

Intelligent Investor Australian Equity Growth Fund

(Managed Fund) (ASX:IIGF)

“Good ideas come literally from nowhere. Our job is to recognize them when they show up.” — Steven King

“Having a contrarian view that turns out to be correct can be a brain-destroying experience.” — Friend of Ryan Holiday

“Never, ever, tell anyone about your problems. 90% of the people really don’t care. The other 10% are glad you have them.”
— Charlie Munger

The Fund increased 10.4% for the financial year, slightly trailing the market’s 12.1% gain after Mineral Resources’ share price fell 25% in June as fears deepen around the bust in lithium prices.

Despite a short-lived reprieve early this calendar year when interest rates were expected to fall, ETFs are fuelling the preoccupation with large stocks and those with earnings momentum despite being priced for lousy returns.

In contrast, our holdings offer a combination of growing earnings and dividends that should eventually be reflected in (much) higher share prices, as we’ll discuss below.


Performance (after fees)						
	1 mth	3 mth	1 yr	2 yrs	3 yrs	S.I. p.a
II Australian Equity Growth Fund	-1.5%	-1.9%	10.4%	8.3%	7.7%	11.5%
S&P ASX 200 Accumulation Index	1.0%	-1.1%	12.1%	13.4%	6.4%	11.7%
Excess to Benchmark	-2.6%	-0.9%	-1.7%	-5.1%	1.3%	-0.2%


Inception (S.I.): 5 October 2020





Fund overview


The Intelligent Investor Australian Equity Growth Fund is a concentrated portfolio of 10 - 35 Australian-listed stocks. The Portfolio invests in a mix of large, mid and small cap stocks, focusing on highly profitable industry leaders that have long-term opportunities to reinvest profits at high rates of return.


 **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

The portfolio

We owned plenty of big winners during the year, such as **Audinate, Lovisa, James Hardie Industries, Wesfarmers, RPM Global** and **Pinnacle Investments**. But we expect higher returns from stocks such as **Mineral Resources, MA Financial, ResMed, New Hope Corporation** and **Sonic Healthcare**, which have weighed on our recent performance despite recently trading at much higher prices. Let's dig in.

Mineral Resources' wild ride

Mineral Resources' share price started the year at \$70, then fell to \$50 as the lithium price collapsed. As the lithium price stabilised, the share price rebounded to \$80 before falling back to \$55 as brokers competed for the lowest lithium price prediction.

These are big moves for a \$15bn company, but the myopic focus on lithium prices is missing the progress across the rest of the business. For example, over the next three years its iron ore output will more than double, and costs will more than halve.

The Onslow project, which just started production on budget and ahead of schedule, is planned to underpin an expansion that will see MinRes grow from a marginal high-cost producer to a major miner with decades of output that will be profitable across the cycle.

Over the same period, lithium volumes will grow more than 50%, and costs will fall as pre-stripping is finished and MinRes accesses juicier parts of the orebody.

In the mining services business, volumes at 300m tonnes per year are expected to grow to 800mtpa within five years. Booking \$2 a tonne in operating profit, it will mark a step change in the company's profitability at very low risk. It's virtually an infrastructure business, as contracts run for decades, making it extremely valuable.

Iron ore, lithium, and mining services should all grow meaningfully over the next few years. This isn't an idealistic forecast or idle hope; it's a long-term plan that's bearing fruit after billions of dollars of investment.

Bloated

That spending has created \$3.5bn in net debt while the company's still spending on new projects and iron ore and lithium prices are falling. Markets are worried that a cash crunch will force spending cuts, delay projects and prompt a capital raising.

MinRes has just sold part of a haul road for the Onslow project for \$1.2bn, which helps, as will cash flow from Onslow, which is ramping up to full output. A further \$750m from credit lines is available, although sluggish lithium prices are a problem.

Electric woes

Falling demand for electric vehicles has coincided with rising lithium production. So far, swing production from China and Africa hasn't budged. Their low grades are likely unprofitable, though, and should ultimately exit the market.

But that doesn't help the situation today, which is why MinRes's share price has fallen so far so fast.

The partial sale of the Onslow haul road and the closure of the Yilgarn iron ore mines - which was low margin and required significant fresh capital - show management's determination to avoid a capital raise. Fortunately, no debt matures before 2027 and interest rates are fixed on drawn debt.

