Portfolios Update

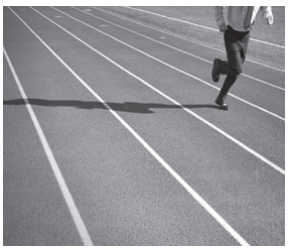
INTELLIGENT INVESTOR SHARE ADVISOR

2014 EFY UPDATE

Income Portfolio gets sporting chance

After taking remedial action in response to a poor showing in the second half of last year, the Income Portfolio is back on track.

BY NATHAN BELL, CFA ▪ 3 JULY 2014

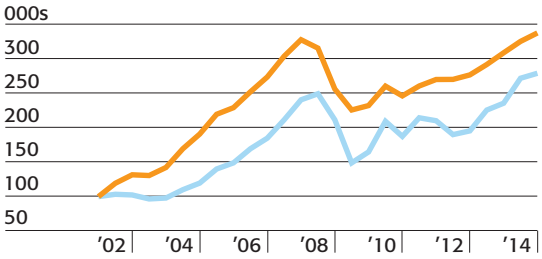


> ***'Professionals win points while amateurs lose them'. Whereas professional players generally win matches with finesse … in contrast amateur matches are decided by the player who makes the least mistakes.***

'Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric. … It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent. There must be some wisdom in the folk saying, "It's the strong swimmers who drown." Charlie Munger in *Damn Right!: Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger.*

Borrowing from the 1975 essay, *The Loser's Game*, by Charles Ellis, and *Extraordinary Tennis for the Ordinary Player*, written by scientist and statistician Simon Ramo, Shane Parish recently contrasted how amateur and professional tennis games are won.

CHART 1: INCOME PORTFOLIO PERFORMANCE VS. ALL ORDS ACCUMULATION INDEX



Income Portfolio Index

Source: Capital IQ

In short, 'Professionals win points while amateurs lose them'. Whereas professional players generally win matches with finesse like Roger Federer, or dogged determination and skill like Rafael Nadal, in contrast amateur matches are decided by the player who makes the least mistakes. Merely keeping the ball in play is a struggle for me, so anyone with the rudimentary skills and temperament (i.e. my wife) will inevitably win the game.

Despite its fair share of unforced errors, the model Income Portfolio has largely followed this playbook by simply being patient, acting with conviction when we find great opportunities and using intelligent portfolio limits. That's produced a 13.5% annualised return since inception, comparing favourably with the All Ordinaries Index Return of 8.3% (see Chart 1).

Injecting the portfolio with more of our best ideas over the past year even if they don't necessarily pay large dividends has also helped improve the portfolio's recent performance (see Table 1 and *2013: Income Portfolio in transition*).

TABLE 1: INCOME PORTFOLIO TRANSACTIONS

ASX CODE	BUY/ SELL	SHARES (NO.)	PRICE ($)	VALUE ($)	DATE
TME	Buy	1,802	$3.54	$6,379	19/2/14
PTM	Sell	300	$7.23	$2,169	4/3/14
HPI	Buy	3,000	$2.00	$5,985	5/3/14
TPAPA	Sell	60	$103.75	$6,225	11/3/14
CPU	Sell	230	$12.33	$2,836	24/3/14
SVWPA	Sell	93	$90.25	$8,393	26/3/14
QBE	Sell	250	$12.00	$3,000	15/4/14
IFL	Buy	800	$8.28	$6,624	23/6/14
WDC	Sell	900	Non-cash		26/06/14
WFD	Buy	900	Non-cash		26/06/14
SCG	Buy	1,122	Non-cash		26/06/14

In the six months to 30 June 2014 the portfolio produced a 6.1% return compared to the index's 2.7% return despite holding 10–15% cash. The portfolio lagged over the past year, though (15.3% versus 18.5% for the index), as we explained in *2013: Income Portfolio in transition.*

