# Fundamentally Speaking

**Newsletter of the Capricorn Diversified Investment Fund (CDIF)**

ARSN: 139 774 646

EDITION 4 – October 2014

this issue



## The purpose of The Fund

CDIF was established in January 2008. The objective of The Fund is to generate returns over time commensurate with those of the equity market with lower year to year volatility in income and asset value. The fund's existing and continued bias is toward recurring income as opposed to capital gains.

To do this the fund will invest primarily in assets which have stable year to year returns. In general, this stability will come at a cost in terms of liquidity. The assets of the fund are anticipated to be beyond the capabilities of the average individual due to scale (i.e., minimum investment requirement), liquidity and the requirements of management or analytical time and expertise.

Compared with the GFC, investment markets of late have been sanguine. While this is welcome, we are not complacent in our outlook. Multiple wars, a sluggish European economy and the impending wind-back of quantitative easing in the US, all have the potential to significantly increase volatility. Further, changes in the way banks are regulated mean that banks' ability to lend will be subject to much greater swings in the future, paradoxically, adding to market instability.

CDIF's ability to access assets which are not directly available to retail investors, and its focus on income, is designed to assist in managing through volatile markets. Both of these factors are empirically verifiable – real estate rents can be expected to increase in line with inflation. So too, income from infrastructure assets. Assets such as the solar electricity system on the top of Suncorp House benefit as electricity prices increase. Many bond-like instruments have a known maturity date, providing the opportunity to reinvest into changed market conditions upon maturity. Small capitalisation shares can be quite challenging to research and manage, but they tend to outperform when economic conditions are improving.

While CDIF is still relatively small in size, we have been successful in building quite an interesting portfolio of assets. With the completion of Suncorp House, we expect internal cash flows to increase, and we expect the fund will become increasingly attractive for investors both within and outside CIPL.

## WELCOME

Welcome to Edition 4 of the Capricorn Diversified Investment Fund's (CDIF) Newsletter – Fundamentally Speaking. Fundamentally Speaking will be distributed periodically with other relevant material. In it, we look at the characteristics of The Fund and highlight the Fund Manager's future intentions for investment and growth in The Fund. Please don't hesitate to contact us if you have any comments or enquiries.

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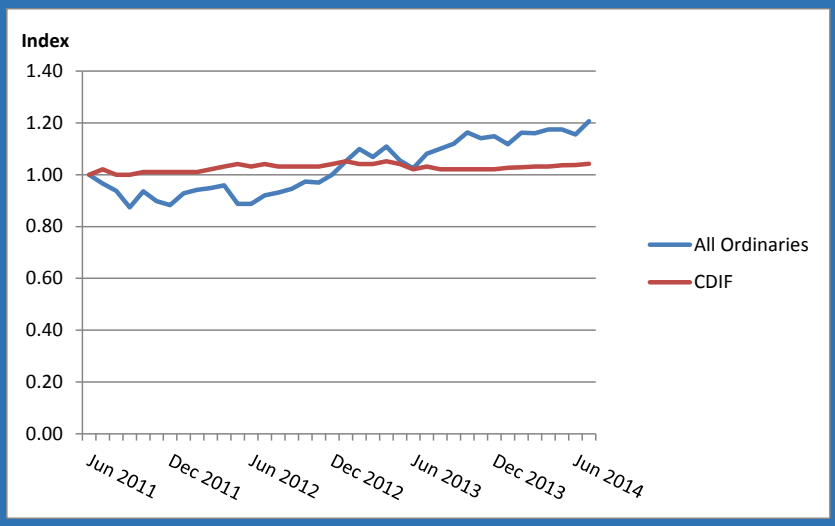
| Asset | Amount |
|---|---|
| Cash | $559,166 |
| Australian Shares | $633,172 |
| Fixed interest | $529,150 |
| Property related assets | $5,757,732 |
| Other unlisted investments *independently valued* | $202,382 |

