Value Fund
Quarterly Update

INTELLIGENT INVESTOR
FUNDS MANAGEMENT

30 SEPTEMBER 2010

Photon spins, performance down

Almost all of the Value Fund's holdings performed well through the 2010 reporting season. The demise of one, however, undid the hard work of the rest.

The Value Fund underperformed the All Ordinaries Accumulation Index by 9.09% in the September quarter, declining by 0.41% in a period where the index rose 8.68%. Most of the underperformance occurred in September and was almost wholly attributable to one stock — **Photon Group**. The remainder of the portfolio has performed well thanks to takeover bids for **Prime Infrastructure** and **Alinta Energy Group**, and good profit results from some of the core holdings.

Photon kills performance

In physics, a photon particle has zero mass. The board and management of marketing services company Photon Group seem determined to give their company's share price the same value. It had already fallen from an all-time high in excess of $6 to approximately $1 when the Fund first invested. As a result of »

SUMMARY OF RETURNS AS AT 30 SEPTEMBER 2010	IIVF	ALL ORDS. ACCUM. INDEX
1 month return	–2.80%	5.02%
3 month return	–0.41%	8.68%
Since inception (2 Nov 2009)	–4.80%	3.69%
Stocks in portfolio	16	

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deteriorating earnings and a $100m blowout in its liabilities, the share price has since fallen another 91% to end September at an all-time low of $0.085. This one stock detracted 12% from the Fund's performance for the quarter (including a 15% loss on the new shares issued at $0.10 as part of the restructure).

The company's problems are not to be underestimated. Despite the recent $102m capital raising, it remains highly leveraged and the recent dramas will have taken a toll on staff morale. This company does not have any tangible capital – if it loses its people it loses its business.

However, while the share price may not indicate it, the deal new CEO Jeremy Philips has done for shareholders is a good one. It was announced soon after his arrival that the company owed approximately $100m more in deferred consideration payments than had been previously disclosed. For a business with a $180m market capitalisation at the time, and not enough cash to make the payments, it was potentially fatal.

Somehow Philips managed to shepherd 15 former business owners into an arrangement whereby they agreed to make $85m of the deferred payments contingent on the overall business meeting certain targets. In effect, shareholders are not far from where they were before the balance sheet hole was discovered, but with more of the potential upside going to deferred consideration recipients (most of whom are now employees of the business). Yet the share price, on a weighted average basis, has fallen by more than half.

Photon owns some of Australia's most successful marketing agencies including Belgiovane Williams Mackay and BMF, and the Bailey Group is the dominant field marketing business (in store advertising, product testing, outdoor promos and the like) in the country. Pulling together these and the 40-odd other disparate marketing businesses Photon owns won't be easy but Philips has done an outstanding job so far and, as a former right hand man to Rupert Murdoch, he seems well equipped to deal with difficult personalities.

Following the capital raising, the Fund's average purchase price is approximately 15 cents. The range of potential outcomes is wide but we still expect healthy returns on our investment.

Prime and Alinta to be no longer

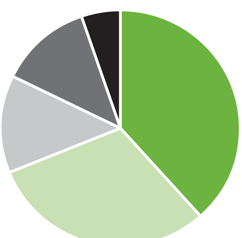
The rest of the news for the quarter was positive. One of the Fund's largest holdings, Prime Infrastructure Group, was the subject of a takeover offer from Canada's Brookfield Infrastructure Partners. Brookfield already owns 40% of Prime and is mopping up the remainder to appease US-based investors who own both Prime and Brookfield and would rather see them combined (only 15% of Prime's securities are owned by Australian domiciled investors). Although Brookfield will do well out of Prime's high quality infrastructure assets, such as Dalrymple Bay Coal Terminal and WestNet Rail, the price looks a fair one and is a nice premium to both the pre-bid trading price and the Fund's average purchase price.

We should also do well out of a small speculative position in Alinta Energy Group. With liabilities hundreds of millions of dollars in excess of its assets, the former Babcock & Brown Power looked certain to be worthless. Due to a quirk in the financing structure, however, some $40m in cash ($0.05 per security) and the equity in Redbank Power Station weren't part of the financing package and represented assets accessible to securityholders, even if the larger Alinta Group couldn't meet its obligations.

In a recently announced 'deleveraging solution', Alinta securityholders are being offered 10 cents

PORTFOLIO DISTRIBUTION (according to market capitalisation)

- Less than $100m **38.4%**
- $100m–$200m **30.5%**
- $200m–$1bn **13.5%**
- Over $1bn **12.4%**
- Cash **5.2%**



per security to hand over all of the assets except Redbank. Half of the 10 cents is being funded out of the $40m cash that already belonged to securityholders, but 96% still represents an excellent return on the Fund's $0.051 average purchase price, assuming the deal goes through over the next few months.

