Mosaic Special Situations Fund

Quarterly Report June 2012

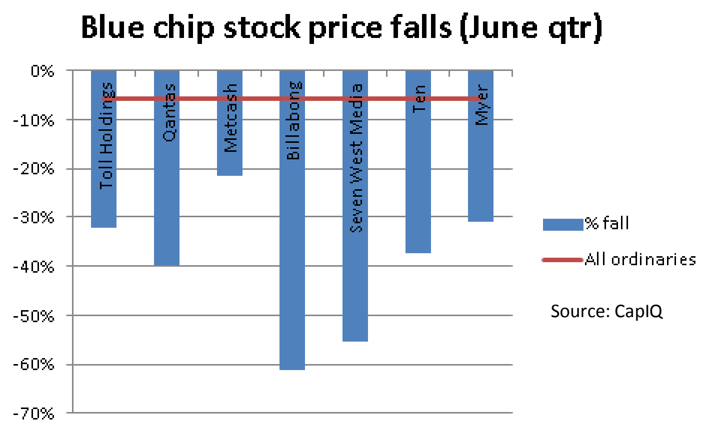
The Mosaic Special Situations Fund's unit price fell 5.8% during the June quarter, underperforming the S&P/ASX All Ordinaries Accumulation Index which fell 5.6%. The result was disappointing, particularly given the Fund's large cash position, and a lack of company specific news.

The best performing stocks for the quarter were 1300 Smiles and Real Estate Capital Partners USA Property Trust, while those that detracted from performance included a small position in Billabong and weak stock price performance from Photon Group (now known as Enero Group), QBE and Infigen Energy.

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

Old business models past their use-by date

The market has never been tougher for many blue-chips stocks. Toll Holdings, Qantas, Metcash, Billabong, Myer, Seven West Media and Ten all announced that this year's profit will fall well short of expectations and their share prices were punished accordingly. Mr Market isn't in the mood for equities at all, let alone ones that are going to disappoint.



Performance Data as at	30/06/2012
1 month	-2.86%
3 months	-5.81%
6 months	3.27%
1 year	0.97%
2 years (p.a.)	10.02%
3 years (p.a.)	14.13%
5 years (p.a.)	1.68%
Since Inception (p.a.)*	2.82%
Net Asset Value ($)	0.9574
Fund Size ($ million)	32.23

* Inception date of Fund 30/09/2004

Top 10 Portfolio Holdings	%
Cash	26.64%
QBE Insurance Group Ltd	11.05%
UXC Limited	8.64%
Infigen Energy	8.03%
Spark Infrastructure Group	7.08%
Ingenia Communities Group	6.72%
RNY Property Trust	6.61%
Real Estate Capital Partners USA	6.57%
1300 Smiles Limited	4.26%
Enero Group Ltd	4.10%
Other holdings	10.30%
TOTAL	100.00%

What's interesting is that these blue-chip stocks are not falling from glorious highs founded on unrealistic growth expectations. Far from it. Many were only trading on single digit price-to-earnings multiples before the downgrades. Most were businesses well entrenched in the corporate landscape as little as five years ago. And, for the most part, the damage looks permanent.

Business models that have survived and prospered for decades are being decimated by the internet, the high Aussie dollar or both.

Media conglomerate Fairfax is a perfect example. This company controlled newspaper distribution and profited very handsomely from it. The internet has fragmented those distribution networks and advertisers now have a plethora of mediums through which to reach their customers. Management is finally trying to jump on the bandwagon itself, announcing that the Fairfax of the future will be much different to the past. But that's not good news for shareholders – the Fairfax of the past was a very nice business.

Valuing this once predicable business is now pure speculation. Fairfax has some high quality digital businesses that, stand alone, could justify the $1.3 billion market capitalisation. The difficulty is, however, that the legacy businesses could prove costly to close down.

