INTELLIGENT INVESTOR WHOLESALE VALUE FUND

MARCH QUARTERLY REPORT 2013

RESPONSIBLE ENTITY

Macro Funds
P. 08 9217 3100
F. 08 9217 3111
info@macrofunds.com.au

INVESTMENT MANAGER

Intelligent Investor Funds
P. 02 8305 6050
F. 02 8305 6052
admin@iifunds.com.au

DISCLAIMER

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Boom Times for Global Markets

PERFORMANCE SUMMARY

	WHOLESALE VALUE FUND	ALL ORDS ACCUM INDEX
1 MONTH RETURN	3.27%	–2.24%
3 MONTH RETURN	15.87%	8.04%
6 MONTH RETURN	15.89%	15.37%
1 YEAR RETURN	26.03%	17.80%
2 YEAR RETURN (P.A.)	19.74%	5.12%
SINCE INCEPTION* (P.A.)	6.13%	8.41%
STOCKS IN PORTFOLIO		**16**
PORTFOLIO SIZE		**$31.9m**

PORTFOLIO DETAILS

UNIT PRICE	
NAV (EX)	$1.2667
APPLICATION	$1.2699
REDEMPTION	$1.2635
DISTRIBUTION	$0.0022
TOP HOLDINGS	
RNY PROPERTY TRUST	11.91%
VISION EYE INSTITUTE	8.78%
INFIGEN ENERGY	8.14%
QBE INSURANCE	7.08%
INGENIA COMMUNITIES GROUP	6.91%

The March 2013 quarter saw shares increase in price across the globe. The MSCI World Index increased 9.2%, led by the US S&P 500 increasing 10.0%. Japan's Nikkei increased 19.3%, although this was offset by the Yen's 8.2% fall against the US Dollar for anyone investing unhedged, and even Europe's markets increased over the quarter despite a resurgence of concern for the future of the Eurozone as a whole. At home the All Ordinaries Accumulation Index increased 8.0% during the quarter.

Against that backdrop, we were very happy with the Intelligent Investor Wholesale Value Fund's 15.9% increase in unit price in the March quarter. For value investors like us booming share markets are unfortunately a source of anguish rather than optimism, because attractive stocks become progressively more difficult to find. Still, we have some reasons to be cheerful, the world's major economies still look structurally unsound, and an opportunity-enriching crisis could come from any of a number of the world's trouble spots.

The Inevitable Euro breakup

We maintain our view that a breakup of the Eurozone is the only long-term solution to that region's troubles. Put simply, the Euro crisis is a relative-productivity crisis. The Northern European countries can produce goods more efficiently that the Southern European countries and that gap is widening. Under a system of fixed exchange rates, the more productive countries end up with all the jobs and all of the money. The Spanish unemployment rate continues to rise while it falls in Germany (now 27% and 5.4% respectively).

The only fixes are politically-impossible real wage decreases in Spain, politically impossible fiscal transfers from Germany or an exit from the Euro so that the exchange rate can be adjusted to bridge the gap (while this also represents a real wage decline for the Spaniards, it is much less noticeable).

In Cyprus, we have been given a glimpse of how an exit might unfold: bank closures, border controls and currency redenomination (or revaluation for Cyprus's depositors). The whole unfortunate saga could drag on for another decade, but there seems only one genuine solution.

China Worries Closer to Home

Since Intelligent Investor Funds opened its doors in October 2009, we have not owned one mining or mining services company. True, it is not an area of deep expertise for us. But digging stuff out of the ground and putting it on a ship is not the world's most complicated business. The reason we haven't owned mining shares is because we are deeply concerned about the prospects of a significant slowdown in demand from China.

We have written a number of detailed pieces on China's problems over the past few years. It is an economy far too dependent on debt funded infrastructure spending for its growth. That infrastructure is—not surprisingly given it is being allocated by bureaucrats with vested interests—not generating enough return to service the debt that was used to build it, resulting in debt growing unsustainably faster than the overall economy.

