

Intelligent Investor Australian Equity Income Fund

(Managed Fund) (ASX:INIF)

“Investors today spend the majority of their time searching for something that nobody else knows. But the easy money is made searching for what others are about to know.”

— Broyhill Asset Management

The market has taken the Ukraine war in its stride. More surprisingly, though, it has rallied despite increasingly hawkish projections of US interest rate rises by US Fed officials, including Governor James Powell.

Justifications have included the benefits of taming inflation and that the US economy can handle multiple 50 basis point interest rate increases, as it did in the early nineties.

While we focus on individual companies, profit margins are currently being squeezed by higher staff and input costs across every industry, triggering a raft of profit downgrades. This means already near or record high valuations are even higher than they appear.

It's a reminder that we need to have valuation on our side in what will be a tough environment even for resources companies, which have been recent beneficiaries of higher commodity prices.

Performance (after fees)


	3 mths	1 yr	2 yrs (p.a)	3 yrs (p.a)	S.I. (p.a)
II Australian Equity Income Fund	5.2%	19.9%	37.2%	13.3%	9.1%
S&P ASX 200 Accumulation Index	2.2%	15.0%	25.7%	10.6%	8.0%
Excess to Benchmark	3.0%	4.9%	11.5%	2.7%	1.1%


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

Resources stocks have driven the fund's recent performance. You can see the contrast in our Ethical Fund, which doesn't own any resources stocks, as they don't pass our ESG filter.

But with the formerly depressed valuations of resources stocks now much higher in most cases, our focus is on what these companies will do with the flood of cash. Acquisitions will be expensive, as will be expanding mines amidst supply and labour shortages.

The good news is that numerous companies in the fund have reinstated dividends, which should grow quickly. Though it will still take a couple of years for the fund's dividend yield to fully recover from the impact of COVID.

Global and domestic borders aren't fully open yet, which impacts **Auckland Airport**, for example. Visitors to casinos (more on our holdings below) are still well down, and it will be years before international tourism fully recovers.

Tabcorp (more below), **LendLease**, **RPM Global** and **United Malt** are four others that will take time to recover from COVID impacts. Aside from LendLease, they're also potential takeover targets.

While resources stocks have captured the market's imagination recently, tech and growth stocks, particularly small caps, have been punished in lieu of higher interest rates and a reassessment of the risks.

Recent market action mimics historical behaviour around major trend changes. The impact starts at the perimeter with the weakest and riskiest stocks before hitting higher quality stocks, as we're seeing with market darlings like **Domino's**, which has fallen over 50%. Even **Xero** was down over 40%. It's not just the hype stocks being revalued.

The tech sector still isn't cheap. The NASDAQ took around two years to fall 85% after the late

nineties tech boom. Given this tech boom was much bigger, and the NASDAQ only fell around 20% recently before rebounding, there's likely more pain to come as interest rates rise.

But many names that we want to own for the long haul are cheaper than they've been for some time. If the US central bank is serious about increasing interest rates to at least 2%, we may not have long to wait for many more opportunities.

Portfolio

The fund increased 5.2% during the quarter, compared to the market's 2.2% gain.

Telstra's mobile business continues to flex its muscle and support dividends. CEO Andy Penn announced he'll be replaced by current CFO Vicki Brady, who comes with high expectations.

The iron ore miners, including our holding in **BHP**, continue to mint cash and pay huge dividends, as the iron ore price has rebounded.

Regardless of swings in the iron ore price and China's efforts to reduce its dependence on Australian iron ore, BHP should pay healthy dividends. We'll continue to manage the position based on valuation, although it's unlikely we'll ever have 20% of the fund invested in three iron ore miners like the index.

Jeremy Grantham recently warned that the window of cheap and easy extraction of the world's once abundant natural resources is nearing an end. That means higher prices, which is why we hold a diversified cornerstone position of resources companies such as **Woodside Petroleum**, **South32** and **Alumina** amongst others.

While some components of the current high inflation prints will be transitory, once wages start increasing it becomes entrenched, as wages don't usually fall. The more entrenched

inflation becomes, the higher interest rates will need to go.

Our coal miners **Newhope** and **Whitehaven**, along with oil and gas giant Woodside Petroleum, are benefitting from large increases in commodity prices. Even though they should normalise over time, these companies have huge amounts of cash and franking credits to pay large dividends for years to come.

The world is increasingly opening its borders and capital cities, which will be good news for holdings such as Auckland Airport, LendLease, **Star Entertainment**, **Crown Resorts** and **Frontier Digital Ventures**.

LendLease's recent results were a mess, as new CEO Tony Lombardo resets the company for faster, more efficient growth. It will be years before we see the results, but at the current price we believe we're being compensated to wait.

Fallen stars

Star Entertainment CEO Matt Bekier finally resigned after his disgraceful behaviour and the horrendous culture he fostered throughout the company was laid bare during testimony at recent investigation hearings.

A recent article in *The Australian* suggested things ended badly for Bekier. We disagree. He gets to keep all his bonuses and other remuneration.

How chairman John O'Neill can become temporary CEO to oversee the recruitment of a new CEO is beyond us.

