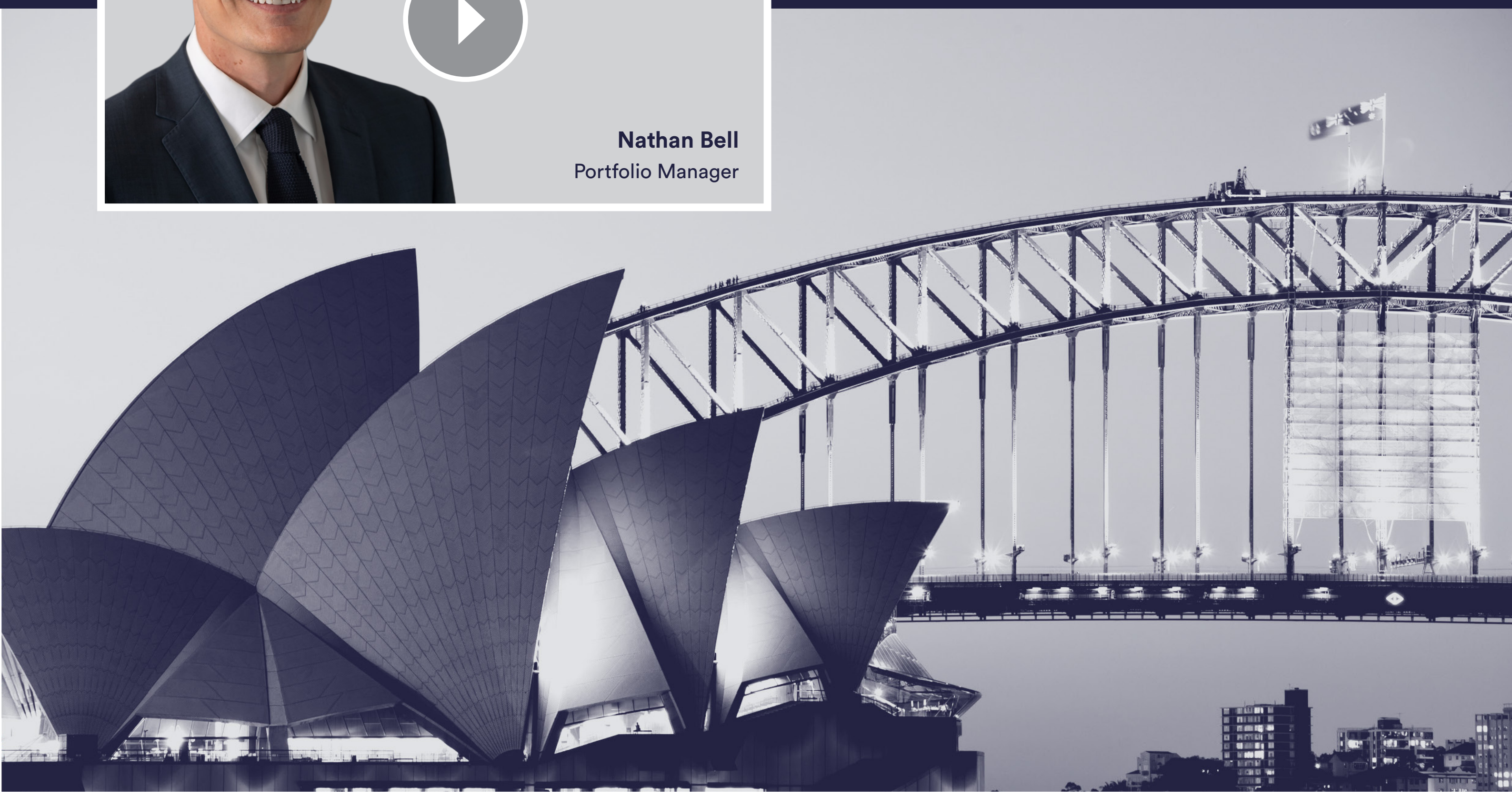
InvestSMART Australian Equity Income Fund

(Managed Fund) (ASX:INIF)

Quarterly Report

30 JUNE 2019

- Top 20 stocks unlikely to repeat recent performance
- Good announcements from 360 Capital
- Turnover back to normal levels since February



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InvestSMART Australian Equity Income Fund