If lithium prices fall enough to eliminate production margins, expect MinRes to shut its mines. This isn't a business that has tolerated losing money, shuttering output in the last downturn. It won't please the market, but it should be enough to avoid a capital raise.

Longer term, MinRes will be a larger, more profitable business following the investments made now, in difficult times.

Iron ore volumes and margins will expand even as prices fall; lithium margins could easily get worse with lower prices but will be offset by higher volumes and eventually rise with prices. Mining services earnings are growing, and gas assets are a free option. MinRes will be more profitable over time and we expect the share price to follow.

MA Financial

MA Financial's share price is half its 2021 peak when interest rates were low and corporate activity was peaking. The company was also perhaps the biggest beneficiary of Australia's Significant Investor Visa (SIV) program, assets under management were increasing and hotel property values were recovering from COVID which had impacted one of its funds.

Earnings per share peaked at 45c, albeit it included property revaluations that won't be included on the income statement anymore, and fully franked dividends were increasing rapidly.

Three years later and interest rates are much higher, corporate activity is reawakening very slowly, the SIV program has been closed, the company is investing heavily to grow businesses like its MA Money lending business and earnings per share has almost halved.

We laud managers that sacrifice short term profits to grow profits faster over the long term, but it's anathema in the current momentum driven market.

If management's target for MA Money is realised in a couple of years, earnings per share could increase back to 45c, putting the stock on a price-to-earnings ratio of just 10. With that growth, the stock could easily double while we collect a 4.3% fully franked dividend yield before dividends are increased further by a shareholder friendly board.

ResMed

In the medical world, designing a blockbuster therapy and proving it works is just the beginning — you also must show that it's superior to the competition. This can lead to some large bumps in the road, as ResMed just discovered.

Eli Lilly recently released the results of a highly anticipated clinical trial called SURMOUNT-OSA. The Phase III study assessed the efficacy and safety of tirzepatide — a 'GLP-1' drug that causes weight loss — in treating moderate-to-severe sleep apnea in obese adults.

First, the bad news: the data shows that weight loss drugs can significantly reduce the severity of sleep apnea. In fact, tirzepatide reduced sleep apnea severity by up to 63%, or about 30 fewer airflow-restricting events per hour of sleep.

Crucially, the study found that 43% of participants in one sub-group reached what's called 'disease resolution' — after a year of therapy, their sleep apnea had improved to the point where doctors wouldn't even prescribe a continuous positive airway pressure (CPAP) device.

On the face of it, that's a pretty frightening result for a company whose core product line is CPAP devices and masks. In terms of the financial implications for ResMed, the result is negative, but not as negative as the recent share price reaction might have you believe.

What does it mean?

Firstly, the study is a comparison between the industry's standard of care (CPAP) and a new therapy — the trial isn't saying CPAP doesn't work, it's saying tirzepatide does work. That's important because it signals this is a competitive issue, not an effectiveness issue, where market dynamics, price, reimbursement rates, branding, etc. will all play a part in determining how sales unfold.

More than that, if we unwrap the headline numbers, they're a lot less scary.

The trial participants were separated into two groups: those who were unable or unwilling to use CPAP, and those who were using it and planned to continue using it.

Here's what we found interesting: those on the combination therapy — terzepatide plus CPAP — performed better on every measure than the group using terzepatide alone. This suggests that combining therapies might be the best approach to tackling moderate-to-severe sleep apnea.

While 43% of participants on terzepatide alone reached 'disease resolution' that number was 52% for those using CPAP, too. Put another way, 57% of participants taking terzepatide alone would still require an alternative intervention.

More than a number

Have you ever gone to a store looking for one thing, but the salesperson convinced you to buy something else?

There's a chance that the increased awareness of sleep apnea due to the availability of GLP-1s leads to more patients being diagnosed and subsequently prescribed CPAP as part of a combination therapy. We suspect plenty of patients have delayed getting assessed because they're scared of the result. If weight loss drugs ease that fear, and more people are assessed, it could actually increase the number of CPAP prescriptions.

The net effect of GLP-1s will probably still be a reduction in the total population needing CPAP, but we need to leave room for unexpected benefits: it isn't weight loss drugs vs CPAP; interest in one may fuel interest in the other.

Finally, SURMOUNT highlighted numerous side effects, including more than a quarter of participants experiencing diarrhea and nausea, while 17% experienced vomiting and 15% were constipated.

