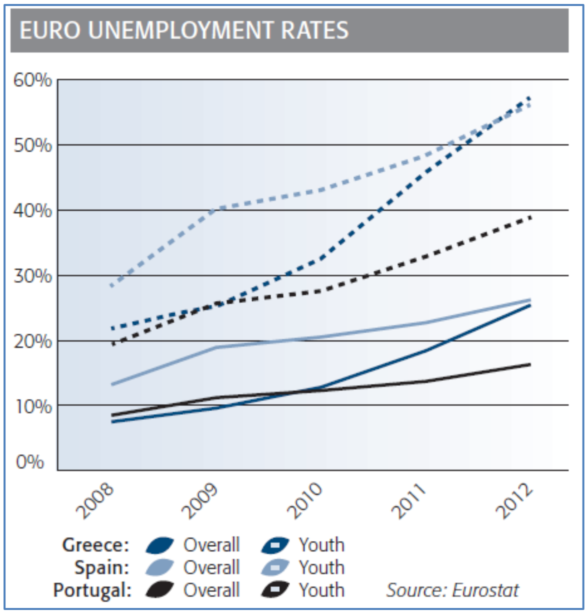
Bad Year, Stellar Results

Nothing particularly good happened in 2012. The economic Armageddon in southern European countries continued. Unemployment reached 25% in Greece and Spain. In both countries, more than one in two people aged 15–24 that want a job don't have one.

Greece agreed a 'debt swap' in March of last year – swapping an old €100 debt for a new €$30 debt is a default in anyone else's language – and won't be able to repay what's left. Portugal and Spain will likely need their own swap at some point and even France, one of the economic giants of the region, had its debt downgraded by ratings agency Standard and Poor's in October.



On the other side of the Atlantic, the US government did nothing to fix its long-term problems. The country racked up its fourth largest government deficit, as a percentage of GDP, since the Second World War. And, in August, political wrangling sent the US government absurdly close to defaulting on its outstanding debt as Republicans refused to raise the US$14 trillion ceiling on debt.

Closer to home, the Chinese economy slowed markedly. The 7.4% GDP growth registered for 2012 was the third lowest of the past 30 years and the structural problems with its growth – overreliance on debt-funded infrastructure spending – became publicly acknowledged by the IMF, the World Bank and the Chinese government.

Asia's other economic giant, Japan, confirmed itself a basket case. Another recession. Another year of piling up government debt, taking the total debt to GDP ratio to an eye-popping 230%. And another change of prime minister, the fifth in five years and back to Shinzo Abe, the guy who had no idea how to fix the country's problems when he last had a go at running it in 2007.

Despite all this, the world's stockmarkets had their best year since 2009. The US's S&P 500 returned 10.5%, including dividends. The London Stock Exchange's FTSE index rose 5.8%, the Euro Stoxx 50 rose 17% and the ASX All Ordinaries added 19%, also including dividends. Best of all, Greek Government Bonds returned investors 78% for the calendar year.

Before you write off financial markets as absurd and their participants as loonies, there are important lessons for all of us in 2012's very healthy returns.

Markets didn't rally because of what happened last year. They rallied because of what didn't happen. At the end of 2011, the general consensus was that the Eurozone was about to collapse and send the world economy into another cardiac arrest.

	Wholesale Value Fund	All Ords Accum Index
1 month return	-0.09%	3.43%
3 month return	0.02%	6.78%
6 month return	15.46%	15.54%
1 year return	19.25%	18.84%
2 year return (p.a.)	14.57%	2.59%
Since inception* (p.a.)	4.44%	7.66%
Stocks in portfolio	15	
Portfolio size	$28.69m	*6-Sep-04

	Unit price
NAV (ex)	$1.0951
Application	$1.0978
Redemption	$1.0924
Distribution	$0.0040
	Top holdings
INA	10.48%
RNY	10.17%
QBE	10.11%
IFN	9.02%
UXC	8.31%

Contact details

Responsible entity
Ph: (08) 9217 3100
Fax: (08) 9217 3111
Email: info@macrofunds.com.au

Investment manager
Ph: (02) 8305 6050
Fax: (02) 8305 6052
Email: admin@iifunds.com.au

Alan Kohler told his Eureka Report subscribers in his last weekend briefing of 2011 that he was significantly reducing his 'already reduced exposure to equities, possibly to zero' because of the high risk of 'another major panic sell-off on the market'.