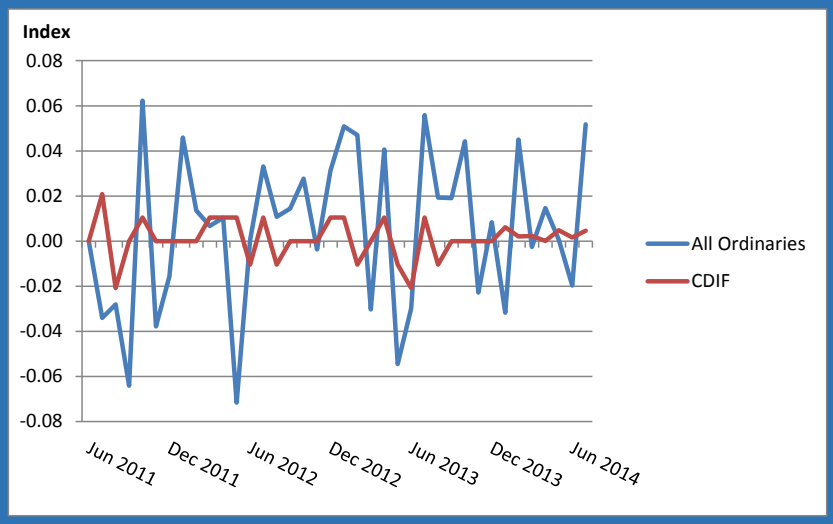
*All figures are approximate as at October 2014*

# Comparative Performance

Returns from The Fund comprise both income and capital components. Since inception the capital component has reduced by about 6 cents to 90 cents. On the other hand The Fund has made distributions of 10 cents, bringing the total value up to $1.00. The graph below shows the overall effect compared with an investment in the All Ordinaries (the broadly based measure of the stock market).




The Fund outperformed from inception to around June 2013. After June 2013, The Fund has underperformed the broader index. At least as importantly however, CDIF's volatility has done exactly what we would expect – compared with the All-Ordinaries Index, Chart 2 shows that CDIF's volatility is markedly reduced.




It is worth noting that CDIF has achieved this outcome while:

- Incurring establishment costs;
- Incurring non-capitalised costs associated with the redevelopment of Suncorp House, such as the payment of rates and not having an income from the property for almost two years; and
- Making 10 cents in distributions to take advantage of accumulated (establishment-related) tax losses.

## The fish John West reject!

The CDIF management team is always looking for investment opportunities for the fund. Investments have to be, not only interesting, but take into account risks that might present, they have to stand up financially. While opportunities may arise from anywhere, the financial success of an investment is mainly due to the diligence applied at the time of researching the opportunity.

Over the past few years CDIF has evaluated and rejected a wide range of opportunities including:

- a retirement village where the price was too high and the conditions of purchase too onerous;
- a small shopping centre where research revealed significant lease expiries were looming and a major tenant had a rent holiday if vacancies exceeded a certain level;
- seaside units where we found the "wholesale" offering was no different from that available to individual investors who bought them directly;
- Taxi cab licenses where our analysis revealed that the owner of the licence needs to drive at least one shift per day to make economics work (we all agreed that we did not need an additional job!);
- An aircraft lease where although attractive, the vendor kept shortening the period in which the money was required.

All of these opportunities were judged to be outside of the investment criteria of CDIF, and so were left to others.

# CDIF Small Caps Update

## Background

Small Caps are listed companies that fall outside the ASX 100 Index. They will typically have a market value of $300-$1500M. As smaller companies, they tend to be more narrowly focussed than Big Caps, and are often run by founders or executives who have large personal holdings in the business. Small Caps are in markets where it can be difficult to get a direct exposure through larger companies.

The weaknesses of Small Caps tend to go hand in hand with the attractions: they have less diversification, and therefore potentially more risk, and their shares tend to be illiquid.

