20th August 2012

Mosaic Special Situations Fund
Investment Manager's Annual Letter 2012

Note: The following commentary is prepared by the Manager of the Fund, Intelligent Investor Funds, and represents the views of the Manager.

It has been another solid year for the Mosaic Special Situations Fund. The last remaining legacy positions have been unwound and the Fund returned 1.0% for the year to 30 June 2012. Whilst our objective is to make investors money, in any one year the external environment will have a significant impact on returns. In the past 12 months, where the S&P/ASX All Ordinaries Accumulation Index returned -7.0%, the Fund's 8.0% outperformance is a respectable result.

Global worries put equities on the nose

In last year's annual letter we focused on Europe's 'seemingly intractable debt problems' and concerns over the nature of growth in China. If anything, those two issues have worsened over the course of the year and are rapidly being reflected in the prices of resources and mining services businesses.

The 'Euro crisis', as it has now become known, has provided financial markets with plenty of volatility but little in the way of solutions that are anything more than short-term patches. The only viable long-term solutions are a fiscal union, effectively the creation of a United States of Europe, or unwinding the Euro and allowing deficit nations to regain competitiveness by returning to their own currencies and benefiting from the subsequent depreciation. Given the former seems politically impossible, the latter looks inevitable.

We don't profess to have any special insight into how or when this is going to unfold. All we can do is closely monitor the potential impact on the Fund and minimise risk where possible.

The economic developments in China, on the other hand, look much more predictable. Investment markets do have a lot less faith in the China story than they did 12 months ago. The S&P/ASX 30d0 Resources Accumulation Index is down 28% during the 12 months to the end of June. BHP Billiton and Rio Tinto are down 26% and 31% respectively. But, based on anecdotal evidence only, it seems many Australian investors are yet to grasp the fundamental problem. There is much focus on China's exports and the impact a weak global economy is having on that driver of the Chinese economy. China's growth rate has fallen from 10% to 7.6% per annum, and that seems to have the market worried.

If that were the extent of China's problems – and the only thing required for a recovery was a rebound in exports – we would be viewing the current turmoil as a buying opportunity in the Australian resources sector. China's problems are not so short term. Nor are they reflected in its overall GDP growth rates. It is perfectly plausible that China will continue on growing for the next decade, while its demand for Australian resources wanes.

China's problem is not overall GDP growth, but the composition of that growth. Its economy, viewed by most as export dependent, has an unhealthy addiction to internal investment, and it is this addiction that is driving rampant demand for Australian resources.

Infrastructure spending props up GDP growth in the short-term. The long-term consequences depend on how efficient and productive the spending is. Infrastructure that earns more than its cost of capital will contribute to GDP growth. Infrastructure that doesn't will detract.

Time will tell how well China has spent its money. The associated buildup of local government debt and signs of significant reductions in capacity utilisation suggest that there will be plenty of white elephants.

Irrespective of how well the money has been spent (yes, we are skeptics), though, the Chinese authorities are acutely aware that the GDP growth is, in the words of Premier Wen Jiabao, 'unstable, unbalanced, uncoordinated and unsustainable'. They need consumption to play a much larger role in China's growth and, one way or another, that is what they will get. Either the transition will be carefully managed, or the fundamental laws of economics will force a more abrupt and painful adjustment a few years down the track. The prospects for commodity demand look dim, just as vast amounts of supply comes to market.

The Special Situations Portfolio is positioned so as to minimise the damage from any fallout and – should the Australian dollar weaken significantly – benefit from a large exposure to the US. In a relative sense, the Fund has already benefited significantly from this strategic alignment, but we anticipate more benefits to come over the next few years.

Performance review

The stability inferred by a net return of close to zero belies significant volatility in the underlying portfolio. Of the larger holdings, Real Estate Capital Partners USA Property Trust's (RCU) unit price fell 44%, Infigen Energy fell 36% and Photon Group (now Enero) fell 31%.

Both RCU and Enero ended the year with a clearer future than they began it, but at significant cost to shareholders. RCU undertook a heavily dilutive capital raising in February of this year and sold its largest property asset, at a discount to book value, in June. It now owns two completely unencumbered properties and an interest in a portfolio of properties leased to the US government, so is clearly not going bust. But the amount of value destroyed over the past 12 months means the Fund is not going to earn the returns originally envisaged either.

Similarly, Enero's balance sheet now shows about $17m of cash and no debt, versus $118m of debt at this time last year. The improvement is due to a number of business sales during the year but the transition has inflicted much pain, with key staff and clients of the remaining companies departing en masse. It is very difficult to tell at what point the desertion will stop and what level of profitability that will entail, which is why the company's market capitalisation is only $43m. We think the value will be more than that but are disappointed with the deterioration in operating performance over the past 12 months.

Offsetting those two disappointments were large gains for Ingenia Group, formerly known as ING Real Estate Community Living Group, where the unit price increased 65% over the course of the year,1300 Smiles (up 73%), RNY Property Trust (up 13%) and Spark Infrastructure which returned another 26%, including distributions, on top of last year's excellent gains.

Ingenia management get the prize for most productive management team over the past 12 months. CEO Simon Owen sold the trust's US retirement assets for excellent prices, negotiated the internalisation of management from ING Group, improved occupancy in its retiree rental portfolio and arranged the sale and purchase of a number of smaller retirement villages in Australia. Owen's strategy is to use repatriated proceeds from the US asset sales to strengthen the trust's balance sheet, resume distributions and purchase new retirement assets in an extremely distressed market. Despite the gains of the past 12 months, we like the management team and see plenty of potential for further gains during the coming years.

Likewise, RNY Property Trust has been able to improve its prospects meaningfully during the past 12 months. Most significantly, RNY's manager was able to create in excess of $30m in equity value by refinancing its largest pool of assets at a discount to the original debt value. Given RNY's market capitalisation is only $36m that is significant in its own right. But the new five year debt facility also gives unitholders the potential to participate in any price appreciation on $US194m of property which we expected to lose, on top of the US$155m of conservatively financed property on which our investment case was originally based. Despite the unit price increases last year, this remains one of the most attractive opportunities in the Portfolio.

Current Portfolio

Apart from the significant reduction in the Oceania Capital Partners position, the Portfolio composition hasn't changed dramatically in the past 12 months. Key positions still include large companies QBE Insurance, Spark Infrastructure and Infigen Energy. The Fund also retains positions in smaller companies UXC, Enero, 1300 Smiles, RCU and RNY.

We see plenty of potential for more corporate action in the Portfolio over the coming year. Absent a significant market rally, the Fund's returns will likely come from takeovers, assets sales, dividends or capital returns and the Portfolio contains numerous prospective targets. We will continue to look for further opportunities and seek to maximise the value of the current Portfolio where possible. Given the attractive pricing of the stocks currently owned, we are optimistic about further healthy returns over the coming years.

Thanks for you support of the Mosaic Special Situations Fund and, as always, please contact us if you have any queries about a current or prospective investment.

Kind regards,

Steve Johnson
Chief Investment Officer
Intelligent Investor Funds

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