Mosaic Special Situations Fund

Quarterly Report March 2012

The Mosaic Special Situations Fund's unit price increased 9.6% for the quarter, versus a 9.0% increase in the All Ordinaries Accumulation Index. A distribution of 0.506 cents was also declared. Whilst the overall performance was only marginally better than the market, the result was pleasing given the large cash position retained by the Fund post the Oceania Capital Partners buy-back.

There were a number of stock specific events that contributed to the quarter's returns. We discuss **RNY**'s refinancing, further good news from **ING Real Estate Community Living Group** and a significant return this quarter from our investments in UXC and QBE later in the report. The Fund also benefited broadly from substantial US-focused investments and a lower exposure to an increasingly wobbly Australian economy.

Strength in the US, weakness in China

For the past few years, the correlation between the AUD/USD exchange rate and the Dow Jones Industrial Average (refer Chart on page 2) has been extremely high (0.89 for the stats enthusiasts, which means 89% of the movement in the exchange rate can be explained by movements in the Dow Jones Industrial Average). Every time the US economy shows signs of life, the Dow Jones index rises, and so does the Aussie dollar. The theory presumably being that a strong US economy means a strong global economy and plenty of demand for Australian commodities.

With a large portion of the Fund invested in US-exposed stocks, every piece of good news on US employment or GDP has been offset by bad news on the currency front.

The strength of the prior correlation had surprised Intelligent Investor Funds. For commodity prices, a strong US economy is minor good news. A slowdown in China is major bad news. As we've been pointing out for more than a year, internal infrastructure spending is far more important to China's economy (more specifically, China's demand for our resources) than exports. So a strong US won't offset a slowdown in infrastructure spending in China.

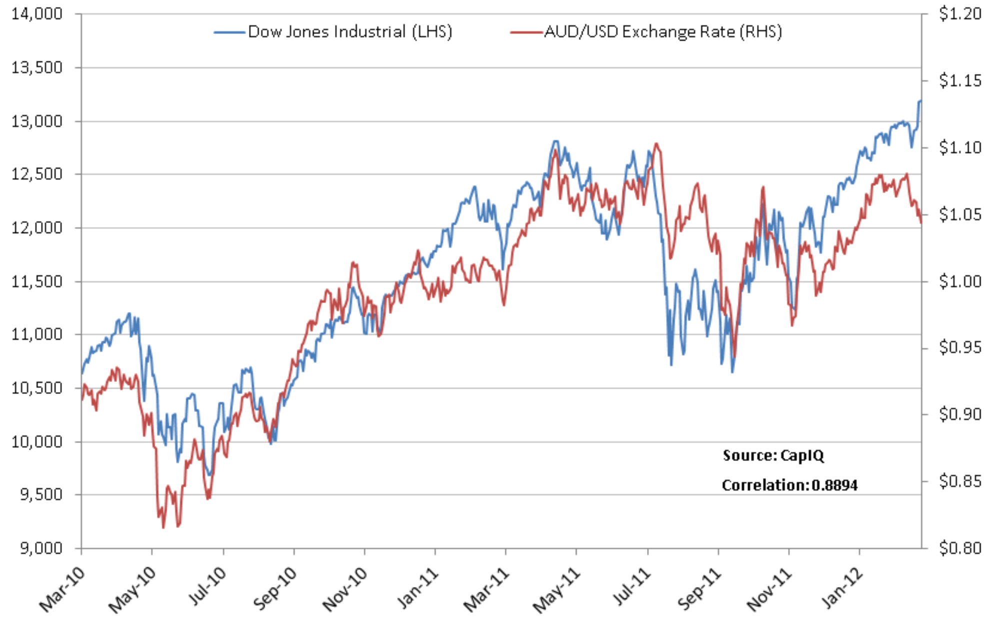
There is plenty of evidence to suggest the much-needed slowdown in debt-funded infrastructure spending has already begun. In a recent Bloomberg article, JP Morgan analyst Adrian Mowat was quoted as saying "China is in a hard landing. Car sales are down, cement production is down, steel production is down, construction stocks are down. It's not a debate anymore, it's a fact."

