InvestSMART Ethical Share Fund

(Managed Fund) (ASX:INES)

Quarterly Report

30 JUNE 2019

- The Fund is 73% invested
- Profit downgrades have produced opportunities
- Good announcements from 360 Capital

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InvestSMART Ethical Share Fund

PERFORMANCE TO 30 JUNE 2019 (AFTER FEES)	1 MTH	3 MTHS	6 MTHS	1 YR	S. I.
InvestSMART Ethical Share Fund	N/A	N/A	N/A	N/A	-1.13%
S&P ASX 200 Accumulation Index	3.70%	7.97%	19.73%	11.55%	1.32%
Excess to Benchmark	N/A	N/A	N/A	N/A	N/A

'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**.

First, thank you for investing in the Intelligent Investor Ethical fund. It's been over 13 years since I first walked into Intelligent Investor's humble digs in Bondi Junction, and investing has only got harder in part due to the monetary experiments currently underway around the world that only Dr Jekyll himself could've formulated.

There are also fewer investors that believe in our long-term process of doing something different to the market. For now, it's easy just to buy an index fund without the need for emotional endurance to steer clear of manias and buy when others are selling.

So far, the Fund is 73% invested. The recent rally means we have to be patient to invest the rest safely, and we'll keep you updated each month and quarter. Don't get sucked into watching the unit price too regularly, though. Investing is a marathon, not a sprint.

As the current performance is meaningless, we'll first have a look at what's been driving the market. We'll then update some key holdings, and lastly, we've included a full write up of two smaller stocks in the portfolio with plenty of potential. Note the reviews were written six months ago, but along with the updates below they're still relevant.

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. The silver lining of our recent underperformance is that we can turn it around just as quickly.

The iron ore majors, including **BHP**, **Rio Tinto** and **Fortescue**, which constitute a mammoth 18% of the index, had a phenomenal year that won't repeat. **Commonwealth Bank**, **Newcrest Mining**, **CSL** and **Telstra** also performed well.

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 performance is unlikely to repeat.

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 weakening 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 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 analyst justified half this eye watering valuation on products that haven't even been announced yet. Bear in mind that the company's novel Trophon device used to disinfect 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, of which we have a couple, we also own some hidden gems where the value is building but being completely ignored by the market.

Take **360 Capital**, for example. We explain the investment case in detail below, but in summary we're paying net tangible assets – which is mostly cash – and you get 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. 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.

"WHILE THE MARKET IS CURRENTLY CONSUMED WITH PERCEIVED SAFE STOCKS AND COMPANIES SHOWING RAPID REVENUE GROWTH, OF WHICH WE HAVE A COUPLE, WE ALSO OWN SOME HIDDEN GEMS WHERE THE VALUE IS BUILDING BUT BEING COMPLETELY IGNORED BY THE MARKET.

Selling from several small cap funds winding up is also likely weighing on some of our smaller value stocks. This trend won't last forever, either. As long as we keep our discipline and the value in our portfolio keeps building the market will eventually catch on, just like it's starting to with **Frontier Digital Ventures**.

Stock news

Let's now look at some recent news for specific holdings. **Clydesdale Bank** is down a third from our average purchase price. In simple terms, our original investment case was that we believed a bank that could produce a return on equity of around 12% deserved a value above book value.

While the UK economy has held up reasonably well despite the Brexit mess, lower interest rates, intense competition selling mortgages, 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 and Virgin's broader range of products, which will include a revamped loyalty program.

> **"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.**

Duffy will also be cutting 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 running a bank also apply. But given the low share price and the big increase in dividends expected in 2021 and 2022, we're remaining patient.

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 administration of Neil Woodford's UK funds. But rapid withdrawals following poor performance combined with many 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 illiquid stocks. 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, the situation feels similar. More unexpected bad news piled on top of bad news, that's unlikely to have long-term consequences.

The share price of **Frontier Digital Ventures** has been strong recently, but we'd like to see higher volumes traded based on rapidly improving profitability before getting excited. The selling that's dogged the share price since listing appears to be exhausted. Too many shares were given to investors hoping for a stag profit when it listed a couple of years back.

Also helping is more respectable long-term investors have also recently joined the share registry, and the recent announcement that Zameen, by far Frontier's largest investment, produced its first quarter of breakeven with revenue doubling from a year earlier. The range of possible outcomes is wide, but it includes the share price increasing many times over if Zameen follows the success of online property classifieds businesses around the world include Realestate.com.au in Australia, Rightmove in the UK and 99acres.com in India.

