InvestSMART Australian Equity Income Fund

(Managed Fund) (ASX:INIF)

Quarterly Report

30 SEPTEMBER 2019

- Better quarter of performance
- Several changes in September
- Solid reporting season

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(Managed Fund) (ASX:INIF)

Quarterly Report – September 2019

PERFORMANCE TO 30 JUNE 2019 (AFTER FEES)	1 MTH	3 MTHS	6 MTHS	1 YR	S. I. (P.A.)
InvestSMART Aust. Equity Income Fund	2.3%	3.3%	7.2%	2.3%	1.9%
S&P ASX 200 Accumulation Index	1.8%	2.4%	10.5%	12.5%	12.3%
Excess to Benchmark	0.5%	1.0%	-3.3%	-10.2%	-10.4%

Sometimes you have to give things time, and sometimes you have to do things quickly and just take the band-aid off, and I think the art and the skill is probably knowing which is which.'

– Beverley McGarvey.

Nature does not ask your permission, she has nothing to do with your wishes, and whether you like her laws or dislike them, you are bound to accept her as she is, and consequently all her conclusions.

– Russian novelist Fyodor Dostoyevsky.

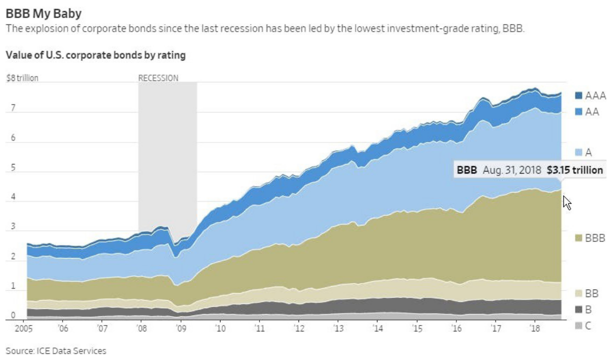
Risk is what's left over when you think you've thought of everything else.

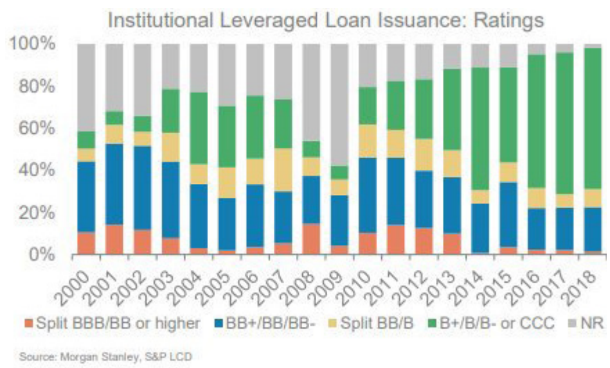
– Carl Richards.

Old solutions for old problems

Low interest rates have boosted the stocks of perceived bond proxies, such as Transurban and Goodman Group, and companies with rapidly growing revenue, such as the WAAXA technology stocks. But this action seems tame compared with the shenanigans in the beating heart of the global financial system, the US credit market.

The following two charts show the explosion in triple-B rated bonds, which is essentially the lowest rung before becoming junk bonds, or non-investment grade bonds. Unlike the incredible metamorphosis that turns caterpillars into butterflies, there's no mystery to how triple-B bonds dissolve into junk bonds; too much debt, not enough cashflow.



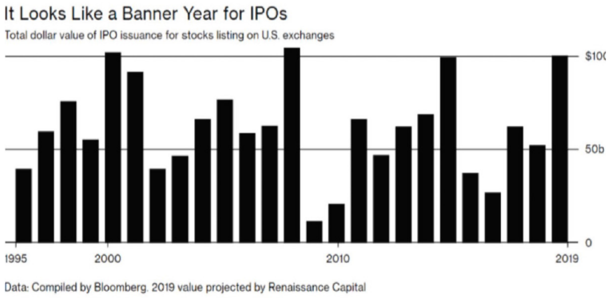


Jim Grant from Grant's Interest Rate Observer highlights one market where risky loans have reached bubbly proportions.

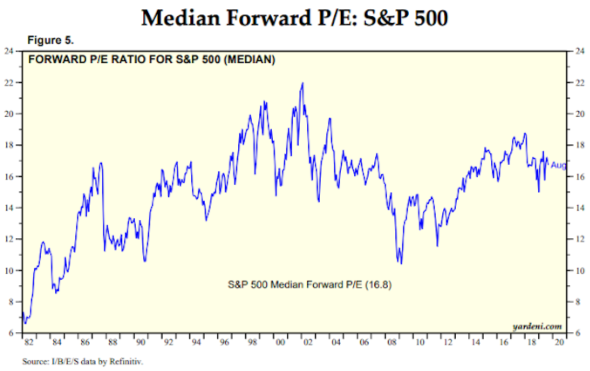
'…this provides a window into the ongoing private equity [PE] boom, as p.e. backed companies constitute 85% of the $1.2 trillion loan market. As the post-crisis economic expansion continues into a record 112th straight month, p.e. has paid ever higher prices and tacked on more debt, with Bain Capital's 2019 Global

Private Equity Report finding that the average LBO [Leveraged Buyout] price rose to 10.9 times Ebitda last year, well above the 9.9 times seen in 2007, while leverage at p.e.-sponsored companies footed to 6 times Ebitda in 2018, compared to 4.9 times in 2007.'