Performance Data as at	31/03/2012
1 month	3.79%
3 months	9.63%
6 months	13.94%
1 year	13.77%
2 years (p.a.)	8.94%
3 years (p.a.)	18.99%
5 years (p.a.)	3.33%
Since Inception (p.a.)*	3.73%
Net Asset Value ($)	1.0203
Fund Size ($ million)	36.69

* Inception date of Fund 30/09/2004

Top 10 Portfolio Holdings	%
Cash	33.59%
QBE Insurance Group Ltd	10.21%
UXC Limited	7.84%
Infigen Energy	7.52%
ING Real Estate Community Living	6.50%
Spark Infrastructure Group	6.09%
Reckson New York Property Trust	6.01%
Photon Group Limited	5.69%
1300 Smiles Limited	3.33%
Tassal Group Limited	3.11%
Other holdings	10.10%
TOTAL	100.00%

Correlation between the AUD/USD exchange rate and the Dow Jones Industrial Average:



All the while, the news out of the US has remained encouragingly positive. The housing sector, a crucial part of the US economy that has been missing in action since the housing bubble burst in 2007, has been showing signs of life. The unemployment rate has been slowly coming down and overall GDP growth has been registering at 2-3%. It's all perfectly consistent with sluggish recoveries from previous debt crisis identified by Rogoff and Reinhart in their book This Time Is Different.

With the consumer debt-to-disposable-income ratio down to 113% (from 132% at its peak) and corporate balance sheets in rude health, a return to more normal growth rates is within sight, perhaps within two years.

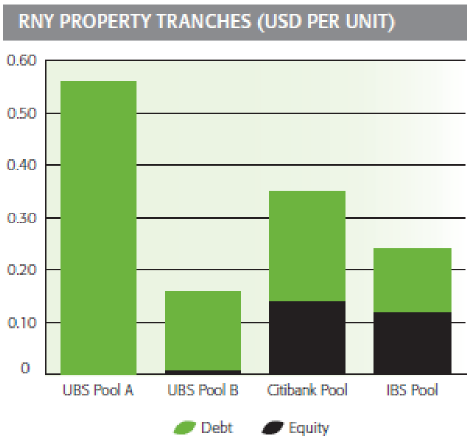
The implications for Australia of a weak China and a strong US are starting to be reflected in stock prices and exchange rates. During the first quarter of this year, the US stock market has risen while the Aussie dollar has gone down (you can see this clearly for yourself on the far right of the graph). No longer constrained by the correlated dollar, stocks like **QBE** and **CSL**, with significant exposure to the US, have been in demand (the shareholder returns for the quarter were 11% and 12% respectively). In contrast, BHP's share price rose less than 1% during the same period.

It is, of course, impossible to say with confidence. But it would seem we're at an important inflection point. One the Mosaic Special Situations Fund is well prepared for.

RNY on the verge?

As for stock specific news, the most important was provided by **RNY Property Trust (RNY)**, an Australian REIT which owns a portfolio of mid-tier office space in the New York tri-state area. RNY announced in February that it had reached agreement on a 'payoff arrangement' for a US$196.1m loan which expired in September 2010 (UBS Pool A in the chart below).

Restating the original investment case, RNY's four debt facilities are limited recourse to four separate pools of property. Two of those pools, conservatively financed with long-term debt, are worth significantly more than the current unit price. The Manager's base case assumption was that, because loan to value ratios were close to 100%, RNY would lose the other two pools of property when the loans came due in 2010.



Source: RNY 2011 Full Year Results

The recent announcement suggests that investors are going to be pleasantly surprised. Based on the notes to RNY's annual report, the 'imminent' payoff arrangement related to UBS Pool A consists of two new loans totaling US$159m - a senior five-year US$123m loan and five year US$36m mezzanine loan – being used to pay off the existing loan at a discount. Paying off US$196m of old debt with US$159m of new debt creates US$37m of equity out of nothing, 75% of which belongs to RNY.

