THE INTELLIGENT INVESTOR
VALUE INVESTING EXPERTS
PORTFOLIO UPDATE
AS AT 30 JUN 2009
JUN '09
PORTFOLIO UPDATE

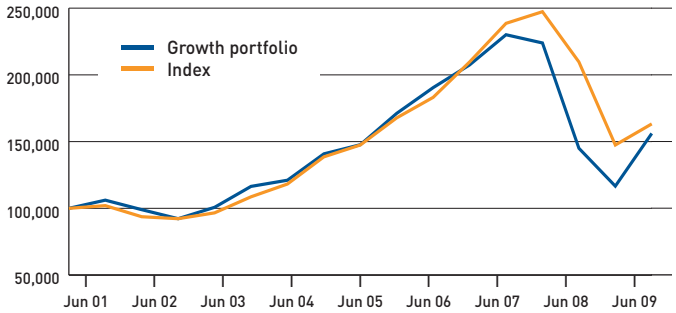
Portfolios recover from wild ride

Beleaguered investors hoping for a strong recovery in stock prices in 2009 were initially disappointed. The market—as measured by the All Ordinaries Accumulation Index—hit a nadir of 20,859 on 6 March, down 13.6% from the end of calendar 2008. That came on top of a 40% decline in 2008.

Governments quelled the upheaval in the global financial system by releasing a spate of economic stimulus packages. Low interest rates, declining oil prices and government handouts combined to combat the fallout from rising unemployment and lit a match under the stock market. The index staged a dramatic recovery, and rose 28% between the March low and the close of the 2009 financial year.

As you can see from the chart, the Growth portfolio's trajectory reflected the market's wild ride. The portfolio is a collection of our best ideas, designed for investors who can tolerate a reasonable amount of risk and volatility. As the past 12 months has shown, pursuing high returns is like playing a game of snakes and ladders. Temporary setbacks are inevitable.

Growth Portfolio vs All Ordinaries Accumulation Index



The rollercoaster ride left the Growth portfolio up 33.6% for the half year to 30 June, which compares very favourably against the index's 10.7% increase. Since inception the returns are 5.8% and 6.4% a year, respectively, which puts us back within striking distance of the index.

Of course we'd rather be out in front. But we were comfortable underperforming while the resources sector carried the market to a crescendo (which also meant we missed the crash-landing of commodity prices). And we've steered clear of highly leveraged businesses that have, more recently, led the market's recovery.

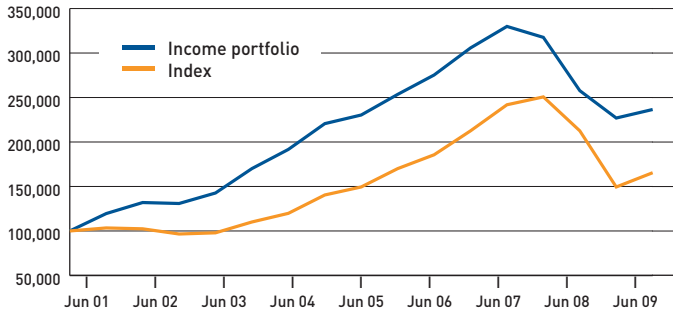
As the portfolio's 33.6% return this half shows, you don't need to take on excessive risk to do well. The ground that we've made up against the index recently is due to a healthy mix of holding on tight (also known as doing nothing), picking up bargains amidst the panic, and participating in discounted capital raisings. At these junctures it has paid to have spare cash lying around.

The Growth portfolio's star performer was **RHG Group** (up 296% since 31 Dec 2008), which has 10-bagged since hitting a record low of 4.6 cents in Jul 2008. Since then, the stock's weighting in the portfolio has risen from 1.5% to 13.8%.

The Income portfolio is designed to provide income growth over the medium term without the sort of risks that could spoil a sound night's sleep. Many risky financial structures promised high yields during the boom but, when boom turned to bust, unsuspecting investors were left smarting over the destruction of their portfolios. Several years of high distributions is inadequate compensation for permanent loss of capital.

