

Portfolio update



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TO JUNE 2012

Income Portfolio delivers steady returns

Jason Prowd

In our regular six-monthly update on the Income Portfolio Jason Prowd teases out what drove its performance, and distils a few investing lessons.

It takes a rare investing talent to impress Joel Greenblatt, Jeremy Grantham, Seth Klarman, and Warren Buffett, but Howard Marks, co-founder and chairman of Oaktree Capital Management, has done just that. Over forty-odd years in the market, Marks has forged a reputation as an original and insightful investor, garnering the respect of the best in the business.

Careful portfolio management is one of the keys to Marks's success and we've taken many of his lessons to heart in the management of our [Income Portfolio](#), which aims to provide a steady, reliable stream of income from companies with minimal risk of bankruptcy.

As Marks puts it: 'Superior investment performance is not our primary goal, but rather superior performance with less-than-commensurate risk ... Thus, rather than merely searching for prospective profits, we place the highest priority on preventing losses.'

Marks believes that a skilfully managed, risk-averse portfolio should aim to match the performance of the market when it rises and do better than the market when it does poorly. If you can achieve this then, over time, your portfolio should significantly outperform the market.

So how do we stack up against Marks's yardstick? Over the past six months the Income Portfolio returned 4.0% compared to 2.9% for the All Ordinaries Accumulation Index. And since inception in 2001 the portfolio has returned 13.0% a year, well clear of the index's 6.3% (see Chart 1).

Let's look at the principal drivers of the portfolio's performance and the changes we've made over the past six months.

Income lower as cash balance rises

One of the most important things for an income-focused portfolio, is, well, income. In the six months to 30 June the portfolio generated \$3,912 in dividends, giving it a running yield of 4.7% a year. This is lower than the same period in 2011 and well short of the \$7,492 received in six months to December 2006 (see Chart 2 over the page).

Lower income is a direct result of the increased cash in the portfolio, which at 30 June was \$30,777 or 18.4% of the portfolio (including US dollars).

We are keenly aware of the need to boost the portfolio's income, but as we suggested in [The five secrets of tough-times investing](#) on 25 Jun 12, 'Simply buying stocks with the fattest yield ... would be a mistake. Just ask anyone that invested in A-REITs in the lead up the GFC.'

Given the choice, we'll always forego a slight increase in yield to avoid excessive risk, which explains why we've avoided the recent spate of [income securities](#). Increasing our cash holdings when opportunities are scarce leaves the portfolio well placed to act when bargains emerge. (see [The case for cash](#)).

Stable performance reflects low-risk holdings

Turning to performance, there were a couple of notable winners that helped boost returns. **Westfield Group** rose 22% as investors became more excited with its overseas expansion strategy. Westfield is trading around fair value and we remain comfortable with our holding.

KEY POINTS

Income portfolio returned 4.0% and paid \$3,912 in dividends in the six months to 30 June

Long-term outperformance of the market, returning 13.0% a year since inception in 2001

Changes to portfolio reflect a focused, disciplined approach to risk



CHART 1: INCOME PORTFOLIO VS ALL ORDS ACCUM. INDEX

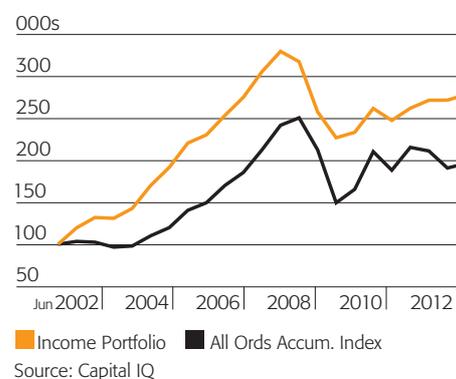
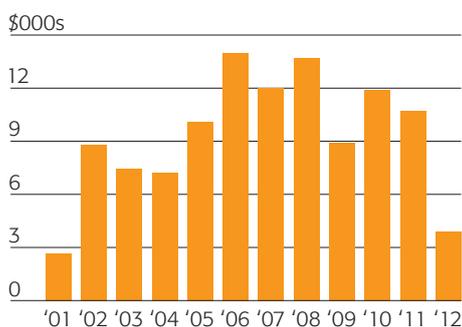
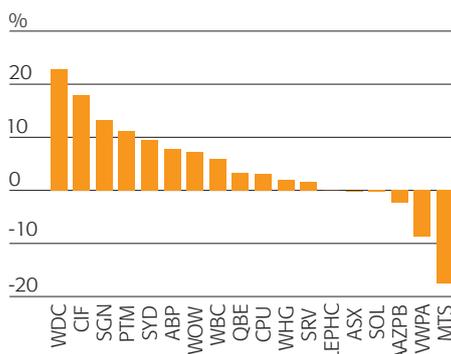