Morgan Stanley's equity strategist predicted a precise 7.2% fall in the US market at the start of 2012. Apparently the 'US presidential election, slower growth in China and Europe's debt crisis' would deter investors.

Markets aren't driven by what actually happens. They are driven by what happens relative to the prevailing consensus view. Nothing particularly good happened in 2012. But some of the really bad stuff that had already been priced in failed to transpire and up markets went.

The key to happiness, my grandmother tells me, is low expectations. The key to high stockmarket returns would seem to be the same.

Resource rebound hurts Intelligent Investor Wholesale Value Fund

The final quarter of the year saw the Intelligent Investor Wholesale Value Fund meaningfully underperform the All Ords Accumulation Index. The unit price was still steady for the quarter but the index rose 6.8%. The Fund was up 19% for the year, matching the 19% rise for the index, so you won't see too many complaints about 2012. But one of the reasons for our outperformance in the first nine months was the complete lack of resources stocks in the portfolio. In the final part of the year much of this benefit was reversed with many mining stocks, particularly the larger capitalisation stocks, bouncing back strongly during the quarter.

Further twist in Real Estate saga

The end was seemingly near for long suffering unitholders of **Real Estate Capital Partners USA Property Trust** (RCU), with a vote being held to approve the sale of assets and wind-up of the trust. However in the lead up to the vote a new substantial holder associated with Melbourne's Liberman family emerged with 10.9% of the register. The new stake was accompanied with a reduction in holding by substantial unitholder Acorn who had indicated support of the proposed sale and wind-up.

This changed the balance of the register significantly; RCU's largest unitholder Greg Woolley has previously had dealings with Liberman family and their investment vehicle LJCB Investment Group. While nothing official was announced, the *Financial Review* reported that the Liberman family stake was likely to join Woolley in voting down the deal and it seems that sentiment was conveyed to the board.

RCU adjourned the meeting until 29 January while the board tries to negotiate a deal acceptable to Woolley as well as the other major unitholders. Despite all of the drama, RCU's unit price ended the quarter unchanged at $0.51.

Closer look at Vision Eye

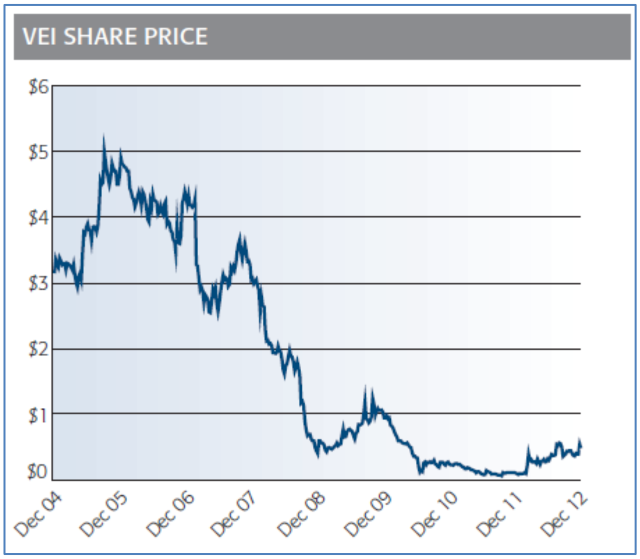
Vision Eye Institute (VEI) is a relatively new addition to the portfolio and a recently announced 2 for 3 capital raising has enabled us to build our position to the point we can discuss it in more detail.

Vision provides ophthalmic services, which is the branch of medicine relating to eye health and to the treatment of eye diseases such as cataracts and glaucoma. It operates a number of consulting clinics and surgery theatres, and employees a range of skilled health professionals including around 40 eye doctors known as ophthalmologists. The doctors are critical to the business because they are in short supply (the training is long and rigorous, currently around 1000 in Australia) and without them Vision has no service to provide.

