

# Value Fund

## Quarterly Report



INTELLIGENT  
INVESTOR  
VALUE FUND

30 SEPTEMBER 2012

## Reflections on the first three years

The All Ordinaries Accumulation Index had a strong September quarter, adding 8.2%. Your investment in the Value Fund did even better, with the unit price rising by 12.3%.

The result took our yearly return to 35%, and the Value Fund's return since inception is now more than 4% p.a. ahead of the benchmark at 6.9% p.a. For reference, the Small Ordinaries Accumulation Index—perhaps a better benchmark for the current portfolio—returned -0.5% p.a. over the same period.

This quarterly report arrives almost three years after the Value Fund's launch. That's an important milestone and one we'll discuss later in the report. First, let's kick off with the quarter's stock-specific action. »

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#### SUMMARY OF RETURNS AS AT 30 SEPTEMBER 2012

	IIVF	ALL ORDS. ACCUM. INDEX
1-month return	2.83%	2.13%
3-month return	12.27%	8.20%
6-month return	11.11%	2.10%
1-year return	35.20%	13.40%
2-year return	13.00% p.a.	1.89% p.a.
Since inception (31 Oct 2009)	6.92% p.a.	2.56% p.a.
Stocks in portfolio	16	

#### UNIT PRICE SUMMARY

##### DATE

30 Sep 12

##### BUY PRICE

\$1.0978

##### REDEMPTION PRICE

\$1.0891

##### MID PRICE

\$1.0935

## UXC powered up

Information technology specialist UXC provided the best result from reporting season. Net profit from continuing operations was \$18m (compared to \$4.5m last year) and UXC repaid all of its net debt. The group has been through a significant restructure and managing director Cris Nicolli deserves credit for overseeing the changes and refocusing the business.

UXC's prospects remain bright. This year's result included \$2m of non-recurring charges and \$1m in interest that won't recur. Also, the second half of the year showed a huge improvement in trading conditions. If next year's performance continues on the same path, profits will show another impressive improvement.

UXC SHARE PRICE



These good results were delivered while facing flaccid economic conditions and delayed projects in most markets. UXC's revenue of more than \$560m generates only 3% net profit margins, which equates to a return of less than 10% on its equity capital. Such figures are paltry compared to some

of its competitors and the results UXC has historically produced.

UXC was one of the fund's first investments and it has been a large one. We've been patient as management has dealt with the group's issues and our investment case—based on profit margins reverting closer to average—is now clearly playing out. We like to think of this blend as our investing signature; being prepared to take a large position in an unloved stock with significant potential and having the patience to let events unfold.

UXC shares rose 79% for the quarter, and closed above \$1 for the first time since September 2009.

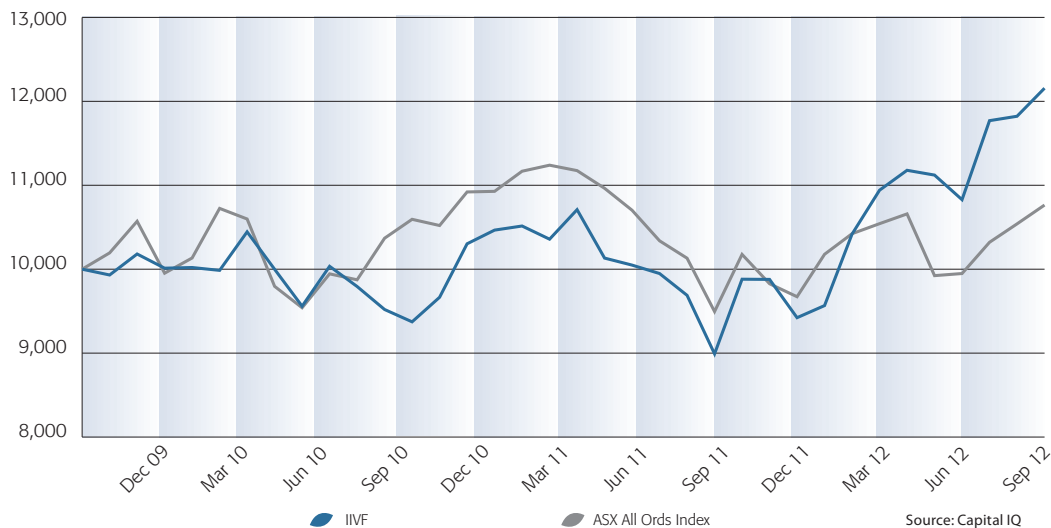
## Cross winds for Infigen

Wind energy group Infigen's annual results allowed for \$57m of debt repayments from operating cash flow. That fell short of our target of \$70m, with costs relating to the United States wind farms continuing to climb as turbines come off their original warranties and become more expensive to maintain. This will also happen in Australia where 70% of turbine capacity is currently on original warranty.