CHART 2: INCOME PORTFOLIO DIVIDENDS PAID



Source: Capital IQ

CHART 3: INCOME PORTFOLIO STOCK PERFORMANCE, SIX MONTHS TO 30 JUN 2012



Note: Excludes dividends, open price used for existing holdings, purchase price for new holdings.

Source: Capital IQ

MORE FROM HOWARD MARKS

‘Howard Marks publishes regular memos on Oaktree’s website, which are available free [here](#). He has also written a book, *The Most Important Thing*, a distilled version of the best of his client letters.’

Challenger Infrastructure Fund rose 17% after announcing the sale of its assets: Inexus and LBC Tank Terminals (see *CIF: Risk reduced, upside improved* from 06 Jun 12 (Long Term Buy—\$1.18) and *CIF: Inexus sale boost* from 26 Jun 12 (Hold—\$1.29)). Challenger is now in wind-up mode and we patiently await the pending capital return.

STW Communications, Platinum Asset Management, Sydney Airport, Abacus Property Group, Woolworths and Westpac all outperformed the market over the past six months reflecting their stable, high-quality nature (see Chart 3).

On the other side of the ledger, **Metcash’s** share price fell 17% following a weak result from its core grocery wholesaling business and a \$325m capital raising. Since the 30 June balance date, we’ve downgraded the company to Hold and sold our holding, chalking up a 11.8% loss (see *Red flags waving for Metcash* from 10 Jul 12 (Hold—\$3.25)).

Risk first, then reward

Recent transactions reflected our focus on risk before reward. Over the past six months we have sold shares in **Perpetual, Westfield Retail Trust, Insurance Australia Group and Spark Infrastructure** following reassessments of their businesses (see Table 1). **Australand** was also sold to reduce our exposure to the property sector and **Treasury Wine Estates** got the chop following its recent price rise.

TABLE 1: INCOME PORTFOLIO TRANSACTIONS

STOCK (ASX CODE)	BUY/SELL	SHARES (NO.)	PRICE (\$)	VALUE (\$)	DATE
WESTFIELD RETAIL TRUST (WRT)	Sell	2,343	2.51	5,881	30/01/12
PERPETUAL (PPT)	Sell	400	24.43	9,772	24/02/12
WHK GROUP (WHG)	Buy	4,000	0.84	(3,360)	3/04/12
TREASURY WINE ESTATE (TWE)	Sell	417	4.155	1,733	3/04/12
SPARK INFRASTRUCTURE (SKI)	Sell	7,000	1.42	9,940	20/04/12
INSURANCE AUSTRALIA GROUP (IAG)	Sell	2,150	3.36	7,224	16/05/12
ASX (ASX)	Buy	200	29.87	(5,974)	8/06/12
AUSTRALAND (ALZ)	Sell	3,060	2.45	7,497	29/06/12
ASX (ASX)	Buy	80	29.26	(2,341)	29/06/12
COMPUTERSHARE (CPU)	Buy	780	7.38	(5,753)	29/06/12
ALE NOTES 2 (LEPHC)	Buy	60	100.50	(6,030)	28/06/12
BETASHARES US DOLLAR ETF (USD)	Buy	750	9.90	(7,425)	29/06/12

These transactions increased the focus of the portfolio, with the total number of holdings decreasing from 21 at 31 December 2011 to 19 at 30 June 2012 (including US dollar ETF). For this type of portfolio, we’re very happy with around 15 to 20 holdings, which should offer most of the benefits of diversification without overly muting the effect of our winners.