Recent boardroom agitation also detracts from the business. Hancock Prospecting apparently doesn't want to launch a takeover bid, but does want influence of some sort and intends to stick around. One gets the feeling Hancock's motives aren't purely profit based, and from the perspective of other shareholders they're probably best considered a net impediment.

Free to air television stations are in a similar situation, suffering from declining advertising revenues as their oligopoly on content distribution is attacked by new, unregulated media platforms. Even if free-to-air television has a place in Australia for another twenty years, it's impossible to see the businesses returning to their historical profitability.

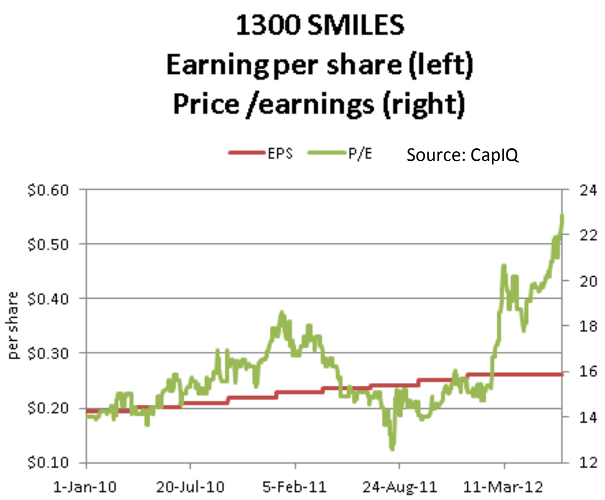
Investing is a dangerous game at the best of times, but when 100-year-old businesses are disappearing before our eyes, we need to tread especially carefully.

Add to this rapidly changing business landscape, a Chinese economy that is looking increasingly wobbly, and it's not easy to find a safe haven in the Australian stock market.

Intelligent Investor Funds remains very content with the current Portfolio, focused on US commercial property, insurance and genuinely defensive businesses. The Fund has benefited over the past 12 months from a lack of exposure to the rapidly changing industries and, whilst working hard to find opportunity amongst the wreckage elsewhere, the opportunities represented in today's Portfolio remain good value on an absolute and relative level.

Work does not equal profit in the funds management game

Two years ago Intelligent Investor Funds was in Townsville meeting with clients and arranged a side meeting with 1300 Smiles Managing Director Daryl Holmes. The Fund didn't own any stock at the time due to a complete lack of liquidity, but the Townsville-based dental operator looked promising; an owner manager, high historical return on equity, a track record of organic growth as well as the odd acquisition, mostly funded from internal cashflow, and minimal use of debt.



As always, there were things to worry about. It was (and still is) a one-man show. The overheads are absurdly low, including a $90,000 salary for Holmes himself, suggesting the margins won't be as high when it comes time to employ a professional management team. And, most importantly, it's a professional services business. The bargaining power, as can be observed with Photon and Vision Eye Institute for example, lies with the professional and not with the owners of the business.

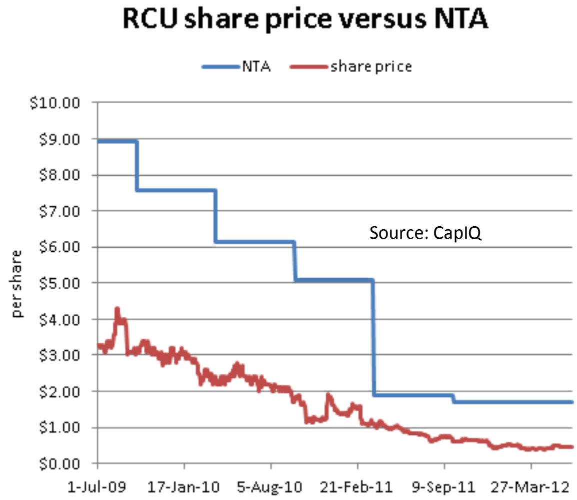
Still, at 15 times earnings and with many years of obvious growth ahead of it, the stock looked reasonably priced.