Discussion continues in the renewable energy sector around the Renewable Energy Target (RET) which requires Australia to source approximately 20% of its electricity from renewable sources by 2020. The policy has bipartisan support but is under fire from business commentators and vested interests including (unsurprisingly) major utility companies.

Criticism focuses on the overlap between the RET and carbon tax/emissions trading scheme policies. Pundits are questioning the rationale for specifically promoting renewable energy in a market that already suitably prices carbon.

COMPARISON OF \$10,000 INVESTED IN VALUE FUND VS ASX ALL ORDINARIES INDEX



We'll leave the merits of the arguments to others but, for us, the important point is that the risk of the RET being modified or downgraded has increased. This will affect what buyers are willing to pay for Infigen's Renewable Energy Certificates (RECs).

Fortunately, our thesis that these assets should be worth replacement cost is starting to play out. Australian wholesale electricity prices have increased more than expected since the carbon tax was introduced and, as a result, bundled prices (which include credits from RECs) have increased by around \$20 per megawatt-hour. This will help with debt repayments and Infigen's management remains confident that its debt burden is manageable. We continue to view this as a challenging situation with substantial upside potential. Infigen shares closed 18% higher for the quarter at \$0.265.

## Gunns dies, BAO flies

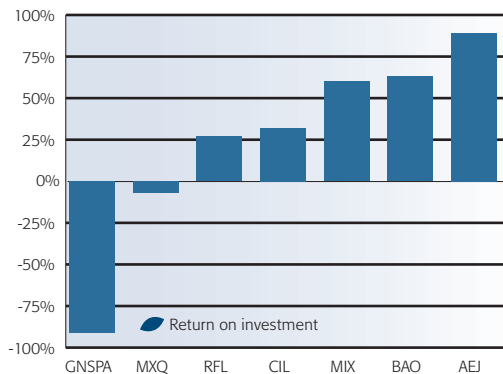
A percentage of the portfolio is invested in a number of esoteric opportunities, including positions in **Rubik Financial** and **Centrebet** which we've previously discussed in detail. It's an area where we believe we can add extra performance in the long term, but which will produce both impressive winners and ugly losers.

This quarter's loser was a position in Tasmanian forestry group **Gunns' hybrid notes**, known as FORESTS. We wrote off this position in August after a needed capital raising fell through. In late September Gunns was placed in voluntary administration and that announcement means there's little prospect of recovering anything from the investment.



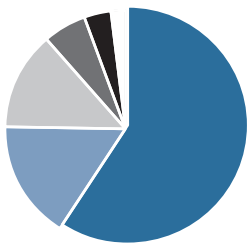
» On the positive side of the ledger, late last year the Fund took a position in the **Brookfield Australian Opportunities Fund (BAO)**, which owns a portfolio

#### WINS AND LOSSES FROM ESOTERIC INVESTMENTS



#### PORTFOLIO DISTRIBUTION (by market capitalisation)

- Less than \$100m **59.2%**
- \$100m–\$200m **16.2%**
- \$200m–\$1bn **13.2%**
- Over \$1bn **5.9%**
- Cash **3.7%**
- Unlisted **1.8%**



of listed and unlisted property trusts. BAO was trading at a large discount to its net asset value, mostly due to a convoluted structure which includes a restriction on paying distributions.

A subsidiary of BAO, which owns about one quarter of its assets, has a preferred income security outstanding which restricts distributions from BAO until interest has been paid to the preferred noteholders.

The relevant assets have not been generating enough income to pay the requisite amount of interest, so BAO distributions have been on hold for four years. The problem for BAO unitholders is that the restriction also applies to the three quarters of its assets which have nothing to do with the subsidiary.

The manager, Brookfield Capital Management, has proposed a restructure to side-step the distribution restrictions. Brookfield will liquidate BAO's listed assets and make a \$3m one off payment to

preferred holders to cover their full annual income entitlement. This will temporarily nullify the distribution stopper and allow Brookfield to make a distribution to BAO unitholders, which just happens to consist of ... all of BAO's remaining assets. These assets will be 'distributed' into a new unlisted trust which, conveniently, won't have a distribution stopper.

It's a smart deal for BAO unitholders. A cash distribution of 1.5 cents per unit will be made shortly and the remaining proceeds will be received as the underlying assets are realised. BAO's unit price is still 42% below its net asset value and the discount is close to 50% once the upcoming cash distribution is accounted for. We're not thrilled by the prospect of owning an unlisted investment but the stock continues to represent good value even though it's already up 62% on our average purchase price.

## Real Estate Realigns

Late in September the board of troubled property trust **Real Estate Capital Partners USA Property Trust (RCU)** announced the 'alignment of governance and management arrangements'. That's code for the removal of the management team.