Portfolio eyes opportunities abroad

Additions to the portfolio have broadly fitted into three categories.

First, as we’ve discussed extensively, now is a great time to invest overseas (see *Why now is a great time to invest abroad, Ripe for the picking: Eight overseas stocks to buy now* and *Overseas stock opportunities—Pt 1*).

The Income Portfolio only invests in ASX-listed stocks so we’ve increased our overseas exposure by investing in share registry **Computershare**, which generates 81% of its sales offshore. This complements our existing internationally focused holdings, Westfield Group and **QBE Insurance**. We have also diversified our currency holdings by placing about 20% of the portfolio’s cash in a US dollar exchange traded fund (see *Topping up model portfolios* from 29 Jun 12).

Secondly, we’ve added some high-quality, blue-chip stocks. Computershare has already been mentioned and also fits this category. We’ve also purchased some **ASX**. ASX has a quasi-monopolistic position as the owner of our main securities exchange, helping it generate large licks of free cash, which translate into a fat fully-franked dividend yield of 6.2%.

Finally we’ve purchased two high-yielding second liners. WHK Group, an existing investment, was doubled to a 4.8% weighting, whilst a new position was taken in ALE Notes 2, an income security on an attractive 7.4% yield secured by ALE Property Group’s 87-strong pub network.

Overall, these were modest changes, reflecting our steady, risk-averse approach to building and managing an Income Portfolio.

The Income Portfolio is a dynamic, practical demonstration of how we think about investing, and is designed to complement our stock research, helping you build and manage your portfolio. The results, especially over the longer-term, demonstrate the value of our approach.

TABLE 2: INCOME PORTFOLIO (AS AT 30 JUN 12)

STOCK (ASX CODE)	PRICE MOVEMENT SINCE 31/12/11* (%)	CURRENT YIELD (%)	MOST RECENT RECOMMENDATION	SHARES (NO.)	PRICE (\$)	VALUE (\$)	% OF PORT- FOLIO
ABACUS PROPERTY GROUP (ABP)	7.4	8.5	Hold—\$1.90 (13 Jun 12)	2,350	2.04	4,794	2.9
ALE NOTES 2 (LEPHC)	0.0	7.4	Buy for Yield—\$100.50 (28 Jun 12)	60	100.50	6,030	3.6
AUSTRALAND ASSETS (AAZPB)	-2.2	9.4	Hold—\$93.10 (9 May 12)	100	89.00	8,900	5.3
ASX (ASX)	-0.2	6.2	LTB—\$29.87 (8 Jun 12)	280	29.82	8,350	5.0
CHALLENGER INFRA. FUND (CIF)	17.0	n/a	Hold—\$1.29 (26 Jun 12)	3,600	1.31	4,716	2.8
COMPUTERSHARE (CPU)	2.9	3.9	LTB—\$7.82 (14 Jun 12)	780	7.58	5,916	3.5
METCASH (MTS)~	-16.6	8.9	Hold—\$3.25 (10 Jul 12)	2,500	3.37	8,425	5.0
PLATINUM ASSET MGMT (PTM)	10.5	6.2	Hold—\$3.69 (11 Jul 12)	1,500	3.89	5,835	3.5
QBE INSURANCE (QBE)	3.1	6.6	Buy—\$14.09 (5 Apr 12)	700	13.70	9,587	5.7
SERVCORP (SRV)	1.5	4.5	LTB—\$2.85 (22 Feb 12)	1,800	2.65	4,770	2.9
SEVEN NET. TELYS4 (SVWPA)	-8.2	10.6	Hold—\$82.50 (18 May 12)	93	77.99	7,253	4.3
STW COMMS (SGN)	12.5	8.3	Hold—\$0.92 (21 Jun 12)	7,000	0.95	6,615	4.0
SYDNEY AIRPORT (SYD)	-13.2	7.2	LTB—\$2.61 (27 Feb 12)	3,280	2.90	9,512	5.7
W H SOUL PATTS. (SOL)	-0.3	3.1	Hold—\$13.40 (12 Jul 12)	700	13.79	9,653	5.8
WESTFIELD GROUP (WDC)	21.6	5.0	Hold—\$9.18 (16 May 12)	1,086	9.50	10,317	6.2
WESTPAC BANK (WBC)	5.7	7.4	Hold—\$22.93 (4 May 12)	320	21.13	6,762	4.1
WHK GROUP (WHG)	1.8	8.1	LTB—\$0.83 (23 Feb 12)	9,500	0.84	7,980	4.8
WOOLWORTHS (WOW)	6.8	4.6	LTB—\$26.44 (1 Jun 12)	400	26.80	10,720	6.4
CASH (AUD)					23,442	14.0	
CASH (USD)^					7,335	4.4	
TOTAL PORTFOLIO VALUE (\$)						166,912	
CURRENT ANNUALISED YIELD (%)						4.6	
RETURN SINCE INCEPTION (P.A)						13.0	

