Quarterly Update

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Intelligent Investor Australian Equity Income Fund (Managed Fund) (ASX:INIF)

Issued by
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"The greatest danger in times of turbulence is not the turbulence. It is to act with yesterday's logic."

— Peter Drucker

"... what he desires is to be told specifically which particular stock to buy or sell. He wants to get something for nothing. He does not wish to work. He doesn't even wish to have to think."

— Jesse Livermore

The bill for a decade of Frankenstein monetary policies is falling due. Sovereign debt issues are threatening some emerging and European countries and UK pension funds have been exposed in a classic case of reaching for yield.

UK pension funds thumbed their noses at zero interest rates trading their conservative reputation and financial promises for leveraged bets on bonds.

The margin calls on these soured bets are so large that a range of rescue measures from the UK government have reduced the British economy's standing to comparisons with emerging markets.

Confidence is evaporating, the pound is collapsing and it's just the start as increasing interest rates lift the veil on the full extent of risk taking over the past decade.

Performance (after fees)

	3 mths	1 yr	2 yrs (p.a)	3 yrs (p.a)	4 yrs (p.a)	S.I. (p.a)
II Australian Equity Income Fund	6.1%	1.8%	20.9%	9.6%	7.7%	7.2%
S&P ASX 200 Accumulation Index	0.4%	–7.7%	9.8%	2.7%	5.0%	5.5%
Excess to Benchmark	5.7%	9.5%	11.1%	6.9%	2.7%	1.7%

Inception (S.I.): 18 Jun 2018



Fund overview

The Intelligent Investor 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.

5+ yrs
Suggested investment timeframe

10 - 35
Indicative number of securities

Risk profile: High
Expected loss in 4 to 6 years out of every 20 years

S&P/ASX 200 Accumulation Index
Benchmark

Investment fee
0.97% p.a.

Performance fee
Nil

With the RBA losing $37bn on its own bond sales recently as it reverses QE purchases, the final bill from this epic everything-bubble promises to be monumental. US interest rates are still increasing and it could be years before the full impact is known.

We don't normally say much about the economic environment unless it's directly impacting our stocks. But amidst the fear and whining about higher interest rates, it's worth highlighting that appropriate interest rates maximise the efficient use of our limited resources and help avoid speculative manias and their aftermath.

In recent years, central banks have been fuelling asset bubbles experimenting with zero interest rates and quantitative easing to paper over fundamental problems exposed by the GFC. They're now resurfacing, creating new problems as well.

Getting the official US interest rate past 2% was recently considered almost impossible in a world drowning in asset bubbles and debt. If 4-5% is achieved, as is looking more likely, it would be a major success.

Savers wouldn't need to take large risks to earn a decent return. Much of the current misallocation of resources would end as the economy adjusts, and fundamental investing would reassert itself.

The upshot would be a healthier, more stable and sustainable economy hopefully more focused on productivity and long-term investment rather than speculation and flipping houses.

It would've been better if central bankers had started this process years ago – or never needed to at all – instead of being forced to by the inflation caused by their own risky, naive policies. But we welcome the emerging opportunities.

Performance

The Fund increased 6.1% during the September quarter compared to the market's 0.4% return, chiefly driven by our coal stocks, **Whitehaven Coal** and **New Hope**. Both recently announced profit and dividend bonanzas and the best may lay ahead.

Whitehaven Coal's dividend next year is expected to be $1.50 fully franked. That's 50% above the price we paid for some of our shares a year ago without the franking credits, and an 18% fully franked yield based on the current share price.

When your winning stocks are front page news the secret is out and they're unlikely to be cheap. The coal companies are an odd situation, though, and we're trying to hang on as their share prices surge.

It would be much better to bank our profits with fully franked dividends than capital gains. Whitehaven also recently discussed an off-market buyback to distribute its rapidly growing bank of franking credits.

But with share prices now 4-9x higher than our purchase prices, we're walking a tightrope. A recession and/or an end to Putin's miserable war could slam coal prices and eliminate our tax concerns along with our profits.

With Putin blowing up gas pipes and recruiting anyone that can hold a gun, including prisoners – one-way tickets out of Russia on a private jet have reportedly reached US$29,000 – a recession seems more likely. Should their share prices rise much further we'll be forced to start selling.

A recession is already being priced into **Woodside Petroleum**. But with a pristine balance sheet there's an increasing chance of a special dividend this year to accompany its regular dividend.

NSW regulators who, like their Victorian compatriots, judged the casinos too big to fail because of their thousands of hard working, innocent staff, have given **Star Entertainment** one last chance to go straight. Unfortunately, there will be few, if any, serious penalties for the guilty.

The company is working with its lenders to cover its estimated fines potentially in the hundreds of millions of dollars until the cash starts flowing from the new Brisbane casino. At the current price you're paying next to nothing for the casino licenses, so a worst case from here is most likely almost fully priced in.

The share price of **Mineral Resources** bounced after discussing potentially listing its lithium business separately abroad. The market is still very excited by green metals, such as lithium, so we're unlikely to get a big chance to increase our stake until the excitement wanes.

