31 December 2021

Quarterly Report

# Intelligent Investor Ethical Share Fund

(Managed Fund) (ASX:INES)

**Quarter Highlights**

- **The fund has benefited from profit taking during recent market weakness mostly affecting highly valued stocks**
- **Sold Sydney Airport, Seek and Aussie Broadband while adding RPM Global, Ansell and Magellan Financial**
- **Updates for Audinate, Frontier Digital Ventures, Altium and Pinnacle Investments**

CERTIFIED BY RIAA

## 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 11 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**

11 June 2019

**SUGGESTED INVESTMENT TIMEFRAME**

5+ years

**NUMBER OF STOCKS**

10 - 35

**INVESTMENT FEE**

0.97% p.a.

**PERFORMANCE FEE**

N/A

**MINIMUM INITIAL INVESTMENT**

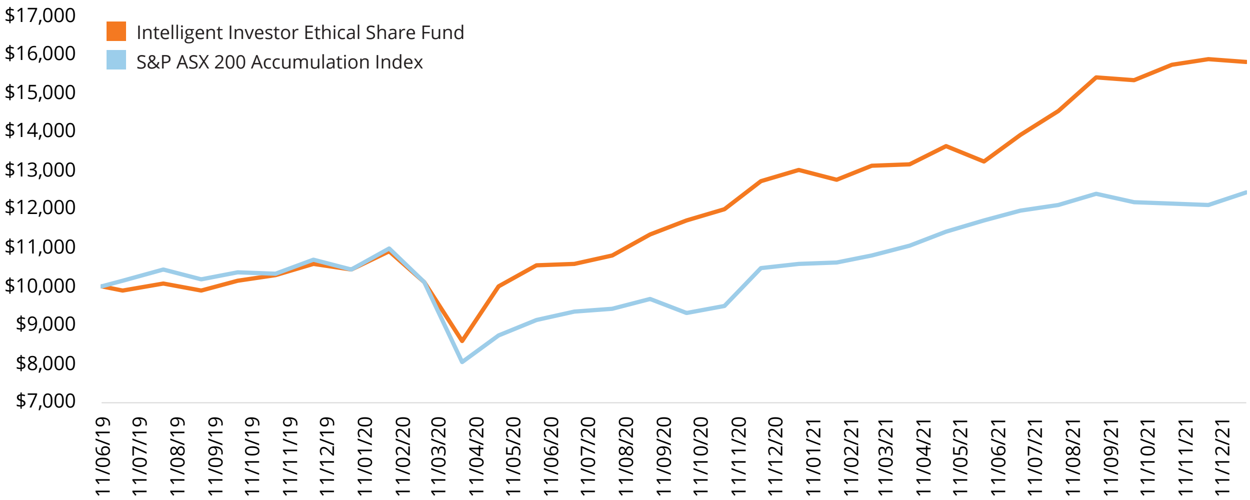
N/A

RIAA's RI Certification Symbol signifies that a product or service offers an investment style that takes into account environmental, social, governance or ethical considerations. The Symbol also signifies that Intelligent Investor Ethical Share Fund adheres to the strict operational and disclosure practices required under the Responsible Investment Certification Program for the category of Product. The Certification Symbol is a Registered Trademark of the Responsible Investment Association Australasia (RIAA). Detailed information about RIAA, the Symbol and Intelligent Investor Ethical Share Fund's methodology, performance and stock holdings can be found at www.responsiblereturns.com.au, together with details about other responsible investment products certified by RIAA.[1]

1. The Responsible Investment Certification Program does not constitute financial product advice. Neither the Certification Symbol nor RIAA recommends to any person that any financial product is a suitable investment or that returns are guaranteed. Appropriate professional advice should be sought prior to making an investment decision. RIAA does not hold an Australian Financial Services Licence.