$m	FY12	FY11	FY10	FY09	FY08	FY07
Revenue	111	107	108	114	111	99
EBITDA	27	24	29	36	38	34

The original idea was to corporatise an industry historically dominated by small private practices, like **1300SMILES** is doing in dentistry and **Primary Health Care** has done in medical centres.

Vision didn't do it as well as the aforementioned. It borrowed money to acquire practices at high upfront prices and banked some future profit into the upfront consideration. Instead of paying a market price for the practice and paying the ophthalmologists a market salary, Vision paid over the odds upfront and locked the eye doctors in at below market rates, with the lower salary showing up as increased profit over the typical 5-year term of a deal.



That, of course, is not sustainable business. At the end of the fixed agreements, the doctors demanded higher wages or left and Vision took heavy impairments as the 'earnings' it bought began to evaporate. Under a crippling debt burden, Vision's share price fell from a high of $5.00 to a low of $0.10 in early 2012.

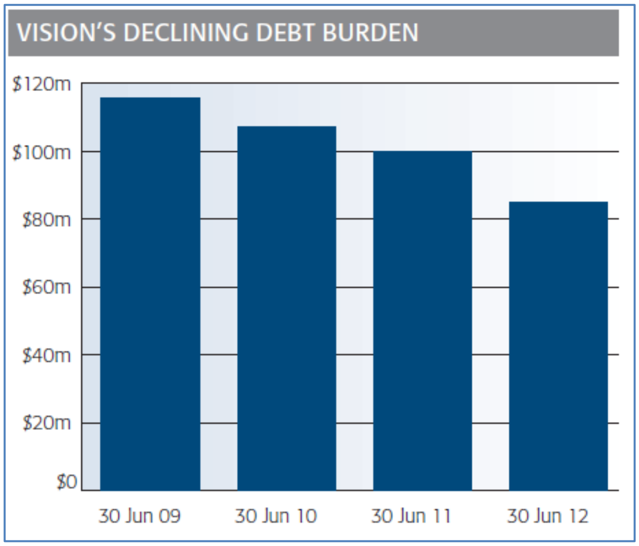
The banks didn't pull the pin, though, and there are good reasons why. The business has very little tangible worth and the employees are significant shareholders. If the banks wind it up, they will have no staff and no assets. So they have stuck with it, and Vision has made substantial progress switching to a sustainable business model. Under a new remuneration scheme, the doctors are being rewarded based on the operating margins of their work. This incentivises them to bring in more revenue, allows them to earn close to market remuneration and, combined with cost reductions, helped profitability rebound.

Current market capitalization	$79m
Expected net debt at 30 June 13	$50m
Enterprise value	$129m
2013 Underlying EBIT (f)	$20m
2013 Underlying Net Profit (f)	$12m
EV/EBIT (f)	6.5 x
P/E (f)	6.7 x

The business has been throwing off plenty of free cashflow and using it to repay debt, as you can see in the graph below, and the Fund has been building its stake as the business has stabilised and the debt reduced.

The share price had already appreciated significantly since the Fund's first purchase but by December 2012 it was still a cheap, reliable business burdened with too much debt. That problem has now been rectified. Vision announced a rights issue to existing shareholders and a placement raising a total of $26m, which will enable it to repay more debt and likely reinstate dividends. With $27m of surplus franking credits, it should be able to pay healthy fully franked dividends for many years to come.

Adjusted for the rights issue, Vision shares closed the quarter up 18% at $0.47 but, as you can see in the table above, at less than 7 times expected earnings, it still looks cheap and we expect some more healthy returns to come.



Chronic Dental Pain

On the topic of health care, Daryl Holmes the managing director of **1300 SMILES**, a dental provider which the Fund owns, released a provocative speech in November concerning the impact to the dental industry of a discontinued government funding plan. The plan, known as the Medicare Chronic Disease Dental Scheme (CDDS), provided Medicare benefits to people with chronic medical conditions whose oral health was impacting their general health.

It seems the CDDS was being exploited heavily by the industry which contributed to its demise. Holmes estimated that around 20% of dental industry revenue was derived directly from the scheme and predicted calamity will ensue, cheekily indicating that most dental practises in Australia will be worth less than zero once the scheme is removed and the costs of the personal exertion of dentists are properly accounted for.

