THE INTELLIGENT INVESTOR
VALUE INVESTING EXPERTS

Portfolio report

[Growth and Income portfolios as at 31 December 2009]

ANALYSTS: GARETH BROWN & NATHAN BELL | JANUARY 2010

Portfolios sailing fast with tailwind

The six months to 31 December 2009 saw a speeding up of the recovery that began in March. The market, as measured by the All Ordinaries Accumulation Index, rose a whopping 27.1% over the six-month period.

That's an amazing figure and a big hurdle for our portfolios to climb. The Income portfolio failed to mount it, returning 18.6% over the period. But that's no reason for concern. Aiming for low-risk income from a group of stocks means avoiding the frothiest parts of any market.

Indeed, if the Income portfolio were to rise in tandem with a big bull market, either we're the recipients of an unusual amount of luck or we're probably taking risks we shouldn't with such a conservative portfolio. During such a rapid market increase, the income portfolio should underperform.

As the chart shows, since inception in July 2001 the portfolio has outperformed its benchmark, delivering a compound annual return of 14.9% versus 9.8% for the index.

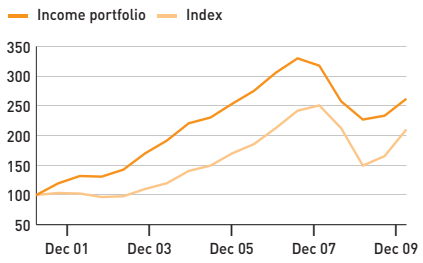
But please be careful drawing any conclusions from such results. For the reasons stated above, this figure is almost too high. We'll happily settle for market-matching results in future, especially if we can do so in investments with lower-than-average risk.

Our portfolio of best ideas, the Growth portfolio, is a different matter. It aims to beat the index over the long term and therefore carries more risk in trying to meet that objective. Unfortunately, the portfolio's 8.6% average annual return since inception in August 2001 puts it slightly behind the All Ordinaries Accumulation Index's 9.1%.

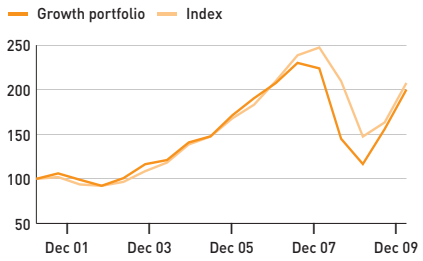
As the attached chart illustrates, the portfolio missed out on the tail of the boom that ended in late 2007 but then shared fully in the carnage that followed, with some significant missteps such as Timbercorp and **Roc Oil** hurting results.

But the Growth portfolio has beaten the index in each of the past three half-year periods, rising 28.5% in the six months to 31 December 2009 versus 27.1% for the index.

INCOME PORTFOLIO VS ALL ORDS ACCUMULATION INDEX ('000s)



GROWTH PORTFOLIO VS ALL ORDS ACCUMULATION INDEX ('000s)



Rewiring brains

It's easy to forget that it has been less than a year since the market hit rock bottom. At the time, even battle-hardened investors were receiving unambiguous messages from their limbic system—*take less risk*.

Hindsight has shown this response to be the opposite of that required. It was a time to take on more risk, not less. Those who reaped the most from the 2009 bull market were those prepared to override the brain's warning system a year ago. It's an issue Steven Johnson explored more fully in a Bristlemouth blog post

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at the time—*The difference between defensive businesses and defensive stocks* (28 January 2009).

Today, our amygdalas have relinquished control, and most investors are once again attuned more to reward than risk. Again, the lesson of inversion applies. Bull markets require a great focus on risk, not returns. That's why you'll notice a greater focus on high quality, defensive businesses in our recent coverage. These significantly lagged the pack in 2009 and currently offer the best prospects for 2010 and beyond. (For example, see recent reviews on **IAG**, **Santos** and **Sonic Healthcare**).

