INVESTSMART

Intelligent Investor Equity Growth Portfolio

Monthly Update - October 2018

PERFORMANCE TO 31 OCT 2018	1 mth	3 mths	6 mths	1 yr	2 yrs	3 yrs	Since Inception (p.a.)
Intelligent Investor Equity Growth	-9.06%	-6.47%	-3.16%	0.31%	4.82%	7.63%	8.25%
S&P/ASX 200 Accumulation Index	-6.05%	-5.92%	-0.42%	2.94%	9.34%	8.25%	6.57%
Excess to Benchmark	-3.01%	-0.55%	-2.74%	-2.63%	-4.52%	-0.62%	1.68%

Key points

- **Market close to fair value**
- **Seven new additions**
- **Several swaps and sales**

October lived up to its haunted past for investors, as markets spent the month spooked by volatility and economic concerns. The falls were widespread, with the Equity Growth Portfolio falling 9.1% compared to the 6.1% fall in the All Ordinaries Accumulation Index.

The list of worries seems chilling. But despite many stocks falling over 30% from their highs, the US economy is growing quickly and it's unlikely to hit a brick wall for at least a year or two as interest rates increase. Unemployment is low and falling in the US and Australia, though the real numbers of those looking for work is much higher than the official statistics suggest.

Interest rates remain low, and despite some markets being overvalued (including numerous property markets around the world), the falls in October essentially brought the Australian stock market back to its long-term average valuation.

Unlike the US market, which is currently priced to offer a lousy 3-5% annualised return over the next decade, the Australian market's comparatively poor performance since the GFC means it should return around 8%, largely in line with its historical average.

The path of returns from year to year promises to be rocky, as we combat our world-beating swag of mortgage debt. But combined with franking credits (for now), the potential returns from the stock market look far more attractive than those for other popular investments, such as property and anything linked to pygmy interest rates (see **How will you deal with zero interest rates?**).

The returns will be even better if we continue our long historical record of outperformance. As our portfolio is quite different to the index, the performance will also vary from year to year. But unlike a good holiday, successful investing is all about the destination, not the journey.

"THE PATH OF RETURNS FROM YEAR TO YEAR PROMISES TO BE ROCKY, AS WE COMBAT OUR WORLD-BEATING SWAG OF MORTGAGE DEBT"

Despite October's volatility, most high-growth stocks that we'd like to own offer no margin of safety, so our biggest advantages for now are patience and acting quickly when there's an opportunity.

This is not the time to be overreaching. There are numerous areas where we expect investors will get their hands chopped off 'reaching for yield' e.g. using debt to juice returns and buying income securities where you're taking equity-like risk for fixed income returns. As US interest rates rise, our conservatism gets closer to being rewarded.

Shortening franking credits

A popular question we're being asked is what happens if Bill Shorten ends franking credit rebates for low or zero-taxed individuals.

First, there wouldn't likely be any change to your distributions from InvestSMART. The only difference is that you wouldn't be entitled to a franking refund, which you'd show in your tax return.

Second, many expect it would have a big impact on share prices, as more Australian investors consider investing abroad, for example, or start favouring A-REITs and infrastructure stocks where after-tax dividend yields are higher than those offered by stocks they currently own.

We wouldn't expect much change because franking credits are only one part of the investment equation and superior investment alternatives to owning a portfolio of high-quality businesses paying increasing dividends as their earnings grow are virtually non-existent.

Investments related to interest rates currently offer dismal returns, and few investors want to invest their money abroad in unfamiliar markets and companies. As long as the Australian stock market is offering a 4-5% dividend yield before franking, your dividend yield is nearly double the 2.8% you've historically received in the US, for example.

Any changes in company values would likely be marginal, but it would be interesting to see if any companies reduce their dividends and reinvest more to grow their businesses.

Few, if any, companies would be willing to dramatically change their dividend payout policy with a rusted-on investor base expecting large dividends, but this could produce higher company values for businesses that can invest more at high rate of return. The question then, though, is why they wouldn't be doing that already.

Portfolio

We'll spend more time in the quarterly report explaining the investment case for October's new additions, but for now they include fibre cement company James Hardie, AMP, Platinum Asset Management, Frontier Digital Ventures, Reece, Reliance Worldwide and Class.

Anything related to the slowing US homebuilding market has been dented or smashed. US homebuilding stocks have been sawn in half or more, and James Hardie is down over 20%.

