31 December 2021

Quarterly Report

Intelligent Investor Australian Equity Income Fund

(Managed Fund) (ASX:INIF)

Quarter Highlights

- **Resources stocks backpedal but could be at the beginning of long bull market with big dividends**
- **Bank profit margins squeezed; we can imagine not owning any banks**
- **Added four new stocks including Frontier Digital Ventures, Mineral Resources, Magellan Financial and Waypoint REIT**

About Us

With a 20-year track record of beating the market, clear and straightforward language, and an 'open book' approach to stock research and analysis, *Intelligent Investor* offers actionable, reliable recommendations on ASX-listed stocks.

In 2014, *Intelligent Investor* became a part of the InvestSMART family, extending our expertise to even more Australian investors seeking quality analysis and advice.

Fund overview

Listed on 18 June 2018, this Fund mirrors the Intelligent Investor Equity Income Portfolio.

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.

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 estimated intrinsic value.

Investment objective

To produce a sustainable income yield above that of the S&P/ASX 200 Accumulation Index.

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. Nathan returned to *Intelligent Investor* in 2018 as Portfolio Manager, having previously been with *Intelligent Investor* for nine years, spending five of those as Research Director. Nathan has a Bachelor of Economics and subsequently completed a Graduate Diploma of Applied Investment and Management. Nathan is a CFA Charterholder.

Key Fund 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

18 June 2018

SUGGESTED INVESTMENT TIMEFRAME

5+ years

NUMBER OF STOCKS

10 - 35

INVESTMENT FEE

0.97% p.a.

PERFORMANCE FEE

N/A

MINIMUM INITIAL INVESTMENT

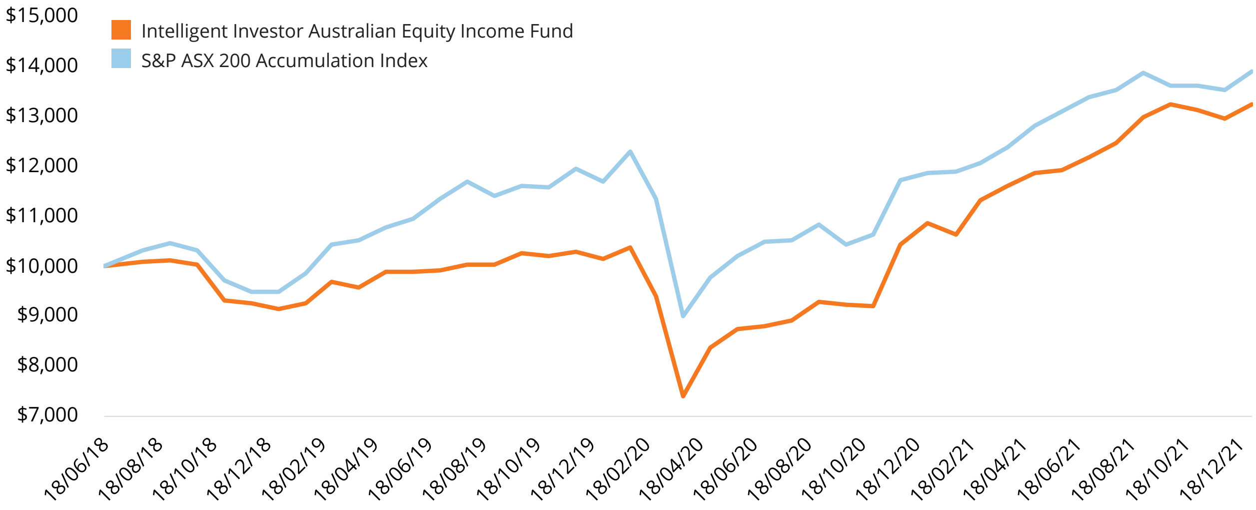
N/A

SUITABILITY

A portfolio focused on generating income without forsaking capital growth by investing in cash rich businesses with the ability to pay growing dividends

As at 31 December 2021

Performance of $10,000 since inception



Fund inception: 18 Jun 2018

Performance (after fees)

	3 mths	6 mths	1 yr	2 yrs	3 yrs	S.I. (p.a)
Intelligent Investor Australian Equity Income Fund	–0.1%	8.6%	21.7%	14.1%	13.1%	8.2%
S&P ASX 200 Accumulation Index	2.1%	3.8%	17.2%	9.0%	13.6%	9.7%
Excess to Benchmark	–2.2%	4.8%	4.5%	5.1%	–0.5%	–1.5%

