Intelligent Investor Equity Growth Portfolio

Monthly Update - January 2019

PERFORMANCE TO 31 JAN 2019	1 mth	3 mths	6 mths	1 yr	2 yrs (p.a.)	3 yrs (p.a.)	Since Inception (p.a.)
Intelligent Investor Equity Growth	2.11%	-1.43%	-7.81%	-6.87%	3.54%	6.94%	7.22%
S&P/ASX 200 Accumulation Index	3.87%	1.45%	-4.55%	1.37%	6.64%	10.09%	6.52%
Excess to Benchmark	-1.76%	-2.88%	-3.26%	-8.24%	-3.10%	-3.15%	0.70%

Key points

- **The art of selling**
- **Added to Frontier Digital**
- **Sold AMP**

This monthly update is dedicated to the art and science of selling. Since I re-joined InvestSMART in August, I've sold stocks for every reason I can think of except to minimise tax.

As it's led to several of you questioning whether I've given up on long-term investing, I'm aiming to quell those fears with this update. Before that, though, some commentary on this month's performance and portfolio changes.

As the new year rolled over the market once again coveted high growth stocks. That's left our more conservative portfolio a little behind, adding to the underperformance last quarter.

While we should always be focused on the next five to ten years, not the next five to ten months, it's worth noting that December was the second worst December in history and the quarter was the worst since the GFC. That created the backdrop for a market bounce but, as property prices keep falling, we're likely to get better opportunities as the year progresses.

While our recent performance has suffered, we're happy with the names we've been adding to the portfolio. They've substantially increased the potential return of the portfolio without adding much risk. You now own several stocks in addition to existing holdings like Audinate and Nanosonics that could increase many times over during the next decade.

Even if these companies are successful, it will take time. As I explained last quarter, this is the price we must pay for superior returns over the long term. Our ability to think long term and act accordingly is our biggest advantage in a world drowning in information and short attention spans.

There are many stocks that we'd love to own at the right price, and we hope reporting season will provide at least a couple of opportunities to add them to the portfolio or at least beef up existing positions.

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Portfolio changes

As I explained in Nathan's View: Selling AMP and why I'm bullish on US housing, AMP was sold as it got within earshot of our valuation of around $3.

Our original valuation pegged AMP's worth above $4 per share, which, along with dividends, could provide 20% annualised returns for several years assuming a worst-case scenario from the Hayne inquiry was avoided. We kept the position size relatively small for that reason, but were hopeful that incoming CEO Francesco De Ferrari could fix the culture and find new growth avenues that could increase our valuation.

Our valuation soon dropped to our purchase price of around

$3, however. In a highly unusual turn of events, acting CEO Mike Wilkins and the board, led by David Murray, forged a complex deal which included the sale of AMP's life insurance business amongst other smaller assets for a lousy price. Had the share price remained around $3 we would've sold, but it dropped under $2.30 as investor's panicked.

That price was too low in our view, so we waited until the price got closer to our estimate of fair value before selling. With high quality businesses like CSL and ResMed, for example, you must fight the temptation to sell when they get a bit expensive, as they're likely to continue creating an enormous amount of value over time. These are the types of businesses we usually own.

But occasionally we'll buy a cigar butt like AMP, where we believe we're being compensated for the risks with one last puff. In those cases, we're much more disciplined about selling as we approach fair value. And so, we exited AMP at close to what we paid. A classic case of heads we win, tails we don't lose too much.

The situation is analogous to what Yale's legendary endowment manager David Swensen recognised many years ago:

Active management strategies demand un-institutional behaviour from institutions, creating a paradox that few can unravel. Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom. The most attractive investment opportunities fail to provide returns in a steady, predictable fashion.

It's too early to draw lessons, but AMP was always a smaller position so a worst-case outcome following the Hayne Inquiry recommendations was never going to unduly hurt the portfolio. Buying into such fluid situations is often not a great idea, but we felt we were well protected, as panicked investors had already halved the share price.

We remain eager to see what De Ferrari's future plans are for the business, as it should include more capital being returned to shareholders. All that said, usually the best investments are the simplest.

We also trimmed BHP and Woodside after reporting mixed updates, which helped make way for more predictable businesses like Sonic Healthcare. We added to Crown, as it has a clear and sensible growth strategy and its balance sheet is in rude health. The portfolio is well placed for increased shareholder returns, particularly from companies with high franking balances, such as BHP and Flight Centre.

Several stocks also announced positive updates, including ResMed and Audinate, although the market wanted more from ResMed after its share price inexplicably increased 20% after we bought it.

"ALL THAT SAID, USUALLY THE BEST INVESTMENTS ARE THE SIMPLEST."

The 13% increase in Audinate's share price during January was consistent with general share price trends, where the statistically cheaper stocks have remained so, while investors are still bidding up quality growth stocks. Though it looks expensive based on current metrics, it has the potential to grow to become many times its current size.

