INVESTSMART

31 March 2019

Intelligent Investor Equity Growth Portfolio

QUARTERLY UPDATE

This quarter Nathan discusses:

- The market favouring hyper-growth stocks
- Selling off the remaining low-quality businesses
- The increasing potenital with new names added

Intelligent Investor Equity Growth Portfolio

PERFORMANCE TO 31 MAR 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	-0.73%	6.41%	-6.28%	0.87%	4.48%	7.35%	8.14%
S&P/ASX 200 Accumulation Index	0.73%	10.89%	1.75%	12.06%	7.20%	11.46%	8.10%
Excess to Benchmark	-1.46%	-4.48%	-8.03%	-11.19%	-2.72%	-4.11%	0.04%

'Choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot.' **– Joel Greenblatt.**

'If we begin with certainties, we shall end in doubts; but if we begin with doubts, and we are patient with them, we shall end in certainties.' **– Sir Francis Bacon.**

'Have opinions at extremes, and wait for extreme moments.' **– Joe Rosenberg, former CIO for Loews Corp.**

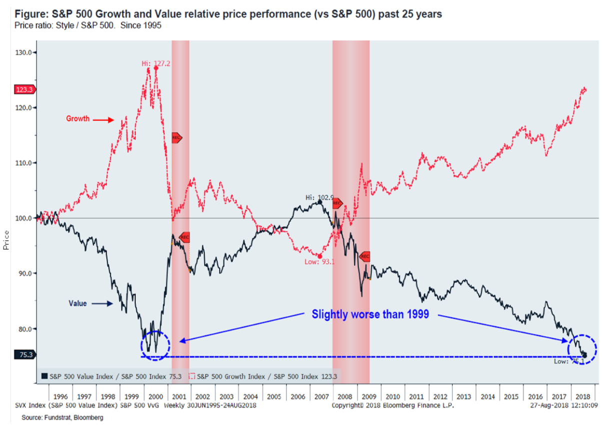
Key points

- **Market favouring hyper-growth stocks**
- **Sold remaining low-quality businesses**
- **Portfolio's potential increasing with new names**

Extreme moments (underperforming like it's 1999)

It's not a coincidence that we've included Joe Rosenberg's quote above about having an opinion at extremes. During the March quarter, the gap between the value of Growth and Value stocks in the US pipped the previous extreme at the height of the tech bubble in 1999 (see Chart 1 below).

Chart 1

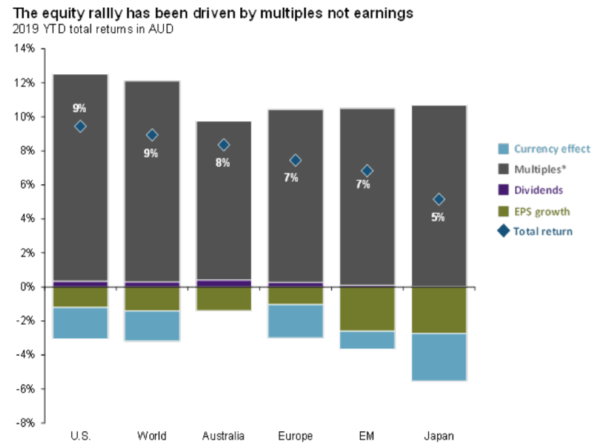


If the 9% fall in the ASX200 during the December quarter aimed to scare those taking excessive risks, then the market's 10% return during the March quarter served to embarrass portfolios without uber-growth stocks.

As fireworks fittingly signalled the end of 2018, investor nerves settled. But instead of a broad recovery, the big gains belonged to market darlings, such as Appen, Altium, Afterpay and Wise Tech Global. Strong revenue growth reported in February sent their share prices into overdrive.

Chart 2 shows the market's recent strong performance is almost entirely due to increasing price-to-earnings ratios. Over the long-term growth in earnings and dividends drive markets, but in the short-term greed and fear can swing prices wildly. Clearly, we remain in the greed cycle.

Chart 2



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. *Multiple expansion is based on the forard price-to-earnings ratio. Chart is for illustrative purposes only. Past performance is not indicative of future results. *Guide to the Markets - Australia*. Data as of 20 February 2018.