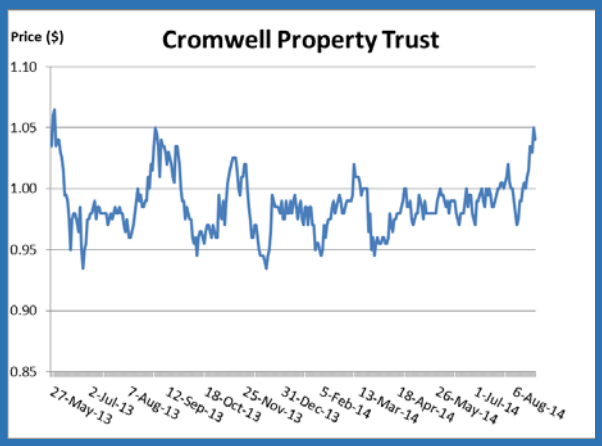
Historically CIPL individual portfolios had a number of Small Caps in them. The difficulty was that if advisers wanted people to buy or sell a Small Cap holding the lack of liquidity and the process of executing ATPs meant that clients could be disadvantaged.

What we determined to do was offer to swap the direct Small Cap holdings of CIPL clients into units of CDIF, with CDIF managing the holdings directly.

## The Portfolio

The portfolio initially passed to CDIF included four stocks:

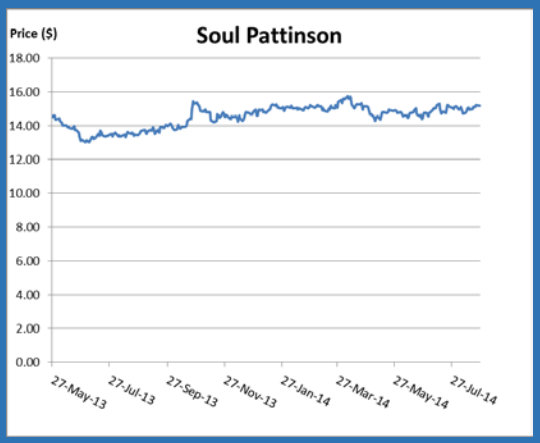
- **Cromwell Property Trust (CMW)**, which specialises in relatively high end properties with government tenants. It yields slightly more than 7%;




- **NIB Holdings (NHF)**, a Newcastle based health insurer, which over the past decade has grown from a small mutually owned business to one of the larger players in the market in NZ and Australia; and

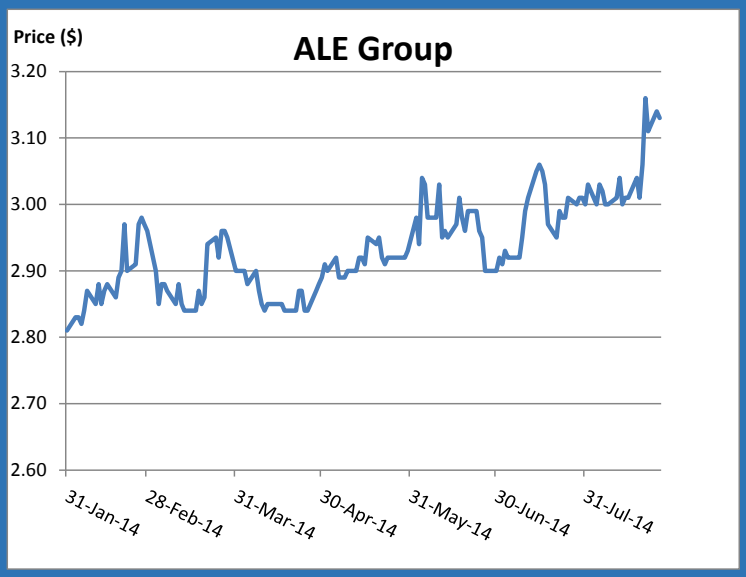

- **IRESS (IRE)**, which operates market information systems, primarily in Australia but also in NZ, SA, the UK and Canada. It generates a very high return on equity and has historically grown EPS by 9-10% per annum;


- **Soul Pattinson (SOL)**, a diversified conglomerate with a 100 year track record, which has large shareholdings in listed coal mines, bricks, property, financial services, agricultural services and Telcos.