^Held via US dollar ETF at current market prices

*Since purchase for new additions

~Sold post 30 June

Note: For more on portfolio management check out [Building and managing an Income Portfolio—Part 1](#) or dive into our back catalogue of model portfolio reviews. Look out for a [Growth Portfolio](#) update next week.

Disclosure: The author, Jason Prowd, owns shares in Challenger Infrastructure Fund, QBE Insurance and Computershare. Other staff own shares in many of the stocks mentioned. For a full list please refer to the [Staff portfolio](#) on the website. First published online 13 Jul 2012.

“The Income portfolio is a dynamic, practical demonstration of how we think about investing.”

Growth Portfolio: Persistence pays

Jason Prowd

KEY POINTS

Growth portfolio returned 6.8% in the six months to 30 June 2012

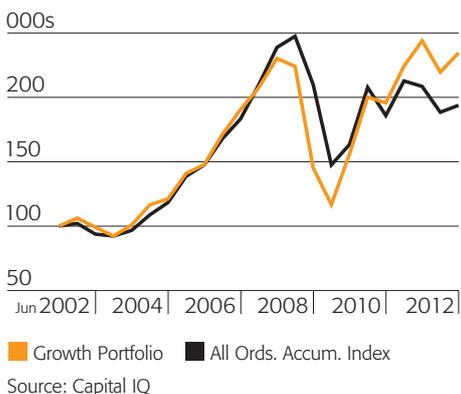
Persistence combined with a sound strategy typically leads to outperformance

We're here to partner with you over the long term



“Our steady, risk-averse approach has been paying off.”

CHART 1: GROWTH PORTFOLIO PERFORMANCE VS ALL ORDS ACCUMULATION INDEX



In our latest Growth Portfolio update Jason Prowd explains why persistence combined with a sound strategy typically leads to outperformance.

‘Nothing in the world can take the place of persistence ... The slogan ‘press on’ has solved, and always will solve, the problems of the human race’.

US President ‘Silent Cal’ Coolidge’s words were, of course, intended for a wider audience, but if we’ve learnt anything over the past 14 years it’s that the ability to stay the course is crucial.

Since 2001 we’ve run the model [Growth](#) and [Income](#) Portfolios to provide you with a live ‘how to’ guide for managing money.

The [Growth](#) Portfolio is designed for investors wishing to build wealth, but who don’t need to generate regular income from their investments. It aims to beat the All Ordinaries Accumulation Index.

For a number of years the portfolio lagged that index. However, by turning the global financial crisis into an opportunity, it has since overtaken it (see [The five secrets of thoughtful investing](#)). Since inception, in 2001, the portfolio has return 8.1% a year, 1.8% ahead of the index’s 6.3%—a margin we aim to increase. In that regard, we’ve been on the right track in the six months to 30 June 2012, with the portfolio returning 6.8% compared to the index’s 2.9%.