This rhetoric suits Holmes's acquisition plans and we expect the risks have been overstated. But it will be interesting to see the impact on ONT's own results – the high multiple this business trades on doesn't leave much room for slip ups.

The regulatory changes didn't deter health insurer Bupa, which purchased a controlling stake in ONT's competitor, and the largest provider of dental services in Australia, Dental Corporation. The purchase values Dental Corporation in excess of 1.5 times turnover, where-as ONT currently trades in excess of 2.5 times turnover, although ONT is the much higher margin business.

China Buys Itself Some Time

Two years ago we had a thesis on China that was mildly contrarian. After finding a convincing argument in the writings of Michael Pettis of Peking University, we put a lot of work into understanding the nature of China's economic growth and the potential for its dependence on debt-funded infrastructure spending to cause significant problems.

That research – and the conclusion that the Chinese growth model needed to change dramatically - had a significant influence on our portfolio construction over the past two years. We always focus on stock selection first and foremost. But for the past year and a half we have been overlaying that individual stock selection with a preference for US dollar exposure and stocks not exposed to a vulnerable Australian economy. Hence the Fund's significant weightings to US commercial property trusts **RCU** and **RNY**, and defensive or countercyclical businesses like **1300 SMILES** and **QBE Insurance**.

The thesis is no longer mildly contrarian. You could say it's almost mainstream, based on the proliferation of articles in prominent Western media. Or genuinely mainstream, given it seems to be accepted as fact by Chinese policymakers.

Bloomberg posted an in-depth piece over the Christmas break clearly laying out the shortcomings of China's current growth model and the problems faced by incoming President Xi Jinping:

> *Bad debts of as much as 9 trillion yuan will impair banks' ability to lend and begin choking off investment later [in 2013], at a time when there are no alternative growth engines to drive the economy, said Adam Wolfe, senior Asia economist at Roubini Global Economics in London. Growth will slip below 7 percent in the final quarter and to about 5 percent in 2014 as debt drags on the economy, he said.*
>
> *"Faster growth now only pushes China closer to the inevitable sharp slowdown that will come when its debt-fueled, investment-led growth model collapses," Wolfe said.*

The theme is reiterated throughout the article and consistent with our own views: China's growth is extremely unbalanced and building more infrastructure is making the problem worse not better. It was a front-page feature article on Bloomberg. And the same theme is showing up in the Chinese newspapers. This from website Xinhua on an address Xi Jinping gave to a Beijing symposium:

> *"The growth that we achieve must be tangible, not exaggerated growth, and should be efficient, of good quality and sustainable," Xi said. He urged adherence to market-oriented reforms and well-conceived top-level reform designs.*

They say that by the time news is on the front-page of the paper, it's too late to do anything about it. Whatever 'they' say, it was certainly what we were thinking when assembling our portfolio 18 months ago. But it hasn't been the case this time around. The Intelligent investor Wholesale Fund has had a big year *despite* the China-protection overlay, not because of it.

The Australian dollar trades within a whisker of its all time highs. One of the best performing stocks in the portfolio – **UXC** – is the one most exposed to the domestic economy. And the iron ore price is back at US$150 a tonne.

The amount of optimism flooding back into commodity markets is baffling. 'The market hasn't yet priced in the amount of rebalancing China has yet to go through', Pettis said in a December newsletter, 'and so it has also not priced in either the full reduction in hard commodity demand or the extent of rebalancing on China's export competitiveness'. Those hard commodity prices are up more than 20% since.

China's problems seem to be front page news, but the commodity bulls aren't listening.

Fortunately we don't short-sell, so time cannot be our undoing. Whether the adjustment happens in 2013 or 2014, whether it's forced on the economy by a debt crisis or expertly managed by the Chinese bureaucrats, we're in for a long, sustained commodity price slump in the foreseeable future.

And for such an environment, the Intelligent Investor Wholesale Fund will remain prepared.

Kind regards,

Steve Johnson
Chief Investment Officer
Intelligent Investor Funds