Since Inception (S.I.): 18 Jun 2018

Asset allocation

Financials	22.7%
Materials	20.0%
Consumer Discretionary	16.5%
Information Technology	9.2%
Real Estate	8.3%
Cash	6.0%
Consumer Staples	3.6%
Health Care	3.2%
Energy	3.2%
Industrials	3.0%
Utilities	2.5%
Communication Services	1.9%

Top 5 holdings

BHP Group (BHP)	8.7%
Star Entertainment Group (SGR)	5.2%
RPMGlobal Holdings (RUL)	5.0%
Pinnacle Investment Mgmt Group (PNI)	4.3%
Woodside Petroleum (WPL)	4.2%

Intelligent Investor Australian Equity Income Fund

Quarterly Update

'It isn't the mountains ahead to climb that wear you out; it's the pebble in your shoe.'

— Muhammad Ali

'You never know what the American public is going to do, but you know that they will do it all at once.'

— Bill Seidman

'I always come out with my best when my back's against the wall. It's always when the luxury and financial rewards come piling in that I begin to lose it.'

— Ozzie Osbourne

The Fund was unmoved for the quarter, while the market increased 2.1%. The enthusiasm for resources stocks earlier in the year petered out, though we could be at the beginning of a long period of substantial gains given the underinvestment in oil projects, for example, and low starting valuations.

Our pair of coal stocks **Newhope Coal** and **Whitehaven Coal** lost some of their strong recent gains, as the Chinese government tries any way it can to reduce coal prices. You know its worried when it starts accepting Australian coal despite its current hostile attitude to Australia.

We don't expect coal prices to stay as strong as they have been recently, but there's still plenty of potential for capital gains and big dividends next year from Newhope and Whitehaven, which remarkably should be debt free early next year.

Casinos

Our small holding in **Crown Resorts** benefited from a favourable regulatory decision in Victoria. It has two years under the watchful eye of Stephen O'Bryan, QC, to clean up its act and keep its casino license.

Blackstone also made a third tilt to acquire Crown Resorts, increasing its offer to $12.50. We're not getting too excited, though, as any takeover for such a politically and regulatory sensitive business will be drawn out.

Though the regulatory news was also good for our larger holding in **Star Entertainment**, the share price still fell 18% during the quarter following a *60 Minutes* investigation into a host of alleged regulatory and governance failures.

The company is facing regulatory investigations in New South Wales and Queensland, but we don't expect the company to lose its licenses. Even if it did, you're not paying much for the casino licenses at the current price given the company's valuable properties in Sydney and Brisbane and on the Gold Coast.

It's a classic case of heads we win, as profits recover at Star Sydney following COVID lockdowns and the company keeps its licenses, or we don't lose much if the regulatory outcomes don't follow the precedent at Crown.

Once the new $2bn Brisbane casino opens next year, the company should be producing plenty of cash as we move on from COVID to pay high dividends.

Banks

Our low exposure to the big banks has been justified by recent results from our holdings in **Commonwealth Bank** and **Westpac**, which show increased competition for mortgages is squeezing profit margins.

If they haven't already, it's time for investors to reconsider investing in traditional sources of income.

Consider that we upgraded **CSL** in our subscription business on 20 Jan 2010 (Long Term Buy - $31.30) when the dividend yield was a paltry 2.2%. Since then, capital gains have been 21% a year and dividends have increased by 13% a year. The shares currently yield 9% on the original upgrade price.

Over the same period, Commonwealth Bank's capital gains have been 5% p.a. with no dividend growth. In other words, the original dividend yield of 4.2% hasn't changed in more than a decade. You tell me which was the better income stock 12 years ago?

Unless you bought the banks during last year's bear market when there were far better opportunities all over the place, banks haven't been good investments for a long time. The share price of Commonwealth Bank, the best performing bank by far, is at the same level as 2015. That's despite a rampant property market and less competition than they face now.

Our focus remains on companies that can grow their earnings and dividends over long periods. **Pinnacle Investment Management**, for instance, has increased both at around 50% for the past four years. Accepting a lower yield now can be far more profitable in the long run.

Pinnacle's share price has slipped below the $16.50 offer price it used to raise around $100m for a cornerstone shareholding in alternative asset manager Five V Capital. It's small beer next to Pinnacle's $3.5bn market value, but the stock remains a core holding despite taking profits as its share price exploded out of last year's bear market.

Credit Corp jumped 8% on the final day of November after announcing the purchase of Radio Rentals from embattled **Thorn Group**. The $60m purchase is dwarfed by Credit Corp's $2.2bn market value, but it also came with a handy upgrade in full year earnings, as the company starts to profit from years of investment in the US.

