31 December 2020

Quarterly Report

# Intelligent Investor Ethical Share Fund

(Managed Fund) (ASX:INES)

**Quarter Highlights**

- **Fund up 10.9%**
- **Trailed the index due to lack of cyclical stocks**
- **Added Aussie Broadband and Infratil**

## 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 12 June 2019, the Intelligent Investor Ethical Share Fund is an Active ETF designed for investors seeking a diversified selection of Australian companies that produce growing, sustainable profits at low risk of interruption from the increasing threats associated with Environmental, Social and Governance (ESG) factors.

The Fund will invest in undervalued companies with strong long-term capital growth prospects based on the Intelligent Investor's value investing research process. Making more than 500 Buy recommendations since 2001 with an average outperformance of 5.2%^ a year relative to the ASX 200.

## Investment objective

To invest in a portfolio of ethically and socially responsible undervalued stocks to achieve medium to long-term capital growth.

## 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**

1 July 2019 for the PMA
12 June 2019 for the Listed Fund

**SUGGESTED INVESTMENT TIMEFRAME**

5+ years

**NUMBER OF STOCKS**

10 - 35

**INVESTMENT FEE**

0.97% p.a.

**PERFORMANCE FEE**

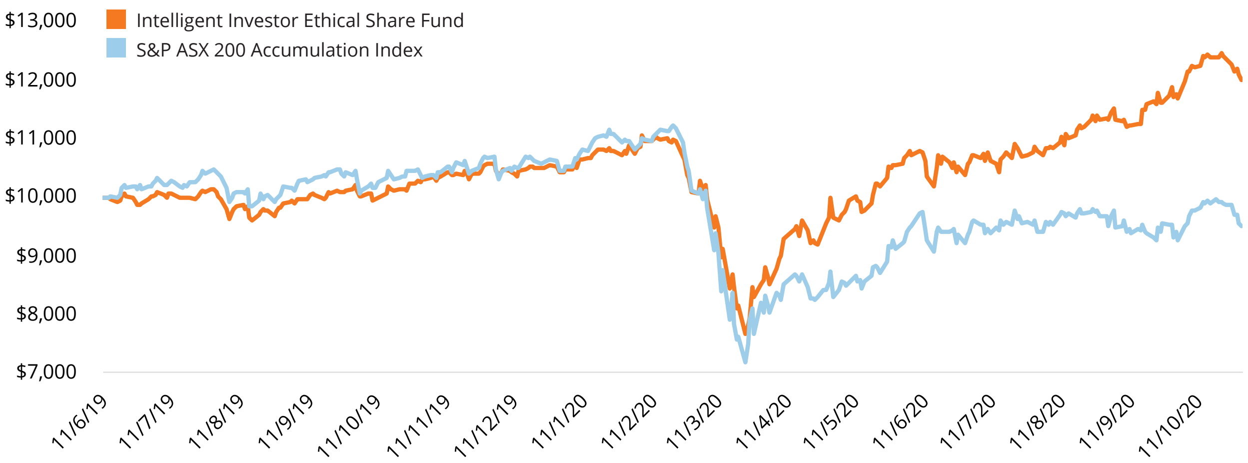
N/A

**MINIMUM INITIAL INVESTMENT**

N/A

## As at 31 December 2020

### Performance of $10,000 since inception




### Performance (after fees)

| | 1 mth | 3 mths | 6 mths | 1 yr | S. I. |
|---|---|---|---|---|---|
| **Intelligent Investor Ethical Share Fund** | 2.1% | 10.9% | 23.0% | 24.5% | 18.3% |
| **S&P ASX 200 Accumulation Index** | 1.2% | 13.7% | 13.2% | 1.4% | 3.7% |
| **Excess to Benchmark** | 0.9% | –2.8% | 9.8% | 23.1% | 14.6% |

### Asset allocation

| | |
|---|---|
| **Cash** | 26.2% |
| **Information Technology** | 21.3% |
| **Industrials** | 18.8% |
| **Communication Services** | 10.8% |
| **Financials** | 8.0% |
| **Real Estate** | 6.4% |
| **Utilities** | 3.6% |
| **Health Care** | 2.8% |
| **Consumer Discretionary** | 2.1% |

### Top 5 holdings

| | |
|---|---|
| **Frontier Digital Ventures (FDV)** | 8.4% |
| **Audinate (AD8)** | 7.6% |
| **Sydney Airport (SYD)** | 6.7% |
| **360 Capital Group (TGP)** | 6.2% |
| **AMA Group (AMA)** | 5.9% |

# Intelligent Investor Ethical Share Fund

## Quarterly Update

***'To me, it's obvious that the winner has to bet very selectively. It's been obvious to me since very early in life. I don't know why it's not obvious to very many other people.'***

**– Charlie Munger**

***'How many of you have 56 brilliant ideas in which you have equal confidence? Raise your hands, please. How many of you have two or three insights that you have some confidence in? I rest my case.'***

**– Charlie Munger**

***'Twenty years from now you will be more disappointed by the things that you didn't do than by the ones you did do. So throw off the bowlines. Sail away from the safe harbor. Catch the trade winds in your sails. Explore. Dream. Discover.'***

**– Mark Twain**

The fund increased 10.9% during the quarter compared to a 13.7% gain for the index. The gap is due to the large response of cyclical stocks (that mostly don't meet our ESG criteria) to the vaccine announcements.