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PERFORMANCE TO 30 JUNE 2019 (AFTER FEES)	1 MTH	3 MTHS	6 MTHS	1 YR	S. I. (P.A.)
InvestSMART Aust. Equity Income Fund	0.35%	3.76%	8.43%	-1.35%	-0.80%
S&P ASX 200 Accumulation Index	3.70%	7.97%	19.73%	11.55%	13.05%
Excess to Benchmark	-3.35%	-4.21%	-11.30%	-12.90%	-13.85

'Abraham Lincoln once posed the question: "If you call a dog's tail a leg, how many legs does it have?" and then answered his own query: "Four, because calling a tail a leg doesn't make it one." Abe would have felt lonely on Wall Street.' – **Warren Buffett**.

'The mind of man at one and the same time is both the glory and the shame of the universe.' – **Blaise Pascal**.

'If everything you do needs to work on a three-year time horizon, then you're competing against a lot of people. But if you're willing to invest on a seven-year time horizon, you're now competing against a fraction of those people, because very few companies are willing to do that. Just by lengthening the time horizon, you can engage in endeavours that you could never otherwise pursue. At Amazon we like things to work in five to seven years. We're willing to plant seeds, let them grow- and we're very stubborn. We say we're stubborn on vision and flexible on details.' – **Jeff Bezos, 2011**.

Given this is the first anniversary of listing INIF, we'd love to be telling you what a great year we had. Unfortunately, markets don't always work like that.

There's also only one thing worse than losing money in the stock market, and that's watching others making more. That describes our financial year. Despite a lot of hard work, the portfolio lost 1.4% while the index produced an 11.6% return.

While dividend payments were good, replacing mistakes, such as **IOOF**, **AMP** and **Ovato**, and a host of fairly valued stocks, including **Scentre** and **Ale Property Group**, has yet to pay off.

In contrast, the share price of fashion jewellery retailer **Lovisa** increased 35% as the market gains confidence in its US store rollout. If its success in Australia is emulated abroad, the share price should exceed $20 per share while we collect a growing stream of dividends helped by management's relentless focus on costs.

Recent purchases, such as **Smartgroup** and **Tabcorp**, haven't had time to prove their worth. But as interest rates fall, the dividend yields of companies like these that can also grow earnings over time should become more popular.

A few profit downgrades haven't helped, either. As we explain below, though, the pain for stocks including **Link Administration** and **Clydesdale Bank** should be temporary.

A year of two halves

It was a year of two halves, with the index increasing almost 20% this calendar year after producing the worst December quarter since the GFC. Our portfolio failed to keep up during the recent recovery, increasing 8.3%, but we believe it has far more potential than the big names currently driving the index while paying a higher dividend yield.

Before we drill down on some portfolio names, let's dissect the market's strong recent returns to explain why we don't have much exposure to the big movers.

Let's start with the iron ore majors, including **BHP**, **Rio Tinto** and **Fortescue**, which constitute a mammoth 18% of the index. They had a phenomenal year due to a surge in the iron ore price that's unlikely to repeat. Though their dividends should remain attractive, which is why we own BHP and Fortescue (see below), having 18% of a conservative income portfolio in cyclical miners is far too risky in our view.

Commonwealth Bank, **Newcrest Mining**, **CSL** and **Telstra** also performed well. CSL pays a paltry dividend and is expensive, Telstra is unlikely to see its share price increase almost 50% again and bank earnings and dividends face more pressure each time interest rates fall. While markets are unpredictable, the 2019 performance of this group is unlikely to be repeated.

In summary, the top 20 stocks that comprise almost 60% of the index had an exceptional period, with the average return from each stock reaching almost 20%. But given their huge size, and the bubble building in perceived safe stocks, the recent performance is likely an aberration.

To show you how confused and desperate parts of the market have become, let's discuss two examples. First, the Australian gold price has soared as the currency has fallen due to falling interest rates that signal a weak economy. Yet, despite lower interest rates also crunching bank profit margins, bank share prices have increased. Eventually this conflict will be resolved.

There's also a bubble in technology stocks, judging by the nonsense being used to justify valuations. Take one bank's recent commencement of coverage of a stock we recommended way back in 2014, **Nanosonics**, which we sold from our Growth portfolio a few months back due to its hefty valuation.