Our steady, risk-averse approach has been paying off.

Overseas exposure drives performance

Whilst we’re hesitant to focus on short-term performance, there are a number of share price movements worth highlighting.

As we’ve explained in several articles (see [Ripe for the picking: Eight overseas stocks to buy now](#) or [Why now is a great time to invest abroad](#)), we think that buying into overseas earnings streams now is a sensible way of taking advantage of the high Aussie dollar and diversifying away from Australia’s banking and resources-dependant economy.

If it seems like we’ve laboured the point, the portfolio’s recent performance demonstrates why we’ve been so insistent. While fears about the local economy have been driving share prices lower, companies with overseas earnings have outperformed.

Indeed, most of the Growth Portfolio’s performance in the six months to 30 June 2012 was driven by [News Corp](#), [CSL](#), [Westfield Group](#), [Cochlear](#), [Sonic Healthcare](#) and [Aristocrat Leisure](#) which rose by 24.6%, 23.2%, 21.6%, 6.2%, 12.6% and 25.5% respectively. The latter as signs of a nascent turnaround emerge (see [2 Jul 12 \(Long Term Buy—\\$2.45\)](#)).

In the words of Mae West, ‘too much of a good thing can be wonderful’ and, with this in mind, we’ve increased our overseas exposure over the past year. Over 40% of the portfolio’s earnings are now derived offshore (see [Chart 2](#)), and we’ve further diversified our currency exposure by placing a portion of the portfolio’s cash in a US dollar exchange traded fund (see [Topping up model portfolios](#) from 29 Jun 12).

Other notable performers include 4WD accessories company [ARB Corporation](#), whose share price jumped 17.7%, and [Challenger Infrastructure Fund](#) whose security price rose 17.0% following the sale of its two assets, effectively placing the company in wind-up mode (see [CIF: Risk reduced, upside improved](#) from 06 Jun 12 (Long Term Buy—\$1.18) and [CIF: Inexus sale boost](#) from 26 Jun 12 (Hold—\$1.29)).

Meanwhile, grocery wholesaler [Metcash](#)’s share price fell 16.6% following hard evidence that its business has weakened. Since 30 June we have downgraded the stock and disposed of our holding (see [Red flags waving for Metcash](#) from 10 Jul 12 (Hold—\$3.25)).

Even so, the impact on the portfolio’s total return has been minimal, highlighting the importance of sensible diversification.

The share prices of [Tap Oil](#) and [Infigen Energy](#) swung wildly over the period, rising 16.0% and falling 16.7% respectively. This kind of price volatility reflects the risk of each investment, which is why they are relatively small positions.

Buying and selling further boosts offshore earnings

As already noted, we have increased the Growth Portfolio's overseas exposure in the past year, and that's been a feature of the buy and sell decisions over the past six months.

On the sell side, we have disposed of holdings in the locally exposed **Perpetual** and **Spark Infrastructure**.

In the case of Perpetual, this reflected concerns about fund outflows and management turmoil. This led to a downgrade (see [Doors close on Perpetual](#) from 24 Feb 12 (Sell—\$24.43)) and the sale of our holding at a small loss.

With Spark, we took a profit of 32.5% in just over a year after management indicated it is fishing for acquisitions. This could trigger a capital raising and increase debt, while diluting our exposure to the reliable and growing revenue stream from its prized electricity infrastructure assets.

Other disposals included the reduction of our stake in 4WD accessories maker **ARB Corp** following its price rise, and the sale of a small position in gold explorer Integra Mining (see [Topping up model portfolios](#) from 29 Jun 12).

Additions of **QBE Insurance**, Infigen Energy and **Computershare** have increased the portfolio's overseas exposure.