The mezzanine loan is expensive. The interest rate is 13% and RNY has to pay an additional 15% of any residual cash flow from the properties to the mezzanine note holder. But the weighted average interest rate for both loans is a manageable 7% and, just as importantly, unitholders now have a 5-year option on an improvement in the US commercial property market. A 20% improvement in prices over the five year loan period would add almost $US30m to RNY's net tangible assets on this pool of assets alone (the current market capitalisation is $36m).

While the unit price rose 41% this quarter, that doesn't seem to reflect the addition to RNY's value from this deal, let alone the fact that it was cheap to begin with.

Polar opposite at RCU

The news from the Fund's other US property trust showed the difference a management team can make.

While Scott Rechler and his associates at RNY have struck a deal of immense value to unitholders, Andrew Saunders and his team announced another capital raising for Real Estate Capital Partners USA Property Trust (RCU), just 12 months after the last supposedly definitive one. This time a 0.98 for 1 rights issue was to be fully underwritten by RCU's largest unitholder, Frost Holdings, an entity controlled by Greg Woolley. This means Frost Holdings will buy every unit not taken up by other unitholders under the rights issue (known as the 'underwriting shortfall'). Given the rights issue was unlikely to be strongly supported by retail investors, the underwriting arrangement effectively delivered control to Woolley without paying the rest of us unitholders a premium. In fact, the $0.40 price at which he would be gaining control is a 61% discount to the post-raising net tangible assets of the trust.

The good news accompanying the rights issue announcement was that RCU had agreed a lease extension on its most valuable asset, a US$92.5m property currently leased to RSA Security until December 2016. Albeit at lower rents than would otherwise have been received over the next five years, the lease extension extends the tenancy, provides a guarantee from RSA's parent company EMC Corporation (listed on the NYSE) and makes this asset extremely saleable.

The $17m of net proceeds from the rights issue will enable RCU to provide tenant improvements as part of the abovementioned lease extension and refinance loans due in August this year.

That's all the more reason to be upset that Woolley was attempting to gain control of the trust on the cheap. Fortunately, in conjunction with other major unitholders, the Manager was able to apply to the Takeovers Panel to force RCU to restructure the rights issue so as to mitigate the control impact of allowing Woolley to be the only underwriter.

The Takeovers Panel found in Intelligent Investor Funds' favour and ordered Woolley to offer all other unitholders a pro-rata share of the underwriting shortfall. The Manager is yet to make a final decision on participation but if all institutional unitholders participate to the maximum extent possible, it will limit Woolley's ownership to approximately 30%. If retail unitholders take up some of their rights, the impact will be even less, a satisfactory outcome for all involved.

Despite all of the action surrounding RCU, the unit price hardly moved during the quarter, but the Manager expects the impact on future returns will be significant.

Dental operator's painless operation

Dental practice operator 1300 Smiles (ONT) doesn't get much focus in our quarterly reports due to the pain-free and consistent nature of its progress. But it has been one of the most significant positive contributors to the Fund's return since the stock was acquired in May 2010. Its February results announcement continued that trend, with a 14% increase in earnings per share causing the share price to rise 33% over the quarter. The company now has a market capitalisation of $125m, which brings it onto the radar of a wider group of institutional investors, many of whom seem to have taken an interest in ONT's high profitability and growth prospects.

The Manager shares others' optimism about the future and intends on maintaining an investment in this stock for a long time. But the current high interest in the stock also represents an opportunity to realise some profits and redeploy capital elsewhere given the lower discount to intrinsic value.

Accordingly, the Manager took the opportunity to realise some profits during the quarter.

UXC share price revival

The Fund's investment in information technology services business UXC returned 31% for the quarter, but we're somewhat at a loss to explain why.