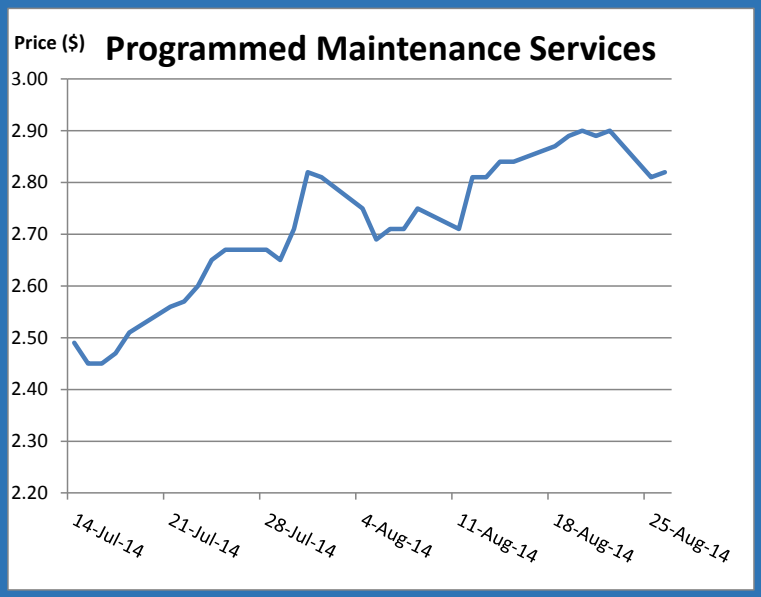
## The Portfolio - continued

During fiscal 2014 we rebalanced the portfolio to reduce the extremely large holding in CMW and purchased a small investment in ALE Property (ALH), which owns the freehold under the Woolworths/Bruce Matheson pubs joint venture. We expect that this business will prosper so long as people drink beer in Australia. The yield was 5.8% and the group is coming up to a renegotiation period for a large portion of the asset base.




The performance of The Fund during fiscal 2014 was extremely good, driven primarily by a 54% increase in the NIB share price. We have progressively reduced our holding in NIB by a third as the stock moved through $3.00. The value of our holding has fallen by around 10%.

At the beginning of fiscal 2015 we added Programmed Maintenance (PRG) which does outsourced painting and landscaping for local and state governments, has a small electrical business and a blue collar employment hire business. The primary attraction of the stock was the low multiples (P/E of <10x) and high fully franked yield (7.0%). The business is highly cash generative and under geared.




At cost the portfolio has a yield excluding special dividends but including franking credits of 7%.

## Some thoughts on Iron Ore

As most readers would be aware iron ore has been a driving force for the earnings of BHP and RIO over the past decade and has been, along with LNG, the key driver of a decade long explosion in resources related capex that has carried the economy since 2002.

In 2004 Australia exported 210mt or iron ore at A$30/t. This accounted for less than 6% of goods exports. In 2014 exports totalled 687mt at A$108/t. This accounted for 27% of exports. Since 2004 iron ore exports have growth at 28% compound in A$ terms.

The performance of iron ore over the past decade is unprecedented for a basic commodity since the industrial revolution. Realistically this ought to be considered a once in forever occurrence.

Over the past few months the combination of sluggish demand from China and a very large increase in exports from Australia and Brazil, which combine for nearly 65% of traded iron ore production, has seen prices fall from around US$110/t to US$80-85/t.

The coming 18 months should see a further 15-20% increase in exports from Australia and Brazil. In the absence of a sharp recovery in demand growth from China we would expect prices to stagnate at around or below present levels.

The implications of this are unambiguously bad for Australia. For smaller iron ore producers (particularly those with low Fe content) earnings will be hit very hard. Some will likely be forced to curtail or close mines. Even the lowest cost groups like RIO (81% of EBIT from iron ore) and BHP (52% of EBIT from iron ore) are likely to experience pressure on earnings.