OVERALL PORTFOLIO PERFORMANCE AS AT 31 DEC 09

	DATE OF INCEPTION	ANNUAL % CHANGE SINCE INCEPTION [ALL ORDS]	% CHANGE SINCE 30/06/09 [ALL ORDS]
INCOME	Jul 01	14.9 [9.8]	18.6 [27.1]
GROWTH	Aug 01	8.6 [9.1]	28.5 [27.1]

Income portfolio

The Income portfolio returned 18.6% in the six months to 31 December 2009. While that's lower than the 27.1% increase in the All Ordinaries Accumulation Index, it's an impressive return from a portfolio focused on non-cyclical investments like income securities and infrastructure stocks—a portfolio specifically designed to do well in less ebullient markets.

Early in the half, we invested most of the portfolio's excess cash in a broad mix of high quality, income producing investments including **QBE**, **Corporate Express**, **Servcorp** and the four infrastructure stocks recommended in our July 2009 special report, *The case for essential infrastructure*. Later in the half we topped up on shares of **Sigma Pharmaceuticals** (via a rights issue) and QBE, and bought shares in **STW Communications** at the time of an upgrade on *9 Nov 09 (Buy—$0.725)*.

Although no investments were sold during the half, that situation is likely to change in the coming months, especially if the market continues to rise. Six months ago there was just one stock in the portfolio that failed to earn a positive recommendation. Today, there are 12 Holds.

In all probability, over the next few months we'll take some profits and put the proceeds into high quality, high yielding opportunities. Such opportunities might come from our existing list of positive recommendations—**Prime Infrastructure**, for example. But our increasing focus on blue chips, as highlighted in *Out with the old, in with the blue* of 7 Jan 2010, is likely to result in a few new positive recommendations in stocks suitable for this portfolio.

Of the stocks in the Income portfolio since 30 June 2009, only one—Sigma Pharmaceuticals—decreased in price, falling 19% after poor half-yearly results. Offsetting this were some big increases; **Platinum Asset Management**'s share price rose 35% due to excellent fund performance, which should lead to growing funds under management and profits; Sydney Airport-related income securities **Southern Cross SKIES** rose 22%; Investment company **Washington H. Soul Pattinson** enjoyed a 26% share price increase; and **Wilson Investment Fund** by 29%. In addition, the portfolio of income stocks bought in late 2008 and infrastructure stocks added in mid-2009 have increased in value and delivered attractive income.

The portfolio collected $4,986 in dividends over the half—more than was collected in the prior half but less than the $7,354 collected in the corresponding half in 2008. Many companies cut dividends in order to hoard cash during the

INCOME PORTFOLIO—RETURNS

	AVERAGE ANNUAL	LAST 6 MONTHS	HISTORICAL YIELD
PORTFOLIO RETURN	14.9%	18.6%	5.8%
ALL ORDS ACCUM.	9.8%	27.1%	3.5%

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	8,939.54

financial crisis. There's room for further dividend growth as the siege mentality abates.

The portfolio's weighted average historic yield, which excludes special dividends like the one received from Soul Pattinson in late 2009, is 5.8%. This compares with 3.5% for the All Ordinaries Accumulation Index.

INCOME PORTFOLIO - TRANSACTIONS

STOCK (ASX CODE)	BUY/SELL	NO. OF SHARES	PRICE	VALUE ($)
AUSTRALAND ASSETS (AAZPB)	Buy	80	67.00	5,360.00
QBE INSURANCE (QBE)	Buy	500	20.36	10,180.00
CORPORATE EXPRESS (CXP)	Buy	1,650	3.74	6,171.00
SERVCORP (SRV)	Buy	1,800	3.35	6,030.00
AUSTRALIAN INFR. FUND (AIX)	Buy	2,500	1.49	3,725.00
CHALLENGER INFRA. FUND (CIF)	Buy	2,400	1.53	3,672.00
MACQUARIE AIRPORTS (MAP)	Buy	1,550	2.36	3,658.00
SPARK INFRASTRUCTURE (SKI)	Buy	3,550	1.05	3,727.50
SIGMA PHARMACEUTICALS (SIP)	Buy	2,617	1.02	2,669.34
QBE INSURANCE (QBE)	Buy	200	21.35	4,270.00
STW COMMUNICATIONS (SGN)	Buy	7,000	0.725	5,075.00