If nothing else, it shows the value of backing the biggest and best in an industry where size matters.

RPM Global's latest update reaffirmed sales are recovering post-COVID when it was all but impossible for sales staff to meet clients in person. It also recently swapped its coal consulting business for an ESG one, which should make it much more appealing to ethical funds. Either through increasing earnings or a takeover, there's more value to come in our view.

Woodside announced and confirmed several deals, including the massive purchase of BHP's oil business. The upshot is a pristine balance sheet and plenty of ways to increase sales for decades to come.

We believe the share price should be above $30 at current oil and gas prices but given the huge number of shares its issuing to fund the BHP deal it will take time before the share price begins marching up.

United Malt announced another set of lousy results. Although revenue has held up, margins have been crushed like an empty tinnie as higher margin on-premises sales were replaced by pre-packaged sales during lockdowns.

Throw in a full year of corporate costs for the first time (United Malt previously shared corporate costs with **Graincorp**), currency movements, accounting changes, and subsidy impacts, and you can see why this was a messy result with more adjustments, one-offs, and significant items than we are very uncomfortable with.

Management is desperately trying to flatter the company's results with things not going to plan since being spun out of Graincorp with high expectations. A full recovery post COVID puts the stock on price-to-earnings ratio of 12 with some growth, which is why, for now at least, we're being patient.

Lastly, we sold **Sydney Airport**. It's sad to see such a great business leave the ASX, but a higher takeover bid is unlikely and the return from holding on assuming it's taken over is miniscule. We'd rather have the cash now and wait for new opportunities, as QE is ending early in the US and interest rates are starting to increase around the world.

That won't be good for highly priced infrastructure stocks, though there should still be decent upside in COVID casualties like **Auckland Airport** as international travel, profits and dividends recover.

Additions

We added four new positions during the quarter. The first will be familiar if you've invested in our Growth or Ethical funds. **Frontier Digital Ventures** owns stakes in online property classifieds businesses in rapidly growing emerging markets.

Frontier Digital's share price drifted lower after a strong start to the quarter despite announcing that its acquisitions made a year ago are performing at or above expectations.

It also raised money to acquire the remaining 73.7% of Encuentra that it doesn't already own. Founder Shaun Di Gregorio clearly believes he can add more value with full control of the business.

Given he knows the business inside out and has paid four times revenue, there's a lot of potential given similar mature businesses trade for four to five times as much. The key is profit margins, but it will take many years to increase them to mature industry averages.

Frontier Digital has made enormous progress over the past 18 months with the company virtually breaking even on a cashflow basis at the end of September. The importance of this achievement cannot be overstated.

As we've seen with similar businesses such as **REA Group**, once they become profitable, they're a license to print money if you're the market leader, as Frontier's investments typically are.

Despite the good news, Frontier still trades at around eight times next year's revenue, while **iCar Asia** – essentially the Indonesian version of **Carsales** and a deeply inferior business to Frontier – recently accepted a takeover offer priced at 15x revenue. REA Group currently trades at 22x revenue.

While Frontier is far riskier than REA Group due to the countries in which it operates, it might deserve a higher multiple given the company's higher growth – not to mention the potential for further acquisitions that could materially boost profits.

Frontier is currently valued at $570m, but Zameen (the Pakistan version of REA Group of which Frontier owns 30% with internet giant Naspers owning the remainder) alone could eventually be worth billions. The country has 225m people with Karachi and Lahore both boasting populations of more than 10m, and a large pool of expats in places like the UK that regularly buy property at home.

In contrast to REA Group and its ilk that rely purely on advertising, transactional revenue from taking a cut of property sales and other property services across Frontier's portfolio has increased to around 50%. Yet this form of revenue is still near zero for some of the company's recent acquisitions, which shows their potential.

Before the Encuentra deal, management had a clear line of sight to $100m of annual revenue (currently $70m) and inclusion in the ASX300, which would force index funds to buy shares. Given how tight the current shareholder registry is with a handful of value investors like ourselves, that should put a rocket under the share price.

Frontier's accounts remain a mess due to a mix of minority shareholdings and recent acquisitions. That, Frontier's small size currently, funds being unable to buy shares in companies that aren't reporting an accounting profit and the fear of investing in frontier markets, likely explains the low share price.

But as profits start flowing through in the years ahead the stock will become impossible to ignore, as founder Shaun De Gregorio aims to build a business worth $3.5bn–5bn dollars.

Although the stock is unlikely to pay a dividend, as the fund's dividend yield should exceed the market's yield once earnings have fully recovered from COVID, and we need companies with genuine pricing power to offset increasing inflation, buying Frontier Digital was an excellent use of cash.

