Quarterly Update

31 March 2023

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Intelligent Investor Australian Equity Growth Fund (Managed Fund) (ASX:IIGF)

"People would rather believe than know."

— E.O. Wilson

"As bear markets age, valuation tends to become an increasingly important driver of defensiveness."

— Ben Inker

"The greatest wealth is created by...believing in something before the majority understand it."

— Mark Yusko

The market finished the quarter up 3.5% after getting off to a flyer in January, increasing 6.2%. The Fund fell 3.5% chiefly due to **Star Entertainment**, **Domino's Pizza Enterprises** and a general fall in energy and small cap stocks as the yield on the six-month US Treasury bond eclipsed 5%, the highest since 2007.

Our contrarian portfolio is currently of little interest to Mr Market, who is sheltering in large, familiar names despite lousy growth prospects. In contrast, you own at least ten stocks that could potentially double or more.

Most of the large stocks that dominate the index haven't produced any capital gains over the past 15 years and the next 10 look no better. Yet investors are paying huge premiums for their perceived safety when bonds offer similar returns with less risk.

Performance (after fees)

	3 mths	6 mths	1 yr	S.I. p.a
II Australian Equity Growth Fund	–3.5%	2.6%	–1.9%	13.6%
S&P ASX 200 Accumulation Index	3.5%	13.2%	0.1%	12.3%
Excess to Benchmark	–7.0%	–10.6%	–2.0%	1.3%

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

Our best returns typically follow periods of distress, which isn't broadly reflected in current valuations despite some frightening headlines. Hopefully that changes as higher interest rates continue to rattle markets, slow the economy, and punish years of malinvestment.

We'd love to hasten the process, but it takes time for debts to fall due and cash to run out. While government and central bank intervention can delay the destruction, it seems inevitable with rates increasing so far and fast already.

If not, the fund's mix of hidden gems, discarded cyclical companies whose earnings are temporarily depressed and owner-operated companies with long records of growing earnings and dividends should perform fine over time.

Our handful of quality small caps led by their founders look especially cheap currently. We expect them to lead the fund's performance when their results improve, and more investors eventually emerge from their financial bunkers seeking higher returns. We'd own more if we could.

We don't want to report a 7% performance deficit too often, but as we've shown consistently through many cycles over the past 24 years, we can make up the underperformance and then some very quickly once the market recognises the value that we see outside the market's most popular stocks.

If you can't stomach the occasional periods of lousy performance, you'll never outperform over the long term.

The last to know?

While many think the stock market is an efficient discounting machine that looks clearly into the future, history suggests they're the last to recognise trouble after it becomes obvious.

The investing environment has changed dramatically with bank collapses on both sides of the Atlantic. Yet investors are still trying to reflate the same stocks that drove the previous bull market. That's typical behaviour following euphoric financial episodes, but until their confidence is crushed, we're unlikely to enjoy a broad buying opportunity.

If/when it comes, it will likely come quickly and not last long once people regain their senses after the initial shock. The key to taking advantage is staying relaxed, and alert with your shopping list close by.

Some good news

While we never enjoy underperforming even for the right reasons (i.e buying quality, unloved stocks with large capital gain and dividend potential), there are two pieces of good news.

First, the dividends from several portfolio holdings still haven't recovered from COVID despite the fund's large distribution last year and another expected this year.

Second, you own many stocks that could more than double once the current deleveraging process ends. Our aim is to add as many more as possible before the next bull market begins (assuming it hasn't already), and not to discard our investment process to foolishly try to manage short term performance.

The bad news is that the deleveraging process has barely begun, and we may only be halfway through the cycle. That means the recovery period when our performance is usually best may still be a way off. The key is making sure it's worth waiting for.

The future, I hardly knew you

It's almost laughable how quickly Quantitative Tightening (QT) turned back to Quantitative Easing following the collapse of SVB in the US. It hasn't taken long to expose the financial system's fragility after such a long period of zero interest rates and easy money.

According to *Grant's Interest Rate Observer*, 'A $38b increase in Reserve Bank credit lifted interest bearing assets on the Fed balance sheet to $8.7t. That's $228b below the March 2022 highs, but $392b north of its holdings three weeks ago, before Silicon Valley Bank bought the farm.'