TABLE 1: GROWTH PORTFOLIO TRANSACTIONS

STOCK (ASX CODE)	BUY/SELL	SHARES (NO.)	PRICE (\$)	VALUE (\$)	DATE
QBE INSURANCE (QBE)	Buy	293	11.10	-3,252	13/01/12
PERPETUAL -PPT	Sell	331	24.43	8,086	24/02/12
ARB -ARP	Sell	700	9.32	6,521	03/04/12
INFIGEN ENERGY -IFN	Buy	18,500	0.25	-4,533	03/04/12
METCASH -MTS	Buy	1,100	4.15	-4,560	03/04/12
SPARK INFRASTRUCTURE -SKI	Sell	6,493	1.42	9,220	20/04/12
INTEGRA MINING -IGN	Sell	4,100	0.375	1,538	29/06/12
COMPUTERSHARE -CPU	Buy	300	7.38	-2,213	29/06/12
BETASHARES US DOLLAR ETF -USD	Buy	1,100	9.90	-10,890	29/06/12

QBE Insurance and Computershare look like they are suffering from market myopia, with too much focus being placed on short-term earnings and risks. This is often a fertile ground for value investors. Our own successes in this area in the past include **Flight Centre**, **Sydney Airport** and **Goodman PLUS**. QBE and Computershare should both be earning appreciably more in five years' time than they are today.

Infigen, on the other hand, is a case where complexity and debt are masking an attractive situation (see [Infigen an energetic spec buy](#) on 19 Sep 11 (Speculative Buy—\$0.24)).

We've weighted each investment according to the risks and rewards on offer. The more speculative nature of Infigen means we've only invested 1.8% of the portfolio in the stock, whereas we are comfortable placing around 6% in both Computershare and QBE.

With the benefit of hindsight, our investment in Metcash was a mistake as we were overly optimistic about the company's future prospects, including the recent Franklins acquisition. Metcash won the battle with regulators, but the cost of the war means the acquisition won't produce high returns on capital as we initially expected. We've bitten the bullet since the half-year ended, escaping with a total loss on the holding of 17.7%. Although, as we've already noted, the overall effect on the portfolio was small due to the large dividends that the portfolio has received from Metcash.

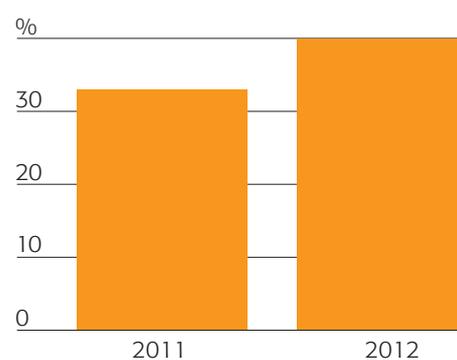
Persistence, resistance and support

Managing money isn't easy. But it is nowhere near as hard as many financial pundits would have you believe. Our model portfolios, in combination with our [stock research](#), aim to make the task far less burdensome.

Recently we've made enhancements to our website to make it even easier, such as adding [detailed financial data](#) and the [My Stockwatch](#) feature. We have also just published a [special report](#) on how your brain undermines your performance and what you can do to keep it in check, as experience suggests that being prepared and doing the right thing at the right time has a larger impact on your wealth than anything else.

The next few years are likely to be tough, but we're here to help. It'll require

CHART 2: INTERNATIONAL EARNINGS



Source: Capital IQ

“Managing money isn't easy. But it is nowhere near as hard as many financial pundits would have you believe.”

fortitude and persistence but, combined with a sound process, beating the market remains distinctly achievable.

