Quaterly Update

30 September 2024

Intelligent Investor Ethical Share Fund (Managed Fund) (ASX:INES)

Issued by
InvestSMART Funds
Management Limited
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AFSL 246441

Managed by
Intelligent Investor
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CAR 1255 838

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ASX Code: INES

"We are built with an almost infinite capacity to believe things because the beliefs are advantageous for us to hold, rather than because they are even remotely related to the truth." — Dee Hock

"If you don't care whether you are rational or not, you won't work on it. You will stay irrational and get lousy results." — Charlie Munger

"Patience can be learned. Having a long attention span and the ability to concentrate on one thing for a long time is a huge advantage." — Charlie Munger

In a recent **blog post**, Cole Smead explains how Warren Buffett's investing approach has mimicked the style of poker player Andy Beal who challenged a player's ability to adapt.

Buffett's early career was spent finding statistically cheap stocks known as cigar butts, looking for one last puff. Then, in 1998, Buffett invested heavily in Coca Cola.

'He was criticized at the time for paying for what in the 1980s was a nosebleed high-teens P/E (price-to-earnings) multiple. The value crowd was following what he did, but as the flop came out on this hand, they didn't know how to read his play.'

Performance (after fees)

	1 mth	3 mth	1 yr	2 yrs	5 yrs	S.I. (p.a)
II Ethical Share Fund	3.6%	2.5%	16.2%	10.1%	10.0%	9.6%
S&P ASX 200 Accumulation Index	3.0%	7.8%	21.8%	17.5%	8.4%	8.6%
Excess to Benchmark	0.6%	-5.3%	-5.6%	–7.5%	1.6%	1.0%

Inception (S.I.): 11 Jun 2019

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 Australian Ethical Share Fund (ASX: INES) 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 Australian Ethical Share Fund (ASX: INES) methodology, performance and stock holdings can be found at www.responsiblereturns.com.au, together with details about other responsible investment products certified by RIAA.

Fund overview

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

5+ yrs
Suggested investment timeframe

10 - 40
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

CERTIFIED RESPONSIBLE INVESTMENT
CERTIFIED BY RIAA

Back then, the value crowd coveted low statistical valuations, but eventually they adapted realising the superiority of buying quality companies that can reinvest their profits at high rates of return for decades.

Rhyming with the Nifty-Fifty episode in the 70s, the market has currently taken that approach to extremes, making the anxiety of paying high-teen multiples during the eighties and my early career laughable by today's standards.

I remember when recommending **CSL** and **Cochlear** as Buys in our subscription business at 17x earnings was a big deal, and now **Commonwealth Bank** trades for 25x with measly growth.

The big banks are an aberration in this group given their virtually non-existent growth prospects, but the key point is that what's worked recently isn't going to work anywhere near as well over the next decade. Buffett is adapting by buying oil company **Occidental Petroleum** and selling **Apple**.

We agree with Cole's conclusion that 'the future winning hands look cheaper and more cyclical but provide attractive returns on capital.'

An unlikely bubble

We've endured extreme pricing in all four major index components since I rejoined Intelligent Investor in 2018.

The A-REITs' dream run was felled by higher interest rates in 2021, CSL's share price remains below its peak nearly five years ago after becoming 10% of the index, the iron ore majors rallied four or five times before finally capitulating recently, and now it's the banks setting ominous records led by Commonwealth Bank reaching 10% of the index given **BHP**'s and CSL's performance since they recorded the feat.

Several growth stocks also deserve mention, but as we've owned some and they're not a third of the index like the banks they haven't impacted our relative performance anywhere near as much. But like every other bubble, it won't last.

In fact, at the end of the quarter the market started rewarding value in unpopular areas, such as small and mid-cap stocks and resources stocks where the fund is tilted.

We hope the early oughts in the US are instructive, when large caps trod water for six years while small cap value stocks increased 16% per year.

Performance

The fund increased 2.5% for the quarter, trailing the market's 7.8% due to banks trading at record valuations and the increase in the Australian dollar, as we discussed in last month's report.

Bubbles are normally reserved for over-hyped growth stocks in rapidly changing industries, but this time it's a tidal wave of hot money escaping exposure to China heightened by the rise of passive funds.

If you own these stocks, make sure you cash in before the tide turns. We never expected bank valuations to reach these dizzying heights, and they'll become a long tailwind for our performance again soon enough if the process hasn't started already given China's latest stimulus measures.

We highly recommend reading last month's letter, which includes analysis of **Mineral Resources** and **RPM Global**, which is benefitting from inclusion in the ASX300 index. This month let's focus on recent portfolio changes and reporting season.

Portfolio Changes

We sold our small position in **Johns Lyng** after a poor result which raised concerns about acquisitions and the health of its core business.

In contrast, **Pinnacle Investments** has possibly been the fund's best investment returning multiples of what we paid with fully franked dividends that have grown about 50% per year. Pinnacle is the perfect example of what we look for in the fund.

We thank Ian Macoun and his staff for their wonderful job building a business that can grow much bigger yet. But the current share price offers little protection against falling performance fees, so we cashed in and will wait patiently for the next buying opportunity.

We also sold **Wesfarmers** after its valuation soared like a tech stock's. The returns were far higher than we could've hoped in the short time we owned it, and for once our selling was perfectly timed.

With the proceeds we bought **Infratil** and repurchased **Macquarie Technology** after its share price fell 25%, as their data centres look cheap next to those recently sold by AirTrunk.

Reporting season

MA Financial's share price is finally showing signs of life after treading water for two years. If its MA Money lending business continues growing, financial markets remain calm and corporate activity recovers, profits could increase 50% by 2026.