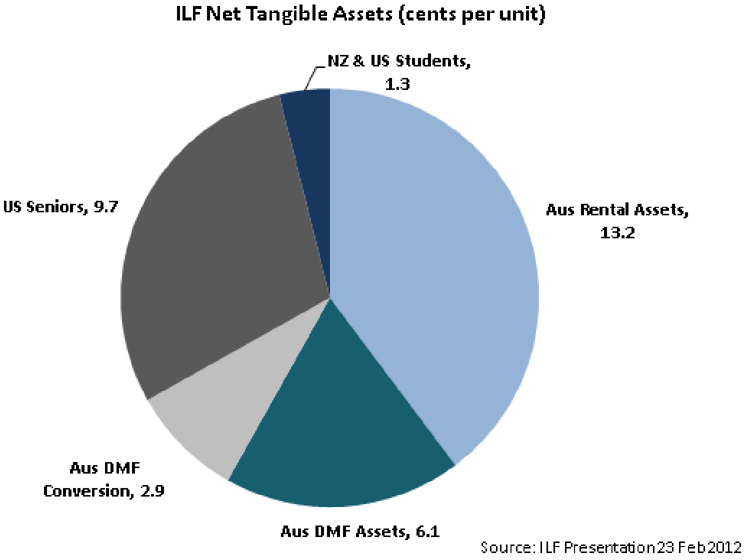
Half year results were mixed, UXC showed reasonable revenue growth of 6%, but net profit margins remain anaemic at 2% leading to a poor profit result. With the field services business divested, however, management can now focus more of its attention on operating matters. Margin improvement targets were flagged and cost reductions of $10m per annum have apparently already been implemented.

UXC shares traded up modestly in the days following the half year results, but interestingly surged 27% from mid-March on higher than usual volumes to close at 58.5 cents. No news of importance was released to the market during this period and no substantial holder notices have been filed at this point.

ILF to become Ingenia

ING Real Estate Community Living Group (ILF) has announced that internalisation will be the preferred option put to unitholders as ING completes its withdrawal from property management in Australia. CEO Simon Owen and other key staff will transition to the internalised group which will be renamed 'Ingenia Communities'.

The name is apparently inspired by 'ingenuity' which in typical corporate drivel 'reflects management's philosophy of operating with resourcefulness and strength'. ILF has indicated $1m in one-off costs and we expect it to incur higher ongoing management costs as the benefits of ING's scale are lost.



Notwithstanding this, the Manager views internalisation as the right move for ILF, it will allow the interests of unitholders and management to be better aligned, and is certainly preferable to ING selling its management rights to another external manager. ING will include sweeteners to the value of $4.1m (free rent and the like) but otherwise seems intent on collecting on most of its $10.5m in unpaid fees. Judging by the fall in payables on the December balance sheet, it has already taken a decent chunk.

ILF remains optimistic on the sale of its stake in six New York retirement properties, again indicating that a premium to book value is the likely result, and has also flagged the possibility of distributions recommencing in 2012.

ILF closed up 34% for the quarter at 21.5 cents.

QBE's rollercoaster ride

Including dividends, QBE shares returned 11% for the quarter. That result, however, belies an unbelievable amount of volatility during the period. Its share price plumbed to less than $10 in early January, before increasing more than 40% to end the quarter slightly higher than $14.

In the Manager's view, the volatility was caused by short-term issues outside the company's control ($300m of losses from floods in Thailand spooked investors early in January). Intelligent Investor Funds took advantage of the panic, adding significantly to the Fund's investment at less than $11 per share and selling some of that stock back into the market at more than $14 per share. The net result was total returns to the Fund for the month of substantially more than the 11% stock return suggests. The Manager believes that QBE is one of the world's best insurance businesses and, whilst always at the behest of Mother Nature and her violent mood swings, the Manager expects it to earn excellent returns over a three to five year period.

Wrapping up the financial year

The Special Situations Fund has made good progress over the past twelve months returning 13.8% compared to the return of -6.2% from the All Ordinaries Accumulation Index.

Encouragingly, despite some of our holdings appreciating substantially, the Manager still has high expectations for the current Portfolio. The Manager believes that the Fund owns some very cheap stocks and some of them have important milestones ahead that should result in at least part of that value being realised.

The next quarterly report will be July but as usual we will publish monthly updates to keep you informed on the Fund's progress throughout the quarter.

As always, please call or email if you have anything you would like to discuss.

Kind regards,

Steve Johnson
Chief Investment Officer
Intelligent Investor Funds