INVESTSMART

30 September 2018

Intelligent Investor Equity Income Portfolio

QUARTERLY UPDATE

This quarter Nathan discusses:

- What brought him back to InvestSMART
- What you should expect from the Portfolio
- Some of the Portfolio's current holdings

Intelligent Investor Equity Income Portfolio

PERFORMANCE TO 30 SEPT 2018	1 mth	3 mths	6 mths	1 yr	2 yrs	3 yrs	Since Inception (p.a.)
Intelligent Investor Equity Income (%)	-0.89	-0.37	5.95	7.37	6.91	11.94	11.23
S&P ASX 200 Accumulation Index (%)	-1.26	1.53	10.13	13.97	11.58	12.11	8.81
Excess to Benchmark (%)	0.37	-1.90	-4.18	-6.59	-4.68	-0.17	2.41

Key points

- **Recent underperformance to be expected**
- **Trade Me paid a special dividend**
- **Increased international exposure**

The Portfolio fell 0.4% during the quarter ending 30 September, compared to a 1.5% gain by the ASX200 Accumulation Index. It was a similar story over the past year, with the Portfolio's 7.4% return trailing the index's 14.0% return.

Defensive portfolios typically underperform late in the business cycle. We're comfortable owning a portfolio of businesses that have proven themselves through business cycles before, provided weaker relative returns in the short run means higher returns once valuations for higher growth stocks return to earth.

During the quarter New Zealand online classifieds business **Trade Me** justified its position as the Portfolio's largest holding. The share price increased 13% after announcing an encouraging annual result following a couple of years of heavy investment that have pressured margins and profits. The stock's total return was 20% once a special dividend was included.

Despite minimal increases in property, job and car listings, classifieds revenue increased 12% as customers spent more on premium ads. Though not before time, the company is following the hugely successful premium ad strategy used by **REA Group**. Customers will willingly pay more for premium ads provided it produces profitable sales. Trade Me is only starting to flex its pricing power muscles.

Newscorp, which is a cheap, indirect way to own REA Group amongst other assets, was the quarter's worst performer, falling 12%. The old-style media businesses that rely on advertising continue to struggle, but newer online housing classifieds businesses such as REA Group and Move, and venerable mastheads like *The Wall Street Journal*, which has successfully moved online, are growing nicely.

"DURING THE QUARTER NEW ZEALAND ONLINE CLASSIFIEDS BUSINESS TRADE ME JUSTIFIED ITS POSITION AS THE PORTFOLIO'S LARGEST HOLDING."

Education provider **Navitas** was the only stock sold during the quarter. The company's trend of falling earnings over the past four years was supposed to be rescued by the company's big US push, which is showing increasing signs of failure.

Spin-offs

Spin-offs occur when a company demerges a business division to be listed independently. Recent examples include **Wesfarmers** spinning off Coles and **BHP**'s spin-off of South 32.

Historically they've been wonderful investments, as the smaller stock often gets sold off heavily, as most investors are either forced to sell it due to liquidity issues or are only interested in owning the larger parent company. As newly motivated management releases the value in the business the returns can be astounding.

A similar situation is unfolding at **Unibail-Rodamco-Westfield**. With French property owner Unibail-Rodamco's acquisition of Westfield, the Westfield stock has been replaced by the Unibail Chess Depositary Interest (CDI).

Technical issues, such as French transaction taxes, and research houses not wanting to cover a French business, means Australians have been dumping their shares for reasons that have nothing to do with their value – just like the spin-off example.

We believe this is a mistake. With a starting 6.4% distribution yield; a gold standard property portfolio that provides our portfolio with valuable overseas diversification; and one of the industry's best management teams; we took advantage of the selling and added it to the portfolio.

We also added **Clydesdale Bank** to the portfolio, which was spun off from former parent **National Australia Bank** (NAB) a couple of years back. Clydesdale recently acquired Virgin Money, creating the UK's sixth largest bank. The stuffy old Clydesdale brand will be replaced by the Virgin Money brand, which has more appeal to younger customers.