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

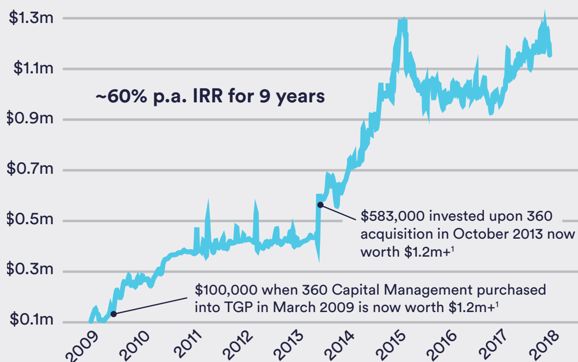
360 Capital

Note: This and the following analysis of Frontier Digital Ventures are very lightly edited versions of articles we shared for Intelligent Investor's Christmas special report i.e. they contain no new information if you've already read them.

In 2009, as I was sifting through the ruins of the commercial property sector, a friend urged me to look at a small A-REIT called Trafalgar. Like every A-REIT at the time, its portfolio of B-Grade office properties was trading at a large discount to its net tangible assets (NTA).

What distinguished Trafalgar was a man named Tony Pitt, who'd bought a major shareholding and planned to sell the assets one by one to eliminate the discount. Over a few years he delivered on his promise much to shareholders' benefit (see chart below).

TPG's total return post 360 Capital Management involvement



1. On a total return basis assuming dividends were reinvested. Since 360 Capital's initial strategic stake in Trafalgar (ASX: TGP), through which 360 Capital later listed.

Source: 2018 Annual Results Presentation

I then sold my shares, thanked my friend for the recommendation, paid my tax, and moved on to 'better' opportunities, missing the huge share price gains as Pitt reversed his strategy and began making acquisitions.

Renaming the company 360 Capital, he kept buying undervalued property and rode the recovery in commercial property prices.

Clean slate

Now, Pitt is again starting with a clean slate. Having recently agreed to sell 360 Capital's last major property to NextDC, which also happens to be the tenant, 360 Capital is flush with cash and a new strategy.

When emerging from downturns like the global financial crisis, owning equity maximises your returns as asset prices recover. At the opposite end of the business cycle, which is where we are now, Pitt wants the extra protection of supplying debt with covenants rather than equity. You don't need to sacrifice returns too much, either.

Property development returns have increased due to the withdrawal of Australian banks, which have been forced to ration credit to satisfy regulators as they prepare for lower housing prices and higher bad debts.

Big opportunity

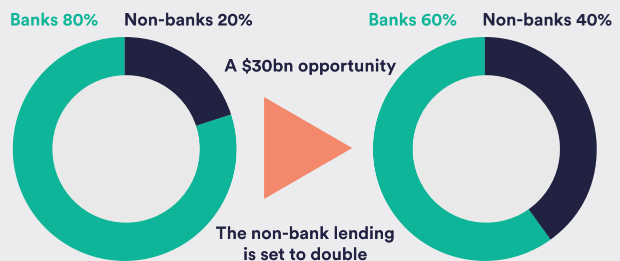
This market opportunity can be quite lucrative. Providingdebt for a year or two on a small property developmenttypically earns a 10–11% annual return. Not bad wheninterest rates are below 2%, if you get your money back.

Anecdotally, we've learned those returns are more like 15%right now. The chart below, which shows the (expected)falling market share of Australia's banks for propertylending, is a visual description of the size of the opportunity.

Let's now look at how this might unfold in practice.

$30bn lending gap

Traditional banks are unable to service the demand for real estate lending, creating a funding gap for non-bank lenders[1].



Currently, the market share of commercial real estate debt held by banks is approximately 80%.
It is expected that this share will decline to 60% over time, creating a A$30+ billion opportunity for non-bank lenders[1].

1. Goldman Sachs research 2017

Source: 2018 Annual Results Presentation

A typical development for 360 Capital might be a $30m suburban doctor's office. Because of the small size, in a worst-case scenario where the developer goes under, leaving the project unfinished, Pitt could take control and complete it. More capital might be required, either

directly from 360 Capital's balance sheet or by finding a new developer and/or investor, but that shouldn't be a problem. If the story ended here, we'd currently be paying net tangible assets (NTA) for 360 Capital. Given Pitt's track record that could be very cheap indeed. Over time, we'd receive distributions as if owning an A-REIT. The value of 360 Capital, meanwhile, would grow as profits are banked from completed projects and reinvested in new ones.

That's pretty good for a company where a shrewd, shareholder-friendly chief executive owns a quarter of the shares and which is orientated towards leaner times but has the potential to capitalise on higher development returns while they last.

Lending platform

But the story doesn't end here. 360 Capital also owns a 50% stake in a property lending platform called AMF Finance, which earns fees from matching developments requiring capital with investors willing to supply it. Here's how it works.