The bailout means QT has barely begun, as policymakers are stuck. Press the brakes too hard and the financial system will break. Touch the accelerator and inflation could take years to contain.

As markets adjust, our focus remains on minimising mistakes until conditions are right to swing hard and set the fund up for the next five to 10 years with minimal interference to maximise your after-tax returns. Until then, the fund's dividend stream will keep growing with the value in our holdings.

The ugly

Let's reverse the order of Sergio Leone's famous movie *The Good, the Bad and the Ugly* and deal with the ugly first.

New Star Entertainment CEO Robbie Cooke cleared the decks with a painful $800m capital raising. When he joined we thought $500m would suffice at a price well above the $1.20 raising price, so the dilution of per share value is much worse.

Things are either worse on the inside than we know, we're underestimating the imminent pain from fines, taxes and other familiar problems or perhaps Cooke is just being conservative. We'd probably do the same if we were in his shoes, though would've acted sooner to minimise the dilution to existing shareholders.

The best we can say is that Star is on a much surer financial footing, and we'll still likely come out ahead after participating in the capital raising absent any new problems.

Soggy result

Our previously published fears about **Domino's** profit margins arguing for a smaller position were realised in its interim result. Despite sales falling 4% profit fell 21%, demonstrating the dangers we've previously highlighted of buying stocks trading on high multiples that rely on high volumes.

We lost all our recent gains after Domino's failed Warren Buffett's pricing power test.

'A couple of fast tests about how good a business is. First question is 'how long does the management have to think before they decide to raise prices?' You're looking at marvellous business when you look in the mirror and say 'mirror, mirror on the wall, how much should I charge for Coke this fall?' [And the mirror replies, 'More'.] That's a great business.'

'When you say, like we used to in the textile business, when you get down on your knees, call in all the priests, rabbis, and everyone else, [and say] 'just another half cent a yard'. Then you get up and they say 'We won't pay it'. It's just night and day. The ability to raise prices — the ability to differentiate yourself in a real way, and a real way means you can charge a different price — that makes a great business.'

Domino's increased prices to protect its franchisors' profits and, like the priests and rabbis, customers baulked. For a volume-based business facing increased pressure from a broad array of delivery options, this is deeply concerning.

CEO and major shareholder Don Meij said the remedy would be more discount offers but that will also undermine margins, especially as interest rates increase and people tighten their belts. Like Meij, many companies have based their full year expectations on a better second half, but that seems foolish with inflation and interest rates increasing.

We've kept our small position, as longer term the company should be able to grow profits, as recent store acquisitions mature. But we'll need a much lower price to buy more.

This is no longer – if it still was – a simple store rollout story. The next ten years will be much tougher than the past ten.

The Bad

It seems laughable to complain about an interim dividend that's a 30% fully franked yield on some of our purchases. But **Whitehaven Coal**'s interim dividend fell well short of what we were expecting with management seemingly keener than us on a huge share buyback.

It was more of a bonus than the bonanza we'd predicted. We'd prefer the money in our hands as soon as possible lest management find something lousy to do with its expected $2bn cash hoard.

We sold **Omni Bridgeway** for a small loss following a lacklustre result filled with more promises than results. There's a possibility the new CEO may change that, but our patience has worn out and you never know what skeletons a new CEO will find.

Pinnacle Investment Management announced an unsurprising fall in profits for the six months ending last December. The frightful performance by some of its growth funds and corresponding fall in performance fees had already been flagged, but the company's prospects remain undimmed. Mixed performance by its diverse family of funds should be expected in the absence of zero interest rates.

Credit Corp's share price continues to fall as fears of recession loom over lenders. Albeit not our major banks.

The share price has fallen over 50% from its highs and it's tempting to increase the position as we believe its long-term prospects in the US are bright. But we're waiting to see the full impact of higher interest rates. Debt ledger companies can get far cheaper than you ever imagined when panic sets in, but history says it pays to back the market leader.