The reprieve from higher interest rates in the US and at home has seemingly given investors one last opportunity to roll the dice before a host of economic realities hit home. Unsurprisingly, our portfolio is lagging, though dividends from reporting season in February were higher than expected. The many names we've been adding to the portfolio over the past six months need time to play out, though sucking our thumb on a few opportunities hasn't helped.

Aside from minnows like Audinate and Nanosonics (which we sold in February), which have caught the bull market's eye for stocks with rapidly growing revenue, our portfolio is currently a mix of undiscovered gems and slower-growing but predictable businesses protected by reasonable if not downright cheap valuations.

Frontier Digital Ventures, for example, would be three times its current price if it traded on the same valuation as its nearest competitor. That's why we recently increased our position with the proceeds from selling our subscale position in **iCar Asia**.

With each quarter since separating from the *Intelligent Investor* subscription service, we've increased the portfolio's potential without dropping our standards as our Watchlist of new targets grows.

The recession we have to have?

Several individuals of varying credibility expect the property market has either bottomed already or will very soon. Economic forecasting is a mug's game, but in the style of Oaktree founder Howard Marks, we're focused on second level thinking i.e. searching beyond obvious first order effects for the dangers and opportunities in second and third order effects.

"OVER THE LONG-TERM, GROWTH IN EARNINGS AND DIVIDENDS DRIVE MARKETS, BUT IN THE SHORT-TERM GREED AND FEAR CAN SWING PRICES WILDLY."

Housing markets are very slow moving, particularly given how long it can take to sell a home. Tony Pitt, chief executive and major shareholder of current holding **360 Capital**, would love a large downturn to take advantage of distressed sellers. We would, too, as 360 Capital is flush with cash.

But, at a recent meeting, he suggested the property downturn in Sydney would be soft. That's because the excess supply of apartments would only take a couple of years or so to work off given population growth and the imminent collapse in construction.

Chart 3

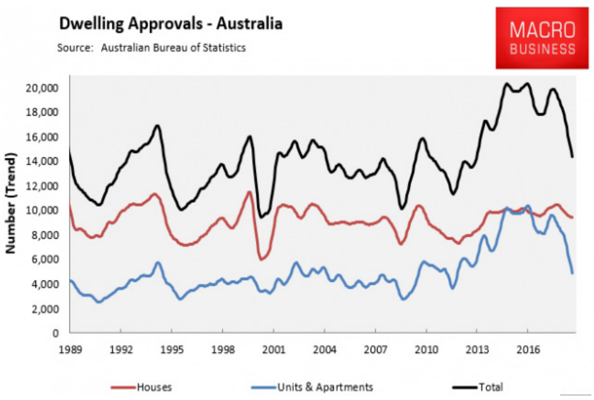


Chart 4

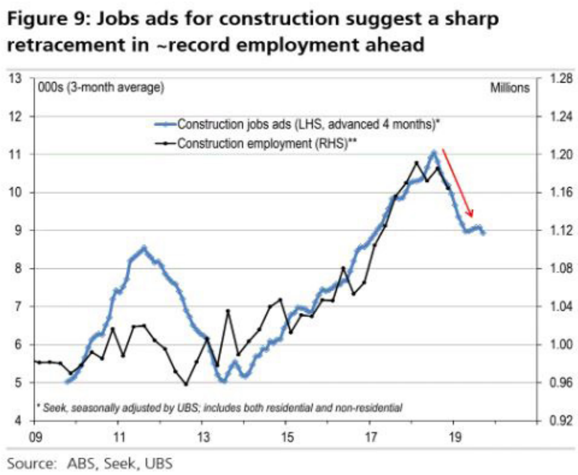
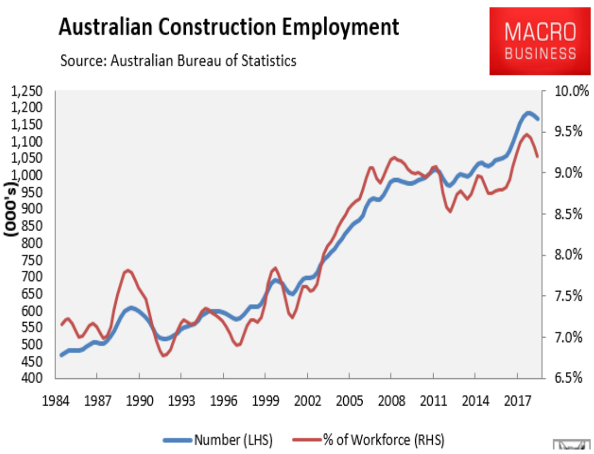