But that couldn't dim what has been an outstanding year for the fund, safely outperforming the index by 23%.

We launched the fund in May 2019 as we believed our investment process honed over the past two decades through numerous market downturns could beat the market with an ESG filter applied.

In fact, an analysis of our ~500 recommendations over nearly twenty years suggested our focus on quality businesses with owner-operators and a contrarian bent would prove even more profitable.

If your investment process doesn't stand up under tough market conditions, then turning on an ESG filter isn't going to save you.

That all of the fund's huge outperformance since inception has come since the COVID-induced downturn helps show that it's our investment process that matters more than the ESG criteria itself.

We held ~20% cash coming into the downturn as valuations were excessive, and calmly putting that money to work during the fastest and deepest bear market in history has paid off in spades. Thank you for your support.

## Portfolio

We increased our stake in **Sydney Airport** and took profits on **James Hardie Industries** and **Reece** that performed much better, much faster than we could've hoped for.

The big jump in Reece's share price came from an expansion in its price-to-earnings ratio rather than an improvement in its financials, which is what's driving the market's current excesses.

We also added **Infratil**, which has built an excellent track record of acquiring and selling businesses in similar fashion to a private equity operator. Infratil's share price popped after the company rejected a potential takeover offer from a large Australian superannuation fund.

We also added **Aussie Broadband**, which sells premium internet and recently listed on the ASX. You may have noticed their adverts on TV.

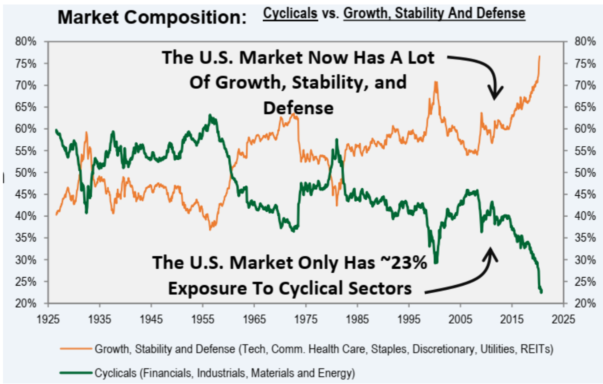
**AMA Group** announced the sale of one of its smaller businesses that will help reduce the company's burdensome debt load and allow management to focus on its core smash repair business.

**360 Capital** expects to double earnings per share to four cents this year, as its rapid launch of new funds starts to increase fee revenue. Boasting a ~5% distribution yield, $80m of cash, excellent management, a clear growth strategy that's attracted several high calibre executives all while trading at a discount to its net tangible assets, the market can't ignore this stock forever.

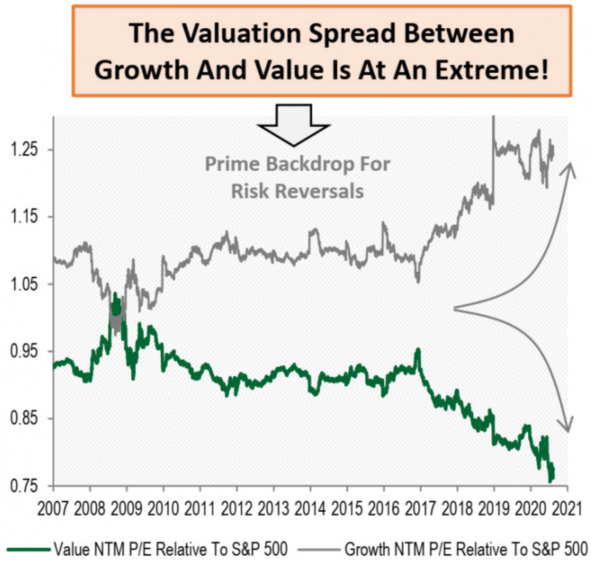
Earlier in the quarter we reduced **Frontier Digital Ventures** back below 10% after receiving an allocation of shares in its rights issue that took our holding above our maximum holding limit of 15%. We've now almost banked more in profit than we initially invested and still own a ~9% position that could be worth multiples of the current share price as profits explode from a low base.