Although the long-term performance of the Income portfolio blitzes the index—14.9% versus 9.8%—we'll happily settle for matching the index over time. But, as the yield comparison above suggests, we expect a greater percentage of the Income portfolio's total return will come from dividends when compared with the index.

This income-focus is designed for those investors who rely on dividends to pay the bills. Capital preservation and income remain the overriding concerns of this portfolio.

INCOME PORTFOLIO CURRENT STATUS

COMPANY NAME (ASX CODE)	PURCHASE PRICE ($)	PRICE ($) AT 31/12/09	LAST RECOMMENDATION—ISSUE # (PRICE AT REVIEW)	SHARES	VALUE ($)
AUSTRALAND ASSETS (AAZPB)	67.00	84.91	Hold—279 ($75.52)	80	6,792.80
AUSTRALIAN INFR. FUND (AIX)	1.49	1.78	Hold—285 ($1.740)	2,500	4,450.00
CHALLENGER INFRA. FUND (CIF)	1.53	1.87	Hold—285 ($1.855)	2,400	4,488.00
CORPORATE EXPRESS (CXP)	3.74	3.96	Long Term Buy—286 ($4.20)	1,650	6,534.00
DEXUS RENTS (DXRPA)	70.00	83.50	Hold—279 ($83.00)	56	4,676.00
INFOMEDIA (IFM)	0.52	0.32	Hold—286 ($0.365)	42,500	13,600.00
MACQUARIE AIRPORTS (MAP)	2.36	3.03	Hold—282 ($2.90)	1,550	4,696.50
PLATINUM ASSET MMT (PTM)	4.30	5.55	Hold—284 ($5.58)	4,200	23,310.00
QBE INSURANCE (QBE)	20.64	25.60	Long Term Buy—284 ($21.35)	700	17,920.00
SERVCORP (SRV)	3.35	3.55	Buy—287 ($3.54)	1,800	6,390.00
SEVEN NET. TELYS (SEVPC)	84.11	93.45	Hold for Yield—266 ($78.25)	93	8,690.85
SIGMA PHARMACEUTICALS (SIP)	1.55	0.99	Hold—281 ($1.070)	10,467	10,362.33
SOUTHERN CROSS SKIES (SAKHA)	71.00	90.00	Hold—282 ($83.40)	55	4,950.00
SPARK INFRASTRUCTURE (SKI)	1.05	1.39	Buy for Yield—279 ($1.100)	3,550	4,916.75
STW COMMUNICATIONS (SGN)	0.73	0.75	Buy—284 ($0.725)	7,000	5,250.00
TAPS TRUST (TTXPA)	78.00	97.51	Hold—275 ($96.60)	50	4,875.55
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	13.58	Hold—281 ($13.25)	700	9,506.00
WESTFIELD GROUP (WDC)	19.40	12.54	Long Term Buy—279 ($13.03)	1,086	13,618.44
WILSON INV. FUND (WIL)	0.93	0.76	Long Term Buy—279 ($0.730)	19,689	14,865.20
CASH (LIFETIME DIVIDENDS RECEIVED)					**84,901.00**
CASH (AVAILABLE FOR INVESTMENTS)					**7,106.33**
TOTAL					**261,899.74**

Growth portfolio

The Growth portfolio has less modest aims. It is designed to beat the index over time. And while we've made some costly errors during its history, it's outperformed the index for three consecutive half-year periods. The long-term average return of 8.6% since inception in August 2001 is within sight of the 9.1% generated by the All Ordinaries Accumulation Index.