## As at 31 December 2021

### Performance of $10,000 since inception




**Fund inception: 11 Jun 2019**

### Performance (after fees)

| | 3 mths | 6 mths | 1 yr | 2 yrs | S. I. (p.a) |
|---|---|---|---|---|---|
| **Intelligent Investor Ethical Share Fund** | 3.1% | 13.6% | 21.6% | 23.0% | 19.6% |
| **S&P ASX 200 Accumulation Index** | 2.1% | 3.8% | 17.2% | 9.0% | 8.8% |
| **Excess to Benchmark** | 1.0% | 9.8% | 4.4% | 14.0% | 10.8% |

**Since Inception (S.I.): 11 Jun 2019**

### Asset allocation

| | |
|---|---|
| **Cash** | 39.0% |
| **Communication Services** | 17.8% |
| **Information Technology** | 10.5% |
| **Financials** | 10.3% |
| **Real Estate** | 8.3% |
| **Health Care** | 6.8% |
| **Industrials** | 4.7% |
| **Utilities** | 1.6% |
| **Consumer Discretionary** | 1.0% |

### Top 5 holdings

| | |
|---|---|
| **Frontier Digital Ventures (FDV)** | 7.4% |
| **Uniti Group (UWL)** | 6.6% |
| **Auckland International Airport (AIA)** | 4.7% |
| **Pinnacle Investment Mgmt Group (PNI)** | 4.3% |
| **Lendlease Group (LLC)** | 4.0% |

# Intelligent Investor Ethical Share 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 increased 3.1% during the quarter compared to the market's 2.1% increase.

The biggest change to the portfolio this quarter was selling **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.

We also sold the last of our small holding in online job classifieds business **Seek** on valuation grounds, and we sold **Aussie Broadband** after excellent results led to a record share price and valuation. We only wished we'd made it a larger position, but it's produced incredible returns in a short period despite not catching it at the IPO.

This is an area where we can do much better. While most IPOs are rubbish, all great businesses start life as an IPO and we're not catching our fair share of good ones early enough.

This is a cultural hangover from the past when Warren Buffett's warning that the best ideas don't usually show up in your letterbox was taken so literally that IPOs were mostly ignored. This is slowly changing.

### Additions

On the flipside, we finally added mining software company **RPM Global** to the portfolio. Its software is used by miners to maximise efficiency and limit waste.

Unfortunately, it also used to own a coal consulting business rendering it unfit for inclusion in an ethical fund in our view, despite how cheap the stock has been. Fortunately, that's now changed. The company has recently sold the coal business and acquired and ESG consulting business, which should make it more attractive to ethical funds like ours.

We want to support companies who are genuinely transitioning to a greener future and those that can help them, but only when the economics stack up.

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 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. Not to mention Magellan has extreme key man risk in founder Hamish Douglas.

We've resisted doubling down partly as we prefer the more diversified and faster growing fund manager **Pinnacle Investment Management**.

Lastly, we added **Ansell** after its share price fell further than we believe it deserved following its successful push toward more specialised and higher margin gloves. That should support higher profit margins than the market expects as demand for cheaper protective gloves fades post COVID.

We'll also be speaking to management regarding recent claims that one of its suppliers is abusing its workers. This isn't the first claim, and historically we've supported management's position that it would rather work with suppliers to fix any issues than immediately sever ties allowing any abuse to continue.

## Stock updates

Circuit board software company **Altium** fell back into favour after releasing a good set of numbers, showing growth in new products and those affected by COVID.

The share price of Pinnacle Investment Management slipped below the $16.50 price that it raised around $100m at to buy 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.

## Audinate

Audio company **Audinate** is struggling to buy enough microchips to fulfil demand for its products. The 9% fall in the share price following the announcement was an overreaction in our view, but neither a surprise nor unwelcome; the market's tendency to put too much emphasis on short-term factors is a large part of the reason that value investing works.

Of course, this assumes that the problems faced by Audinate are short-term in nature and don't affect years 2024 to infinity in our valuation model (and the remaining 99% of the value) – and we think they are.

The problems stem from the well-publicised global chip shortage. Specifically, a Korean semiconductor foundry has been unable to provide silicon chips to a US-based 'Top 30 global semi-conductor manufacturer' which needs said chips to make a component that goes into Audinate's higher-end Brooklyn II, Broadway and Dante video products. To make matters worse, Audinate's OEM customers also use the components themselves in implementations that utilise Audinate's products.

The US-based supplier 'can no longer guarantee delivery' of orders for the part, and in Audinate's case this applies to orders dating back to January of this year. Supply of the part will apparently remain constrained for the foreseeable future.

Audinate has some existing stock, but this is expected to be exhausted in the second half of the current financial year, from which point revenues will be affected. As a result, while management still expects revenue growth for the current year, it will not be in the 25%-plus pre-COVID historical range, which it had previously been guiding towards.