Although we avoided the most common traps, the portfolio's 4.3% half-year return to 30 June ends a run of 18 months of losses. And although the portfolio trailed the index's 10.7% return over the half, the 13.8% annualised return since inception remains well ahead of the index, which has returned 6.5%.

Income Portfolio vs All Ordinaries Accumulation Index



However, as we'll discuss later, an abnormally large cash pile was a drag on performance. Low interest rates and companies hoarding cash have also led to the lowest collection of dividends for five years.

We also stumbled into our fair share of value traps. It was far from a fatal blow, but losses on **Timbercorp Bonds** and **Convertible Notes**, as well as **Great Southern's TREES2**, highlighted the misplaced trust we'd put in the MIS sector.

Somewhat controversially, we also hit the Sell button on the big four banks following a spike in their respective share prices as markets recovered.

All in all, the portfolios have so far stood up under duress. However there are many reasons why the market's

[CONTINUED ON PAGE 2]

Portfolios see bear looming—get mauled anyway

[FROM PAGE 1]

recent rally might run out of steam. Should bargain prices re-emerge, we'll selectively add new stocks offering value and continue reinvesting in companies that we feel will deliver the goods. This is no time to abandon strategies that have served us well in the past. Let's now consider each portfolio in more detail.

Overall portfolio performance as at 30 Jun 09

	DATE OF INCEPTION	ANNUAL % CHANGE SINCE INCEPTION (INDEX)	% CHANGE SINCE 31/12/07 (INDEX)
Growth	Aug 01	5.8 [6.4]	33.6 [10.7]
Income	Jul 01	13.8 [6.5]	4.3 [10.7]

Growth portfolio reins in index

The Growth portfolio provided plenty of good news in the six months to 30 June so, in a fittingly contrarian manner, let's deal with the bad news first.

We switched our stake in Timbercorp into Timbercorp Convertible Notes, but should have sold out instead. This mess has received plenty of space in our publication, but it was an unforced error that we should have avoided.

And, in an unusual chain of events, we changed our tune on independent mortgage broker **Mortgage Choice**, shifting from Buy to Sell and offloading our stake at a small loss compared with the initial purchase price. In light of the banks regaining market share and cutting broker commissions, we recalibrated Mortgage Choice's earnings prospects and decided to set the stock loose.

Growth Portfolio—Returns

	SINCE INCEPTION	AVERAGE ANNUAL	LAST 6 MONTHS
Portfolio Return	55.8%	5.8%	33.6%
All Ords Accum.	63.3%	6.4%	10.7%

Stocks that the bulls left behind during the past six months included **Souls Private Equity** (down 27%) and **Westfield** (down 12%). Vacancies at the retail property juggernaut's US malls are mounting but the current security price offers an attractive long term buying opportunity, particularly if you don't already own the stock. Let's now turn to the star performers.

RHG Group was undoubtedly the Growth Portfolio's star performer, but a 78% surge in the oil price, to US$70, also helped turn the tide for junior oil explorers **Roc Oil** and **Tap Oil**, which increased 57% and 48%, respectively.

Our timing wasn't great, but we reduced our stake in industrial conglomerate **Brickworks** in April, right before the stock took off to produce a stirring 42% return.

Macquarie Group plummeted to $15.00 in March as detractors questioned whether the investment bank's financial structure and business model were obsolete. But by June all that was forgotten and the stock finished up 36% for the half. After myriad transactions, and banking a tidy profit from the company's share purchase plan (SPP), we took advantage of the share price recovery and reduced our overall stake, from 250 shares to 150.

Furniture and electrical retailer **Harvey Norman** and four-wheel drive accessories manufacturer **ARB Corporation** share some common ground. Both have been enduring holdings of the portfolio, both were up 25% and, although they aren't the bargains they were in March, both sport positive recommendations.

We also took advantage of favourable buying opportunities in the shares of travel agent **Flight Centre** and office supplies company **Corporate Express**.