Chart 5



Given the construction industry is one of Australia's largest, a rapid fall in apartment developments could have secondary effects. Construction workers double as property buyers and, with mortgages to pay and less work, higher unemployment could help trigger a second round of price falls and a recession.

Recession or crisis?

A recession in Australia isn't going to bring down the global banking system like the GFC, but the risk of recession will increase if Labor reduces franking credits and negative gearing benefits. Lower interest rates are unlikely to be a match for the wave of deleveraging Australia needs to balance the economy, which hasn't even started. According to the RBA, household leverage recently reached another record.

The next five years will be vastly different for investors compared to the past five, which has important portfolio implications.

Subject to valuation, we're favouring companies that will grow regardless of the economic environment; have large overseas earnings potential; have pricing power, which means they're usually the number one or two in their industry; and that have chief executives prepared to act quickly and decisively in a downturn to increase profits to new highs during the recovery.

In the same way that the best way to judge a fund manager like us is by how you expect us to behave in a bear market, we judge management on their ability to add value through all types of economic environments.

Portfolio

You can follow the links for more detail on purchases and sales during January and February, but during March we added vitamins and supplements company **Blackmores** after its share price fell by a third due to slower sales in China. The share price is now down 57% from its unjustifiable peak of $218 at the end of 2015 and the 2020 price-to-earnings ratio (PER) has dropped to a far more reasonable 22x.

Marcus Blackmore has temporarily stepped in as CEO while the company searches for a permanent replacement after long-time executive Richard Henfrey departed after just 18 months in the top job.

The board has clearly stated it wants change, including lowering costs now that some distribution channels into China have slowed. The company is focusing on developing its own business in China, which should produce more sustainable earnings despite slower initial sales growth compared to the old channels.

Blackmores has just 2% of the Chinese VDS (vitamins, dietary and supplements) market and also has excellent prospects elsewhere in Asia, including Indonesia, which boasts a population almost 10x Australia's.

In the short term, the company needs to hire an operational head in China to oversee the rapid growth in staff, and hire a new CEO, so margins may fall in the short term. But they should increase as sales increase more rapidly outside Australia, which is vulnerable to heavy discounting. The balance sheet is in excellent condition and a 3.1% dividend yield is handy compensation while we wait for earnings growth to pick up.

Marcus Blackmore's large founding stake is also consistent with our preference for insider ownership, as is our view that a new CEO can reinvigorate a business and improve its financial performance.

OFX

We also added online foreign exchange company **OFX**, which has been quietly turned around by chief executive Skander Malcom. While earnings aren't currently growing quickly due to more stable currency markets, this should prove temporary.

In late 2017, OFX replaced its founder-CEO Matthew Gilmour with Skander Malcolm. All the major metrics of business performance have since improved, and the stock is now on a potentially attractive 2020 PER of 18x adjusted for net cash. The 3.5% dividend yield is also handy.

OFX has thousands of competitors, but its foreign exchange transactions are around 75% cheaper than dealing with the major banks and it's doing an excellent job growing its small and medium sized business clients that need to transact every month or quarter with suppliers etc. This is much higher quality revenue than the occasional personal transaction.

The US and Asia are the company's large target markets, where it's been growing strongly off a low base.

Results round up

We sold oil and gas company **Woodside** during March as its share price reached fair value, but it was **Unibail Rodamco Westfield**'s result that left a bitter aftertaste.

With a 7.2% yield that's expected to grow 5-7% per year, we're happy to sacrifice some profit for lower debt levels. And we're not surprised the Westfield acquisition hasn't paid off instantly.