## New module

Fortunately, Audinate was already planning to release a new version of its Brooklyn module, which will use a different part from the same US supplier, which is not dependent on the Korean foundry. It will be a drop-in replacement for the old module, so will not require any re-design work by customers.

The company is now rushing to get the new module ready by the June quarter (which could result in costs being brought forward, and therefore margins being reduced alongside the revenue shortfall, although management didn't specifically warn about this). Management is working on ways to mitigate the supply constraints for the Broadway and Dante video products, but had nothing further to report on that.

It's important to note that none of this is Audinate's fault, so it doesn't reflect on management and affect our long-term valuation in that sense. Neither has it come out of the blue – management has been warning about the potential impact of the global chip shortage since April, and it continues to warn that there may be further problems, with disruptions to the global chip market expected to linger throughout calendar 2022.

## Record demand

Even so, it has no impact on our estimates for Audinate's total addressable market, market share and margins, in five, ten and twenty years' time, which are the key inputs into our valuation. Over the long term, it may even encourage the industry to move more quickly towards software implementations of Audinate's products, which aren't dependent on global supply chains and make higher gross margins.

There were also some more tangible and immediate positives in the announcement. The chip shortage has encouraged customers to place orders further ahead of time, providing better visibility of future demand – even if now it can't all be met. At the end of September, the order backlog stood at US$14.8m, compared to typical pre-COVID levels around US$2.5m.

The company also generated record revenues for the September quarter, with growth of 46% over the same period last year, to US$7.6m (A$10.3m), despite temporary factory closures in Malaysia and China during the period.

## Frontier Digital Ventures

**Frontier Digital Ventures**' share price eventually 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. They key is profit margins, and it will take years to increase them to leading market averages.

Singapore's ProperyGuru, backed by fabled VC investor Peter Thiel and **REA Group**, plans to list in the US soon. It's the closest comparable to Frontier Digital and is expected to list at around 18x revenue.

If FDV traded at the same value, the stock price would be at least $4 compared to its current price of around $1.50.

Frontier Digital has made enormous progress over the past 18 months with the company virtually breaking even on a cashflow basis. 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 – has 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 prospects and numerous deals to sell parts of its business in a couple of years – 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.

## 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 in the blink of an eye when investors drastically reprice a stock due to lower growth expectations, especially in a rising interest rate environment rife with fears of inflation.

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.

Especially those that have been disciplined about valuation, as the track record of this fund and our temporarily high cash balance shows we have been from the very start.

We look forward to sharing plenty of new ideas in the year ahead.

Thank you for your support and happy new year.

*Note: In February I'll be hosting a live webinar about the fund in February where you can submit questions. We'll let you know the date and time soon.*

---

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

INTELLIGENT INVESTOR

## Important information

This document has been prepared by InvestSMART Funds Management Limited (ABN 62 067 751 759, AFSL 246441) (InvestSMART), the responsible entity of the Fund and issuer of units in the Fund.

While every care has been taken in the preparation of this document, InvestSMART makes no representations or warranties as to the accuracy or completeness of any statement in it. To the maximum extent permitted by law, neither InvestSMART, its directors, employees or agents accept any liability for any loss arising in relation to this document.

This document is not an endorsement that this portfolio is appropriate for you and should not be relied upon in making a decision to invest in this product. You should always consider the relevant disclosure document (including Product Disclosure Statement, Investment Menu, and Financial Services Guide along with any accompanying materials) and/or seek professional advice before making any investment decision. Disclosure documents for financial products offered by InvestSMART can be downloaded from the InvestSMART website or obtained by contacting 1300 880 160.

The document provides general financial information only. InvestSMART has NOT considered your personal objectives, financial situation and needs when preparing this document. You should consider your individual objectives, financial situation and needs and seek professional advice where necessary before making any investment decision.

Past performance is not a reliable indicator of future performance. InvestSMART does not assure nor guarantee the performance of any financial products offered.

InvestSMART, its associates and their respective directors and other staff each declare that they may, from time to time, hold interests in securities that are contained in this investment product.

**Intelligent Investor**
**invest@intelligentinvestor.com.au**
**www.intelligentinvestor.com.au**
**PO Box 744, QVB NSW 1230**
**1300 880 160**