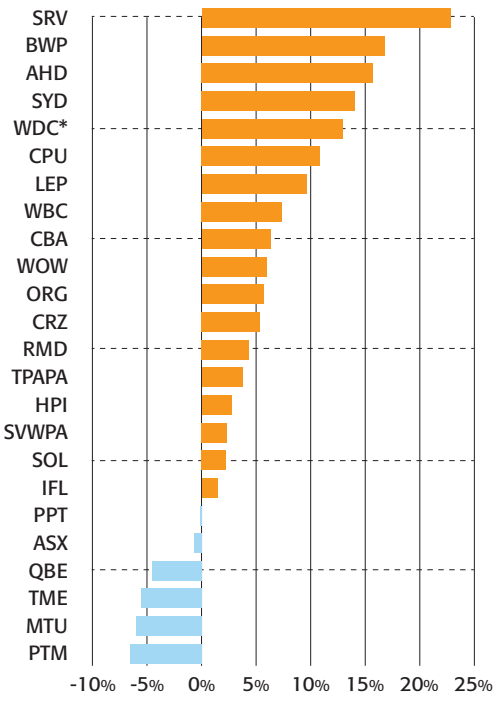
Although we build portfolios one business at a time, the broader themes within the portfolio have remained unchanged. First, we're looking for good quality businesses that pay attractive dividends or are likely to in the future. Second, we'll take international exposure when we can get it at a reasonable price to profit from a lower Aussie dollar. Third, we're avoiding resources stocks as the returns are too unpredictable for such a conservative portfolio. And lastly, we need to balance the need for income with faster growing stocks to protect the portfolio from the ravages of inflation. Let's now look at the best and worst performers over the past six months.

BEST PERFORMERS

After many years of patience, virtual office provider **Servcorp** put in a championship performance over the past six months, returning 23% including dividends (see Chart 2). While the company's Australian business continues to work its way through tough conditions and a few unforced errors of its own, its performance abroad is improving as recently opened floors begin to mature. The increasing overseas profits have also come at a time when they're worth more in terms of the lower Australian dollar. The company also boasts a pristine balance sheet and large insider ownership.

> ***Overall the portfolio remains diversified, the dividends continue to roll in (see Chart 4) and we're waiting patiently for superior opportunities to increase the concentration of the portfolio in our best or new ideas.***

CHART 2: TOTAL PERFORMANCE OF INCOME PORTFOLIO (INC. DIVIDENDS)



Note: Open price used for existing holdings, purchase price for new holdings. For holdings that were sold, the sale price was used.

*WDC converted to 1X WFD+ 1.246XSCG on 25/6/14. The closing price for those securities was used.

Bunnings Warehouse Property Trust's share price has been surprisingly volatile for such a predictable business but it was up 13% for no particular reason, and returned 17% including dividends. It was followed closely by **Amalgamated Holdings**, with a 16% return, and **Sydney Airport**, 14% return, which both benefited from the market's thirst for yield due to low interest rates.

On the flipside, **Platinum Asset Management**'s share price took a breather, falling 9%. After going through a lull a couple of years back the company's funds have mostly been performing very well, which bodes well for future inflows (we highly recommend reading their quarterly reports for a global perspective and insights into the company's investment process). We also took some profit at prices above $7.

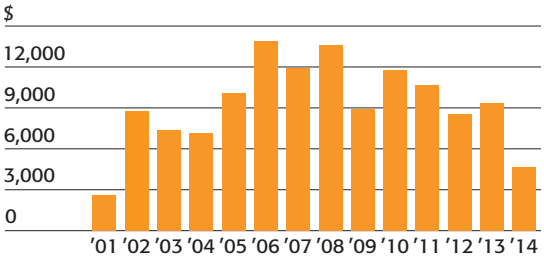
CHART 3: INCOME PORTFOLIO ALLOCATION BY RECOMMENDATION

M2 Telecommunications's share price fell 8% due to concerns that changes to the NBN Network would impact the broader telecommunications industry (see *M2: Interim result 2014*). **Trade Me**'s share price also fell 8% as real estate agents in some parts of New Zealand rebel against the company's new pricing structure (see *Trade Me price guide reduced*).