We started small positions in **MA Financial** and **James Hardie Industries** during September. MA Financial's share price has fallen 55% from its highs due to its unsustainable earnings from slowing M&A activity, for example, and the likely end of special investment visas, which may account for as much as a quarter of the company's earnings.

We've considered any profits from this business a bonus and left plenty of room to build a large position should the price get closer to $3, which would provide a greater margin of safety against a prolonged slump in financial markets and activity, outflows and falling valuations.

James Hardie is unlikely to maintain its current profit margins as US and Australian property markets slow, but the almost halving of its share price has already reflected some of that.

Most of its profits come from maintenance and repairs, which can't be put off forever, but the operating leverage in this business can be painful when volumes fall. Again, we've left plenty of room to increase our stake, as it's a stock we want a large position in at the right price.

On the flipside, we sold **LendLease** after learning more about a large potential tax liability relating to the historical accounting treatment on the sale of some retirement villages.

The stock is potentially very cheap. But a bad outcome following the current investigation by the Australian Tax Office combined with a potential recession and another capital raising if there's a cost blowout on the Melbourne Metro Tunnel would gut the stock's potential.

Also, learning more about both prior and current management's attitude toward legal advice on the matter reminded us of other companies that have recently been in the headlines for all the wrong reasons, such as the banks, the casinos, **Qantas** for its outrageous share buyback and **Rio Tinto** after blowing up an indigenous site.

The disastrous financial and reputational damage from these decisions is clear, and Lendlease is particularly vulnerable given its cyclical, low-margin business. It also has a large exposure to the UK, who's economy is in dire straits.

Frontier Digital Ventures reported another set of excellent numbers, showing rapid growth across its businesses and increasing profitability at its most mature business, Zameen. But fears of a sovereign debt crisis, particularly in Pakistan, are smashing the share price.

Rapidly increasing costs of food and energy for large importers like Pakistan with large overseas borrowings is a toxic mix when the US dollar is surging. Pakistan is receiving financial assistance but there are no guarantees the

currency won't eventually collapse.

That would likely smash FDV's share price, which is why it's not a large position yet, but we'd likely consider it an opportunity as the future of the business is Latin America and the share price is already reflecting a dismal outlook. Albeit some of those countries may have financing issues, too, in a broad financial crisis.

Litigator **Omni Bridgeway** has been a sleeper in the portfolio, recently increasing over 50% due to several pieces of good news including launching new funds, insuring more of its successful claim payouts, and searching for ways to realise cash from its cases sooner.

The stock price isn't much above our initial purchase prices, though, so it's too early to claim victory.

Tabcorp CEO Adam Rytenskild is under increasing pressure from large shareholders to sell itself to bigger rivals before it risks overpaying for the Western Australian TAB wagering license.

Lastly, **360 Capital** announced an eight-cent special dividend, which is a 10% yield at the current share price. However, given the company is now essentially a cash box as CEO and major shareholder Tony Pitt prepares the company for a recession, dividends will fall substantially next year.

No company is better prepared for a recession than 360 Capital despite what the recent fall in its share price suggests.

Most of the commentary this year has speculated that at worst, we'll have a short and sharp recession due to the higher interest rates needed to quell inflation. But we believe these commentators are focused on the wrong thing.

The giant US equity bubble is deflating and it's likely to be slow and painful for those that aren't excited about buying cheap assets for the long term. The portfolio is as well prepared as it's ever been for what lies ahead, and any outperformance right now is a bonus.

Our best returns come when we emerge from tough periods after most investors have long given up. The opportunities are getting better but the earnings downgrades are only beginning.

This time next year we expect to have the best portfolio we've had since we started managing money in 2015. With a bit of luck, it will be sooner.

Please get in touch if you have any questions on **1300 880 160** or at **info@intelligentinvestor.com.au**

Appendix

How to buy ETFs: 4 tips for beginners

ETFs are a great way to diversify your portfolio. Here are four tips to get you more bang for your buck.

Investing in exchange-traded funds (ETFs) has never been simpler – you can now own a portfolio of dozens of stocks within minutes and with as little as $500.

Last year, the Intelligent Investor Ethical Share Fund (ASX:INES) listed on the ASX and it's important to us that you get the most value out of it. If you've never bought an ETF before, the following tips will set you up for success.

No. 1 – Know what you're buying

ETFs can seem intimidating at first, but they're actually quite simple – rather than buying a single stock, you're buying a basket of stocks instead. Someone else chooses which stocks go into the basket, but you can buy and sell the basket whenever you like and set the price at which you're willing to trade.

The important thing to remember is that because individual investors set the price at which they choose to buy or sell, the ETF's share price doesn't automatically reflect the value of what's in the basket. An ETF's share price can be wildly different to the collective value of the individual stocks inside it.

What's more, you don't always know when the last transaction occurred – for infrequently traded ETFs, it may have happened days ago, causing an even larger discrepancy between the share price you see on your trading screen and what the basket is worth.

For this reason, before purchasing any ETF, we recommend checking its 'indicative net asset value,' or iNAV, on the ETF provider's website. This figure represents what the fund is worth if you added up the market value of all of the individual stocks inside it. In most cases, it's updated every minute or so.