We've been pushing hard for this outcome. The quantum of related party expenses that have been charged to the trust in the past four years (for often less than satisfactory outcomes) has been disgraceful. The trust's future direction is not yet clear but we'll exert what influence we can to try and ensure the replacement manager is less expensive, more motivated and better qualified.

RCU also announced that joint-venture partner Saban Capital is undertaking due diligence with regards a purchase of RCU's assets. Saban is the logical buyer of RCU's assets but there is no certainty it will make an appropriate offer and, with management issues

## Selection of holdings

STOCK	BUSINESS	PORTFOLIO WEIGHTING
AS AT 30 SEPTEMBER 2012		
1300 Smiles	A corporate dentistry business located predominately on the east coast of Queensland.	5.3%
Enero Group	A collection of advertising and marketing research agencies.	7.3%
QBE Insurance	Australia's largest international general insurance and reinsurance group.	5.9%

finally being addressed, we're prepared to play this patiently.

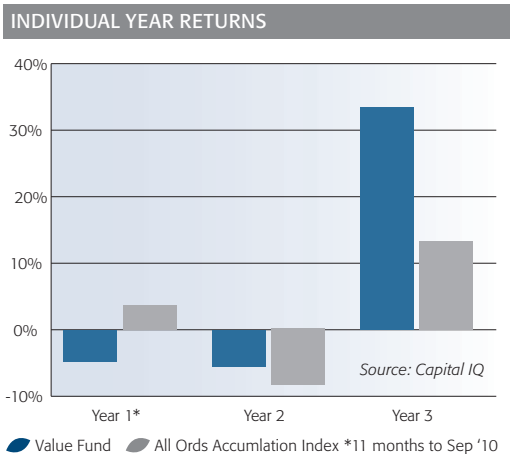
RCU's unit price ended the quarter at \$0.51, up 7% from its 30 June price.

## Reflections on the first three years

From the outset, we suggested that returns from a concentrated fund like this would be lumpy. And that's certainly proved to be the case.

In almost three years we've produced, in order; one poor year, an average one and capped it off with a stellar 12 months (see chart). The net result has been good with initial investors about 14% ahead of the index, and those who added money or joined later have fared even better.

One-year fund returns are almost meaningless and three-year results are insufficient to make a complete assessment. Yet my opinion is that the three year results are a fair reflection of our efforts. We've done well and the experience gained so far has added some important tools to our shed which sets us up for an even better future.



### Tool one: Experience

Simple, invaluable experience is first cab off the rank. Three years ago we had extensive research experience but no large-scale portfolio management experience. Managing an eight-figure sum on behalf of others requires new skills which, in some cases, have been acquired the hard way.

We now have a better understanding of liquidity issues, the broking industry and the potential leverage we can wield as a large investor. The

» downside of being large is that it can be hard to get in and out of investments but size also brings benefits. Of late we've been using our influence to protect our interests and crystallise value where we can, with RCU being a case in point.

### Tool 2: Humility

The second tool is a more humble approach to portfolio management. A look back over our individual stock performances to date indicates that our stock picking skills are more than satisfactory.

The fund has owned 24 stocks that contributed, either positive or negative, more than a \$100k to the portfolio. Of those, 75% were positive and 25% negative. That's an excellent strike rate. And if we can stay close to it, we'll generate outstanding returns for you for a long time to come.

The portfolio's performance would have been significantly improved by having equal weights in

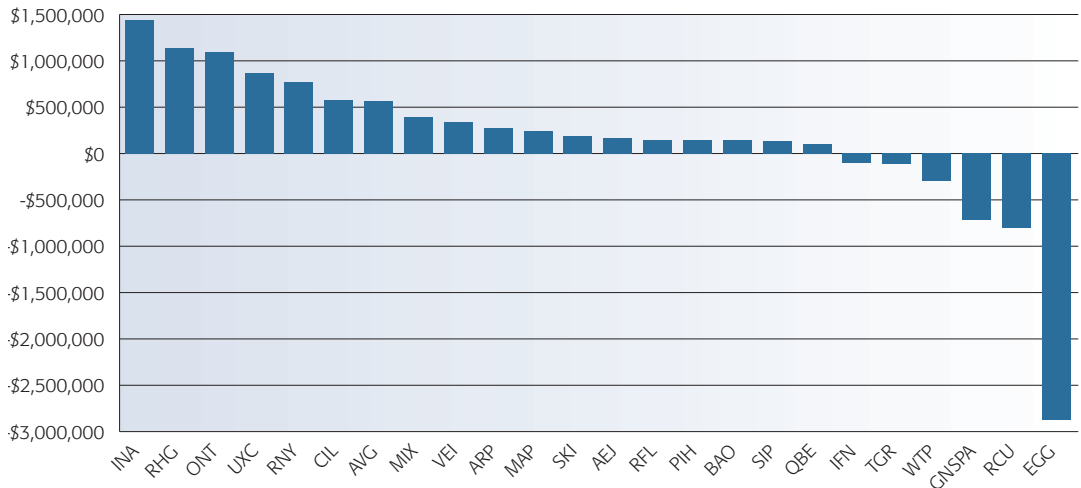
all of the stocks we've owned. So the humility has come from taking a few nasty lumps in the area of portfolio allocation. This is a crucial skill for any investor but especially those dealing with the kind of situations we've found value in so far.

