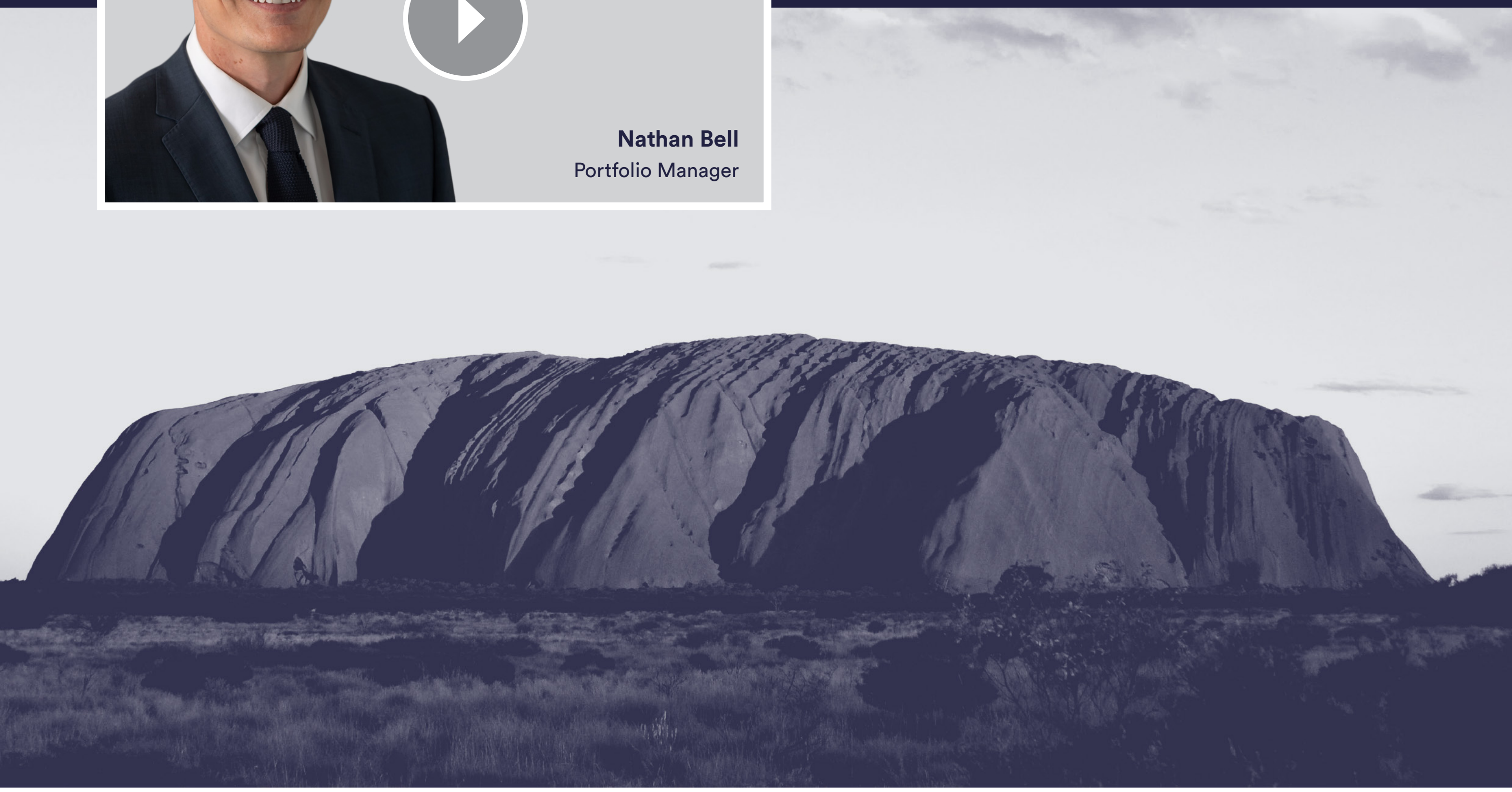
Intelligent Investor Equity Growth Portfolio

Quarterly Report

30 SEPTEMBER 2019

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



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Intelligent Investor Equity Growth Portfolio

Quarterly Report – September 2019

PERFORMANCE TO 30 SEP 2019 (AFTER FEES)	1 MTH	3 MTHS	6 MTHS	1 YR	2 YRS (P.A.)	3 YRS (P.A.)	4 YRS (P.A.)	S. I. (P.A.)
Intelligent Investor Equity Growth	4.1%	5.0%	11.0%	4.3%	8.2%	5.6%	10.7%	9.9%
S&P ASX 200 Accumulation Index	1.8%	2.4%	10.5%	12.5%	13.2%	11.9%	12.2%	9.7%
Excess to Benchmark	2.3%	2.6%	0.5%	-8.2%	-5.0%	-6.2%	-1.5%	0.2%

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.