For the Ethical Share Fund, you can find the iNAV under 'Key Facts' on its **information page**.

It's unlikely (though not impossible) that you'll be able to buy an EFT at a large discount to its iNAV, but avoid paying too much more. Otherwise, it's a bit like buying a 6-pack of beer for $20, when you can buy the individual cans for $2 each.

No. 2 – Use limit orders

When you go to buy or sell an ETF, you will need to put in a trading order with your broker, typically through your online brokerage account.

On the main trading screen, you will be asked for a few bits of information, such as the ETF's ticker symbol (INES, in the case of the Ethical Share Fund) and how many units you want to buy.

You'll also be given the option to choose between a 'limit' or an 'at market' order. With Tip No. 1 in mind, *always* choose the 'limit' option and enter the maximum price you are willing to pay per unit.

The 'at market' option is essentially saying to your broker that you want to buy the ETF at the best available price – whether its $1 or $100 – so you're more likely to be caught overpaying.

For example, at the time of writing, the Ethical Share Fund has a net asset value of $3.18 per share. It's ok to put in a limit price a cent or two above this to ensure you get matched quickly, but don't go much higher than that or you're leaving money on the table.

If you aren't matched by the end of the day, you shouldn't leave your order overnight (look for the 'good for 1 day' option when you place the trade). If something major happens overseas while you're asleep, it could mean that the market moves significantly the next morning, and you could be caught overpaying or selling for less than the fund is worth.

No. 3 – Do your trading at lunchtime

Unfortunately, investors often forget or don't realise that early trading can be a time of major price swings for ETFs. There's often an imbalance between buy and sell orders, causing some people to buy at a much higher price than the ETF is worth. This ultimately reduces their long-term returns.

We recommend you give the market some time to settle before making any ETF trades. Normal trading on the ASX takes place from 10:00 am to 4:00 pm, Sydney Time, so it's a good habit to place your orders after 10:15 am and before 3:45 pm to ensure the fund's iNAV has settled and the fund's share price reflects it.

No. 4 – Be patient

Patience is just as important for holders as it is buyers. In one study, researchers found that those who trade the most lagged the overall market's performance by 6.5%, partly due to 'frictional costs' like excessive brokerage commissions and taxes (see ***Why patience pays off***).

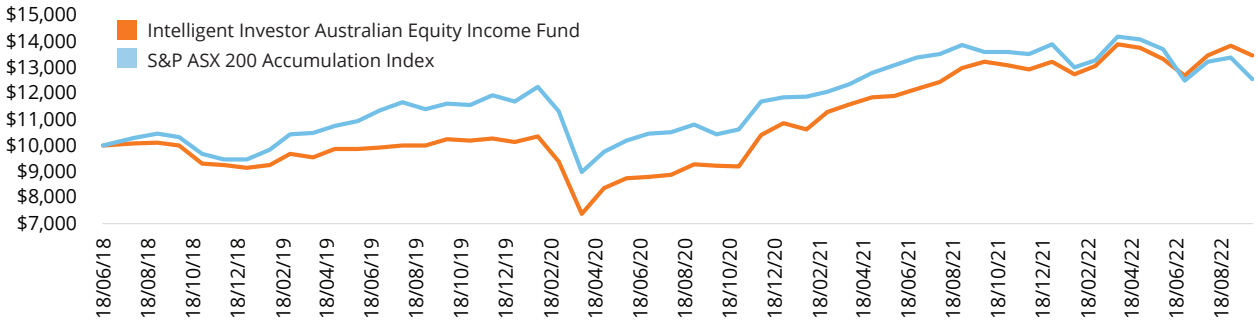
Historically, stocks and funds have outperformed most other asset types over the long term, but volatility in the interim can be gut-wrenching.

When you buy the Ethical Share Fund or any other, you should go in expecting there to be bumps in the road and have a commitment to ignore the short-term fluctuations. Investment ideas can take a while to play out.

When buying any sort of fund, it's better to focus on the fund's investment strategy, management fees, and long-term performance, rather than how it performed in the past month – or even the past year, frankly. We're pleased to report that our Ethical Share Fund beat the All Ordinaries Index by 18% over the past 12 months, but there will inevitably be years where it struggles too.

'The biggest thing about making money is time,' Warren Buffett says. 'You don't have to be particularly smart, you just have to be patient.'

Performance since inception



Inception (S.I.): 18 Jun 2018

Asset allocation

Materials	24.1%
Cash	16.2%
Consumer Discretionary	13.4%
Energy	13.1%
Financials	10.2%
Information Technology	6.3%
Industrials	5.4%
Real Estate	4.2%
Communication Services	2.9%
Utilities	2.3%
Health Care	2.0%

Top 5 holdings

BHP Group (BHP)	9.9%
Whitehaven Coal (WHC)	7.5%
Woodside Petroleum (WPL)	6.9%
New Hope Corporation (NHC)	6.1%
Auckland International Airport (AIA)	5.4%

Fund Stats

Income yield	12.24%
Net asset value	$2.78

Important information

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All tables and chart data are correct as at 30 September 2022.