The meeting with Holmes went well and shortly afterwards the Manager managed to convince Holmes to sell some of his own stock at $2.70 per share, enabling the Fund to establish a meaningful position in the company.

The Manager speaks to Holmes on average twice a year, after the company announces its interim and full year results. Those conversations usually last about 20 minutes. The Manager also keeps an eye on the industry and 1300 Smiles' competitors, and has put some work into the Fund's participation in a later capital raising. All up, however, it's probably the stock in the Portfolio with the least work put into it.

1300 Smiles has increased its earnings per share 30% since the original purchase. On 29 June the share price closed at $5.99. The Fund has collected $0.31 in fully franked dividends along the way for a total return of 117% (43% per annum). It just goes to show that, in investing, sometimes the less work needed the better.

Lessons learned help minimise damage from RCU



Further evidence of the lack of correlation between work and results is provided by Real Estate Capital Partners USA Property Trust (RCU), on which the Manager has spent a disproportionate amount of time over the past 12 months, only to watch the value continue to dissipate.

Some mistakes in investing should never be repeated. Photon is a good example. The warning signs were all present when the Manager first bought the stock. They were, unfortunately, either missed or ignored to the detriment of the Fund. There have been lessons learned, and processes improved, that mean these mistakes should not be made again.

Then there are other mistakes that are an inevitable part of investing. With the information available at the time, a competent decision is made, but the investment decision still doesn't work out as hoped.

RCU falls into the latter category. Whilst the performance of this investment since it was purchased has been poor, the Manager isn't of the view that a mistake was made in the analysis at the time.

Since the original investment was made, the situation has been managed well. Sufficient capacity was kept to participate in a capital raising without overstretching the Fund (another lesson from Photon). The Manager has also stayed in close contact with other significant unitholders, which helped to stave off a low-ball takeover offer from fellow unitholder Greg Woolley, and Intelligent Investor Funds is now leading the charge to replace the manager with someone both better placed and better incentivised to realise the underlying value.

If the proposed change of management does eventuate, the Fund may end up making a small positive return on the overall investment. In any investing, but particularly the style of investing that the Manager practices, losses are inevitable. As the Photon and RCU case studies show, the way that losses are reacted to, managed and ultimately learned from, can have a significant impact on the Fund's returns.

Ingenia Jumps Out the Blocks

It was another busy quarter for Ingenia Communities' CEO Simon Owen. In May Ingenia, previously known as ING Real Estate Community Living Group, completed the sale of its last remaining US assets and finalised a separation from its former manager, ING, internalisation of management and a name change.

June wasn't much quieter. Ingenia announced the disposal of a 65-unit village in Victoria and a $2 million acquisition in the New South Wales Hunter Region, near an existing Ingenia village.

Transactions like this, though small, are an area where Owen can add a lot of value. Whilst for the major players in retirement living, like FKP and Lend Lease these transactions are too small to move the dial, for Ingenia they are an opportunity to build scale and earn attractive incremental returns. There is a lot of distressed selling in the retirement space, particularly at the smaller end of the market, and with 11.3 cents per unit coming back to Australia from the US asset sale, Ingenia has plenty of capacity to take advantage of it.

Wrap up

The current investment manager of the Special Situations Fund has been in this role for a little over two years now and would like to take this opportunity to thank the investors in the Fund for their support. In April, the Manager was able to meet with many of the advisers who elect to use the Fund on behalf of their clients and would like to also thank those who provided feedback, which was overwhelmingly positive.

Results from the last two years have been good without being outright spectacular; the Fund has overall returned 10.0% per annum versus the S&P/ASX All Ordinaries Accumulation Index's 2.1% per annum. As mentioned in the last quarterly report, the Manager is excited about the prospects of the current Portfolio and there are important milestones ahead that the Manager believes should result in part of this value being realised.

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

Kind regards,

Steve Johnson
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Intelligent Investor Funds