At the patient level, individuals couldn't give two hoots about trial data — they'll consider whether the benefits of treatment outweigh the cons for them personally. Some people may prefer more trips to the loo than the inconvenience of CPAP, but plenty won't.

Adherence to weight loss therapy is low. A 2022 study found that 45% of patients had stopped using a GLP-1 after 12 months, with 65% of users quitting before 24 months.

Overreaction

So what does the SURMOUNT study really tell us?

We know that 50-70% of sleep apnea patients are overweight, making them candidates for weight loss drugs.

Of those who try them, more than a quarter may experience side effects that would make them think twice about continuing, and more than half of patients will probably quit within a couple of years. Of those who stick with therapy, around half will continue to experience symptoms severe enough to warrant CPAP be used in combination.

Multiplying those probabilities, we estimate that weight loss drugs could reduce ResMed's pool of potential CPAP users by 10-20%.

A reduction of that size in a mature market — buyers of mobile phones, for example — would cause a comparable decline in sales. Sleep apnea, however, is nowhere near universally known and diagnosed.

Around a quarter of the adult population has some form of sleep apnea and only around 10-15% are receiving treatment in developed markets. Even if the total market size falls to just 80% of its previous estimate, the population of untreated people who might benefit from CPAP is still four times larger than those currently using it.

Remember, the market is still growing, too, due to factors such as population growth, the ageing population, and rising incomes in the developing world.

Do you think Bill Gates would have cared in 1975 if we had told him that smartphones and tablets would one day reduce the population of people needing desktops? The total addressable market size matters, but it doesn't matter nearly as much as how much of the market you currently serve.

We don't buy companies for their market size, we buy them for their ability to sell goods and turn a profit.

ResMed is a well-run company with a long history of innovation and a 45-50% market share. Before GLP-1s, most of ResMed's growth was coming from increasing penetration within an untapped market, not growth in the overall market. That story remains and there's every reason to believe ResMed can still grow device sales by 5% a year or more.

SURMOUNT confirms our prior assumptions that combination therapy will most likely win out and that significant side effects will mean the proportion of patients sticking to GLP-1 treatment over the long term will be far below 50%, ensuring the continued use of CPAP as a mainstream therapy.

Newhope Coal

The coal boom isn't over. New Hope, at its out-of-cycle interim results, reported a net profit of \$252m and operating cash flow of \$130m, even as coal prices sank almost 60% compared to the same period last year.

Despite that decline, thermal coal prices still sit over US\$130 a tonne, well above long-term averages. Our view remains that thermal coal prices will stay higher for longer. High prices have failed to incentivise enough supply, and

demand remains steady.

New Hope did benefit from hedging, which added \$61m to profit, but the economics of the Bengalla mine are mouth-watering without it. Bengalla is one of the lowest-cost mines in the country, with cash costs of just \$68 a tonne, selling coal at almost \$200 a tonne.

Surplus cash flows were once again paid in dividends; the business paid 17cps for the period and is likely to yield about 8%, fully franked, for the full year.

We see this as a base case outcome. Coal prices are seasonally low and susceptible to supply shocks and price spikes. New Hope has also been investing heavily in expanding output – it spent over \$300m in the period – which will result in higher output and, ultimately, higher dividends. We believe New Hope should generate low-to-mid-double digit returns for years while taking little risk.

The balance sheet remains pristine, and management suggest it will retain at least \$300m in net cash as a buffer.

Expansion comes from three sources. Bengalla, which was producing 8mtpa a few years ago, will ramp to 10mtpa (New Hope has an 80% stake); New Acland, which began production this year, will raise output to 5mtpa by 2027; and a 19.9% stake in Malabar Resources will yield 1mtpa of low-cost coal as it begins production over the next three years.

All up, New Hope – the most conservative, dull coal miner on the market – will double output by 2027.

Those tonnes will be high quality and low cost, generating more cash flows to pay higher dividends while carrying a net cash balance sheet and doing nothing silly. There aren't many miners we would be happy holding for the long term, but New Hope is an unlikely candidate.

Other results and portfolio changes

Sonic Healthcare announced that good revenue growth is being offset by higher costs. It's been a similar story for many other companies, such as James Hardie Industries, which we'd sold before announcing a lacklustre outlook that knocked its share price down by a quarter.

