INTELLIGENT INVESTOR
WHOLESALE VALUE FUND

September Quarterly Report

30 September 2012

The All Ordinaries Accumulation Index had a strong September quarter, adding 8.2%. Your investment in the newly named Intelligent Investor Wholesale Value Fund (previously the Mosaic Special Situations Fund) did even better, with the unit price rising by 15.4%. An investment in the Fund has returned 23.9% in the past year and 15.6% per annum over the past two years, well in excess of the All Ordinaries Accumulation Index's 13.4% and 1.9% per annum returns respectively.

In this report we'll talk a little about the recent changes to the administration of the Fund, and review some of the results reported by our investment positions including our best performing stock for the quarter, information technology provider UXC.

Change of name, same approach

The Mosaic Special Situations Fund has recently been renamed the Intelligent Investor Wholesale Value Fund to reflect the retirement of Mosaic as the responsible entity. Macro Capital Limited has been appointed as the responsible entity for the Fund and is well placed to do so, having undertaken the administration of the Fund since its inception in September 2004.

The changes relate to the administration of the Fund and there won't be any changes to the investment approach. The new name better reflects the strategy of the Fund for the last two years under the current investment manager, which with has widened from a sole focus on special situations to a broader focus identifying value opportunities.

Apart from that, the only thing you will notice is that the monthly and quarterly reports will be published with the new name, and in a slightly different format.

UXC powered up

UXC reported net profit from continuing operations of $18m (compared to $4.5m last year) and the repayment of all 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.

These good results were delivered while facing flaccid economic conditions and delayed projects in most markets.

	Wholesale Value Fund	All Ords Accum Index
1 month return	3.38%	2.13%
3 month return	15.44%	8.20%
6 month return	8.75%	2.10%
1 year return	23.91%	13.36%
2 year return (p.a.)	15.62%	1.89%
Since inception* (p.a.)	4.58%	7.03%
Stocks in portfolio	14	
Portfolio size	$33.52m	*6-Sep-04

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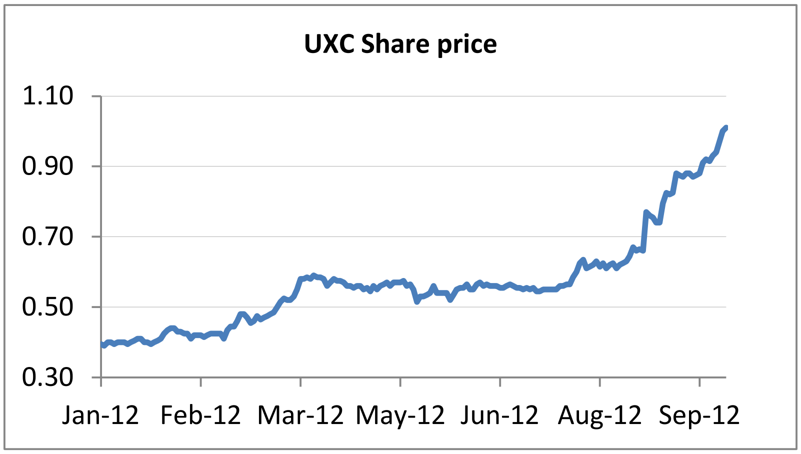


UXC's revenue of more than $560m generates only 3% net profit margins, which equates to a return of less than 10% on its equity capital. Such figures are paltry compared to some of its competitors and the results UXC has historically produced.

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.

QBE's loss of interest

Having put the outsized catastrophe losses of 2011 behind it, QBE Insurance Group reported net profit of US$760m for the first half of 2012 (the full year profit for 2011 was only US$704m). Unfortunately, hurricanes, cyclones and earthquakes aren't the only problems for the insurance industry at the moment.

The profit which QBE earns is a combination of the operating margin it earns on its insurance policies and the investment returns it earns on shareholder policyholder funds.

Interest rates in the United States, where QBE does the majority of its business, remain at sustained record lows. This hurts QBE's earnings because it reduces the returns QBE can earn on its investment portfolio. Much of the investment portfolio has to be invested in short term fixed interest products to ensure that they are available to pay claims when needed, and the returns available in these investments are heavily dependent on interest rate levels.