The company also achieved a major milestone by producing its maiden operating profit before its share price bounced back after digesting its capital raising that included its maiden 100% business acquisitions rather than acquiring minority stakes like it has historically.

**Audinate**'s share price also responded well as its revenue starts to recover from the COVID-induced downturn, up ~35%. The share price of fund manager Pinnacle also increased over 40% as markets have increased, which augurs well for base and performance fees of its diversified stable of fund managers.




Source: millervalue.com via Cornerstone Macro.




Source: millervalue.com via Cornerstone Macro.

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

# Aussie Broadband's head start

**How is this little NBN reseller taking so much market share?**

Aussie Broadband's shares doubled the day they listed. We expected a rise on listing day – we telegraphed that much when we covered the business in ***Aussie Broadband's perfect pitch*** – but the soaring price was a turn off.

A business we had expected to list at just over $200m was suddenly worth $350m and we decided not to pursue it further. New information, however, challenges that view.

Initial public offerings (IPOs) aren't our natural hunting ground. Over the past decade, I can't recall a single instance of us purchasing an IPO. That's because they are usually associated with insiders cashing out by telling a hot story in a hot market.

## Promising IPO

This one, as we noted earlier, was different. Not a single existing shareholder was selling stock at the IPO. The founders were being diluted, but they kept their monetary interests in the business. That's unusual.

Aussie also ticked another important box by raising money for a specific, defined purpose. The business currently sells NBN broadband plans by leasing fibre to access the NBN at wholesale rates. It proposed to use cash from the listing to build its own fibre network to replace leased fibre to access the NBN.

Doing so would, at a stroke, lower lease costs by about $15m and allow the business to scale more successfully. By controlling its own fibre, Aussie could also offer new products and services while raising margins. It's a logical next step.

## A quiet conquest

Customer growth has been tremendous. Connections have grown from 60,000 in 2018 to 240,000 at listing time. Data from the ACCC shows that, since listing, Aussie has been busy accumulating even more customers.

It appears to have almost 310,000 customers on its books now, almost 90% higher than a year ago. That means Aussie's share of the entire market has grown to about 4%.

That is extraordinary when we consider the humble origins of the business. Started as a reseller from regional Victoria, Aussie has grown to become the fifth-largest broadband provider in the country, outfoxing over 100 competitors and the largest telcos in the land.

Aussie did this without any obvious competitive advantage other than its own operating nous.

It built its own software systems for billing and customer management; onboarding with Aussie is among the quickest in the industry and completely automated. Interactions with the NBN for purchasing wholesale bandwidth is monitored by internally developed software. It's only a small exaggeration to say that Aussie is actually a software business that sells broadband rather than a mere reseller.

Customer satisfaction ratings are industry-leading and the clamour from customers to become shareholders – the customer stock allocation during the IPO sold out within an hour – says plenty about customer love for the brand (your analyst is now a customer, too).

## Running faster

ACCC data shows that customer love is translating to real dollars. Of all NBN connections over the last quarter, one in ten went to Aussie. Its market share is growing quickly.

Even more impressively, its share of high-end broadband plans is growing quickest of all. More than

40% of all Aussie customers choose ultra-fast plans (defined as more than 100mbs) compared to 12% of the market and an incredible 86% of new ultra-fast connections to the NBN came from Aussie.

This suggests that Aussie is growing rapidly but, more significantly, it is collecting the most profitable customers. All this is being achieved with a marketing budget that is probably less than Telstra's executive lunch bill.

In our initial analysis, we suggested that Aussie could grow to about 6% market share by 2025, generating average revenue per user of $80. We now think those numbers are too conservative.

With so much growth coming from high-value plans, ARPU is likely to approach $90 and market share should comfortably get to 6%, perhaps earlier than expected.

That means that Aussie is on track to generate about $860m in revenue and, assuming 5% EBIT margins, perhaps over $40m of EBIT. The business isn't profitable today but that will change.

If it meets our expectations, Aussie could be trading on an EV/EBIT of less than 9.0 times. That's not screamingly cheap for a telco, especially considering that value will take a few years to appear.

We are yet to consider, however, new products and services likely to be introduced. The business has already built an enterprise portal to sell direct to businesses and could easily add new services to its offering.

## A different case

The investment case for Aussie as a reseller of NBN alone is reasonable, but weak because it's hard to identify a moat. It is only when we consider what the business has overcome that we can appreciate its true competitive advantage.

Aussie fought over 100 competitors and industry giants; built an industry-leading software platform and is collecting an outrageous share of high-end broadband users because its management and culture are superior. This advantage is intangible and hence hard to replicate. It's also hard for investors to see and adequately price.

To some, this might look like a $350m business that makes no money in a competitive industry. In our view, this is a fine example of a business with a deep cultural moat. Those are the hardest to breach.

INTELLIGENT INVESTOR

## Important information

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