Sonic's fall was modest by comparison, partly because its share price has been slowly deflating for a while following its enormous, temporary Covid profits, which we believe has been intelligently invested. The stock offers the best value in years for such a steady business where tuck-in acquisitions reinforce its network and increase margins.

Dicker Data's share price fell 10% after announcing a regrettably timed profit downgrade at 3:30pm on a Friday. Management blamed the weak economic environment for a 10% fall in revenue for the March quarter but admirably largely held profits flat.

Management expects AI products to be a major source of growth and it's continued to sign-up high-profile vendors such as Adobe while remaining a chief supplier for household names like Microsoft.

Lastly, **Woolworths** has returned to the portfolio after a long absence. The share price should bounce back after a turbulent period including mediocre results, bad publicity and executive turnover, which included the CEO. The share price is almost back to where it was when I joined Intelligent Investor in 2006, showing how easy it is to overpay for quality businesses, no matter how safe they seem.

Summary

It's common for value funds to underperform when the market is hot, particularly when a small number of large stocks are producing most of the returns. This isn't unique and each time the returns eventually broaden across the market, which is what we're positioned for.

Our returns may come one stock at a time, as stocks like RPM Global, MA Financial and Mineral Resources produce the expected step change in their profits and are added to more indexes. Or it may come when interest rates start falling. We saw how quickly things can turn between November and March before fears of higher interest rates returned.

As we can't predict the timing or afford to miss the big, early gains when the market's preoccupation with large stocks changes, we must be positioned now and ignore the temporary volatility that's weighing on our performance.

That's how we've done it for 25 years and how we'll continue to outperform for the next 25 no matter how the world changes.

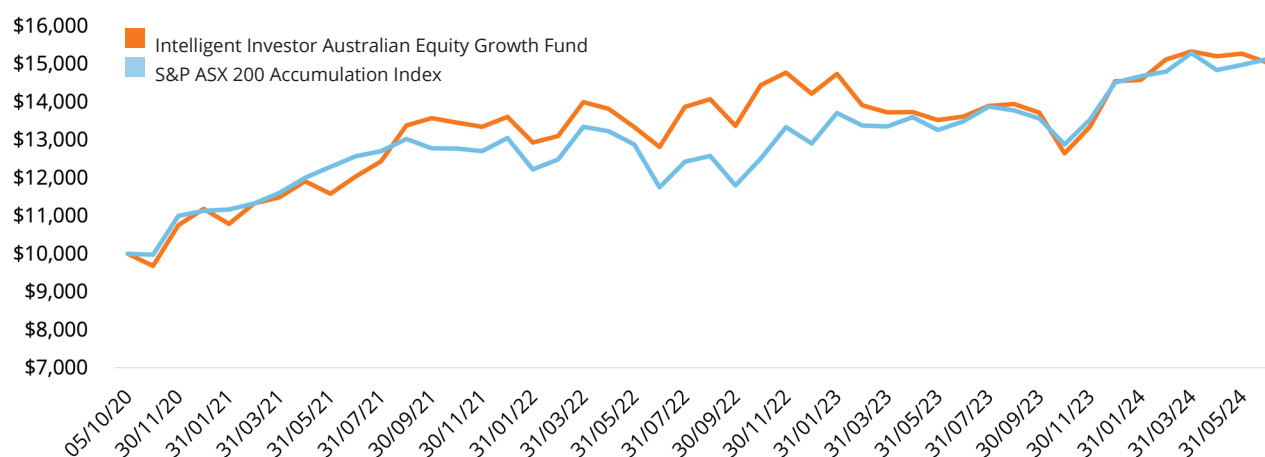
As always, thank you for your support.

Please get in touch if you have any questions

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Performance since inception



Inception (S.I.): 5 Oct 2020

Asset allocation

Information Technology	16.5%
Cash	15.7%
Materials	15.7%
Health Care	15.1%
Consumer Discretionary	11.3%
Financials	9.3%
Industrials	3.7%
Energy	3.6%
Communication Services	3.4%
Consumer Staples	3.1%
Utilities	2.5%

Top 5 holdings

RPMGlobal (RUL)	10.1%
CSL (CSL)	6.8%
New Hope Corporation (NHC)	5.7%
Wesfarmers (WES)	5.2%
Pinnacle Investment (PNI)	5.2%

Fund Stats

Distribution yield	1.12%
Net asset value	\$2.98

Important information

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All tables and chart data is correct as at 30 June 2024