For QBE to produce the same profits while interest rates remain low, it needs to increase its insurance profitability. QBE has historically performed well in this area, with underwriting profits, a measure of insurance profitability, regularly above 10%. But whereas this number needs to be trending up, recently things have been trending the wrong way, as the table below shows.

	2012 1H	2011	2010	2009	2008	2007
Net earned premium (US$m)	7,359	15,359	11,362	9,446	11,087	10,210
Underwriting profit (US$m)	522	494	1,168	981	1,275	1,438
Underwriting margin %	7%	3%	10%	10%	11%	14%

The 2011 results are impacted by catastrophes, but whilst the 2012 half year results are an improvement they are not where they need to be. Fortunately we think there are better results to come. The whole industry is suffering from low interest rates, and prices in the long term are set to earn reasonable returns on shareholders capital. Returns on equity across the industry are currently very low, and we expect premiums will rise to make up the difference. QBE historically has earned amongst the best underwriting margins in the business and in our it view will continue to do so.

In the table below we've shown a basic valuation we've put together and compared to the current market capitalisation. Our conservative valuation is 35% more than the current share price.

$ bn	Current/market	Our valuation
Net earned premium	15.9	15.0
Insurance margin	7%	15%
Insurance profit	1.1	2.25
Value at 7 times pre-tax earnings		15.75
Shareholder funds	11.5	11.5
Discount		20%
Value at 20% discount		9.2
Total business value		24.95
Debt		(4.3)
Equity value	15.3	20.65

Of course there is no guarantee things will work out as we plan, insurance is after all a business that involves transacting in risk. But we continue to view it as representing excellent value. QBE shares closed the quarter at $12.95 and returned negative 0.2% for the quarter (including the dividend paid).

Swimming upstream at Tassal

The Fund has a small position in Tasmanian salmon farmer **Tassal** (TGR) which reported full year profit of $28m, down from $30m in the year prior. Tassal, by far the largest producer of salmon in Australia, sells its fish to three key markets: the domestic supermarkets (Woolworths, Coles and Aldi); the domestic wholesale market; and the global export market.

The export market is currently in a dreadful state due to global oversupply problems which are expected to remain for a number of years. But in the domestic supermarket and wholesale businesses, Tassal has some protection due to restrictions on the imports of fresh fish (fresh salmon cannot be imported to Australia unless the heads have been removed, which causes the fish to degrade quickly and makes the endeavour unviable).

Tassal has spent around $200m over the last five years expanding and upgrading its facilities, on which it currently earns modest returns (the overall return on equity was only 9.5% this year that was helped by the fact they don't yet pay tax). Tassal, however, is yet to see the full production benefits of its investments; it produced 23,000 tonnes of salmon in 2012 but this should increase to 30,000 tonnes in 2015.

Despite this Tassal sells at less than 10 times its operating net profit (operating net profit excludes the impact of changes to the value of live fish in the water) and a 23% discount to its tangible asset value. And as basically the sole-supplier of salmon (excluding canned, and limited competition in smoked products) to the supermarkets, we don't view it as being totally at the mercy of Coles and Woolworths, unlike **Goodman Fielder** for example. Tassal can at least hold some ground in negotiations.

Its strength in this area is also something of a weakness, however. As the largest player in the market Tassal needs to increase the domestic per capita consumption if it wants to sell more fish. It also needs to do this without decimating local prices.

Tassal is also a perennial consumer of capital. After a long period of heavy investment they should have new equipment and require less capital expenditure, but in 2012 they spent $30m on property plant and equipment, twice the depreciation expense of $15m. Add to this the risk of changes to the import restrictions, which could cause serious damage, and you can see why we haven't taken a large position.

Still, we think the capital consumption dynamic will reverse over the next decade and, even if it the current marketing campaign doesn't produce the expected profit growth, the increased production is not likely to cause to a *fall* in overall profits. If necessary Tassal can always divert excess product to the export market or curtail production. The current price looks to be good value, but it's a stock we'd likely sell down if it ever surpassed book value.

Tassal shares closed September at $1.35, returning 3% for the quarter including dividends.

Excellent returns will Spark tariff cuts

The Fund has owned Spark Infrastructure (SKI) since late 2010. Spark is a holding company that owns a 49% interest in three electricity business - South Australia's electricity distribution network (formerly known as ETSA), and CitiPower and PowerCor which own the power distribution networks for Melbourne and regional/rural Victoria respectively.