Note: For more on portfolio management check out [Building and managing your portfolio](#) or dive into our back catalogue of [. For the latest on the Income Portfolio check out \[Income Portfolio delivers steady returns.\]\(#\)](#)

TABLE 2: GROWTH PORTFOLIO (AS AT 30 JUNE 2012)

STOCK (ASX CODE)	PRICE MOVEMENT SINCE 31/12/11* (%)	MOST RECENT RECOMMENDATION	SHARES (NO.)	PRICE^ (\$)	VALUE (\$)	% OF PORT- FOLIO
ABACUS PROPERTY GRP (ABP)	7.4	Hold—\$1.90 (13 Jun 12)	3,060	2.04	6,242	2.7
ARB CORP (ARP)	17.7	Hold—\$8.75 (1 Mar 12)	1,300	9.1	11,830	5.0
ARISTOCRAT LEISURE (ALL)	25.5	LTB—\$2.45 (2 Jul 12)	3,000	2.76	8,280	3.5
AUSTRALAND (ALZ)	2.9	Hold—\$2.74 (07 May 12)	2,180	2.47	5,385	2.3
AWE (AWE)	2.7	Spec. Buy—\$1.78 (6 mar 12)	4,175	1.34	5,595	2.4
BRICKWORKS (BKW)	-6.9	LTB—\$10.16 (13 Jul 12)	600	10.1	6,060	2.6
CHALLENGER INFRA. (CIF)	17.0	Hold—\$1.29 (26 Jun 12)	9,000	1.31	11,790	5.0
COCHLEAR (COH)	6.2	Hold—\$57.95 (20 Mar 12)	200	65.84	13,168	5.6
COMPUTERSHARE (CPU)	-7.7	LTB—\$7.82 (14 Jun 12)	1,815	7.58	13,766	5.9
CSL (CSL)	23.2	Hold—\$35.62 (10 Apr 12)	150	39.42	5,913	2.5
ELDERS PREF. SHARES (ELDPA)	6.6	Hold—\$34.00 (22 May 12)	70	34.10	2,387	1.0
INFIGEN (IFN)	-16.7	Spec. Buy—\$0.22 (27 Jun 12)	18,500	0.23	4,163	1.8
MACQUARIE GROUP (MQG)	9.3	LTB—\$25.66 (18 May 12)	490	26.00	12,740	5.4
SYDNEY AIRPORT (SYD)	9.0	LTB—\$2.61 (27 Feb 12)	4,027	2.90	11,678	5.0
METCASH (MTS)-	-16.6	Hold—\$3.25 (10 Jul 12)	2,100	3.37	7,077	3.0
NEWS CORP CLASS A (NWSLV)	24.6	Hold—\$21.95 (28 Jun 12)	710	22.42	15,916	6.8
PLATINUM ASSET MGMT (PTM)	10.5	Hold—\$3.69 (11 Jul 12)	2,700	3.89	10,503	4.5
QBE INSURANCE (QBE)	3.1	Buy—\$14.09 (5 Apr 12)	1,043	13.70	14,285	6.1
SERVCORP (SRV)	1.5	LTB—\$2.85 (22 Feb 12)	1,636	2.65	4,335	1.8
SILVER LAKE (SLR)	-6.6	Hold—\$3.05 (20 Jun 12)	850	2.81	2,389	1.0
SONIC HEALTHCARE (SHL)	12.6	Hold—\$12.81 (16 May 12)	1,000	12.70	12,700	5.4
TAP OIL (TAP)	16.0	Spec. Buy—\$0.64 (18 May 12)	4,600	0.69	3,174	1.4
WESTFIELD GROUP (WDC)	21.6	Hold—\$9.18 (16 May 12)	695	9.50	6,603	2.8
WOOLWORTHS (WOW)	6.8	LTB—\$26.44 (1 Jun 12)	430	26.80	11,524	4.9
CASH (AUD)				16,121	6.9	
CASH (USD)^				10,758	4.6	
TOTAL PORTFOLIO VALUE (\$)				234,380		
RETURN SINCE INCEPTION (P.A)				8.1		

^Held via US dollar ETF at current market prices

*Since purchase for new additions

~Sold post 30 June

Disclosure: The author, Jason Prowd, owns shares in QBE Insurance, Challenger Infrastructure Fund and Computershare. Other staff own shares in many of the stocks mentioned. For a full list please refer to the [Staff portfolio](#) on the website. First published online 17 Jul 2012.

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Notes



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