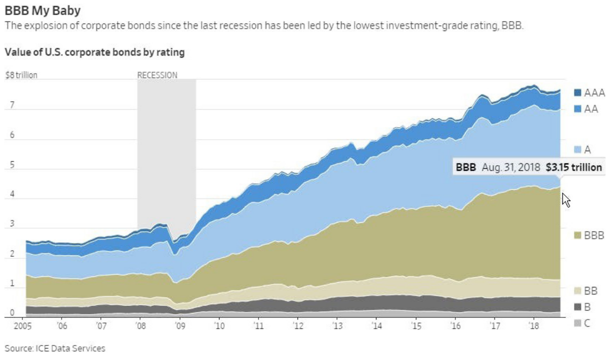
Risk is what's left over when you think you've thought of everything else.

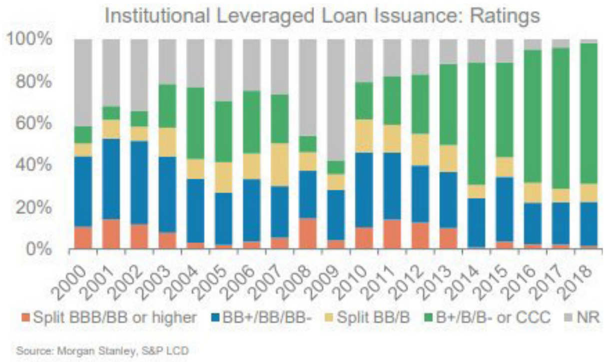
– Carl Richards.

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.



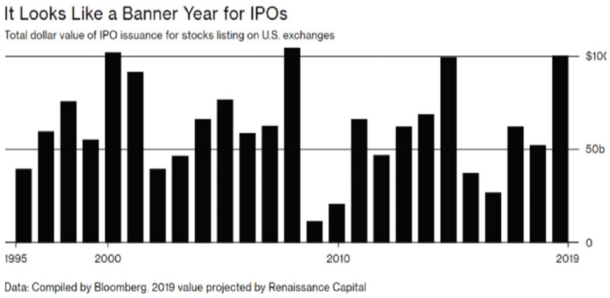


Jim Grant from Grant's Interest Rate Observer highlights one market where risky loans have reached bubbly proportions.

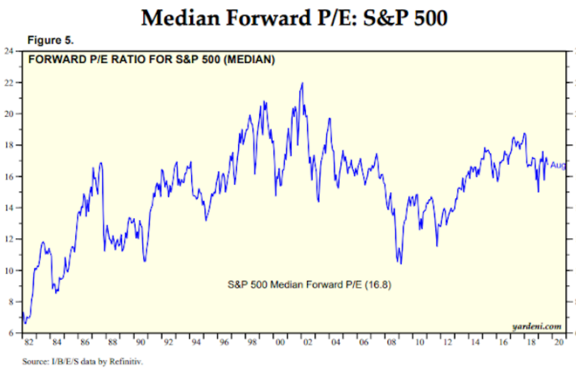
'...this provides a window into the ongoing private equity [PE] boom, as p.e. backed companies constitute 85% of the $1.2 trillion loan market. As the post-crisis economic expansion continues into a record 112th straight month, p.e. has paid ever higher prices and tacked on more debt, with Bain Capital's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



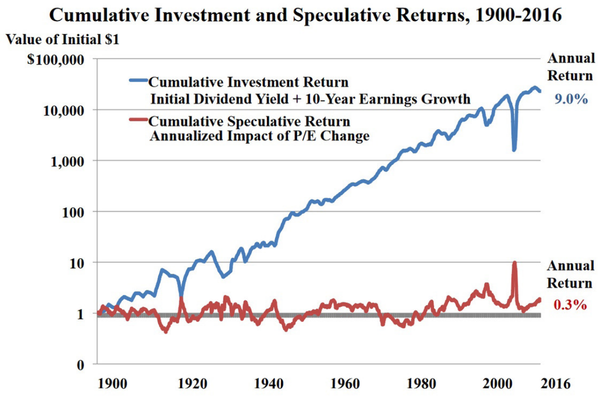
The risky behaviour in credit markets is also pumping up valuations in the stockmarket. But the tide is not lifting all boats.



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

The only change in July and August was selling **Clydesdale Bank** to make room for resources software company **RPMGlobal** while preserving our small amount of cash for an expected increase in volatility. Even though we still believed Clydesdale was cheap (an opinion we changed after the company announced a massive increase in payment protection insurance claims), RPMGlobal has much more potential.

RPMGlobal has invested $70m upgrading its software designed to manage large resources projects. It's a large investment for a $150m company that's conservatively been entirely expensed in the profit and loss statement. In other words, the income statement currently shows all the costs without the value from increasing subscription sales over many years.

Software sales are also growing quickly in the first six weeks of this financial year, with annual recurring revenue from subscription sales up 65%. Management's recent statements have been the most bullish we've seen yet the stock is flying under the radar with only one broker covering the stock from Brisbane.