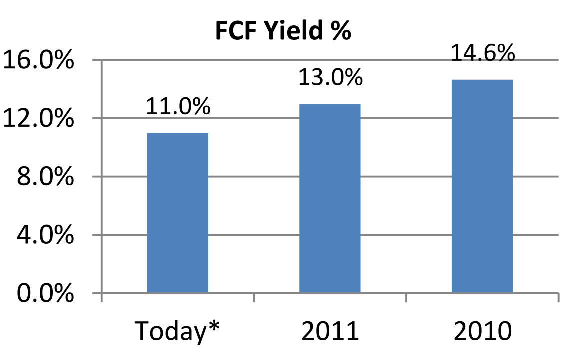
It's a very attractive business. Spark operates under a model where the Australian Energy Regulator (AER) controls the price it can charge for the use of its networks. On a five-yearly cycle Spark submits its estimated network demand, operating costs, and the required level of investment in the network. The regulator decides the appropriate return on capital, and then sets a tariff that will allow Spark to meet this return on capital. The tariff is set up front for the entire five-year period, which means the assumptions at the time are very important.

When the tariffs were last set in 2010, the AER set a return on assets of just under 10% for the South Australian and Victorian networks. This was justified by the troubled financial markets at the time, and the particularly high debt financing costs. In practice, Spark's cost of debt has been much lower than assumed and falling interest rates have made the stock even more appealing. When we first purchased Spark it had a free cash flow yield of nearly 15%. Better still it was only paying around 60% of its cash flow out as distributions, and the remaining 40% was being reinvested at these appealing rates of return.

Since the Fund's first purchase at $1.13 per security, then it has returned $0.29 in distributions, and the stock price has increased to $1.63, making for a total return of 70%. Part of the distribution is tax-deferred which means some tax can be delayed until a capital gains event occurs. It has provided fantastic returns for a very low-risk business.

Unfortunately it's no longer as attractive as it once was. The chart below shows how the free cash flow yield available to investors has diminished as the unit price has increased. Spark's utility assets are now mid-way through their 5 year regulatory periods, and we don't expect they'll benefit from lower borrowing costs than the regulator assumes again. The excellent returns being earned haven't gone unnoticed, indeed they have attracted some criticism in the media, and with interest rates falling, the AER's targeted return on capital will reduce meaningfully in the next 5 year period. All of this points to a reduction in the regulated tariffs.

Our eye is now moving closer to the exit. Including a distribution of 5.25 cents Spark returned 10.3% for the September quarter to close at $1.63.



*30 Sep 12 market price divided by 2011 free cash

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.

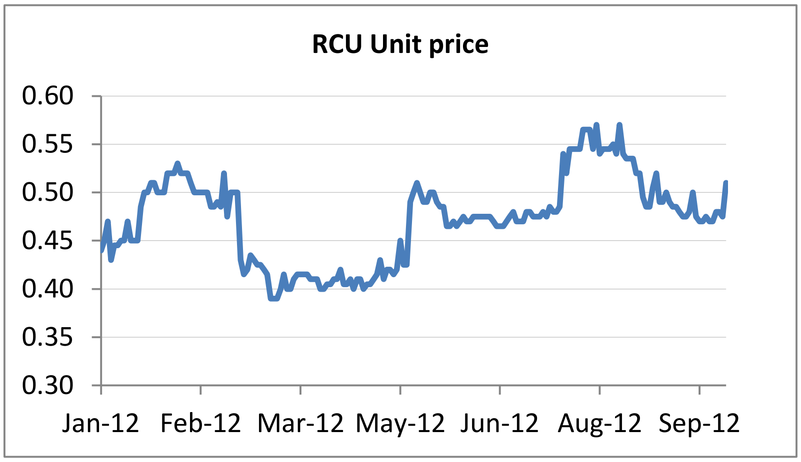
We'll leave the merits of the arguments to others but, for us, the important point is that the risk of the RET being modified or downgraded has increased. This will affect what buyers are willing to pay for Infigen's Renewable Energy Certificates (RECs).

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.

Real Estate Realignments

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 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.

Wrap up

The Fund has produced very pleasing results over the last two years and is now the top ranked in Morningstar's mid/small growth category over the past one and three years. We expect the returns to be volatile but our aim is to remain one of Australia's best performing funds over the long term.

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

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