Over the half, the portfolio rose 28.5% versus 27.1% from the index. Only two of the 24 stocks in the portfolio—**Brickworks** and **Roc Oil**—fell in the period. **Flight Centre**'s share price rose more than any other in the portfolio, by 113%, while speculative income security **Goodman PLUS** jumped 74%.

Shares in four wheel drive accessory company **ARB Corporation** were up 56% (adjusting for special dividends) and 30%-plus gains were seen from **Macquarie Airports**, **Platinum Asset Management**, **Souls Private Equity** and **Treasury Group**. More pedestrian returns were seen from important holdings like **Cochlear**, up 20%, **Corporate Express**, up 6%, **RHG Group**, up 4%, and **Westfield Group**, up 10%.

During the half the portfolio acquired a small additional number of shares in Macquarie Airports in a capital raising, and a small number of **Servcorp** shares on market at a price cheaper than that company's own entitlement offer. We also added to our position in QBE, and acquired two small stakes in dirt-cheap private equity players, **ING Private Equity** and **Oceania Capital**.

To fund these purchases, we sold down some successful investments that were becoming an imprudently large percentage of the portfolio; Flight Centre, RHG Group and Platinum Asset Management.

The portfolio collected $4,447 in dividends during the half, or $3,247 excluding the major special dividend from ARB Corporation. The weighted average historic yield—excluding special dividends—is 3.3% compared with 3.5% from the All Ordinaries Accumulation Index.

GROWTH PORTFOLIO—RETURNS

	SINCE INCEPTION	AVERAGE ANNUAL	LAST 6 MONTHS
PORTFOLIO RETURN	100.1%	8.6%	28.5%
ALL ORDS ACCUM.	107.6%	9.1%	27.1%

GROWTH PORTFOLIO - TRANSACTIONS

STOCK (ASX CODE)	BUY/SELL	NO. OF SHARES	PRICE	VALUE ($)
MACQUARIE AIRPORTS (MAP)	Buy	227	2.30	522.10
RHG GROUP (RHG)	Sell	11,800	0.745	8,791.00
PLATINUM ASSET MMT (PTM)	Sell	450	5.99	2,695.50
FLIGHT CENTRE (FLT)	Sell	200	16.50	3,300.00
QBE INSURANCE (QBE)	Buy	230	23.31	5,361.30
SERVCORP (SRV)	Buy	136	3.82	519.52
ING PRIVATE EQUITY (IPE)	Buy	8,700	0.23	2,001.00
OCEANIA CAPITAL (OCP)	Buy	720	2.79	2,008.80

That's not at all bad. The portfolio includes three oil stocks that don't pay regular dividends, a few other non-dividend payers, and numerous great companies that are able to reinvest a large percentage of their profits at high rates of return. The apparently low overall yield is actually quite high.

As with the Income portfolio, one of the current issues with the Growth portfolio is the large number of Hold recommendations—now accounting for more than 50% of the portfolio by value. We're very happy to hold stocks such as Cochlear, **Harvey Norman**, Macquarie Airports and Platinum Asset Management for the long term, despite them not being obviously cheap.

Still, we'd be more comfortable if more of the portfolio was invested in outright bargains. It's a pity there aren't many of them, despite our searches. If and when we do find some, Brickworks, Flight Centre, Infomedia and Roc Oil are towards the top of the list of stocks to sell. This is our portfolio of best ideas and so, as our best ideas change, so should the Growth portfolio.