Once you apply some financial gymnastics to adjust for the company's cash and coal advisory business that makes a $5m operating profit, you get the software business for around one times sales compared to 10x sales multiples or more for the current crop of software darlings.

Spring clean

Come September, we replaced **Amcor** 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.

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.

> **"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 THINGS GO RIGHT.**

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 things go 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

We'll compare four results from **Smartgroup** and **Jumbo Interactive**, which have performed exceptionally well since being added to the fund, and **Reliance Worldwide** and **Link Administration**, which have not.

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.

Reliance Worldwide

Reliance Worldwide had previously announced a profit downgrade that included a laundry list of issues. But its share price has been recovering since its full year result included a rosier outlook and management confirmed its recent acquisition of UK business John Guest remains on track.

Reliance is not the world's greatest business, but its global distribution of push-to-connect plumbing supplies that save plumbers huge amounts of time is a competitive advantage.

While the fittings are cheap, they're also easy to replicate. Success relies on plumbers paying a premium for Reliance's SharkBite branded fittings, and continued innovation to maintain pricing power and benefit from the switch away from time consuming soldering and crimping methods historically used for plumbing repairs.

Smartgroup

The recent 40% 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.

Jumbo Interactive

Lastly, Jumbo Interactive's share price initially fell 19% despite an excellent result from the online lottery company that included an announcement from founder and chief executive Mike Veverka that he was aiming for a three-fold increase in ticket sales to $1bn by 2022.

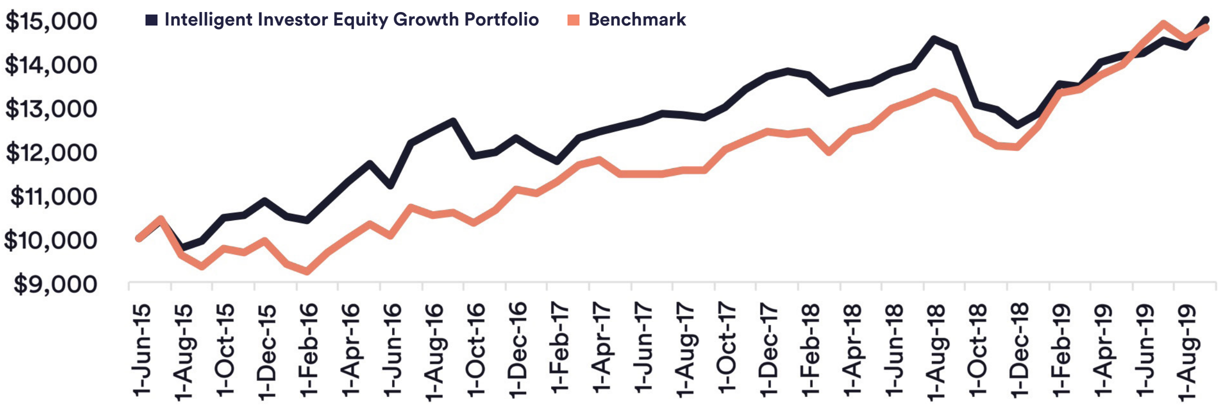
The stock price has now fully recovered, and our only complaint is that our initial position in the fund was kept to 2% so we could average in over time.

" RELIANCE IS NOT THE WORLD'S GREATEST BUSINESS, BUT ITS GLOBAL DISTRIBUTION OF PUSH-TO-CONNECT PLUMBING SUPPLIES THAT SAVE PLUMBERS HUGE AMOUNTS OF TIME IS A COMPETITIVE ADVANTAGE.

In summary, the portfolio continues to improve as we add more potential from high quality names that are flying under the radar. We've benefited from strong performances over the past year from stocks including **ResMed**, **Frontier Digital Ventures**, **360 Capital**, **Audinate** and **Lovisa**, amongst others, but several profit downgrades have undone much of the good work. That should be less of a problem from here.

Turnover has fallen dramatically since the portfolio was given a major overhaul in February. And with the portfolio now having far more potential than the market, we look forward to more major buying opportunities like last December as volatility increases.

PERFORMANCE OF $10,000 SINCE INCEPTION



ASSET ALLOCATION

Sector	Weighting
Industrials	19.8%
Information Technology	18.7%
Consumer Discretionary	18.5%
Communication Services	12.5%
Cash	8.9%
Health Care	7.1%
Financials	6.0%
Real Estate	4.9%
Energy	1.9%
Consumer Staple	1.8%

TOP 5 HOLDINGS

Security	Weighting
Frontier Digital Ventures (FDV)	5.6%
Audinate (AD8)	5.4%
Lovisa (LOV)	5.2%
SEEK (SEK)	5.0%
ResMed (RMD)	4.9%

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. 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. Table 1 performance figures; after investment and admin fees, 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 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 invest in 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
0.97% p.a.

PERFORMANCE FEE
N/A

MINIMUM INITIAL INVESTMENT
$25,000

Important information

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