On a price-to-earnings ratio of 20, which seems mundane compared with current bank valuations, the stock would nearly double. The company's shareholder friendly dividends will hopefully make this Pinnacle 2.0.

ResMed's share price has gone from strength to strength as confidence increases that new weight loss drugs may help increase sleep apnoea diagnosis. And **Sonic Healthcare**'s share price seems to have finally settled now that the abnormal profits from Covid have washed through.

Lastly, **Aussie Broadband** finished the quarter up 10% after initially falling 20%. Concerns around growth and the cost of a new, cheaper service that requires investment were forgotten as the company reported another good set of numbers.

Overseas holdings

Rightmove is the UK equivalent of **REA Group** and has traded at a fraction of REA's valuation until REA made several attempts during the quarter to acquire it. While we're disappointed that Rightmove's board didn't engage or grant REA more time, as the gatekeeper of UK property advertising the company should deliver high-single to low-double-digit earnings growth to fuel buybacks and dividends.

The US Justice Department recently accused **Visa** of penalising merchants for using alternative networks and strong-arming competitors into partnerships with incentives and fee threats. Basically, the payments giant is an unlawful monopolist that needs to be reined in.

This isn't Visa's first regulatory rodeo. The latest action comes as politicians and big corporations spar over inflation. Attorney General Merrick Garland didn't mince words, stating, 'Visa's unlawful conduct affects not just the price of one thing - but the price of nearly everything.' The government went on to assert Visa's misdeeds fall heaviest on those least able to afford it.

Not convinced

Visa's US take-rate per transaction has fallen from 26 cents per $100 spent in 2010 to 23 cents last year, while rival Mastercard's has been flat at 29 cents. Neither figure is precise, but if Visa is the big bad wolf the government claims, why take a smaller bite? Why not screw merchants more?

Moreover, both companies' worldwide take rates exceed these figures, suggesting the US market is more competitive.

The Justice Department also overlooks a crucial comparison with cash transactions. Consultant BCG pegs the cost of accepting cash at around 4% - dwarfing most card transaction fees, which merchants dutifully pass on the cost through higher prices on goods. Not exactly free.

The government aims to boost competition and lower transaction fees. But a duopoly might be natural in an industry where network effects matter. The prospect of dozens of competing payment networks, each with its own branded card and likely lacking universal acceptance, seems impractical. Plus, there's no guarantee merchants would pass any of the savings on.

Geopolitics are another consideration. Mastercard and Visa's dominance provides the US government with powerful economic levers - tools for sanctions, monitoring illicit activities and projecting financial influence. Weakening the pair's stranglehold might score points but could prove short-sighted.

What's the potential damage?

The lawsuit targets Visa's US debit transactions, which account for 25% of its payment volumes, down from 32% in 2010. Since debit transactions have lower take rates than cross-border or credit card payments, the revenue exposure is likely smaller - our guess is 10-15% of total revenue. Any potential action would likely only threaten a small portion of this.

Legal battles are marathons, not sprints, so any outcome will likely take years. Last year, Mastercard settled similar claims with the US Federal Trade Commission without significant financial penalty, and both have shrugged off regulation in the past.

Please get in touch if you have any questions

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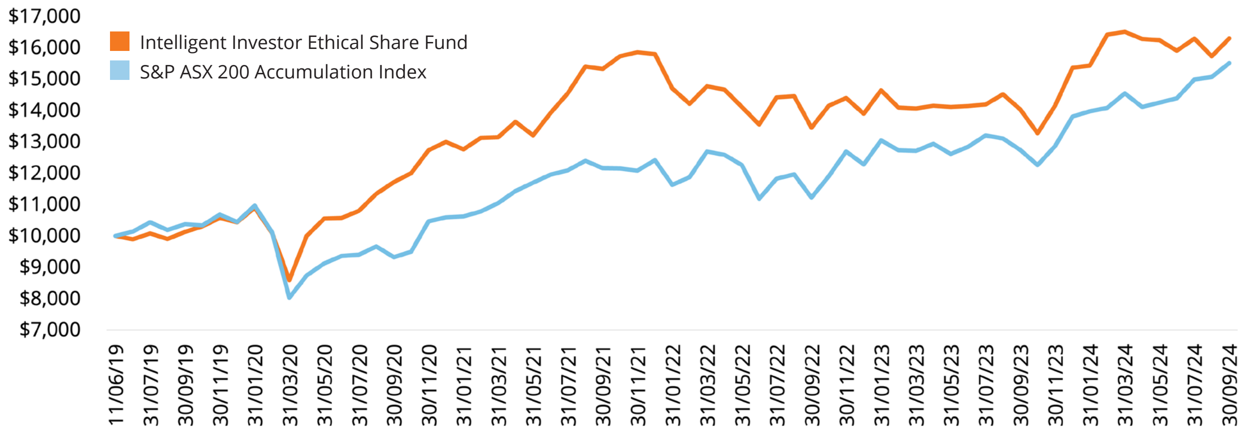
Performance since inception



Inception (S.I.): 11 Jun 2019

Asset allocation

Financials	25.9%
Information Technology	19.1%
Health Care	16.7%
Communication Services	16.1%
Materials	7.6%
Consumer Discretionary	7.4%
Cash	7.3%

Top 5 holdings

RPMGlobal Holdings (RUL)	9.1%
CSL (CSL)	6.6%
Mineral Resources (MIN)	5.3%
CME Group (CME.NAS)	5.3%
MAF (MA Financial)	5.1%

Fund Stats

Distribution yield	4.7%
Net asset value	$3.34