Although we've put **RPM Global** in the 'Bad' bucket, revenue growth has been strong. The near 20% fall in the share price that's materially hurt our performance reflects high costs that are delaying the strong growth in profits we've expected after transitioning from selling software licenses to the more predictable and valuable revenue from selling software subscriptions.

Our faith remains undimmed, and we're hoping the company doesn't find itself in the crosshairs of an opportunistic predator that acquires one of our larger positions at a cheap price. High quality small cap stocks are rare, and we want full value for our patience.

The Good

Though you wouldn't know it from the fund's performance, most of the recent results have been good.

The recovery at **Auckland Airport** is happening quicker than expected with leisure travel bouncing back rapidly. The world is still opening from COVID and Auckland Airport should get back to paying decent dividends soon.

James Hardie Industries' share price increased 20% as investors bet that the worst is over for US home builders and the broader residential real estate industry. Remarkably, US homebuilder share prices are within a whisker of their record highs.

We expect there is more pain to come and are leaving room to increase our position in what's possibly Australia's best cyclical business.

Woodside Energy declared a large dividend which initially lifted the share price, though the large capital gains are now behind the stock. The company's balance sheet is a thing of beauty, but it will fund some large investments to replace reserves like all resources companies, so it remains a small position that we'll happily sell when we find better opportunities.

The Lottery Corporation showed that recession or not people won't sacrifice their weekly $12 lotto ticket. The lotto is a relatively cheap source of excitement and my wife currently views winning the jackpot as our only hope of buying a house in Sydney any time soon.

Although the number of jackpots in any one year can swing profits, the business is about as predictable as it gets. That's why it trades at a premium valuation and is another that we're aiming to replace with better opportunities.

Mineral Resources' increasing lithium profits couldn't meet sky high expectations and the share price fell. The stock has performed much better since we've owned it than we could've hoped, but lithium is still a hot sector, and we'll need the hot money to evaporate before increasing our stake.

MA Financial's result was good considering financial market activity in some divisions such as mergers and acquisitions has slowed rapidly. The credit and loan side of the business is performing well bolstered by inflows, which shows the business's long-term potential.

The share price has fallen over 50% since its highs and will be an exceptional opportunity if it fulfils its potential in the decades ahead. This is true for numerous small cap stocks currently, but as our small cap exposure is limited by ASX liquidity rules we need to manage this bucket carefully to maximise the few swings we have left.

Frontier Digital Ventures' share price was flat after initially increasing 30% following a good if not excellent fourth quarter result showing early signs that the new management team running the Latin American business can increase profitability rapidly in the years ahead.

Just as it looked like a deal was imminent, the IMF has asked Pakistan to shore up other creditors before releasing funds despite the new Pakistan government already implementing several painful economic policies at the IMF's behest.

An agreement that prevents the collapse of the Pakistan rupiah could add $200-400m of value back to the business that we've written off, dwarfing Frontier's current market value of $280m.

Mr Market is clearly concerned about sovereign debt and currency risks, but without a widespread crisis we expect to make multiples of our current investment even if the value of Frontier's Pakistan businesses is undermined by the currency.

One new familiar name, one old

We added diversified retail stalwart **Wesfarmers** and reopened a small position in fast-fashion jeweller **Lovisa** after reporting an excellent result that would've been even better were it not for new CEO Victor Herrero's eye-popping pay-packet.

Herrero is Australia's second highest paid CEO behind **Macquarie**'s Shemara Wikramanayake and has huge plans for Lovisa's international roll out. It's a great test of whether paying up for the best managers is worth it. Even if he only conquers half the targets in his global invasion plans, we expect healthy capital gains and dividends.

Our expectations of Wesfarmers are more modest. Bunnings' giant green sheds of gold are one of Australia's best businesses and slower profit growth should be temporary. We expect at least an 8% total annual return with half that coming from fully franked dividends, which are especially valuable in a highly priced market with limited growth prospects.

Higher returns may come from Wesfarmers' lithium business, though increasing lithium supply in the years ahead will likely reduce prices. Hopefully that will also give us another cheap crack at Mineral Resources.

Summary

While it wasn't a good quarter for the fund vis-à-vis the index, occasional periods like this are par for the course with a contrarian, concentrated portfolio. Particularly when it's compared every four weeks with a highly concentrated index of giant, cyclical companies during the gradual bursting of the world's largest ever bubble.