Flight Centre's share price crashed to $3.39 before taking flight to finish up 5%, at $8.65, and Corporate Express also provided an excellent opportunity to pick up a high quality business at a cheap price—perhaps before its new foreign parent, Staples Inc, makes a full takeover offer.

We also added some new names to the portfolio, including shrewdly-managed insurer **QBE Insurance**, **Macquarie Airports**, temporary office accommodation provider **Servcorp** and, at the opposite end of the risk spectrum, the **Goodman PLUS** floating rate securities issued by industrial property group Goodman Group.

Volatile markets create opportunities, which help explain the portfolio's recent trading activity. We've culled mistakes, added new opportunities, reinvested in some old favourites and locked in arbitrage profits following capital raisings.

For example, we took full advantage of Macquarie Group's SPP. We also responded to the recapitalisation of **STW Communications** by almost tripling our holding, while locking in an arbitrage profit on its 7-for-8 non-

Growth Portfolio—Transactions

STOCK (ASX CODE)	BUY/ SELL	NO. OF SHARES	PRICE	VALUE ($)
Timbercorp (TIM)	Sell	11000	0.11	1,210.00
Timbercorp Convertible Notes (TIMG)	Buy	115	10.5	1,207.50
Brickworks (BKW)	Sell	600	9.87	5,922.00
Flight Centre (FLT)	Buy	500	5.63	2,815.00
Macquarie Airports (MAP)	Buy	2500	1.67	4,175.00
Mortgage Choice (MOC)	Sell	8974	0.925	8,300.95
STW Communications (SGN)	Buy	6315	0.44	2,778.60
STW Communications (SGN)	Sell	3224	0.5	1,612.00
Macquarie Group (MQG)	Sell	250	32.45	8,112.50
Macquarie Group (MQG)	Buy	563	26.6	14,975.80
STW Communications (SGN)	Buy	3224	0.46	1,483.04
Macquarie Group (MQG)	Sell	413	36.97	15,268.61
QBE Insurance (QBE)	Buy	320	19.15	6,128.00
Servcorp (SRV)	Buy	1500	2.88	4,320.00
Corporate Express (CXP)	Buy	800	3.7	2,960.00
Goodman PLUS (GMPPA)	Buy	55	36.21	1,991.55
Net Purchases				**(2,408.43)**

renounceable rights issue. The stock rocketed 47% between our on-market purchase and 30 June. It has since pulled back a little and remains an attractive proposition.

Having pounced on several opportunities, the portfolio is bereft of cash. Should an attractive capital raising emerge, we'll consider selling an existing holding.

Growth Portfolio current status

COMPANY NAME (ASX CODE)	PURCHASE PRICE ($)	PRICE ($) AT 30/6/09	LAST RECOMMENDATION—ISSUE # (PRICE AT REVIEW)	SHARES	VALUE ($)
ARB Corporation (ARP)	3.05	3.55	Buy—266 ($2.85)	3,000	10,650.00
Aust. W'wide Exploration (AWE)	2.40	2.57	Hold—265 ($2.41)	1,025	2,634.25
Brickworks (BKW)	12.45	13.75	Hold—275 ($12.77)	400	5,500.00
Cochlear (COH)	19.04	57.70	Long Term Buy—269 ($57.67)	200	11,540.00
Corporate Express (CXP)	4.31	3.72	Buy—273 ($3.47)	2,300	8,556.00
Flight Centre (FLT)	11.70	8.65	Hold—274 ($8.44)	900	7,785.00
Goodman PLUS (GMPPA)	36.21	38.00	Speculative Buy—274 ($36.00)	55	2,090.00
Harvey Norman (HVN)	2.63	3.30	Long Term Buy—272 ($2.92)	2,650	8,745.00
Infomedia (IFM)	0.53	0.30	Buy—266 ($0.305)	25,800	7,611.00
Macquarie Airports (MAP)	1.67	2.31	Long Term Buy—272 ($2.18)	2,500	5,775.00
Macquarie Group (MQG)	28.50	39.10	Hold—273 ($36.65)	150	5,865.00
Platinum Asset Mmt (PTM)	5.49	4.12	Buy—273 ($3.61)	3,150	12,978.00
QBE Insurance (QBE)	19.14	19.90	Long Term Buy—271 ($21.79)	320	6,368.00
RHG Group (RHG)	0.30	0.52	Buy—274 ($0.415)	41,800	21,527.00
ROC Oil (ROC)	1.36	0.79	Hold—275 ($0.805)	6,080	4,772.80
Servcorp (SRV)	2.88	2.94	Buy—266 ($2.50)	1,500	4,410.00
Souls Private Equity (SOE)	0.21	0.08	Hold—268 ($0.083)	50,000	3,850.00
STW Communications (SGN)	1.13	0.65	Buy—270 ($0.44)	10,000	6,450.00
TAP Oil (TAP)	0.53	1.13	Hold—273 ($1.24)	4,600	5,198.00
Timbercorp Conv. Notes (TIMG)	10.50	—	Sell—270 ($6.50)	115	—
Treasury Group (TRG)	13.49	4.11	Long Term Buy—267 ($2.60)	1,000	4,110.00
Westfield Group (WDC)	13.15	11.38	Long Term Buy—274 ($10.92)	695	7,909.10
Cash					**1,433.13**
Total					**155,757.28**

