market capitalisation)

- Less than $100m **59.2%**
- $100m–$200m **17.8%**
- $200m–$1bn **8.6%**
- Over $1bn **8.0%**
- Cash **5.0%**
- Unlisted **1.5%**



US GENERAL INSURANCE COMBINED RATIO VS BOND RATE TREND



Source: ISO, Federal Reserve

Plugging today's bond yields into a spreadsheet, it's easy to see why bank analysts are downgrading QBE's profitability and, consequently, their valuations.

We don't think the effect will be so dramatic. Insurance companies price their insurance policies to make a profit. When interest rates are high, they can afford to price their policies at an underwriting loss because they know they can generate plenty of income from investing the premiums. When interest rates are low, they need to make more money out of the underwriting operations.

As you can see in the graph opposite, the correlation between interest rates and combined operating ratios (the percentage of premiums collected that gets paid out as claims) is very high. Across the industry, low interest rates mean high prices.

So, while interest rates may well remain low, the insurance industry will adjust. QBE's average combined operating ratio over the past decade—it has paid out just 92% of premiums in claims—looks low compared with historical averages of closer to 100%. But, in the context of extraordinarily low interest rates, such an outcome should be expected. In fact, as one of the world's best managed insurance companies, we expect the underwriting results to get even better.

We're thrilled to add such a high quality business to the portfolio at a very attractive price. Although both still look reasonably cheap, **Spark Infrastructure** and **MAp Group** have made way to fit QBE into the portfolio. Hopefully we'll get a chance to own both again someday but, for now, QBE is clearly better value.

China's boom: it won't last but it won't end now

So the problem with Japan—and indeed with every other country I can think of that suffered very long periods of post-boom stagnation—was massive over-investment based on a very distorted investment-driven growth model. The period of stagnation was partially caused by the struggle to service excessive levels of debt, partly caused by the continued capital misallocation, albeit at a slower pace, and partly caused by the effective writing down of all that overstated GDP.

These—with the possible exception of the debt—are not the problems from which the US or Europe are suffering. They suffer from a typical debt-fueled overconsumption boom, whereas Japan suffered from a typical debt-fueled over-investment boom, and Japan's period of over-investment was much, much more extreme (centralized investment booms can last much longer and go much further than decentralized consumption booms). This is why I think the Japanese experience tells us almost nothing about what Europe and the US will go through.

On the other hand, it might tell us a lot about what China will go through. In fact we can make a more general point. Command economies (Japan, the USSR, Brazil and many others during their 'miracle' periods) tend to have much more rapid investment-driven growth during the good times and much more difficult and longer-lasting adjustments. Capitalist democracies are more prone to consumption-driven booms, which aren't as extreme and don't last as long, and their adjustments tend to be brutal but relatively quick.

—Michael Pettis, August 2011

Michael Pettis is a professor at Peking University's Guanghua School of Management, a Senior Associate of the Carnegie Endowment for International Peace and my favourite commentator on the Chinese economy (I have included some interesting links on the page opposite).

When the US, Europe and most of the developed world entered a recession in 2008, I expected the impact on China's 'export-driven' economy to be dramatic. So did most of the world's investors. Commodity prices plunged, the Aussie dollar traded down to US60 cents and … the Chinese economy grew 9.1%, only slightly less than the prior year.

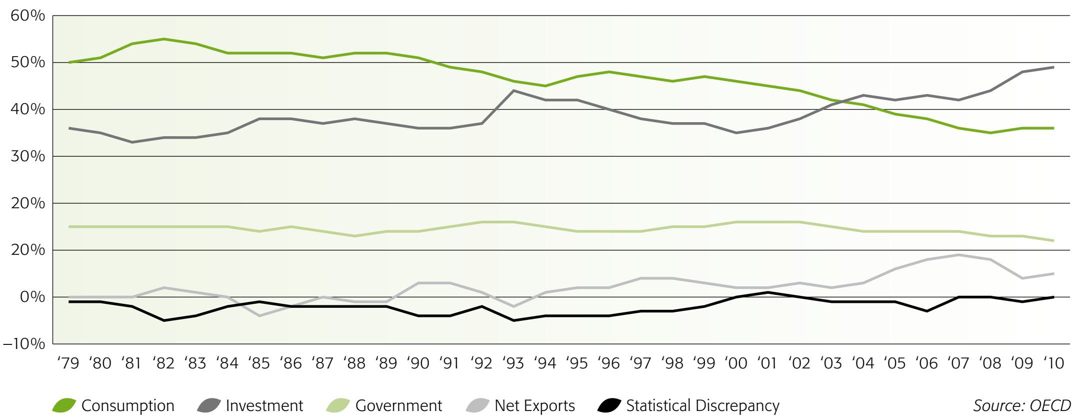
The intriguing part was that the trade component of China's economy did indeed collapse. Net exports contributed 8% of GDP in 2008 and only 4% in 2009. Yet the overall economy still grew healthily. It seems the Chinese economy isn't that export driven at all.

