

Intelligent Investor Equity Income Portfolio & ASX:INIF

Monthly Update - November 2018

PERFORMANCE TO 30 NOV 2018	1 mth	3 mths	6 mths	1 yr	2 yrs (p.a.)	3 yrs (p.a.)	Since Inception (p.a.)
Intelligent Investor Equity Income	-0.66%	-8.76%	-5.53%	-5.03%	3.98%	7.17%	8.01%
InvestSMART Australian Equity Income Fund (Managed Fund)(ASX:INIF)	-0.67%	-8.40%	-	-	-	-	-
S&P/ASX 200 Accumulation Index	-2.21%	-9.28%	-3.67%	-0.96%	6.54%	7.69%	5.71%
Excess to Benchmark*	1.55%	0.52%	-1.86%	-4.07%	-2.56%	-0.52%	2.30%

Key points

- **Coles spin off**
- **A bid for Trade Me**
- **Clydesdale's falling margins**

Spin-Offs have historically delivered outstanding returns, as I discussed in the recent webinar [How to find value](#). Magic can happen when a smart, appropriately incentivised management team, freed from a bureaucratic parent company, can finally make the investments their business needs.

In contrast, the **Coles** spin-off from **Wesfarmers** isn't necessarily poised for outsized returns. First, Wesfarmers' share price increased instantly following the spin-off announcement, so expectations were high before Coles' separate listing.

Second, Coles hasn't been mismanaged or starved of capital, and is well covered by the investing community i.e. it's unlikely to be mispriced and, due to its large size, large funds won't be selling due to illiquidity (a common reason why spin-offs become grossly undervalued).

Furthermore, Coles is carrying a healthy amount of debt in addition to its leases, while simultaneously promising large investments and to pay out nearly all profits as dividends. Should profits come under pressure, perhaps due to increased competition from Amazon or other new and existing players, the dividend may come under pressure and debt could increase.

*Excess to Benchmark refers to the Intelligent Investor Equity Income Portfolio

A forecast price-to-earnings ratio (PER) of ~16 doesn't provide a large margin of safety, nor does Wesfarmers' PER of closer to 18, given its large retail businesses could suffer severely in a slowing economy.

For now, we've kept our small holdings, but prefer our larger holding in rival **Woolworths**, which has already made similarly large investments in its supply chain and is capable of returning more money to shareholders.

The Good

Trade Me recently received a non-binding bid from UK private equity firm Apax Partners priced at NZ\$6.40 (\$6.05),

“COLES HASN'T BEEN MISMANAGED OR STARVED OF CAPITAL, AND IS WELL COVERED BY THE INVESTING COMMUNITY I.E. IT'S UNLIKELY TO BE MISPRICED”

which was followed by interest from US private equity group Hellman & Friedman. A deal is far from guaranteed, so we reduced our position from 10% to 7% to reduce risk and capture some upside from the increase in the share price since the announcement.

Given the amount of investment the company has made in recent years at the expense of short-term profits, we believe the deal undervalues the company and that it would be a damning admission from the board about its fears of future

competition if it agreed to a deal at the suggested price.

The Bad

In an unusual step, we sold **James Hardie Industries** at a nominal loss after a very short holding period. The stock fell 15% after announcing a massive increase in costs that impacted a swathe of US companies the same week.

The consensus is that James Hardie can pass these costs on to customers better than most (we agree), and that the cost increases will be temporary as the US economy adjusts to tight labour and product markets.

Our fear is that, in contrast to the official statistics that show negligible inflation growth, higher costs will be more permanent. The US economy is stretched for skilled labour, for example, which can't be relieved quickly. While we're still US housing bulls, we decided to sell and invest the proceeds in plumbing supplies company **Reece** instead.

Reece's recent US acquisition means it also has a large exposure to US housing. But having also suffered a recent similar fall in its share price, we feel more comfortable with Reece's management and less cyclical business. We'll explain the bull case for US housing and Reece in the upcoming quarterly.

As an aside, it's an important part of investing to admit quickly when you think you've made a mistake. While our valuation of James Hardie may prove too conservative, experience says there's no better time to sell than straight away when you've blundered. Changing your investment case to suit the facts usually only compounds the error and you can always buy the stock back if your fears prove unfounded.

The Ugly

The ugly award this month undoubtedly goes to ageing spin-off and UK bank **Clydesdale**. The share price has almost halved since reaching \$6.33 in August, and we've topped up our holding on the way down.

The bank's profit margins are falling more than expected as the industry cuts home loan rates in response to a slowing housing market. At a price-to-tangible equity of just 0.7 for a

business that should be capable of producing a double-digit return on tangible equity in the years to come and paying a dividend yield beyond 5%, for now we're eager to hear the company's next three-year plan in June.

“A DEAL IS FAR FROM GUARANTEED, SO WE REDUCED OUR POSITION FROM 10% TO 7% TO REDUCE RISK”

Management must prove it can do more than cut costs to get the stock out of purgatory, and we believe it can.

Unfortunately, a messy Brexit may delay the high returns we believe are possible.

PORTFOLIO HOLDINGS



Financials	24.58%
Cash	15.99%
Real Estate	13.48%
Industrials	13.32%
Consumer Discretionary	10.18%
Consumer Staple	8.95%
Materials	5.02%
Energy	4.80%
Telecommunication Services	4.80%

TOP 5 HOLDINGS

Security	Weighting
Commonwealth Bank	8.38%
Trade Me	6.93%
Westpac Banking	6.33%
Seek	4.96%
BHP Billiton	4.86%



Skin in the Game Podcast

Join Portfolio Managers, Nathan Bell and Alex Hughes weekly as they chat about stocks in the news, economic events, markets and much more.



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 November 2018. Performance figures are based on the portfolio's previous investment structure, a Separately Managed Account (SMA). This portfolio is now offered as a Professionally Managed Account (PMA), as of 1 November 2018. The underlying securities remain the same between the SMA and PMA structures. The inception date refers to the SMA. Please see the Investment Menu for full PMA fee details.

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.

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

INVESTMENT FEE

0.60% - 0.97% p.a.

PERFORMANCE FEE

N/A

MINIMUM INITIAL INVESTMENT

\$25,000

STRUCTURE

Professionally Managed Account (PMA)

SUITABILITY

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

PORTFOLIO MANAGER

Nathan Bell, CFA

Important information

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InvestSMART Funds Management Limited
PO Box 744
Queen Victoria Building
NSW 1230 Australia

Phone: 1300 880 160
Email: invest@investsmart.com.au

www.investsmart.com.au