The hefty returns we've produced have not come from typical 'Buffett-type' stocks. At least not the version of Warren Buffett most people are familiar with. Our methods have been more akin to the 1960s-era Buffett, who was running smaller amounts of money in very different ways to his now-famed 'buy-and-hold great stocks' approach.

Our competitive edge has been in buying unpopular stocks. These stocks have typically come with operational problems or high debt levels (and so were shunned by an investing herd over-reacting to the lessons of a debt crisis).

We expect to keep doing well from these situations but they are not the type of stocks in which one can

POSITIVE AND NEGATIVE CONTRIBUTORS



invest 20% of a portfolio. On a probability-weighted basis, the numbers stack up but our current scoreboard indicates how difficult it is to predict in advance which of these will bomb and which will blossom.

Take the two US office property stocks we first invested in during 2009 and 2010, for example. RCU owned a geographically diverse portfolio of properties, long-term leases and tenants including the US government and A-rated, NYSE-listed companies. The manager and responsible entity were separate entities, providing a degree of independence, and there were no controlling unitholders.

**RNY Property Trust**, trading at a similar discount to its asset backing, owned a portfolio of B-grade assets concentrated in suburban areas around New York. The manager owned the responsible entity and had acquired 20% of the trust's units, meaning the prospects for removing them were next to zero. We were specifically warned by a fellow institutional investor that the chances of getting 'screwed over' were high. Which would you rather have owned?

It turns out the latter was the way to go. The manager of RNY has done a magnificent job of generating significant value for unitholders. The manager of RCU delivered considerable value for himself and lost tens of millions of dollars for unitholders. Knowing that in advance, unfortunately, was near impossible.

Perhaps in future the prices of good, unleveraged, well-managed businesses will become relatively more attractive. If that happens, you can expect us to take larger positions in such stocks. For the moment, that pond looks well fished and we see more potential at the other end of the spectrum. But we need a larger basket of these types of

stocks to help the law of averages to play out in our favour and we'll be managing portfolio weightings accordingly.

### **Tool 3: Diligence**

This is one we've honed rather than added. Three years on, our research process has developed further and become deeper, more structured and diligent.

Minimising the number and impact of the stocks on the right hand side of the chart opposite would have a huge impact on the Fund's returns. Easier said than done, of course. Luck and loss are unavoidable

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parts of the investment game. But there are unavoidable losses due to luck and avoidable losses due to analytical mistakes or oversights. By improving our analytical framework and the addition of talented analysts to do the digging, we want to move the latter as close to zero as possible.

Overall, we're better fund managers today than we were three years ago. And with hindsight, we can take considerable heart from the way the past three years have unfolded. If our inaugural year (as opposed to our third) had delivered a positive 35% return, your expectations may have become unrealistic and our egos dangerous.

» As things turned out, we learned some hard lessons early and you now know exactly what 'lumpy returns' mean in practice. Overall we've produced good returns in a period where many fund managers have simply produced excuses.

That leaves us well placed for the future. Having survived the most dangerous period of any fund manager's career (the first three years), the business continues on a stable footing and we're confident we can generate even better returns in future.

We've given ourselves a little pat on the back and think you should indulge in some self-congratulation, too. Investor support in our infancy has been crucial. Not only did you back a start-up fund manager, you stuck by us when returns were less than impressive.

This meant we were able to focus on investing rather than appeasing our own investors. We also think that a patient, knowledgeable investor base is a key competitive advantage in this business. That's something we clearly have and is likely to further improve your returns (we were experiencing *inflows* in difficult market conditions which meant we were

able to do more buying, rather than forced selling, as our opportunity set increased). That was a real blessing.

Thank you for your trust and continued support. We look forward to managing your investments for a long time to come.



Steve Johnson  
Chief Investment Officer

*PS If you can make it to one of our October Roadshows we'd love to meet in person. There is a special session in each capital city for Value Fund investors, from 4:30–5:30pm. Visit [www.intelligentinvestor.com.au/tour](http://www.intelligentinvestor.com.au/tour) for more information.*



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