We also added **Waypoint REIT**. A slightly controversial pick as it owns petrol stations that many worry will be far less valuable as we eventually switch to electric cars. In short, we believe you're being compensated for those risks at the current price and expect the properties to remain valuable despite the remediation costs for potential land contamination if they're eventually redeveloped.

We made an unforced error early in the quarter adding a small position in global fund manager **Magellan Financial**. The share price was subsequently cut in half after the CEO resigned and Magellan's largest investor redeemed their investment due to Magellan's long period of underperformance.

The stock looks very cheap on a price-to-earnings ratio (PER) of 10, but using PERs to value fund managers is risky, as their earnings can swing wildly with markets, performance fees and investor inflows and outflows. We've resisted doubling down, partly as we prefer the more diversified and faster growing fund manager Pinnacle Investments.

Lastly, we added iron ore crushing company **Mineral Resources**, which clips the ticket at some of Australia's largest iron ore projects. We want to build the position into a much larger one over time, as the wild gyrations of the share price suggest its unique business model remains misunderstood.

Often pegged as a poor-quality mining services business tied to a poor-quality mining operation, Mineral Resources is so much more.

The crushing business is the jewel in the crown, and it remains unrecognised. The world's largest crusher started out crushing ore for low quality miners that couldn't justify their own operations. It now crushes ore for almost everyone with a flawless record of speed, reliability and bespoke design.

Crucial crushing

Crushing volumes have consistently grown at 20% a year and we think that pace should continue.

Crushing is a crucial part of the mining. If the plant fails, the entire operation grinds to a halt so reputation, as well as a deep distribution network for parts and services, are crucial advantages that no peer can match. On earnings of more than $500m, we think it deserves much higher multiples than are implied by the market.

All up, we think the services business alone could be worth $25-30 a share. This is by far the most bullish assessment of the segment we have seen but the quality and trajectory of earnings justify it, in our view.

The iron ore business is currently a high cost, low quality operation that relies on high prices to make money. That will change.

Mines getting better

Mineral Resources is investing in two new mining hubs to grow production from about 20m tonnes per year (mtpa) to over 80mtpa over the coming years. Better still, increases in grade and logistics will dramatically lower costs to make the iron ore business profitable over the cycle.

That will not only transform iron ore earnings, it will also attach life-of-mine services contracts that will grow services income and introduce new infrastructure that can be shared with other producers (for a fee of course).

An iron ore business that is currently marginal will grow into one that is consistently profitable, and we think it could be worth another $10-15 per share. Though it will require additional capital.

That leaves the lithium business which is the most contentious.

We don't have strong views on lithium. Demand is growing but so is supply. This is a complicated chemical processing business, but the raw material is hardly scarce. Mineral Resources has two hard rock lithium mines that are world scale.

At each, it has dealt its way into benefiting not only from mining profits but from higher margins as raw material is processed into usable lithium hydroxide.

This is where most miners fall over and where Mineral Resources has been smart, pairing with industry heavyweights to sort out the processing while they focus on services and crushing.

Value, options

Lithium could be worth anything from $10 to $30 a share or more if you're bullish on lithium prices. Management has even suggested it could be split from the business if that's what generates value.

We treat this as a low-cost option and recognise that Mineral Resources isn't being treated with the same fanfare as other lithium miners.

Counting the services business, the iron ore business and lithium potential together, it's hard to see less than $40 a share of value and easy to see much more, potentially up to $80 a share.

The year ahead

We have two main expectations for 2022. First, dividends from the stocks hurt most by COVID-19 should start recovering. The increased confidence in these businesses should also produce capital gains in a market that's priced for meagre returns overall.

Second, interest rates are starting to increase from record low levels around the world. While we expect increases to be slow, at least initially, this will compound many disappointments at the individual stock level given expectations are currently so high.

As we saw with Magellan, for example, share prices can fall a long way when investors drastically reprice a stock due to lower growth expectations, especially in a rising interest rate environment rife with inflation fears.

Our job is to capitalise on the best opportunities to get the potential returns and dividends from the portfolio as high as possible without taking large risks. For the first time, we can imagine not owning any banks for the reasons we explained above.

While a more turbulent market and the end of rapidly increasing prices will scare newer investors accustomed to getting rich quickly, more volatility means more great opportunities for long term investors. We look forward to telling you about them in the year ahead.

It's been a long time since active investment management has had so much potential versus the major indexes. Thanks for your support and happy new year.

If you have any questions, as always, please call us on ***1300 880 160*** *or email us at* ***info@intelligentinvestor.com.au.***

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