Clydesdale Bank is trading around tangible book value (TBV) and is run by one of the most highly rated management teams in the UK. If management hits its 2019 aim of double-digit return on equity, then there is room for the multiple to expand over time if higher interest rates fatten profit margins, or as profits grow from a combination of attracting new customers and cutting costs. The company could also eventually become a takeover target, unlike the five major UK banks.

Hayne inquiry

On a final note, Commissioner Hayne recently submitted his 1,000-page report following the Financial Services Royal Commission. Instead of prescribing solutions, Hayne acknowledged a litany of issues and asked vested interests for their potential solutions, which will be a combination of fines, changed business practices and regulation.

Since the report was released, we've increased our holdings in **Commonwealth Bank** and **Westpac**, whose share price recently hit a five-year low. For the first time in many years bank valuations are starting to compensate for a tougher decade ahead as credit growth slows.

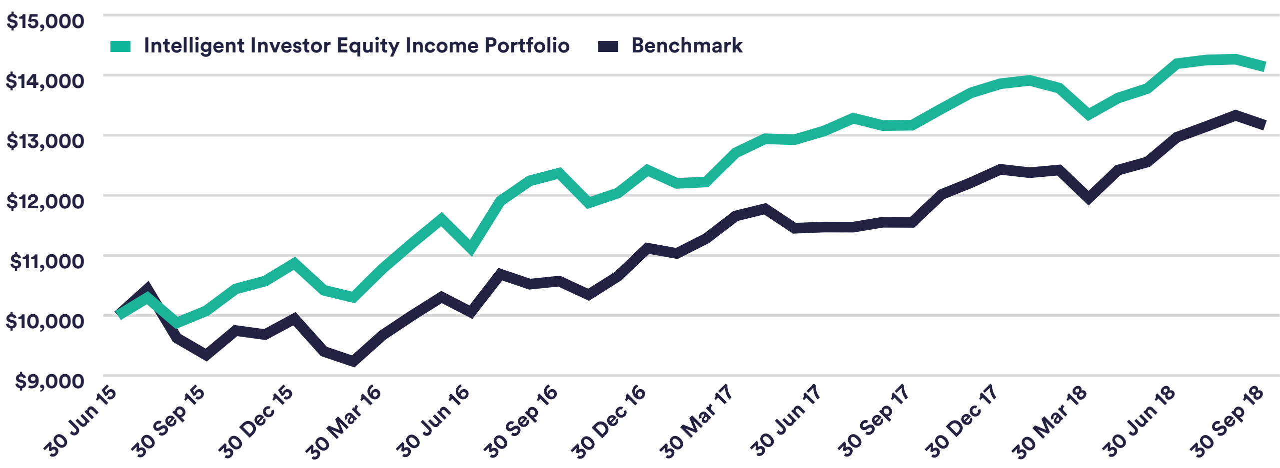
This scenario was unavoidable, which explains why for so many years we've been very underweight the big banks. We also preferred Commonwealth, Westpac and **Macquarie Group** (which we don't currently own due to its high valuation) to **ANZ Bank** and NAB. The two-pronged strategy has worked well.

Commonwealth and Westpac have the largest exposure to mortgages, but as a combination they also have less relative exposure to riskier investment loans and business loans than ANZ and NAB. As the two largest Australian banks, they also have more wiggle room on loan and deposit pricing to help increase profits and raise capital if needed.

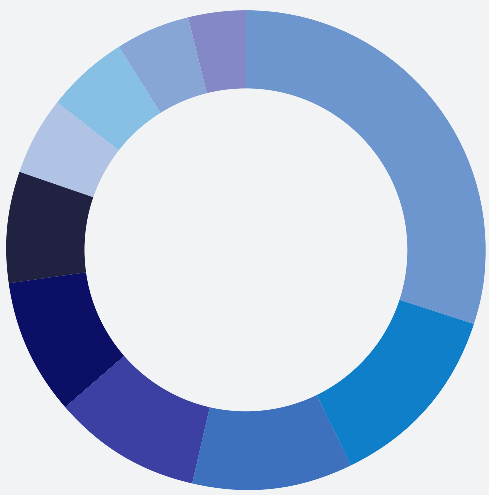
"THE STUFFY OLD CLYDESDALE BRAND WILL BE REPLACED BY THE VIRGIN MONEY BRAND, WHICH HAS MORE APPEAL TO YOUNGER CUSTOMERS."