PLAYING A LONG GAME

Overall the portfolio remains diversified, the dividends continue to roll in (see Chart 4) and we're waiting patiently for superior opportunities to increase the concentration of the portfolio in our best or new ideas. With only about a third of the portfolio currently invested in stocks sporting a Buy recommendation (see Chart 3) we'd be happy if the portfolio returned 10% annually until Mr Market provides a more prospective set of opportunities.

CHART 4: INCOME PORTFOLIO DIVIDENDS PAID (INC. FRANKING CREDITS)



Source: Capital IQ

TABLE 2: INCOME PORTFOLIO (AS AT 30 JUN 14)

ASX CODE	PRICE MVMT SINCE 31/12/13	MOST RECENT RECO.	SHARES (NO.)	PRICE ($)	VALUE ($)	% OF PORT.
AHD	14%	Hold	675	9.33	6,298	2.9%
LEP	7%	Hold	4,500	2.90	13,050	5.9%
ASX	–3%	Buy	320	35.64	11,405	5.2%
BWP	13%	Hold	2,600	2.48	6,448	2.9%
CRZ	4%	Hold	600	10.59	6,354	2.9%
CBA	4%	Hold	60	80.88	4,853	2.2%
CPU	10%	Hold	1,200	12.48	14,976	6.8%
HPI	3%	Buy	3,000	2.05	6,150	2.8%
IFL	1%	Buy	800	8.40	6,720	3.1%
MTU	–8%	Buy	1,000	5.78	5,780	2.6%
ORG	4%	Hold	450	14.62	6,579	3.0%
PPT	–2%	Buy	160	47.38	7,581	3.4%
PTM	–9%	Hold	1,200	6.30	7,560	3.4%
QBE	–6%	Hold	450	10.87	4,892	2.2%
RMD	3%	Buy	2,300	5.48	12,604	5.7%
SRV	21%	Hold	1,800	4.80	8,640	3.9%
SYD	11%	Hold	3,280	4.22	13,842	6.3%
TME	–8%	Buy	1,802	3.27	5,893	2.7%
SOL	1%	Buy	700	14.75	10,325	4.7%
WFD	3%	Hold	900	7.15	6,435	2.9%
SCG	4%	Sell	1,122	3.20	3,590	1.6%
WBC	5%	Hold	140	33.88	4,743	2.2%
WOW	4%	Buy	400	35.22	14,088	6.4%
CASH (LIFETIME DIVIDENDS RECEIVED)					119,636	
CASH (AVAILABLE FOR INVESTMENTS)					31,407	14%
TOTAL					339,847	100%

While we prefer to be fully invested with a concentrated portfolio of cheap stocks you can only make the most of what the market is giving you.

While we prefer to be fully invested with a concentrated portfolio of cheap stocks you can only make the most of what the market is giving you. Force the issue and you end up doing something stupid that you'll regret in the long run, as Munger warns.

Although we're content waiting to take advantage of other people's mistakes, the price in the short-term can be taxing: potential underperformance and the frustration of having more money than intelligent investment ideas.

To help you avoid any unforced errors we highly recommend reading *Jeremy Grantham's latest quarterly* that explains the scourge of being a value investor (remember to save it if you want to read it again one day as the commentaries don't stay on GMO's website for long).

Disclosure: Staff have interests in many of the stocks mentioned. For a full list please see staff holdings on page 7.

Growth Portfolio dares to be great

The model Growth Portfolio is ticking along nicely, but it must continue to do things differently if it dares to be great.

BY NATHAN BELL, CFA ▪ 4 JULY 2014

> ***Howard Marks said 'you can't take the same actions as everyone else and expect to outperform'. By definition if you do the same thing as everyone else then your result must be average.***

'To achieve satisfactory investment results is easier than most people realise; to achieve superior results is harder than it looks.' – Benjamin Graham.

