Officium Special Situations Fund

SECTOR FUNDS

OFFICIUM CAPITAL

Quarterly Report September 2011

All in the same boat

The Special Situations Fund unit price fell by 5.9% during the quarter, compared with a fall of slightly more than 11% for the S&P/ASX All Ordinaries Accumulation Index. This was due to a positive contribution from the Fund's largest position, **Oceania Capital Partners (OCP)**, which was up 7% during the quarter. The rest of the Portfolio was down by about the same as the market.

Given a strong weighting towards US dollar assets and the absence of resources stocks in the Portfolio, it is somewhat surprising that the Portfolio has not performed better during a bad quarter for the market.

One explanation could be the increase in correlation amongst markets and asset classes around the world. *The Economist* recently pointed out that 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.

Performance Data as at	30/09/2011
1 month	-4.51%
3 months	-5.93%
6 months	0.04%
1 year	8.07%
2 years (p.a.)	11.39%
3 years (p.a.)	9.15%
5 years (p.a.)	0.91%
Since 30/09/2004	2.19%
Net Asset Value ($)	0.8999
Fund Size ($ million)	34.67

Top 10 Portfolio Holdings	%
Oceania Capital Partners Ltd.	31.85%
Infigen Energy	7.66%
UXC Limited	7.56%
QBE Insurance Group Ltd	7.28%
ING Real Estate Community Living	5.08%
1300 Smiles Limited	4.52%
Macquarie Group Ltd.	4.51%
Reckson New York Property Trust	4.25%
Photon Group Limited	4.13%
Real Estate Capital Partners USA	4.06%
Other holdings	19.10%
TOTAL	100.00%

Of course, the Fund's ultimate returns will be determined by the businesses it owns, not stock price movements over the course of three months.

Oceania Capital Partners

The Fund's largest holding, OCP, announced in August that it would give shareholders the opportunity to vote on two alternate proposals to return capital.

The first option is for all shareholders to receive a cash distribution of $1.45 per share and retain an interest in debt collection business Baycorp (OCP's one remaining asset). OCP would look to sell Baycorp over time, or buy out its joint venture partner and leave the business listed on the ASX.

The second option has been proposed by OCP's new and largest shareholder HCI Australia, a subsidiary of South African listed Hosken Consolidated Investments. HCI's proposal involves a return of $0.30 per share to all shareholders and a buy-back facility which would enable those shareholders that wish to exit to sell their shares to OCP at $2.07 each.

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HCI will not participate in the buy-back, which means they will own an increased percentage of the company post-buy-back, and intend OCP to subsequently resume investing activities. The $2.37 total consideration on offer is less than the current net asset value of $2.65 but does allow shareholders to realise their investment with certainty in the near future.

Both proposals are due to be voted on at an AGM in November and the Manager will form a view once all of the documentation has been received.

Centrebet comes good

The Special Situations Fund has owned Centrebet since August 2010, with an average purchase price of about $1.60 during the initial period of accumulation. The Manager viewed the business as reasonably priced, but the main rationale was the expectation of merger and acquisition activity within the sector.

It took longer than expected but the Fund collected some healthy dividends along the way and the final outcome was more than could have been 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 had running against the Australian Taxation Office.

IASbet won an almost identical case in July and Centrebet announced that the court case had been postponed while it tried to agree a settlement out of court. With victory looking increasingly likely, the shares traded at $2.24 before delisting and the Fund has exited its investment at that price. The final result was a 40% premium to the initial purchase price and a return of more than 10% on an additional investment made subsequent to the takeover announcement.