Right now, we're backing unpopular businesses that can grow profits and dividends over the next decade, no matter how uncomfortable it might feel, while waiting for new opportunities.

Stock markets may or may not be in denial but, to paraphrase Thomas S Monson, we can't control the conditions, we can only adjust the sails. Valuations for the highest quality businesses remain optimistic and we don't want to lock in mediocre returns for the next decade because we're impatient. That's not what you pay us for.

Major deleveraging periods don't get tied up in a neat bow quickly. Ten to twenty years of malinvestment fuelled by zero interest rates is currently unravelling. We haven't even scaled the fixed interest mortgage cliff in Australia yet.

Our primary goal is to keep your capital intact, make sure we don't lose sight of the long-term while other investors get frustrated and give up, and make sure that we capitalise on their short-sightedness to set the fund up for the next bull market.

We can't control share prices, but we can control how we respond. Patience is currently our most valuable asset while we bank a growing stream of dividends that still hasn't fully recovered since COVID.

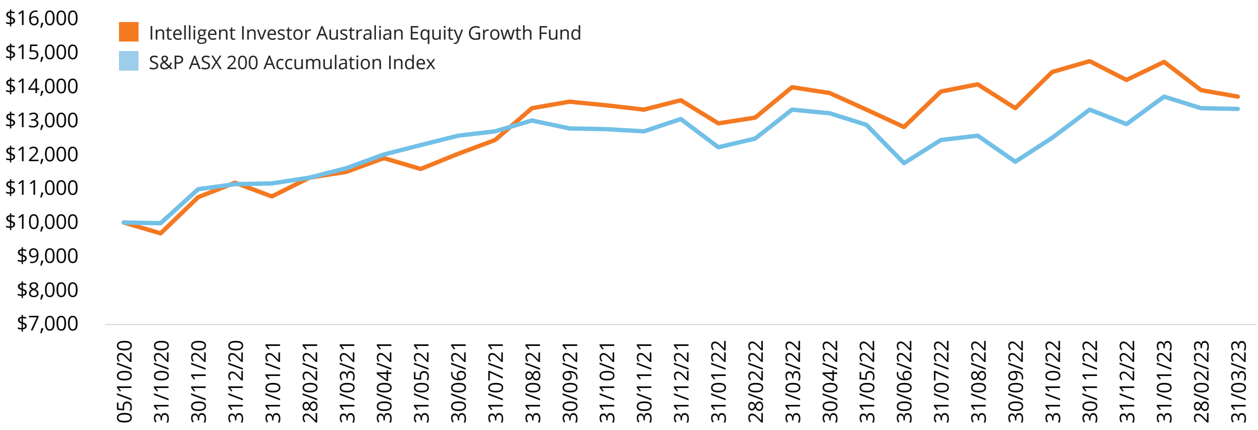
We may only be halfway through the current downturn, and the second half is usually the most painful. If history repeats, that will scare some that have only known one long bull market driven by zero interest rates and never experienced a recession.

We recommend they google why the average investor in Peter Lynch's Fidelity Magellan Fund lost money despite the fund's astounding 29% annual return between 1977 and 1990. Forewarned is forearmed.

But for bargain hunters like us, we wish the market would get on with it already. Here's hoping some big opportunities aren't far away.

Please get in touch if you have any questions on **1300 880 160** or at **info@intelligentinvestor.com.au**

Performance since inception



Inception (S.I.): 5 Oct 2020

Asset allocation

Cash	21.2%
Consumer Discretionary	19.1%
Materials	14.8%
Information Technology	14.3%
Financials	10.3%
Energy	6.5%
Industrials	6.3%
Real Estate	3.2%
Health Care	2.4%
Utilities	2.0%

Top 5 holdings

Auckland International Airport (AIA)	6.3%
RPMGlobal Holdings (RUL)	6.0%
New Hope Corporation (NHC)	5.3%
Audinate (AD8)	4.6%
Alumina (AWC)	4.3%

Fund Stats

Net asset value	$2.882

Important information

All tables and chart data is correct as at 31 March 2023