But when the CEO unnecessarily subordinates these facts to the company's supposedly **'STRONG PERFORMANCE'** shortly after selling a large swag of shares, we wonder why else management is trying to paint such a rosy picture.

Platinum Asset Management's share price had been performing well until founder Kerr Neilson sold $300m of shares. Ditto for **Reliance Worldwide** until founding family member Jonathan Munz resigned as chairman and sold his family's remaining shares for $365m. Neither sale has changed our view of each company's prospects.

Seek surprised the market with a strong domestic result, though the company's success will increasingly be measured by its performance in China.

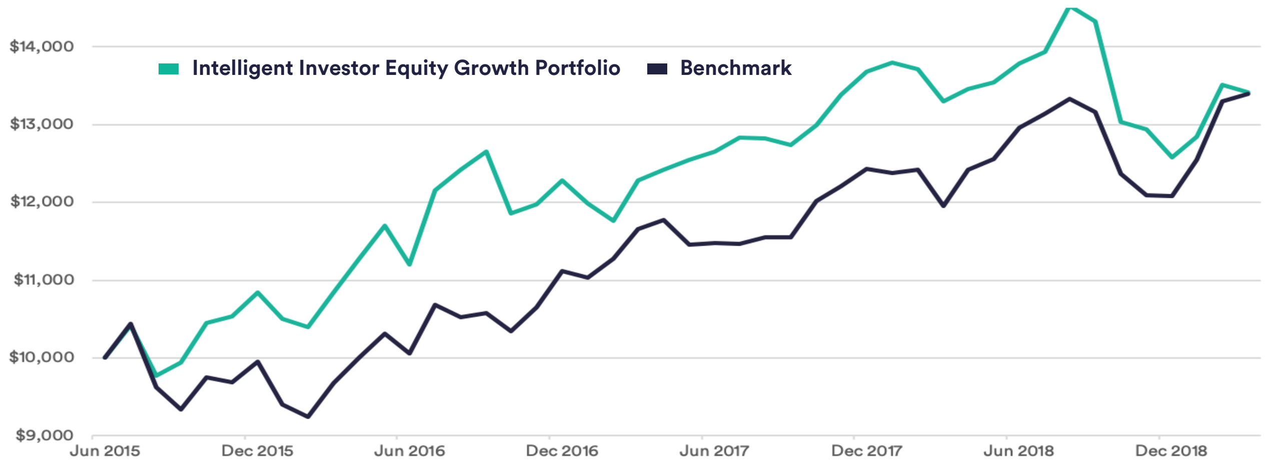
Audio company **Audinate** has been by far the portfolio's best recent performer. It also embodies exactly what we're looking for; a small company that can become a much larger company as it increasingly dominates a large and growing market. As a $370m company that appears to have won its main market potentially worth $1bn, there should be plenty of growth ahead.

Audinate, along with recent additions including **Frontier Digital Ventures**, **Lovisa**, **Pinnacle**, **360 Capital**, **Clydesdale Bank**, **Blackmores**, and **Class**, whose share price has been rebounding since appointing new CEO Andrew Russell, have the potential to produce shareholder returns above 20% per annum over the next few years.

Together with strong franchises, such as **Tabcorp**, **Sonic Healthcare, ResMed** and Reliance Worldwide, just to name a few, the portfolio is well positioned for whatever economic surprises wait in store.

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 March 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. Peers indicated in the performance table is a Morningstar data feed based on similar underlying securities per portfolio.

PERFORMANCE OF $10,000 SINCE INCEPTION



ASSET ALLOCATION

Sector	Weighting
Consumer Discretionary	17.06%
Industrials	16.76%
Information Technology	15.57%
Financials	11.00%
Cash	10.46%
Real Estate	9.17%
Communication Services	7.14%
Health Care	5.96%
Materials	4.05%
Consumer Staples	2.83%

TOP 5 HOLDINGS

Security	Weighting
Sydney Airport	4.93%
360 Capital	4.76%
Audinate	4.70%
Seek	4.53%
Unibail-Rodamco-Westfield	4.50%

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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 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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