Lastly, we prefer the big four to the regional banks even though they're statistically cheaper, as they'll be more likely to receive financial assistance in a crisis. History shows it's usually better to pay a premium for quality during periods of elevated asset prices.

PERFORMANCE OF $10,000 SINCE INCEPTION



Portfolio breakdown



Financials	30%
Real estate	13%
Consumer discretionary	11%
Industrials	10%
Consumer staple	9%
Cash	8%
Energy	5%
Health care	5%
Materials	5%
Communication services	4%

TOP 10 HOLDINGS

SECURITY	WEIGHTINGS (%)
Trade Me	7.56
Woodside Petroleum	5.37
Seek	5.14
Wesfarmers	5.12
BHP Billiton	5.06
ASX	4.96
Commonwealth Bank of Australia	4.81
ALE Property Group	4.44
Sydney Airport	4.40
Scentre Group	4.38

InvestSMART Group Limited (INV) was founded in 1999 and is a leading Australian digital wealth advisor which has over 32,000 clients and over $1.4B in assets under advice. InvestSMART's goal is to provide quality advice and low cost investment products, free from the jargon and complexities so commonly found in the finance industry, to help you meet your financial aspirations.

The Portfolio

The Intelligent Investor Equity Income Portfolio is a concentrated portfolio of 10 - 35 Australian-listed stocks, focused on generating income while still achieving capital growth. The Portfolio focuses on large, mature businesses with entrenched competitive advantages, and dominant smaller companies we believe will produce strong cash flows to support dividends in the future.

Investment Objective

The Portfolio's investment objective is to produce a sustainable income yield above that of the S&P/ASX 200 Accumulation Index, with quarterly distributions.

Why the Intelligent Investor Equity Income Portfolio?

Australia has one of the world's most stable and highest returning share markets and is often considered a safe-haven by investors. As contrarian value investors, producing safe and attractive returns in the stock market means sticking to a disciplined and repeatable process. We do this by patiently waiting for overreactions in share prices, so we can buy at a large discount to our estimate of intrinsic value.

Who manages the investment?

Nathan Bell, has over 20 years of experience in portfolio management and research and is supported by our Investment Committee, chaired by Paul Clitheroe. Before returning to InvestSMART in 2018 as Portfolio Manager, he was the Research Director at our sister company, Intelligent Investor for nine years which included over four years as Portfolio Manager and being a member of the Compliance Committee. Nathan has a Bachelor of Economics and subsequently completed a Graduate Diploma of Applied Investment and Management. Nathan is a CFA Charterholder.

Key Details

INVESTMENT CATEGORY
A portfolio of individually-selected Australian Equities

INVESTMENT STYLE
Active Stock Selection, Value Investing Approach

BENCHMARK
S&P/ASX 200 Accumulation Index

INCEPTION DATE
1 July 2015

SUGGESTED INVESTMENT TIMEFRAME
5+ years

NUMBER OF SECURITIES / STOCKS
10 - 35 stocks

MANAGEMENT FEE
0.60% - 0.97% p.a.

PERFORMANCE FEE
N/A

MINIMUM INITIAL INVESTMENT
$25,000

STRUCTURE
Separately Managed Account (SMA)

SUITABILITY
Suitable for investors who are seeking domestic equity exposure with a growing stream of dividends to offset inflation.

PORTFOLIO MANAGER
Nathan Bell, CFA

Performance numbers exclude franking, after investment and admin fees: excludes brokerage. All yield figures include franking. All performance figures, graphs and diagrams are as at 30 September 2018.

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