Quiet achievers

There hasn't been as much excitement elsewhere, but that is not to detract from some of the excellent businesses forming the core of the Value Fund portfolio. **MAp Group**, **Spark Infrastructure**, **1300 Smiles**, **ARB Corp**. and **Centrebet** all reported substantially improved earnings for the period ended 30 June and continue to return large chunks of profit to their owners. **UXC**'s result for the 2010 financial year was poor but expected and the business looks well placed to justify our expectations for 2011.

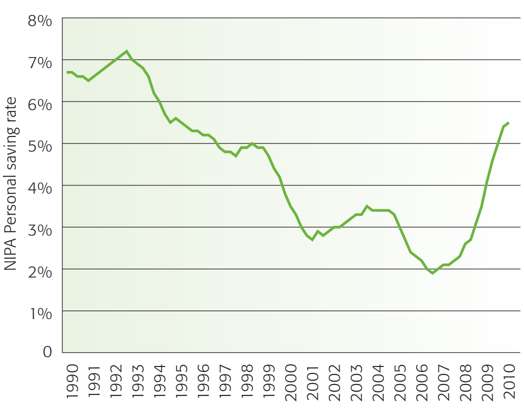
Following a 2 for 7 rights issue from Spark and the Photon raising, the Fund ended the quarter fully invested. We are finding plenty of value in the current market and have been making some room for a couple of new stocks in recent months.

Market commentary

Many commentators and economists have expressed surprise at the sluggish nature of the US recovery from recession. Economic growth rates following previous recessions have averaged 6–8% per annum. Since this recovery began, growth has averaged less than 3%.

The reason is that the cause of this recession was a financial crisis, and recoveries from financial-crisis-induced recessions are typically much slower than other recoveries. After a normal recession, low interest rates induce consumers and companies to borrow and spend. Following a financial crisis, everyone is too busy repairing their

SAVINGS RATES IN THE US



Source: US Bureau of Economic Analysis.

balance sheets to be enticed by low interest rates.

The historical evidence for slower recoveries is strong and the US recovery currently underway is playing out by the book. Not surprisingly given the carnage of the past few years, US savings rates are up despite interest rates at zero (see chart above). By some estimates, assuming savings rates remain around 6%, the debt-to-disposable income ratio for the US will be down to 85% by 2013, back where it was in the early 1990s.

That will be good for the long-term health of the US economy but, with personal consumption representing 70% of GDP, economic growth will be sluggish, at best, for a few years yet.

Currency wars

The Fund owns a number of Australian exporters, none of them in the resources sector. The high Australian dollar, which is now extremely close to parity with the US dollar, is making life very difficult for each of them. »

UNIT PRICE SUMMARY

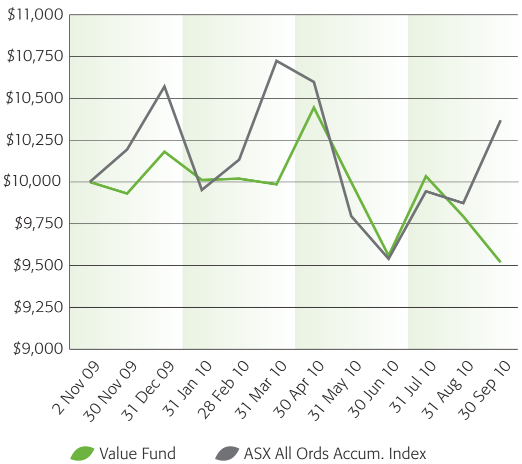
DATE	30 Sep 10
BUY PRICE	$0.9375
REDEMPTION PRICE	$0.9301
MID PRICE	$0.9338

Financial statements

The financial statements for the Fund for the year ended 30 June 2010 are available on the website www.fundhost.com.au

Fundhost Limited, the Responsible Entity of the Fund intends to comply with the continuous disclosure regime set out in the ASIC Regulatory Guide 198, by publishing material information on the website www.fundhost.com.au

VALUE FUND VS ASX ALL ORDS ACCUM. INDEX



It may be good for travellers but it is not good for Australian industry to have our currency trading at a level that decimates domestic exporters. While the US, China and Japan are engaged in a high stakes battle over who can depreciate their currency the most, Australia is wearing the peripheral damage.

There is not much the government can do on a geopolitical level, but it should be doing everything it can on a micro level to support the non-resources export industry through a very difficult time.

The commodities we're digging out of the ground took billions of years to create and, within a few generations, most of the stockpile will be gone. We don't have a permanent income stream. We have an asset base that we are selling off at an increasingly rapid rate and some serious thought needs to go into life after resources. While our political system seems ill-equipped to deal with anything that involves long-term planning, it is concerning to watch the high-quality exporters we own continue to shift their production overseas.

First birthday

This coming November, the Value Fund will have been up and running for one year. It remains early days but it's been an interesting year to say the least and we will review the first 12 months in detail in the next quarterly report.

Until then, as always, please email or call if you have any questions about your investment. Also, don't forget that I'm regularly publishing ideas and thoughts on the Bristlemouth blog.

Kind regards and thanks for your continued support,

Steve Johnson

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