Income portfolio ends string of losses

The Income portfolio has ended a string of losses, returning 4.3% in the half-year to 30 June. But that is anaemic next to the 10.7% increase in the index.

The margin, however, is largely attributable to a build up of cash. In a rising market cash acts like a ball and chain around returns. Though it was largely unintended, we're comfortable with the decisions that led to this situation.

On 28 April we downgraded the big four banks. Collectively they have produced prodigious gains for shareholders over a long period, but mounting bad debts and future capital raisings could keep a lid on returns for years to come. Putting our money where our mouths are, **Westpac**, **Commonwealth** and **ANZ Bank** were jettisoned from the portfolio. Our only regret is that we didn't act sooner.

We also sold several stocks where intrinsic worth took a major hit. **Ten Network** was the first to go, as diminishing advertising revenue cut profits and online advertisers steal market share. We also cut Australia's largest listed food group **Goodman Fielder** from the portfolio, as it struggles to create value from a range of commodity products.

As in the Growth portfolio, we bungled our exit from **Timbercorp** by switching into the convertible notes. The Income portfolio also held **Timbercorp Corporate Bonds** but we're confident of receiving some value for these, as we've highlighted. Again following in the footsteps of the Growth portfolio, we sold out of **Mortgage Choice**. And listed investment company **MMC Contrarian** got the chop, as it appeared unlikely the company would be wound up and it hasn't paid a dividend for 18 months. We also sold half our stake in **Washington H. Soul Pattinson**, primarily to reduce its oversized weighting in the portfolio.

Of the dozen remaining stocks and securities in the portfolio, only Westfield Group was down, as we discussed in the Growth portfolio review.

None of the portfolio holdings increased by more than 20%, reflecting their relatively staid revenues and financial structures. Stocks with riskier business models that were sold down heavily in March have so far led the market's revival, so the portfolio has performed as we would expect.

We picked up four income securities in October 2008, at an average 24% discount to face value (the issue price). Though falling interest rates have depressed distributions,

[CONTINUED ON PAGE 4]

Income portfolio ends string of losses

[FROM PAGE 3]

Dexus RENTS (up 18% since 31 Dec 08), **Seven Network TELYS** (up 17%), **TAPS Trust** (up 16%) and **Southern Cross SKIES** (up 6%) are all trading above their purchase prices.

Signs are also emerging that issuers facing either a 'step up' in distributions or major dilution are choosing, if possible, to redeem the securities at face value. TAPS Trust, for example, is now likely to be redeemed for cash at the first available opportunity (July 2010).

Two companies whose fortunes are tied to the performance of the stock market, fund manager **Platinum Asset Management** and listed investment company **Wilson Investment Fund**, returned 19% and 12%, respectively. And Sigma Pharmaceuticals rose 13%, despite potentially facing cuts to revenue following the government's plan to lower the price of certain generic drugs.