An unsustainable growth model can be sustained a long time in a command and control economy. In 2011 we thought it could be a number of years before the consequences manifested themselves. In 2012, the Chinese economy slowed and commodity prices plummeted, only for the authorities to stimulate again using the most effective (some would say only) tool available to them—infrastructure spending.

That gave the China bulls ammunition for their argument that the Chinese government will do whatever it takes to keep economic growth high, and with that growth maintain the government's own legitimacy. But what was most surprising was how little impact the stimulus provided. GDP growth in China was 7.8% last year, one of the slowest growth rates in the past 30 years. Many economists believe the official statistic substantially overstated reality. What would it look like without a stimulus?

Remember that 'fixed asset investment', or infrastructure spend, represents approximately half of GDP in China. Even to maintain spending in 2013, they need to build the same extraordinary number of roads, airports, ghost cities and train lines. And that would represent zero growth for that huge component of GDP. Even if consumption grew at 15% for the year, overall growth would still be less than 5%.

An Adjustment That Will Take Place

Everyone from new President Xi Jinping down knows that the economy needs to rebalance away from its dependence on debt-funded infrastructure and towards consumption, but no one has yet explained how that can happen without a dramatic slowdown in growth.

Michael Pettis, Finance Professor at Guanghua School of Management at Peking University, reckons the overall growth rate will be 4% or less for the next decade as this rebalancing takes place:

"More than ever I am convinced that if China is to rebalance its economy towards a more sustainable growth model—and rebalance it must if it is to avoid a financial crisis—its GDP growth rate will drop sharply with its average annual growth over the next decade unlikely to exceed 3–4%. My forecast is still an outlier, but over the past six months even the optimists no longer see it as unthinkable and more and more analysts are drawing their own projections closer to mine."

As Pettis points out, he is no longer a lone wolf suggesting a dramatic slowdown in the Chinese economy. And as anyone who owns commodity or mining services stocks will tell you, the thesis is becoming something of a consensus view amongst stock market participants. But the penny still doesn't seem to have dropped on the wider implications for the Australian economy.

While commodity-related shares have fallen significantly, **CBA**, Australia's largest bank, is trading at an all time high and has returned 44% in the past 12 months (including dividends). CBA is the country's best managed bank, and banking is a wonderful business in this oligopoly-friendly country, but it seems incongruous that Mr Market is worried about a dramatic slowdown in China and not worried about highly leveraged residential propertylenders in Australia, one of China's most dependent trading partners.

You could argue we were too early with our negativity on China. You could even argue it is too early today. But while some like to play the game of standing atop an active volcano forecasting that it won't erupt for another 18 months, that's not our game. We like living on volcano-free islands, or sifting through the ashes of those that have already erupted. We've been able to make perfectly good money over the past three years without any exposure to China, and don't see any reason why that won't continue to be the case. When the volcano erupts, our aim is to be as far away as possible.

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Price and Value Rise at RNY

The Fund first bought units in **RNY** in May 2010. At the time this ASX listed trust owned a 75% interest in 25 office buildings in the New York Tri State area. The December 2009 book value (on a 100% basis) was US$500m, against which there was some US$364m of debt—a loan-to-value ratio (LVR) of 73%. While the market cap of $31m looked interesting relative to RNY's $100m share of the equity, what made the investment case compelling was the structure of the debt. The 25 properties were split into four pools, each with their own limited recourse debt. Of the US$145m of equity, US$104m was in two relatively conservatively financed tranches (LVRs of 50–60%) and cash.

Yes, we were likely to lose the properties in the two highly leveraged pools but the remainder was worth more than double the unit price at the time. And there were some interesting options on the upside. The highly geared properties were still controlled by RNY.

The book values themselves—arrived at using an average capitalisation rate of 8.2%—looked attractive in a low interest rate environment. And the USD exposure looked appealing to us Australian investors worried about our local currency's exposure to an unbalanced China.

All options that could be worth nothing, of course. But a free option is a good option. Fast forward three years and the investment opportunity is perhaps more attractive than it was. Granted the unit price has doubled ($0.24 at the end of the March quarter), but one of those options has turned out to be very valuable and the other two are looking increasingly important.