Despite forecasting earnings of just 10 cents per share in 2023 for a price-to-earnings ratio of 65 in four years' time, the eye watering valuation was justified by products that haven't even been announced yet. Bear in mind that the company's novel Trophon device used to disinfect ultrasound probes has taken a decade to produce a small profit.

While the market is currently consumed with perceived safe stocks and companies showing rapid revenue growth, you own some hidden gems where the value is building but being completely ignored by the market.

Hidden gem

Take **360 Capital**, for example. We explained the investment case in detail in our **December quarterly**. In summary, you were paying net tangible assets – which is mostly cash – and you were getting a fledgling funds management business and the excellent track record of insider-owner Tony Pitt for free.

Recently the company launched three small funds aiming to raise $25m each from yield hungry investors. Following that, Pitt announced a joint venture with successful telecommunications businessman David Yuile.

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Yuile led Nextgen Networks from 2014-15 before selling out in a deal that included **Vocus** and was chief executive of data centre operator Metronode prior to his departure in 2018. Yuile is renowned for turning around businesses and selling them at large premiums.

The US$250m fund will invest in all manner of modern telecommunications assets, such as data centres and telecommunications towers, designed to provide investors with a 10% annual return.

It should sell itself in an environment of falling interest rates. And given the subsequent announcement that it's likely to be separately listed on the ASX, it seems there's no shortage of interest. This is only the beginning for 360 Capital's funds management business, and you're not paying a cent for it at the current price.

360 Capital isn't a rare case. Investors are steering clear of small cap stocks generally, with the small companies index flat over the past year.

Selling from several shuttering small cap funds is also likely weighing on our only other smaller value stock, foreign exchange provider **OFX**. This trend won't last forever, either. As long as the value in our portfolio keeps building the market will eventually catch on.

With the portfolio much more settled over the past quarter following an unusually large period of change, the only major recent alteration was replacing **Coles** as it reached fair value with **BHP** and tiptoeing into **Fortescue**.

> **"THE ABILITY TO CARRY OUT A LONG-TERM, CONTRARIAN INVESTMENT STRATEGY IS ONLY AS GOOD AS ITS CLIENT'S SUPPORT. WITHOUT IT, IT'S IMPOSSIBLE.**

Fortescue has done an incredible job increasing the quality of its ore and is almost debt free. Both companies should be able to sustain much higher dividends than in the past even at lower iron ore prices.

Let's now look at some recent news for specific holdings, but as always please see past monthly and quarterly reports for more detail on the investment case for newer holdings.

Stock news

Clydesdale Bank is down a third from our average purchase price. In summary, our original investment case was that as the bank could produce a return on equity of around 12% it deserved a value above book value.

While the UK economy has held up well despite the Brexit mess, lower interest rates, intense competition in the mortgage market, and doubts about the motivation and price chief executive David Duffy paid to acquire Virgin Money has sunk the bank's price-to-book value to just 0.6.

Duffy recently laid out the bank's three-year financial targets at an investor day. Along with rebadging Clydesdale Bank to Virgin Money, Duffy is aiming to produce a 12% return on equity. Were that achieved, the stock price would likely increase 50-100%, as it would be trading on a mammoth 9% dividend yield based on the current price.

Duffy's plan is to reduce the bank's reliance on mortgages and increase unsecured and business loans. Merging Clydesdale and Virgin Money gives Duffy a national footprint to offer an increasingly digital experience supported by Virgin's broader range of products, which will include a revamped loyalty program.

Duffy will also cut costs in line with the most efficient UK banks, which is what he's renowned for. The market is clearly sceptical, as some of Duffy's previous financial targets haven't been met. The usual risks of owning a bank in a low interest rate environment also apply. But given the low share price and the big increase in dividends expected in 2021 and 2022, we're remaining patient.

The missing Link

Following a profit downgrade that knocked 26% off **Link Administration**'s share price, the share price has fallen a further 10% due to Link's questionable administration of famous fund manager Neil Woodford's UK funds. But rapid withdrawals following poor performance combined with many illiquid unlisted holdings caused a subsidiary of Link to halt redemptions.