'The investor's chief problem – and even his worst enemy – is likely to be himself. ' – Benjamin Graham.

In a recent memo titled *Dare To Be Great II*, Oaktree founder and chairman Howard Marks said 'you can't take the same actions as everyone else and expect to outperform'. By definition if you do the same thing as everyone else then your result must be average.

The problem with assembling a portfolio that's different from the crowd and 'trying to be different and better, [is bearing] the risk of being different and worse. To succeed at any activity involving the pursuit of gain, we have to be able to withstand the possibility of loss.'

TABLE 1: GROWTH PORTFOLIO TRANSACTIONS

ASX CODE	BUY/ SELL	SHARES (NO.)	PRICE ($)	VALUE ($)	DATE
NST	Buy	5,400	0.88	4,725	28/01/14
FOXLV	Sell	360	35.08	12,629	7/02/14
MQG	Sell	60	53.60	3,216	11/02/14
CSL	Sell	150	66.98	10,047	13/02/14
TAP	Sell	9,850	0.48	4,728	14/02/14
AZZ	Buy	13,300	0.47	6,251	14/02/14
SHL	Sell	500	16.89	8,445	18/02/14
WDC	Sell	695	10.37	7,207	19/02/14
TME	Buy	2,784	3.54	9,855	19/02/14
VEI	Buy	11,466	0.58	6,650	3/03/14
PTM	Sell	900	7.23	6,507	4/03/14
NAN	Buy	5,000	0.79	3,925	10/03/14
CPU	Sell	415	12.33	5,117	24/03/14
TRS	Buy	1,000	9.89	9,890	1/04/14
QBE	Sell	343	12.00	4,116	15/04/14
ALL	Sell	1,500	5.40	8,100	29/05/14
ACR	Buy	6,250	0.80	5,000	13/06/14
FWD	Buy	3,200	2.17	6,944	23/06/14

'When I first went to work at Citibank in 1968, they had a slogan that "scared money never wins." It's important to play judiciously, to have more successes than failures, and to make more on your successes than you lose on your failures. But it's crippling to have to avoid all failures, and insisting on doing so can't be a winning strategy. It may guarantee you against losses, but it's likely to guarantee you against gains as well. Here's some helpful wisdom on the subject from Wayne Gretzky, considered by many to be the greatest hockey player who ever lived: "You miss 100% of the shots you don't take."'

This is the foundation of our model Growth Portfolio. It's designed to be a portfolio of our best ideas, and to achieve superior returns we're prepared to look wrong much of the time.

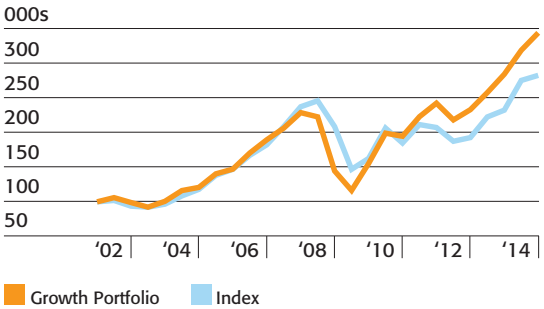
David Swensen of Yale perhaps put it best in Pioneering Portfolio Management.

Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

DARE TO BE DIFFERENT

Being different has panned out pretty well for a portfolio that got off to an average start. Since inception the Growth Portfolio has produced a 10.1% annual return, comparing favourably with the All Ordinaries Accumulation Index return of 8.3% (see Chart 1). The GFC was rough, but the opportunities it produced have underpinned the portfolio's outperformance since then: 17.3% versus 11.1% for the index over the past five years.