Dormant for the past five years, the market for suburban office properties could be about to come to life. A cap rate of 6.5% applied to RNY's assets—a margin over A-grade assets more in line with historical averages, would imply a net asset value for RNY of roughly US$0.75 per unit.

And then there's the income side of the equation. Only 81% occupied at the moment, RNY's portfolio of offices has plenty of space in which to fit new or expanding tenants. Management tells us that demand is still weak but that the 'velocity' of enquiries has picked up substantially. Lease rates are not increasing, but the level of incentives offered to prospective tenants has reduced. A sustained improvement is needed in the US employment market for any upside to arise here but, given our five year window of opportunity until the debt facilities mature, the prospects would seem reasonable that the cashflow generated can increase from today's levels. A 90% occupancy rate, assuming the same average lease rate as today, would imply a 10% increase in net operating income and a commensurate increase in valuations.

TABLE 3: RNY'S UPSIDE POTENTIAL

	CURRENT	REFI POOL B	CAP RATE CONTRACTION	10% OCCUPANCY INCREASE
CAP RATE (%)	8.20	8.20	6.50	6.50
PROPERTY REVENUE (US$000s)	68,226	68,226	68,226	75,049
PROPERTY EXPENSES AND TAXES (US$000s)	31,999	31,999	31,999	35,199
NET OPERATING INCOME (US$000s)	36,227	36,227	36,227	39,850
PROPERTY ASSETS (US$000s)	459,600	459,600	557,338	613,072
CASH (US$000s)	13,900	13,900	13,900	13,900
DEBT (US$000s)	323,169	308,169	308,169	308,169
NET ASSET BACKING (US$000s)	150,331	165,331	263,069	318,803
NET ASSET BACKING PER UNIT (75% OWNERSHIP)	0.43	0.47	0.75	0.91

"We wouldn't be selling RNY even if it was trading at NTA. The asset class itself looks attractive, and we envisage the prospect of meaningful gains in the market value of RNY's assets.

None of this is a fait accompli. Interest rates can, believe it or not, go up. And the world economy is hardly firing on all cylinders. Europe and China are the US's two most important trading partners. Meltdowns in either economy threaten the US's tepid recovery. RNY also has its own problems. Leases expiring this calendar year equate to 15% of floor space and 21% of income. Arrow Electronics, the Trust's largest tenant, has already indicated it will not be renewing its lease when the 31 December expiry rolls around (although the Arrow property is in the pool currently being restructured, which will limit its impact on the overall valuation). And sprucing up unoccupied office space so it can be leased is an exercise that requires capital—something RNY does not have in abundance.

There is downside to the current book values, but we think it much less likely than upside. And, in any case, the discount to book value implied by today's unit price gives us a significant margin of safety. As reflected in the largest weighting we have ever had to one stock, it is our favourite opportunity at the moment by a significant margin.

Tassal Fished Out

We discussed the Fund's small position in Tasmanian salmon farmer **Tassal** in the September quarterly report last year. Back then Tassal was selling at a 23% discount to tangible book value, and despite concerns that the company seemed to perpetually be in need of capital to grow its operations, we viewed the shares as quite an attractive proposition. Tassal has some interesting monopolistic characteristics. Due to restrictive import rules, the company is virtually the exclusive supplier of fresh salmon to the domestic supermarkets. Tassal had also been forecasting sizeable ramp-up in production from its farms as years of investment came to fruition, which should drive profits higher.

TASSAL PERFORMANCE SUMMARY

AVERAGE PURCHASE PRICE	$1.63
DIVIDENDS	$0.16
AVERAGE SALE PRICE	$1.99
PROFIT	32%

Since then the price has rallied 48% to command a significant premium to book value. Tassal shares now trade at 12.5 times operating net income after tax, which is a profit measure that doesn't include the revaluation of biological assets. This looks to us to be fully valued, particularly because Tassal continues to incur capital expenditure significantly in excess of its depreciation, despite having a vast stock of new plant and equipment after years of huge capital investment. Total production has also been poor; in the six months to 31 December 12, production was down 3% on the prior period, with operating revenue only increasing due to higher prices.

With the share price so strong we've used the opportunity to sell out of the position at quite a healthy profit as shown in the table below. We'll apply the proceeds to companies available at a larger margin of safety.