Let's say you're a high net worth individual with $25m to invest over the next few years in our theoretical suburban doctor's office. You plug your details into the AMF Finance system, after which you get a list of projects in which to invest along with the associated terms. You pay a fee for being offered deals on a silver platter, without having to do any of the dirty work.

As projects mature, 360 Capital can then repackage or 'securitise' this debt for less risk tolerant investors willing to accept lower returns. This releases cash for 360 Capital's next development. Sometimes, 360 Capital can turn over its capital more than once a year. With the right fee structure, this can be extraordinarily profitable.

These are early days. The platform has only completed $111m of deals in the eight months to 30 June, although the potential is substantial, if investors get the right outcomes.

Potential 360 Capital shareholders aren't currently paying anything for this potential. Last year, 360 Capital paid a 5.6% dividend yield based on our purchase price but it's unclear what will be paid in future. That's ok, as we can afford to let dividends grow slowly over time if necessary.

The bull case is clear. Tony Pitt is a canny operator with his own money on the line. In a blue-sky scenario, the AMF Finance business could one day be collecting fees on deals valued in the hundreds of millions of dollars.

Just as importantly, Pitt has prepared the business for leaner times. Even if AMF Finance is worthless, we're not paying much, if anything, for it. At worst, we'll own a well-run, entrepreneurial business that's investing in a profitable niche. Pitt excelled during the global financial crisis. We expect nothing less from him during the next downturn.

Frontier Digital Ventures

When local online real estate classifieds business REA Group entered the Italian market in 2007 it looked unstoppable. After conquering Australia's real estate market, attracting 89% of agents and gaining a handy lead over Domain, acquiring Italy's biggest property website, Casa.it, should have been a breeze.

It wasn't. After being overtaken by once distant competitor immobiliare.it, REA sold out of Italy in 2016. The loss of a seemingly insurmountable lead has been put down to the travails of corporate bureaucracy.

REA shareholders' loss is Frontier Digital Ventures' (FDV) gain. FDV acquires stakes in emerging online classifieds. By mimicking the successful parts of REA Group and dropping the mistakes – a classic second mover advantage – Frontier has a decent shot of hitting the big time. With the benefit of hindsight, REA's failed Italian jaunt was the wet stone that honed its model.

Founded in 2014 by Shaun Di Gregorio, a general manager of REA's Australian business for eight years and former iProperty chief executive, Frontier lacks the value sucking management contracts common in other investment vehicles, such as Macquarie Group's former satellites. Instead, Di Gregorio receives a market-based wage and upside via a large stake in the company – alongside renowned Asian classified investor, Catcha Group. It's reassuring that both are aligned to the interests of minority shareholders.

There's another difference between FDV's and REA's approaches to acquisitions. Instead of buying entire businesses, Frontier takes minority stakes in local market leaders, keeping founding entrepreneurs at the helm, suitably incentivised.

This means it keeps local expertise. If needed, though, Frontier will provide guidance to help the businesses entrench their leadership positions (which is often why an owner sells to Frontier in the first place); otherwise it stays out of the way. Again, it's a better alignment of interests. What about the markets in which Frontier operates? Well, the name says it all. 'Frontier' markets are even riskier than 'emerging' markets, but the opportunity for rapid growth is perhaps greater.

Countries like Pakistan and the Philippines have large populations – 197m and 105m respectively – and rates of internet and online advertising penetration are quickly catching up with more developed economies. The allure of Frontier is the potential of owning a market leader, protected from competitors by network effects, with decades of growth ahead of it.

Unfortunately, the comparison with owning, say, REA or US-based Zillow in its formative years is misplaced. Frontier operates in countries with less stable economies, governments and currencies. That means these businesses are exposed to greater risks than their western counterparts, which is why it's a much smaller than average position for the fund so far.

To soften this risk, Frontier takes a portfolio approach.

It currently has 15 investments, with most focusing on property in the Asian region. Of these 15 investments, we'd expect five to wind up worthless, more than that to muddle through and a small handful to be successful.

Given how profitable a dominant online classified business can be, one winner is all that Frontier might need to be a resounding success. An investment in Frontier is therefore much closer to venture capital investing than typical equity investing.

And, as luck would have it, Frontier might have stumbled upon a winner with its very first investment. In 2014, Frontier acquired a 30% stake in Zameen, the leading property portal in Pakistan. At the time this valued the business at US$4m. After adopting Frontier's suggestions, Zameen's market leadership widened and its growth accelerated.

In May this year, Zameen was valued at US$220m. You read that correctly. Frontier's stake is now valued at 55 times its purchase price. How can this be? Well, maybe it's not. The valuation was conducted privately between two parties, both with an incentive to overstate the value to validate their business models.

Either way, Zameen's revenue is almost doubling every year.