Those worried about another global recession impacting China and its demand for Australian resources shouldn't be losing sleep at night. In fact, net exports represent only 5% of Chinese GDP today. Even if the contribution halved again, that would only subtract 2.5 percentage points from China's very healthy growth rates.

If China is not an export-driven economy, then, what is driving the growth?

The four components of China's GDP—consumption, investment, government spending and net exports—are shown in the 30-year chart on the opposite page. You can see net exports down the bottom of the graph, contributing strongly to growth in the early part of the 2010 decade and then declining rapidly towards the end of it. But now take a look at the consumption and investment lines. Consumption has declined from more than 50% of GDP—a low but relatively normal level for a rapidly

CHINESE GDP COMPONENTS % TOTAL



Source: OECD

growing economy—to 36% in 2010. So much for China's consumers saving the world.

Investment, or fixed capital formation, has taken up the slack, particularly in the last decade. It grew from 35% of GDP in 2000 to almost 50% of GDP today (for comparison, in the US consumption and investment represent 71% and 15% of GDP respectively. In Australia the numbers are 54% and 28%).

The chart also explains how China sailed through a global recession; it simply stimulated investment even further to take up the slack from declining net exports. It also explains why demand for Australian resources has been so voracious; it takes a lot more iron ore to build a city or a high speed rail line than it does to make a Big Mac.

But it also begs many questions about the future. How long can this investment driven growth be sustained? What are the long-term consequences of an investment binge this large?

It's not immediately obvious why an investment bias should be a problem. In fact, many observers see China's new cities and shinny fast rail networks as signs of its progress.

There is some truth to this. Investment is generally a good thing and I've been a strong advocate of using Australia's resources windfall to improve our own country's infrastructure. In China, however, investment has become *the* driver of GDP growth, as opposed to one component of a healthy, growing economy. In an editorial piece for *The New York Times*, Pettis explained why this over-reliance on investment is a problem:

> *In all previous cases of countries following similar growth models, the dangerous combination of repressed pricing signals, distorted investment incentives, and excessive reliance on accelerating investment to generate growth has always eventually pushed growth past the point where it is sustainable, leading always to capital misallocation and waste. At this point—which China may have reached a decade ago—debt begins to rise unsustainably.*

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Michael Pettis references

Pettis's China Financial Markets blog contains all of his recent thoughts. Recommendations include Big in Japan and Some Predictions for the Rest of the Decade.

FT Alphaville's podcast—their first [and only, as far as I can tell] podcast—was with Pettis and summarises succinctly the entire landscape.

Then there's China's Debt Monster on *The New York Times* site and why we should Get Used to Slower Chinese Growth on *The Wall Street Journal*.

> *China's problem now is that the authorities can continue to get rapid growth only at the expense of ever-riskier increases in debt. Eventually either they will choose to sharply curtail investment, or excessive debt will force them to do so. Either way we should expect many years of growth well below even the most pessimistic current forecasts. But not yet. High, investment-driven growth is likely to continue for at least another two years.*

It happened in Japan in the 1980s. And it's happening in China now. A recent *Wall Street Journal* article quoted Fitch's estimates of the debt explosion in the Chinese economy:

> *The ratio of outstanding credit to GDP rose from 124% at end-2007 to 174% at end-2010, and is on pace to reach 185% in 2011. Adding in black-market lending and the increasing use of IOUs to settle payments takes the total even higher.*

So where does this end? As Pettis points out, there's no constraint just yet:

> *My guess, and it is only a guess, is that China can continue with the current growth model for at least another four or five years before it runs out of debt capacity—although when it does, it runs the risk of falling into the debt crisis that has stopped every previous example in history of an investment-driven growth miracle. Of course I am hoping that the leadership radically changes the model long before we hit the debt capacity limit.*
>
> *But the point is that I don't think we are there yet. Debt levels are very worrying, and the structure of the debt—when you can actually figure it out—is even more worrying, but I believe we are not yet on the verge of a debt crisis …*

In fact, it's unlikely there will be a debt crisis. China's economic 'miracle' will end with an economy riddled with non-performing loans and underutilised assets. The authorities will then have to decide whether to take short-term pain, in the form of unemployment and economic contraction (the American way), or drag the adjustment out over 20 years and risk enduring a lost decade or two (the Japanese way).

China's leaders are likely to choose the socially acceptable later option. Whichever way it plays out, though, assuming that the current level of demand for Australian resources is sustainable is a very risky business. Assuming recent growth rates are sustainable is nothing but folly.

Kind regards,

Steve Johnson

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