Finding Redemption in RCU

Continuing the good news this quarter, we managed to recover our investment from **Real Estate Capital Partners USA Property Trust** (RCU) at a meaningful premium to recent market prices.

RCU sold its remaining valuable US office property assets in January and has been a cash box since. Fellow unitholders Greg Woolley and Joshua Liberman blocked an initial proposal to distribute the cash to unitholders and by February were pushing for a change of strategic direction for the trust. The changes included replacing the Responsible Entity, appointing Woolley to the board of the new responsible entity, changing the investment strategy to include concentrated private equity style investments, capital raisings and no prospect of distributions. An unappealing prospect for the rest of us to say the least.

We found a clause in the Trust's constitution that implied unitholders could request redemption of their units and that the RCU Board should consider redemption requests if the trust was liquid. The day after the distribution was voted down we submitted our redemption request, and proposed to the Board that all unitholders not wanting to follow Woolley and Liberman should be permitted to exit while the trust held cash. It became a race against time once the RCU board agreed, subject to obtaining a court ruling, that the redemption was legal and permitted by the ASX listing rules. The judge's decision, arrived at after some vociferous opposition from the Woolley lawyers, was handed down just a few days prior to a unitholder meeting that was almost certain to result in a new board—one dramatically less sympathetic to our cause—being appointed.

After 18 months of scrapping, legal fees, value destruction and fee leakage, our final investment losses on RCU are shown in the table below. It is an unfortunate outcome, especially given the portfolio was up 44% during the same period, but one that could have been a lot worse had it not been for our unitholder activism.

RCU PERFORMANCE SUMMARY

AVERAGE PURCHASE PRICE	$0.7492
REDEMPTION PRICE	$0.5685
LOSS	(24.1%)

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Enero Needs More Than a New Name

Regular readers of our reports will know we've had an investment for some time in marketing and advertising business **Enero Group** (previously Photon Group) which has been a serial disappointment. In February Enero reported another lousy set of results, again showing a serious decline in like-for-like sales from the prior period.

Operating earnings before interest and tax (EBITDA) was even worse, down 70% on the prior period. This caps off an unenviable four year record of declining results shown in the chart below. The only positive thing to be said is that Enero managed to retain most of its cash balance.

So where to from here? Enero is a business that is conceptually simple but difficult to value with confidence. The business model is straight forward; the major expense is staff wages and Enero simply needs to book them out at a margin above wages and overheads. If we can estimate sustainable revenue and margins then we can value the business without much fuss.

Unfortunately this is challenging where the revenue is eroding badly and the margins are anaemic. After years of decline we need to decide whether the business will continue to decay, or whether it might revert or at least stabilise.

The signs superficially aren't great. Enero has been through a huge restructure which saps morale. Many key bread-winners have taken a hit to their earn-out payments and others have left taking their earning potential with them. This business has pro-cyclical tendencies and bad news can compound quickly.

But Enero's consolidated results mask the fact that some agencies are loss making and others performing quite well. Whilst the company doesn't provide results for specific agencies, we're almost certain that global marketing agency Naked Communications is losing money and advertising consultancy BMF is also clearly struggling. The other major agencies—public relation firms Hotwire and Frank PR and research house The Leading Edge—are performing quite well. Any of these three businesses could be worth more than the current $32m market capitalisation on their own. Then there's $7.5m of excess cash,

"If Naked and BMF can be returned to their former glory, the share price will be multiples of what it is today.

website owner Dark Blue Sea (once listed on the ASX itself) and a collection of smaller, less valuable businesses.

We're confident that if Enero were to be broken up and sold, shareholders would realise substantially more than the current share price. We're not pushing management to consider that path just yet. If Naked and BMF can be returned to their former glory, the share price will be multiples of what it is today. Yes, that's a big if. But it's another of those free options we like, and for that we're prepared to give them some time.

As always, please don't hesitate to contact us on 02 8305 6050 if you have any questions about the Fund or our investments.

Kind regards,

Steve Johnson
Chief Investment Officer
Intelligent Investor Funds