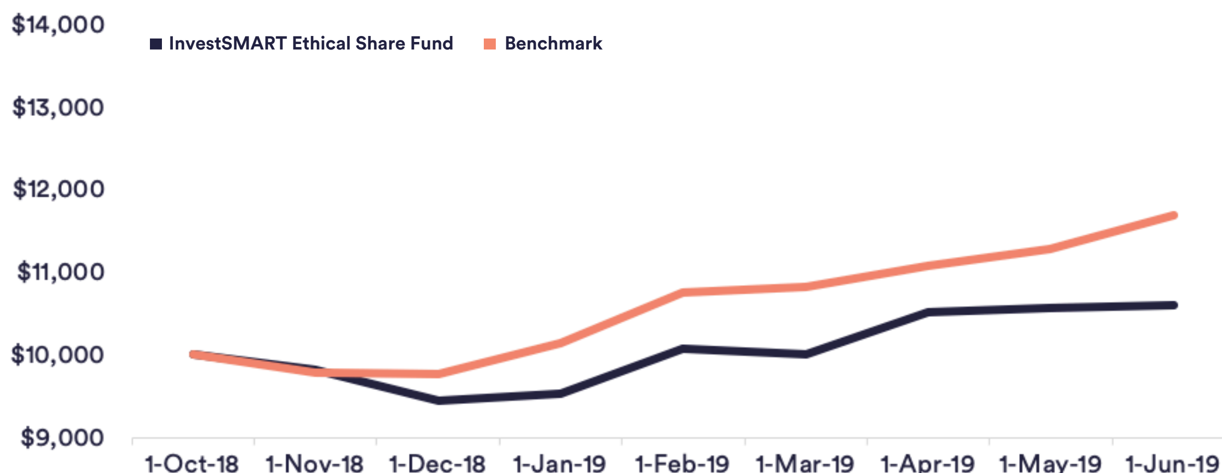
And with the valuation representing a lower multiple of salesthan many listed comparables, it may not be outlandish. There's a chance that Frontier's Zameen stake is worth more than its market capitalisation of $127m, meaning shareholders would get 14 free lottery tickets in the form of its other investments.

Zameen also has the potential to 'get closer to the transaction', which may increase its value further. In many frontier markets, websites garner a higher degree of trust than in the West. This may allow them to facilitate transactions rather than merely advertise them. Zameen could be even more important in Pakistan than REA Group is in Australia, but clipping the ticket on apartment sales, as Zameen does, makes earnings more cyclical.

Frontier's currently burning cash at a rate of $7m each year. But with $20m in the bank it has a few years before passing around the hat. But with nine of its investments expected to breakeven by the end of calendar 2019, it may not need to.

One nagging concern is Gregorio's frustration with the company's share price, which prompted a recent presentation designed to encourage people to buy the stock. A low share price restricts Gregorio's ability to raise cash, make new investments and offer business owners appealing incentives. As frustrating as it may be, we'd prefer Gregorio to stay focused on delivering good numbers and the share price will eventually take care of itself.

PERFORMANCE OF $10,000 SINCE INCEPTION



ASSET ALLOCATION

Sector	Weighting (%)
Cash	26.80
Information Technology	15.25
Industrials	14.32
Communication Services	12.59
Financials	10.93
Real Estate	7.63
Health Care	6.79
Consumer Discretionary	3.68
Consumer Staple	2.01

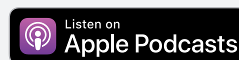
TOP 5 HOLDINGS

Security	Weighting (%)
Frontier Digital Ventures	4.70
360 Capital Group	4.16
Carsales.Com	3.99
Audinate	3.82
Unibail-Rodamco-Westfield	3.70

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.

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.



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 Ethical Share Fund is a concentrated portfolio of 10 – 35 Australian-listed stocks. The Fund invests in a diversified selection of Australian companies that produce growing, sustainable profits at low risk of interruption from the increasing threats associated with Environmental, Social and Governance (ESG) factors and financial criteria to achieve medium to long-term capital growth. This is available as a listed fund (ASX code: INES)or as a separate account through the PMA.

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 Ethical Share Fund?

Australia has one of the world's most stable and highest returning share markets and is often considered a safe-haven by investors. Using a negative screen, the InvestSMART Ethical Share Fund protect against increasing risk from threats from environmental, social and governance (ESG) factors. As value investors, producing safe and attractive returns in the stock market means sticking to a disciplined and repeatable process. We do this by waiting patiently for overreactions in share prices, so we can buy at comfortable discounts to 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 2019 for the PMA
12 June 2019 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
$1 for the Listed Fund

PORTFOLIO MANAGER
Nathan Bell, CFA

Important information

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