CHART 1: GROWTH PORTFOLIO PERFORMANCE VS. ALL ORDS ACCUMULATION INDEX



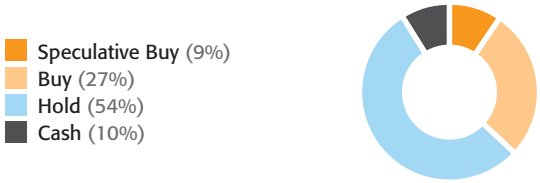
Source: Capital IQ

Over the six months and year to 30 June 2014 the portfolio has also beaten the index – returning 7.9% compared to 2.7%, and 23.0% to 18.5%, respectively. That's while holding a decent amount of cash (which is likely to grow unless Mr Market gives us more opportunities). Chart 2 shows that less than 30% of the portfolio's current constituents sport a Buy recommendation.

Turning to the best and worst performers, you can see that the distribution in Chart 3 is much wider than for the model Income Portfolio (see *2014 EOFY: Income Portfolio*

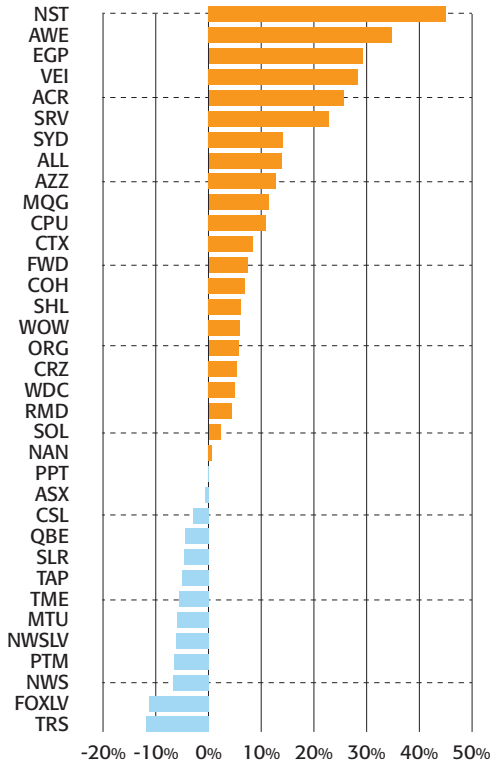
gets sporting chance). That's because the Growth Portfolio takes more risk to produce higher returns.

CHART 2: GROWTH PORTFOLIO ALLOCATION BY RECOMMENDATION



The best performers over the past six months included **Northern Star Resources** with a total return of 45%, as the gold market showed signs of life after being sold off heavily over the past year. **AWE**'s total return was 35% (see *AWE downgraded* on 5 Jun 14 (Hold – $1.82)), while **Echo Entertainment**, **Vision Eye Institute** and **Acrux** produced total returns of 29%, 28% and 26% respectively. While these performances were pleasing, most of this group are only small positions in the portfolio.

CHART 3: TOTAL PERFORMANCE OF GROWTH PORTFOLIO (INC. DIVIDENDS)



Note: Open price used for existing holdings, purchase price for new holdings. For holdings that were sold, the sale price was used.

Source: Capital IQ

The Reject Shop was the worst performer, falling 12% since it was added to the portfolio following another profit downgrade (see *Super Retail Group vs. The Reject Shop* on 1 Jul 14 (Buy – $8.88)). When you're attempting to catch a falling knife like this it can pay to build up a position over time rather than going in all guns blazing, but the portfolio limit remains relatively modest due to the risks of investing in the retail sector.