The UK regulators are now investigating Link's actions, which included a dubious listing of some of the illiquid stocks on a small exchange. Whatever the outcome, it's unlikely to cost the company $300m as suggested by the market's reaction. Although the potential returns are nothing like when the share price of pokie manufacturer **Aristocrat Leisure** fell to two dollars per share in 2011, the situation feels similar. Surprising bad news piled on top of bad news that's unlikely to have long-term consequences.

On a final note, last year we published an article called ***How will you deal with zero interest rates?*** With each passing day it seems more likely Australia will end up with a zero percent interest rate or something that feels like it. Perhaps 0.50%, for example.

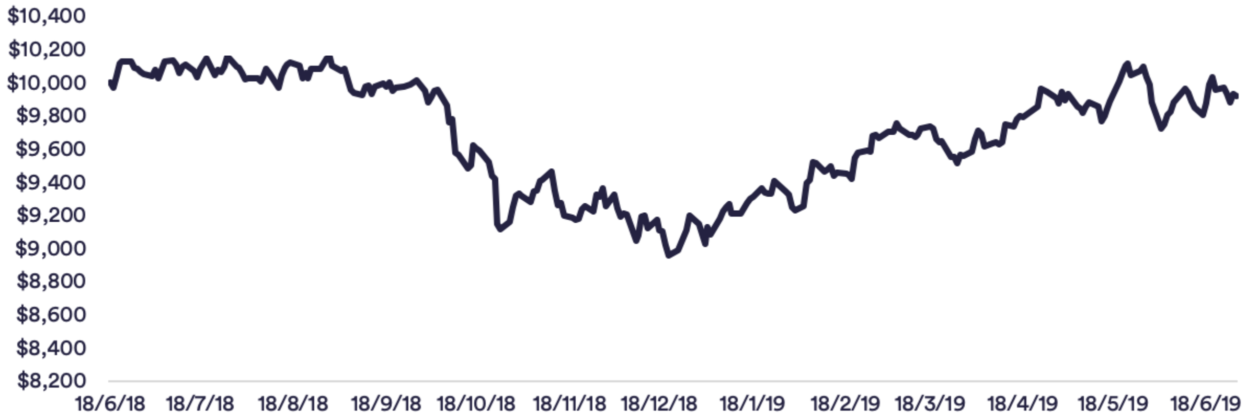
While the market is looking expensive based on historical measures after the recent rally, as term deposits earning 3% start rolling off and retirees are facing 1% returns, we may see high dividend stocks bid up further. A 4.5% fully franked dividend from Tabcorp with a high growth online lotto business sounds far more appealing to us than a fully taxable 1% from a term deposit, for instance.

The ability to carry out a long-term, contrarian investment strategy is only as good as its client's support. Without it, it's impossible.

Thank you for your support, and if you have any questions about the portfolio please call us on 1300 880 160 or email us at **support@investsmart.com.au**.

Kind Regards,
Nathan

PERFORMANCE OF $10,000 SINCE INCEPTION



ASSET ALLOCATION

Sector	Weighting (%)
Financials	24.40
Consumer Discretionary	17.66
Industrials	15.99
Materials	11.28
Cash	9.24
Real Estate	8.60
Consumer Staple	4.68
Communication Services	3.10
Information Technology	2.77
Health Care	2.28

TOP 5 HOLDINGS

Security	Weighting (%)
Commonwealth Bank of Australia	9.45%
Westpac Banking Corp	6.69%
BHP Group	6.08%
Sydney Airport Holdings	5.39%
360 Capital Group	4.88%

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 June 2019. Table of performance figures on page 2 is after investment and admin fees, and includes brokerage. Unit pricing taken at the end of each month.

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 InvestSMART Australian Equity Income Fund (ASX:INIF) is a concentrated portfolio of 10-35 Australian listed stocks. The Fund 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 InvestSMART Australian Equity Income Fund?

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 for the PMA
19 June 2018 for the Listed Fund

SUGGESTED INVESTMENT TIMEFRAME
5+ years

NUMBER OF SECURITIES / STOCKS
10 - 35 stocks

INVESTMENT FEE
0.97% p.a.

PERFORMANCE FEE
N/A

MINIMUM INITIAL INVESTMENT
$25,000 for the PMA
$0 for the Listed Fund

PORTFOLIO MANAGER
Nathan Bell, CFA

Important information

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