As leverage is higher now than it was prior to the GFC, it's not surprising that insiders are dumping their shares.



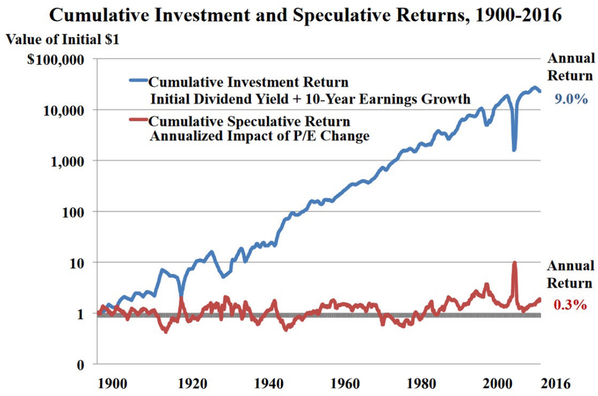
The risky behaviour in credit markets is also pumping up valuations in the stockmarket. But the tide is not lifting all boats.



This is because the market is bifurcated much like it was in 1999, when tech stocks with no earnings were flying high while more traditional and much more profitable businesses were left trading on low multiples. In the following years value investors made fortunes while tech investors lost their shirts. Even investing legend Stanley Druckenmilller lost billions speculating on tech stocks having entered the market the day before the tech wreck began.

In the short-term share prices can swing wildly as price-to-earnings ratios reflect the fear and greed of investors. But in the long-term your returns will reflect growth in earnings and dividends, as the following chart shows.

The key message is as clear as it is simple. Stick to quality, don't get up in the hype, and if you've got lucky owning some stocks whose valuations are currently in the stratosphere, lock in your profits.



Source: ://johncbogle.com/wordpress/wp-content/uploads/2016/10/Bogleheads-15-2016.pdf

Portfolio changes

There were no trades in July and August, but come September we replaced **Amcor**, **Clydesdale Bank** and **Unibail-Rodamco-Westfield** (URW) with **Chorus** and **New Hope Corporation**.

Amcor and URW were bought for their defensive attributes, but we're now finding better opportunities. Our trust in URW's management has also fallen along with the share price. URW has as much chance as any retail landlord to adjust to a world with more online retailing, but management has become increasingly promotional and selective with its reporting. These red flags signal tougher times ahead.

Clydesdale Bank

Clydesdale Bank also announced a massive increase in payment protection insurance claims as the window for claims finally shut in August. The amount was far bigger than anyone expected, including us, at over 20% of the company's market value.

Instead of that money being returned to shareholders through dividends and perhaps a share buyback once the acquisition of Virgin Money is bedded down, as per our investment case, that money will now go to wronged customers. With our investment case broken, we sold out.

Chorus

Chorus has spent almost ten years and NZ$5bn building New Zealand's Ultra Fast Broadband network (UFB), the Kiwi version of the NBN. The UFB is now active and, like the NBN, it is swiftly churning users of copper broadband into users of fibre broadband.

Unlike the NBN, the UFB achieves astonishing speeds – it is about 20 times faster than the Australian equivalent because the entire network, right to each premise, is built on fibre.

Chorus is the owner of about 75% of that fibre network. The remainder will be built and owned by smaller companies who specialise in specific regions. You might expect the owner of crucial piece infrastructure – a bona fide monopoly – would make a thrilling investment.

The problem is no one knows, as the regulation stipulating how much profit the business will earn won't be decided until next year at the earliest. There's a number of key arguments that we won't discuss in detail here, but with the share price falling over 10% recently we believe the bull case materially outweighs the bear case.

Only time will tell, but if the regulation is punitive then we'll still own a small share of a valuable piece of national infrastructure whose dividends will increase dramatically in the years ahead now that we've just passed peak expenditure on what's been a massive project.

New Hope Corporation

New Hope not only represents a small contrarian bet on coal demand and prices, but also on the company gaining regulatory approval to expand its New Acland mine. While volatile coal prices will impact earnings and the share price in the short term, in the long-term management's contrarian streak buying and developing mines means the share price could double if everything goes right.

If not, the company's existing mines should produce an attractive dividend stream. It's a classic case of heads we win big, tails we shouldn't lose too much.

We've lifted some important updates from the August monthly report below.