The portfolio collected $3,953 in dividends—the lowest since 2004—and lower earnings and tight credit markets will keep a lid on dividend growth for a while yet.

While the portfolio is laden with cash, traditional sectors adopted by conservative investors, such as the banking and listed property sectors, are not currently safe havens. We'll only invest in suitable opportunities, but are looking high and low and hope for a little luck soon.

Income Portfolio—Annual Dividends

2001	2,657.65
2002	8,796.08
2003	7,437.59
2004	7,236.89
2005	10,124.95
2006	14,005.43
2007	12,018.55
2008	13,684.32
2009	3,953.36

Income Portfolio—Returns

	AVERAGE ANNUAL	LAST 6 MONTHS	HISTORICAL YIELD
Portfolio Return	13.8%	4.3%	7.4%
All Ords Accum.	6.5%	10.7%	3.3%

Income Portfolio—Transactions

STOCK (ASX CODE)	BUY/ SELL	NO. OF SHARES	PRICE	VALUE ($)
Ten Network (TEN)	Sell	4430	0.805	3,566.15
Goodman Fielder (GFF)	Sell	4000	1.03	4,120.00
ANZ Bank (ANZ)	Sell	406	12.53	5,087.18
GTP Trees2 (GTPGA)	Sell	98	15.25	1,494.50
MMC Contrarian (MMA)	Sell	8375	0.365	3,056.88
Timbercorp (TIM)	Sell	16000	0.11	1,760.00
Timbercorp Convertible Notes (TIMG)	Buy	168	10.5	1,764.00
Mortgage Choice (MOC)	Sell	16484	0.925	15,247.70
Westpac (WBC)	Sell	371	20	7,420.00
W H Soul Pattinson (SOL)	Sell	700	9.99	6,993.00
Comm Bank (CBA)	Sell	205	35.71	7,320.55
Westpac (WBC)	Sell	370	19.76	7,311.20
Net Sales				**61,613.16**

Income Portfolio current status

COMPANY NAME (ASX CODE)	PURCHASE PRICE ($)	PRICE ($) AT 30/6/09	LAST RECOMM.—ISSUE # (PRICE AT REVIEW)	SHARES	VALUE ($)
Dexus RENTS (DXRPA)	70.00	72.00	Buy for Yield—270 ($55.30)	56	4,032.00
Infomedia (IFM)	0.52	0.30	Buy—266 ($0.305)	42,500	12,537.50
Platinum Asset Mmt (PTM)	4.30	4.12	Long Term Buy—273 ($3.61)	4,200	17,304.00
Seven Net. TELYS (SEVPC)	84.11	88.20	Hold for Yield—266 ($78.25)	93	8,202.69
Sigma Pharmaceuticals (SIP)	1.73	1.22	Long Term Buy—272 ($0.98)	7,850	9,577.00
Southern Cross SKIES (SAKHA)	71.00	74.00	Buy for Yield—270 ($64.01)	55	4,070.00
TAPS Trust (TTXPA)	78.00	92.50	Buy for Yield—268 ($74.50)	50	4,625.00
Timbercorp Corp. Bonds (TIMHB)	80.00	—	Hold—270 ($25.00)	97	—
Timbercorp Conv. Notes (TIMG)	10.50	—	Sell—270 ($6.50)	168	—
Washington H Soul Patts. (SOL)	9.03	10.75	Long Term Buy—270 ($9.99)	700	7,525.00
Westfield Group (WDC)	19.40	11.38	Long Term Buy—274 ($10.92)	1,086	12,358.68
Wilson Inv. Fund (WIL)	0.93	0.59	Long Term Buy—260 ($0.60)	19,689	11,616.51
Cash (Lifetime dividends received)					**79,914.82**
Cash (Available for investments)					**61,644.18**
Total					**233,407.39**

DATE OF PUBLICATION 10 Jul 2009.