Longer term the US housing market will need to provide enough homes for the millennial population, America's largest population cohort, as they have kids and buy homes. James Hardie is well placed to benefit (as is US homebuilder NVR for anyone shopping for high quality US stock ideas).

We swapped AMP for IOOF as they face similar risk, but AMP will prove much cheaper if incoming CEO Francesco De Ferrari can get anywhere near the 15% return on equity needed to bank all his incentives.

"INVESTMENTS RELATED TO INTEREST RATES CURRENTLY OFFER DISMAL RETURNS, AND FEW INVESTORS WANT TO INVEST THEIR MONEY ABROAD IN UNFAMILIAR MARKETS AND COMPANIES."

He also has six million reasons to double the current share price to $5.25 and will likely start with plenty of money to invest or return to shareholders. A new CEO is often the catalyst for restoring the value of a business, as I'll discuss in a webinar on 21 November where you can submit questions.

We swapped Perpetual for Platinum Asset Management, as Platinum's share price has fallen around 40% like Perpetual's, but Platinum's funds have historically distinguished themselves in tough markets. Platinum's funds have suffered recently from their Chinese exposure, but the Chinese market looks cheap and is providing opportunities for future outperformance.

Frontier Digital Ventures owns stakes in a portfolio of 15 online classifieds business across emerging markets. Its CEO, Shaun Di Gregorio, and main backer Catcha Group own a combined 66% stake. Unlike offshore acquisitions made by much larger Australian online classifieds' businesses, Frontier partners with local operators. A strategy that produced a great outcome for their past investment in iProperty, which was sold to REA Group.

The company's largest asset by far is Zameen, the Pakistan version of REA Group. Zameen is growing rapidly and should breakeven next year before producing plenty of cash for shareholders. Eventually we expect it will be sold or IPO'd but, for now, Frontier's current valuation suggests you're getting the stakes in the other 14 businesses for free.

Reece is Australia's largest plumbing supplies business, and also has large insider-ownership. Reece has quietly gone about its business for decades until recently raising money to acquire US business Morsco. While success will take time, it should provide the company with plenty of growth for years to come.

Like Reece, Reliance Worldwide operates in the plumbing industry and also made a large acquisition recently after raising money from shareholders, including the founding Munz family. In its largest markets, Reliance is the number one seller of push-to-connect behind-the-wall plumbing.

Most of Reliance's revenue comes from plumbing repairs, which are still typically done using slow traditional methods involving, welding, crimping and soldering. As aging plumbers leave the industry, we expect a much larger take up of Reliance's time saving push-to-connect products.

Class is known for its cheap and functional software to manage SMSFs, where we expect it to continue taking market share from rivals. While its price-to-earnings ratio of 27 Is high, it doesn't reflect the potential of its portfolio management software, which provides cheap access to investments like highly profitable businesses HUB24 and Netwealth do.

"PLATINUM'S FUNDS HAVE SUFFERED RECENTLY FROM THEIR CHINESE EXPOSURE, BUT THE CHINESE MARKET LOOKS CHEAP AND IS PROVIDING OPPORTUNITIES FOR FUTURE OUTPERFORMANCE."

These types of highly scalable businesses deserve high multiples as incremental revenue has a big impact on profits, but we also like management's strategy of sacrificing profits today to build a better business in the future.

Lastly, we sold Ansell and ASX due to their high valuations and IVF treatment companies Monash and Virtus, as we don't believe their statistical cheapness is enough compensation for their weakening competitive advantages.

PORTFOLIO ALLOCATION

Industrials	17.48%
Cash	15.05%
Consumer Discretionary	13.62%
Information Technology	13.08%
Financials	11.28%
Communication Services	6.75%
Materials	5.71%
Consumer Staple	5.02%
Energy	4.83%
Real Estate	3.84%
Health Care	3.36%

TOP 10 HOLDINGS

Security	Weighting
Trade Me	7.57%
BHP Biliton	5.67%
Wesfarmers	5.09%
Woodside Petroleum	5.02%
Hansen Technologies	4.80%
Seek	4.61%
CYBG PLC	4.53%
Reliance Worldwide	4.33%
Sydney Airport	4.27%
Unibail-Rodamco-Westfield	3.89%

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 31 October 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 Growth Portfolio is a concentrated portfolio of 10 - 35 Australian-listed stocks. The Portfolio invests in a mix of large, mid and small cap stocks, focusing on highly profitable industry leaders that have long-term opportunities to reinvest profits at high rates of return.

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 Growth 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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