> ***When you're attempting to catch a falling knife it can pay to build up a position over time rather than going in all guns blazing,***

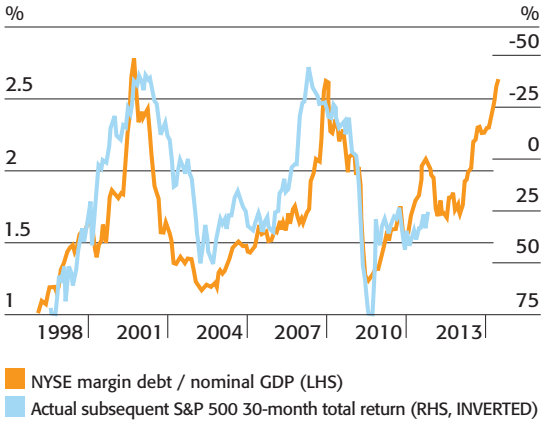
YOUR OWN WORST ENEMY

One of the reasons many people have missed the wonderful returns since the GFC is because they let the awful macroeconomic backdrop overwhelm them. Value investors are wired to focus on the merits of individual businesses, because we know a company's competitive position and ability to reinvest profits at high rates of return is what matters in the long run. But establishing a margin of safety requires an understanding of how a downturn in the economy or markets will impact the business in our portfolios.

Although the mood in the Australian market is hardly euphoric, John Hussman of US funds manager Hussman Funds highlighted some ominous statistical warning signs in February that shouldn't be ignored.

First, margin lending in the US has reached an all-time high. As you can see in Chart 4, only in 2000 has margin lending as a percentage of US GDP been higher. Each time the ratio has surged it has heralded a large fall in the market.

CHART 4: MARGIN LENDING / GDP (%)



Source: Hussman Funds

Second, based on 'historically reliable measures, including price/revenue, market cap/GDP, Tobin's Q, and a variety of properly normalised earnings-based measures' the market is valued at twice the historical norm.

'Uniformly, and across fundamentals that have reliably correlated with actual subsequent market returns, we project likely S&P 500 total returns in the range of 1–3% annually over the coming decade. Given a 2% dividend yield, this implies that we fully expect the S&P 500 to be no higher a decade from today than it is at present.'

Regardless of how conservative your portfolio is positioned, if you own stocks then you need to understand how you and your portfolio will cope with another downturn if the current build-up of leveraged speculation unravels like it has throughout history.

Will you be comfortable with the stocks you currently own? Are you too exposed to certain sectors or companies? Will you have enough cash to reinvest as opportunities arise? Would you have financial obligations that you'd struggle to meet? Would you regret not having enough international diversification?

Only you can answer these questions, and if you dare to be great then you must do something that the herd isn't doing. 'If your portfolio looks like everyone else's,' explains Marks, 'you may do well, or you may do poorly, but you can't do different. And being different is absolutely essential if you want a chance at being superior.' That might mean buying stocks out of favour or selling and paying tax on much-loved stocks that have performed wonderfully.

CURRENT THEMES

Currently the model Growth Portfolio dares to be great in a variety of ways. First, you'll notice it looks nothing like the index. The ability to invest in virtually any company of any size is one of your greatest advantages over the professionals.

Iron ore giants **BHP Billiton** and **Rio Tinto** are wonderful businesses compared to their smaller rivals, but we see no reason to take our chances with them when current prices aren't compensating for the risks recently explained in *Macro: Time to buy iron ore?* on 2 Jul 14.

Second, we're holding a reasonable portion of cash, knowing it may lead to underperformance in the short run. We're prepared to wait patiently for opportunities because, as Warren Buffett warns, 'the stock market has a very efficient way of transferring wealth from the impatient to the patient'.

As Warren Buffett warns, 'the stock market has a very efficient way of transferring wealth from the impatient to the patient'.

Third, we want as much international exposure as we can get provided we're not overpaying for it. Companies such as **Sonic Healthcare**, **ResMed**, **Computershare** and **Platinum Asset Management** should benefit if the Aussie dollar heads back to or below historical averages. Despite a long reform agenda, China remains a large and growing risk, as does the big expected fall in mining and energy investment over the next couple of years.

Fourth, we're looking for companies that aren't highly leveraged to a strong Australian economy, such as the banks (although we'll gladly buy these stocks when they're cheap). Companies such as ResMed, **Sydney Airport** and **Cochlear** are much less sensitive to recessions because of the essential products they provide and their pricing power. Not that the big banks are slouches in this department.