GROWTH PORTFOLIO CURRENT STATUS

COMPANY NAME (ASX CODE)	PURCHASE PRICE ($)	PRICE ($) AT 31/12/09	LAST RECOMMENDATION—ISSUE # (PRICE AT REVIEW)	SHARES	VALUE ($)
ARB CORPORATION (ARP)	3.05	5.13	Long Term Buy—284 ($5.60)	3,000	15,390.00
AUST. W'WIDE EXPLORATION (AWE)	2.40	2.80	Speculative Buy—287 ($2.71)	1,025	2,870.00
BRICKWORKS (BKW)	12.45	12.48	Hold—282 ($14.89)	400	4,992.00
COCHLEAR (COH)	19.04	69.07	Hold—280 ($62.01)	200	13,814.00
CORPORATE EXPRESS (CXP)	4.31	3.96	Long Term Buy—286 ($4.20)	2,300	9,108.00
FLIGHT CENTRE (FLT)	11.70	18.42	Hold—283 ($16.13)	700	12,894.00
GOODMAN PLUS (GMPPA)	36.21	66.00	Hold—286 ($63.00)	55	3,630.00
HARVEY NORMAN (HVN)	2.63	4.22	Hold—286 ($4.30)	2,650	11,183.00
INFOMEDIA (IFM)	0.53	0.32	Hold—286 ($0.365)	25,800	8,256.00
ING PRIVATE EQUITY (IPE)	0.23	0.30	Buy—284 ($0.23)	8,700	2,610.00
MACQUARIE AIRPORTS (MAP)	1.72	3.03	Hold—282 ($2.90)	2,727	8,262.81
MACQUARIE GROUP (MQG)	28.50	48.40	Hold—277 ($43.70)	150	7,260.00
OCEANIA CAPITAL (OCP)	2.79	2.76	Buy—284 ($2.79)	720	1,987.20
PLATINUM ASSET MMT (PTM)	5.49	5.55	Hold—284 ($5.58)	2,700	14,985.00
QBE INSURANCE (QBE)	21.55	25.60	Long Term Buy—284 ($21.35)	550	14,080.00
RHG GROUP (RHG)	0.40	0.54	Hold—287 ($0.58)	30,000	16,200.00
ROC OIL (ROC)	1.36	0.67	Hold—283 ($0.68)	6,080	4,073.60
SERVCORP (SRV)	2.96	3.55	Buy—287 ($3.54)	1,636	5,807.80
SOULS PRIVATE EQUITY (SOE)	0.21	0.11	Hold—286 ($0.10)	50,000	5,500.00
STW COMMUNICATIONS (SGN)	1.13	0.75	Buy—284 ($0.725)	10,000	7,500.00
TAP OIL (TAP)	0.53	1.17	Hold—283 ($1.145)	4,600	5,382.00
TIMBERCORP CONV. NOTES (TIMG)	10.50	—	Sell—270 ($6.50)	115	—
TREASURY GROUP (TRG)	13.49	5.35	Long Term Buy—285 ($5.55)	1,000	5,350.00
WESTFIELD GROUP (WDC)	13.15	12.54	Long Term Buy—279 ($13.03)	695	8,715.30
CASH					**10,254.35**
TOTAL					**200,105.06**

The Intelligent Investor
PO Box 1158
Bondi Junction NSW 1355
T 02 8305 6000
F 02 9387 8674
info@intelligentinvestor.com.au
www.intelligentinvestor.com.au

DISCLOSURE As at 31 December 2009, in-house staff of The Intelligent Investor held the following listed securities or managed investment schemes: AAU, AAZPB, AEA, AHC, ANZ, ARP, AVO, AWE, BHP, BMN, CAM, CBA, CDX, CHF, CLS, CMIPC, CNB, CND, COH, COS, CRS, CSL, CXP, DBS, EFG, EXS, FLT, GMPPA, GNC, HNG, HVN, IDT, IFL, IFM, IVC, KRS, LGL, LMC, LWB, MAU, MFF, MLB, MMA, MNL, MQG, NABHA, NBL, NXS, OEQ, OSH, PIH, PLA, PRY, PTM, RHG, ROC, SAKHA, SDI, SFC, SGN, SHV, SIP, SOF, SRV, STO, TAN, TGR, TIM, TIMG, TIMHB, TLS, TRG, TWO, TZN, WBC, WDC and WHG. This is not a recommendation.

PRICES CORRECT AS AT 31 December 2009

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End of report