We also added to Frontier Digital Ventures, after the recent update showed the investment case is on track. If the stock traded on the same multiples of many of its weaker, slower-growing competitors and equals, it would be three times the price and still growing rapidly.

The art and science of selling

A value investor is expected to have low turnover in their portfolio, as we know the best way to compound your returns at high rates is to buy well, hang on and minimise tax. But there has been an unusual amount of selling since I re-joined InvestSMART, so let's examine the reasons and why it should revert to normal levels from now on.

The best reason to sell is because the stock has performed wonderfully, and it's reached a point where the future returns are no longer satisfactory (TPG Telecom is a good recent example). It's great when you have lots of ideas to replace it with but selling creates risk.

First, you may have underestimated the future returns, just as time will tell whether we have with TPG Telecom. This is the value investor's curse, so we try to fight this urge when we own great businesses with great futures. Their surprises tend to be good ones. TPG is not in this elite category, despite its wonderful track record.

Second, you need to find an alternative stock that can offer

at least the equivalent return of the stock you sold after paying tax. That's not always easy. Selling a business you know inside out for a new stock carries risk.

Shiny-new-toy bias says that we typically overvalue new ideas because they excite us. Compare that with ownership bias where we overvalue items just because we own them, and you see how our biases can play havoc with your brain when it comes to investing. The first line of insurance is being aware of these biases.

Forced sales

Sometimes we're forced to sell, such as with Trade Me. Takeovers can be good news, but quite often good businesses are delisted at prices well below fair value. Management tried to take Sirtex private at around $5 per share, for example. It was eventually acquired for $30.

At other times we sell because we're no longer confident in the company's value. Perhaps we've made a mistake, or the facts change, as was the case with AMP. It's important to analyse the situation without emotion and act quickly when necessary.

If you want to sell, experience suggests that you shouldn't delay i.e. sometimes it's just a feeling in your gut, or in your back as it was for George Soros, but it's important to get out as quickly as possible when you suspect problems. Suspicious share price movements can be an indication, as can management skirting simple questions. If it turns out you're jumping at shadows, you can always buy the stock back.

Profit downgrades can also create buying and selling opportunities. Stockopedia analysed 245 downgrades of small UK stocks between January 2013 and August 2016. The results were mostly consistent with our experience, including that share prices on average fell 6% before a downgrade was reported.

Just 13% had a higher share price after 12 months; 31% had a 5% higher share price; and 45% of stocks that reported a profit downgrade had at least a 10% lower share price after one year.

In contrast to the cockroaches in the kitchen theory, where if you spot one there's bound to be more, 64% of companies only reported one profit downgrade. A quarter of companies reported two, while 5% delivered three and 6% delivered four.

The best way to respond is to determine the future expected returns. We sold James Hardie last year as its profit downgrade suggested our fair value estimate was optimistic and the cost of selling was low i.e. the share price didn't fall too far while our estimated returns had shrunk.

In contrast, we've held on to Clydesdale Bank, despite announcing what amounted to a profit downgrade. That's because the share price fell rapidly to a point where we believe it could double your money with the help of dividends over the next three or four years i.e. for those types of returns, we'll be patient.

Sometimes it makes sense for taxation reasons to sell a stock, though we haven't sold any stocks for that reason. But we have replaced several stocks with names that we believe offer superior returns and that we hope to own for a very long time.

Last year across the Growth and Income portfolios we sold Perpetual, IOOF, Wesfarmers, Ansell, ASX, Virtus, Monash IVF and TPG Telecom for a variety of quality and valuation reasons that we've discussed in previous updates.

In their place are Reece, Flight Centre, ResMed, Pinnacle, Reliance Worldwide, Class, Platinum Asset Management, Frontier Digital Ventures and 360 Capital, all of which have high insider ownership, long growth runways and the potential for high returns over the next decade with minimal risk due to strong market positions and balance sheets.

Add those businesses to existing holdings, such as Audinate, Hansen Technologies, Seek and Crown, which also have high insider ownership, and the amount of selling in the portfolios should subside from now on.

Markets have settled in the new year, but we're hopeful falling house prices will provide more opportunities to add to our elite group of businesses over the course of the year.

As always, please call me with any questions on 1300 880 160 and I hope it hasn't been too much of a struggle returning from holidays.

PORTFOLIO ALLOCATION

ASSET ALLOCATION

Sector	Weighting
Consumer Discretionary	17.87%
Industrials	17.23%
Information Technology	10.58%
Cash	10.55%
Communication Services	9.91%
Health Care	9.67%
Real Estate	8.94%
Financials	8.02%
Materials	3.71%
Energy	3.54%

TOP 5 HOLDINGS

Security	Weighting
Trade Me	7.37%
Uniball-Rodamco-Westfield	4.92%
Hansen Technologies	4.88%
Crown Resorts	4.69%
Seek	4.49%

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 January 2019. 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.

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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 achieve a return of 1% above the S&P/ASX 200 Accumulation Index per annum over five year rolling periods by investing in a diverse mix of Australian equities and cash.

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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