Lastly, we're buying what's unloved or unappreciated for transient or misunderstood reasons. Examples include Echo Entertainment, **Caltex** and Acrux.

Daring to be great is not easy. *The vast majority of fund managers that underperform the index* don't open their doors aiming for mediocrity. But as an individual investor you have many advantages over the professionals, including the ability to hold cash, ignore the index and only having to answer to yourself. To help you put these advantages into action, here's some more motivation from Marks.

'I'm convinced that everything that's important in investing is counterintuitive, and everything that's obvious is wrong. Staying with counterintuitive, idiosyncratic positions can be extremely difficult for anyone, especially if they look wrong at first. So-called "institutional considerations" can make it doubly hard.'

'Investors who aspire to superior performance have to live with this reality. Unconventional behavior is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes. Thus each person has to assess whether he's temperamentally equipped to do these things and whether his circumstances – in terms of employers, clients and the impact of other people's opinions – will allow it … when the chips are down and the early going makes him look wrong, as it invariably will. Not everyone can answer these questions in the affirmative. It's those who believe they can that should take a chance on being great.'

TABLE 2: GROWTH PORTFOLIO (AS AT 30 JUN 14)

ASX CODE	PRICE MVMT SINCE 31/12/13	MOST RECENT RECO.	SHARES (NO.)	PRICE ($)	VALUE ($)	% OF PORT.
ACR	26%	Hold	6,250	1.005	6,281	1.8%
ALL	12%	Hold	1,500	5.26	7,890	2.3%
AZZ	13%	Spec Buy	13,300	0.53	7,049	2.0%
ASX	–3%	Buy	200	35.64	7,128	2.1%
AWE	35%	Hold	4,175	1.80	7,515	2.2%
CTX	8%	Hold	540	21.57	11,648	3.4%
CRZ	4%	Hold	900	10.59	9,531	2.7%
COH	5%	Hold	200	61.70	12,340	3.6%
CPU	10%	Hold	1,900	12.48	23,712	6.8%
EGP	28%	Hold	3,750	3.14	11,775	3.4%
FWD	7%	Spec Buy	3,200	2.33	7,456	2.1%
MTU	–8%	Buy	1,650	5.78	9,537	2.7%
MQG	8%	Hold	240	59.63	14,311	4.1%
NAN	1%	Spec Buy	5,000	0.79	3,950	1.1%
NWSLV	–6%	N/A	90	20.32	1,829	0.5%
NWS	–7%	Spec Buy	300	19.90	5,970	1.7%
NST	44%	Spec Buy	5,400	1.26	6,804	2.0%
ORG	4%	Hold	650	14.62	9,503	2.7%
PPT	–2%	Buy	240	47.38	11,371	3.3%
PTM	–9%	Hold	1,800	6.30	11,340	3.3%
QBE	–6%	Hold	700	10.87	7,609	2.2%
RMD	3%	Buy	3,550	5.48	19,454	5.6%
SRV	21%	Hold	1,636	4.80	7,853	2.3%
SLR	–5%	Spec Buy	2,800	0.51	1,428	0.4%
SHL	5%	Hold	500	17.33	8,665	2.5%
SOL	1%	Buy	570	14.75	8,408	2.4%
SYD	11%	Hold	6,677	4.22	28,177	8.1%
TME	–8%	Buy	2,784	3.27	9,104	2.6%
TRS	–12%	Buy	1,000	8.72	8,720	2.5%
VEI	28%	Hold	11,466	0.745	8,542	2.5%
WOW	4%	Buy	615	35.22	21,660	6.2%
CASH					30,401	8.8%
TOTAL					346,961	100%

Disclosure: Staff have interests in many of the stocks mentioned. For a full list please see staff holdings on page 7.

– Notes –

IMPORTANT INFORMATION

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