Key results

Link Administration's share price had fallen 40% from a peak of nearly $8 in May due to regulatory changes, problems associated with its $1.5bn UK acquisition two years ago and increasing scepticism about the time it's taken to resign key Australian superannuation clients.

Costs to deal with Australian regulatory issues have remained stubbornly high, but they should subside in a year or so when the company should've also upgraded old IT systems in the UK. The company also finally agreed terms with REST superannuation recently, which means it has resigned two of its four major Australian superannuation clients that produced half the company's profits when it listed in 2015. The proportion has roughly halved since the large UK acquisition, but the contracts are still very important to Link's profitability.

Pricing power in Link's financial administration businesses, such as share registry management, is constantly falling and growth is slow. That means management must continue making tuck-in acquisitions to keep lowering costs.

Link will suffer when corporate and market activity slows. But longer term, Link should benefit from increased outsourcing and opportunities such as the UK pension system switching to Australia's system or favouring defined contribution schemes over defined benefit schemes.

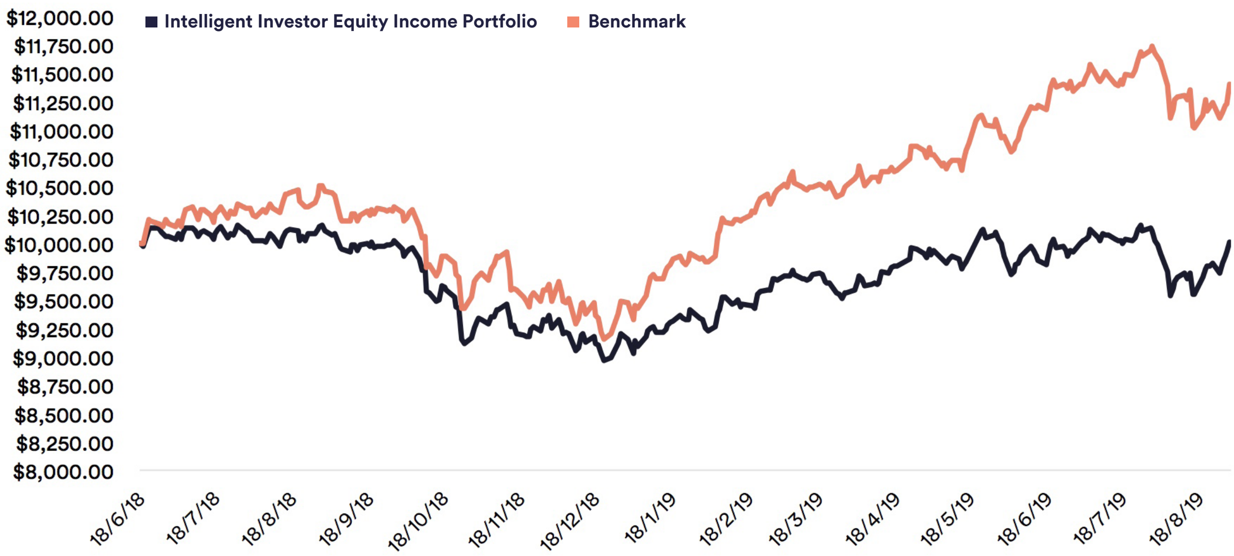
Link currently trades on a forecast price-to-earnings ratio of just 11 after adjusting for its 44% stake in property settlement company PEXA. That leaves plenty of room for a higher valuation should management return the business to growth in 2021 and beyond.

Smartgroup

The recent increase in **Smartgroup**'s share price suggests it reported a scintillating annual result. More truthfully, it reflects fading fears of a large fall in earnings due to lower new car sales.

Smartgroup chief executive Deven Billimoria has made an art form out of acquisitions, but his large anchor of past success will drag on future returns. Still, with the stock trading on a forecast PER of 18 and a 4% fully franked dividend yield, and with a chief that still has skin in the game despite selling a quarter of his shareholding last year, we hope to be long-term shareholders.

PERFORMANCE OF $10,000 SINCE INCEPTION



ASSET ALLOCATION

Sector	Weighting
Financials	20.7%
Industrials	16.8%
Consumer Discretionary	15.7%
Cash	14.4%
Consumer Staples	7.8%
Materials	6.3%
Communication Services	6.1%
Real Estate	5.1%
Information Technology	2.9%
Health Care	2.3%
Energy	1.9%

TOP 5 HOLDINGS

Security	Weighting
Commonwealth Bank of Australia (CBA)	8.9%
Westpac Banking Corporation (WBC)	6.7%
BHP Group (BHP_	5.2%
Sydney Airport Holdings (SYD)	5.2%
360 Capital Group (TGP)	5.1%

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 Sep 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)

InvestSMART 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 invest in 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

Important information

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Investment in securities and other financial products involves risk. An investment in a financial product may have the potential for capital growth and income, but may also carry the risk that the total return on the investment may be less than the amount contributed directly by the investor.

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