Stock in focus – ING 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 (NAV) 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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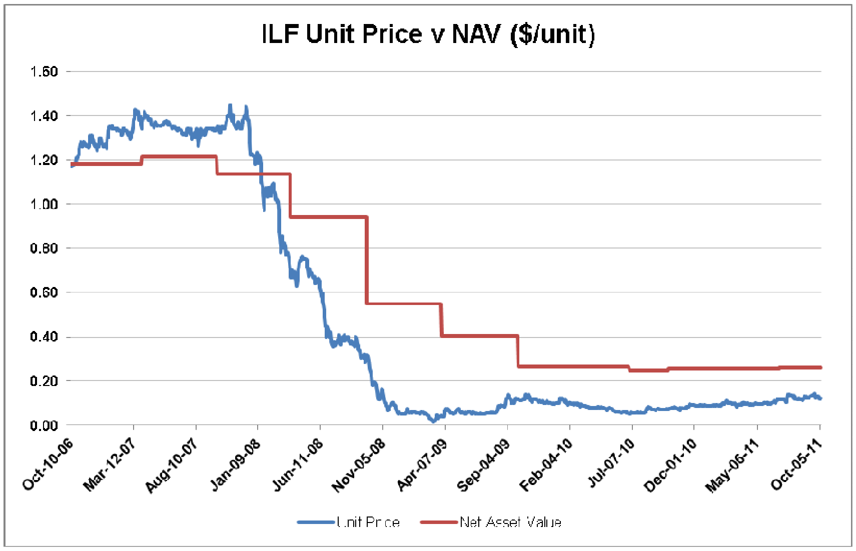
Even without the overseas assets, ILF's NAV should grow from here. Simon Owen was appointed as Chief Executive Officer of ILF in 2009 and has made excellent progress already. Owen was formerly CEO of Aevum, an ASX-listed retirement village operator bought by **Stockland (SGP)** in 2010. Occupancy has 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 NAV.



Source: Capital IQ

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. This end result should be a management team better aligned with the interests of unitholders.

There are risks, particularly the potential flow on effects from a weak residential property market. But the Fund has been able to establish a meaningful position at a discount of around 56% to the NAV (an average purchase price of approximately $0.115) and, given the Manager expects that NAV to grow, there are high expectations for the investment.

Stock in focus – QBE Insurance

The Fund also added to its 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 Fund combined; it is not common for the Manager to find compelling value in stocks this size.

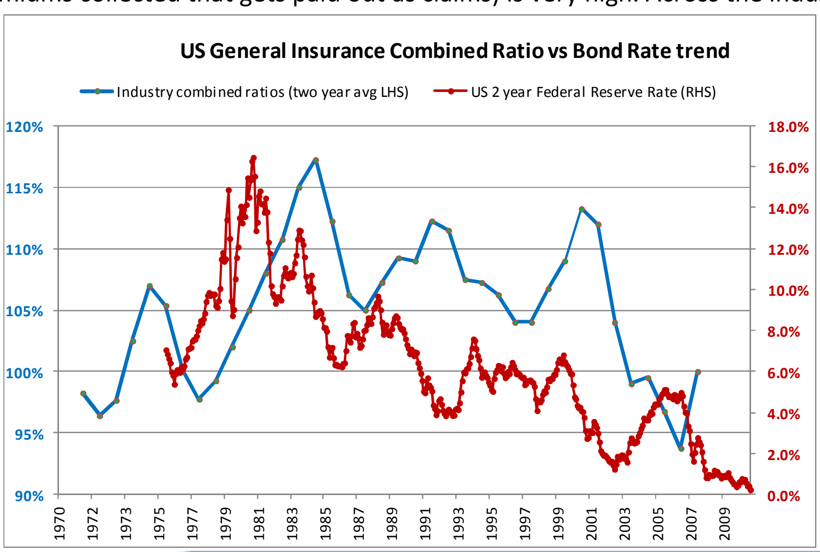
The market, however, has become obsessed with the impact low interest rates will have on QBE's profitability. The share price has fallen more than 60%, from north of $30 in late 2007, to less than $13 at the end of September, during which time the company's net earned premium has grown from $US8.5 billion to US$12.9 billion.

Low rates will obviously have an impact on QBE's short-term profitability. It has $US29 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.

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.

There are good reasons to think the effect will not 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 below, 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 rates mean high prices.



Source: ISO, Federal Reserve

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, the Manager expects the underwriting results should get even better.

The Fund has added to its existing position in QBE over the quarter. Although both still look reasonably cheap, **MAp Group** has made way to fit QBE into the Portfolio, and the holding in **Spark Infrastructure** has been partially sold.

Perhaps as a result of being removed from the S&P/ASX 200 Index, **Infigen Energy** also sold off heavily during September and the opportunity was taken to add to the Fund's existing position.

As always, please get in touch via email (steve.johnson@iifunds.com.au) or call (02) 8305 6050 if you have any queries about your investment.

Kind regards,

Steve Johnson
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Intelligent Investor Funds