That Bekier and chairman John O'Neill didn't confess that there were similar issues at Star during **Crown Resorts's** recent ordeal only reinforces the arrogance of company executives and boards at some of Australia's largest organisations, and why we try to avoid owning

them in favour of companies run by founders with skin in the game.

Star's share price has barely budged, as it already reflects little value for its casino licenses. But we expect a complete clean out of both management and the board, with CFO Harry Theodore likely next to fall on his fountain pen.

After the Western Australian government recently declared Crown Resorts was unfit to hold a casino license, Blackstone's takeover offer passed its first hurdle with the foreign investment review board giving it the green light.

Frontier Digital Ventures released its latest quarterly results for the final quarter of 2021. In summary, the business is performing well with rapid revenue growth across the board. Essentially every business aside from recent acquisitions is at least breaking even, which is a key milestone for these types of businesses.

Profits should grow rapidly beyond breakeven, as online property classifieds businesses assert their dominance with minimal reinvestment needs. Excluding recent acquisitions, for example, Frontier's overall operating profit margin would've been 10%, up from breakeven around a year ago.

It will likely by next year before the company reports earnings per share (partly due to the different ownership percentages), which is what typically drives the share price over the long term. But we're delighted with the company's recent progress.

360 Capital confirmed its excellent recent results and remains very cheap despite the recent overdue 20% jump in its share price. Numerous deals, including a complicated deal with **Charter Hall** to carve up **Irongate**, will increase its funds under management and bodes well for steady future growth.

Credit Corp confirmed its annual forecast which included more ledger purchases than previously expected. Given benign credit conditions over the past year, investors had worried that fewer bad debts would sink earnings.

Credit Corp's management is never idle, though, and has made some intelligent decisions recently to keep revenue ticking over, including the acquisition of Radio Rentals' debt ledger. Credit Corp should be one of the few genuine beneficiaries of higher interest rates.

Outlook

The recent volatility is only the beginning of what's to come. After nearly four decades of falling interest rates, the market isn't going to adjust to increasing interest rates in one quarter.

The number of profit downgrades is growing rapidly, and the bubbles in unprofitable tech companies are popping. We're starting to get excited about cheaper valuations, but we know from experience that it will likely take years for the market to adjust to tectonic changes like increasing interest rates from zero after four decades of falls.

It's vital that we don't lock in mediocre returns from premature accumulation, to quote Bruce Berkowitz. We like what we own. The stocks are cheap and highly profitable, with big increases expected in profits and dividends from the smaller names and those impacted by COVID.

It took over a year before the market finally succumbed to the GFC. The market has only begun to adjust to higher interest rates. While we're expecting the global economy to remain relatively healthy, the types of stocks that will do well from here will be very different to what has done well in recent years. We've been adapting for a while and believe the next five years will be much kinder to active value managers.

The patience to wait for the right prices is all we need right now, and we look forward to increasing the potential return of the portfolio as optimistic valuations crash back to earth.

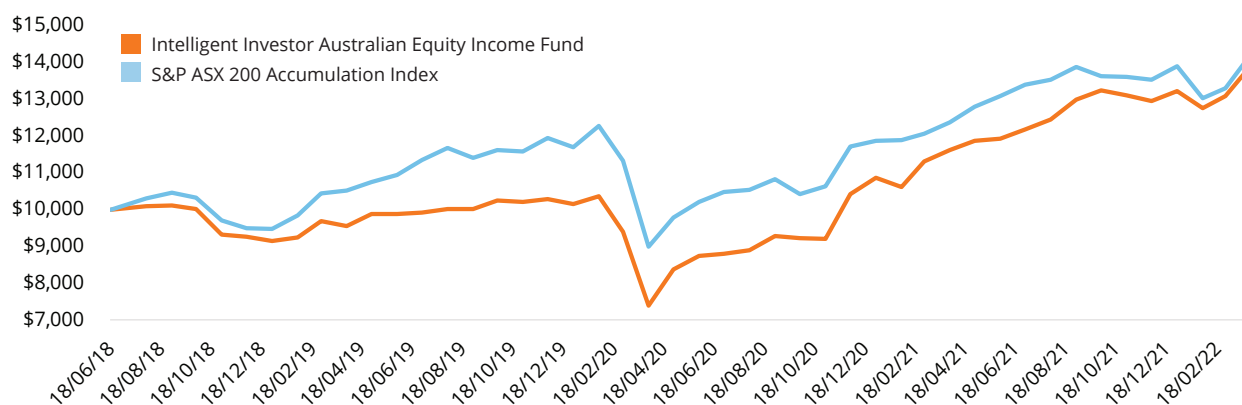
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Performance since inception



Asset allocation

Materials	23.6%
Financials	15.6%
Consumer Discretionary	12.6%
Cash	10.9%
Real Estate	9.2%
Information Technology	9.1%
Industrials	4.8%
Energy	4.7%
Consumer Staples	3.0%
Health Care	2.4%
Utilities	2.3%
Communication Services	1.72%

Top 5 holdings

BHP Group (BHP)	10.5%
Woodside Petroleum (WPL)	6.0%
RPMGlobal Holdings (RUL)	5.6%
Auckland International Airport (AIA)	4.8%
Star Entertainment Group (SGR)	4.8%

Fund Stats

Income yield	1.23%
Net asset value	\$3.21

Important information

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All tables and chart data is correct as at 31 March 2022.