In addition the growth in export earnings will decline from 28% pa to negligible levels. This will impact total export growth from Australia, and presumably the value of the A$.

The implications of this for investors are fairly obvious: avoid iron ore miners, particularly the smaller ones; avoid mining services groups, be very cautious regarding RIO and BHP and look for well managed businesses with large amounts of US$ earnings.

## The Strategy


The strategy has been, and will continue to be, buying solid cash generating businesses with sound track records that do things we can understand. Because we are buying the management as well as the business we have a bias towards:

- Low gearing. Even the best positioned business will struggle from time to time and we have no interest in getting trapped in a potentially terminal situation;
- A track record of sensible expansion. All companies want to grow. We want to invest in people that can grow their businesses without destroying the returns that made them attractive in the first instance; and,
- A track record of returning surplus cash to owners.

NIB is an excellent example of this strategy. Health insurance is, realistically, no different financially from car, home and contents or house insurance. Customers pay for a year and one can make realistic assessments of their risk based on history.

Prices are regulated by the Commonwealth Government; however there are substantial tax and other direct penalties for not buying the product and large subsidies to buy the product.

In 2010, when CIPL holders were first introduced to the stock, the company had been listed for more than three years. EPS was 12.4c, the P/E was 12x and the yield 4.7%. Return on equity was 16%, the company had already done a small buy back with surplus capital and had announced an intention to do more.

Since then 14c in special dividends have been paid, 16c in capital returns have been made, 5% of the stock was bought back and cancelled at $1.47 and one quite sensible acquisition has been executed. In 2013 EPS was 15.9c, the dividend was 20c (including a 9c special) and ROE 21%.

NIB has been an excellent investment for CDIF holders. At $3.30 the stock is on a P/E of 19x with a recurring yield of 3.6%. We suspect that over the next three years NIB may be a better company than it has been over the past three years. We doubt very much that it will be a better stock, hence our decision to slowly reduce our holdings.

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## Portfolio Yield

| Company | Ex date | c/share | $'000 | franked | credit |
|---|---|---|---|---|---|
| SOL | 12/11/2013 | 28 | 2,635 | 100 | 1,107 |
| CMW | 31/12/2013 | 1.875 | 4,301 | 0 | 0 |
| NHF | 03/03/2014 | 5.25 | 3,747 | 100 | 1,574 |
| IRE | 07/03/2014 | 24.5 | 2,713 | 80 | 729 |
| CMW | 25/03/2014 | 1.94 | 3,939 | | |
| SOL | 11/04/2014 | 19 | 1,788 | 100 | 751 |
| CMW | 26/06/2014 | 1.94 | 3,939 | | |
| LEP | 26/06/2014 | 8.25 | 717 | | |
| FY 14 | | | 23,779 | | 4,161 |
| Yield on cost | | | 4.05 | | 0.7 |

| Company | Ex date | c/share | $'000 | franked | credit |
|---|---|---|---|---|---|
| SOL | | 38 | 3,576 | 100 | 1,502 |
| CMW | | 7.76 | 15,756 | 0 | 0 |
| NHF | | 20 | 10,374 | 100 | 4,357 |
| IRE | | 38 | 4,208 | 100 | 1,767 |
| LEP | | 16.5 | 1,435 | 0 | 0 |
| PRG | | 18 | 12,600 | 100 | 5,292 |
| FY 15 | | | 47,949 | | 12,918 |
| Yield on cost | | | 6.25 | | 1.7 |

## Solar – going green!

On 28 July 2014 Suncorp House in Rockhampton (owned by Capricorn Diversified Investment Fund) and managed by CIPL, finalised one of the biggest solar installation projects in Central Queensland. The project, comprising 55kw, essentially covers the entire flat roof.

The decision to invest in solar was not solely driven by a desire to project a green image. Analysis undertaken by the investment committee suggests an internal rate of return of about 18 per cent on the $80,000 investment.

While there is a lot of emotive discussion around solar, there are some points that just cannot be refuted. First the sun is up when most people are in commercial buildings so it makes sense to power the building from the sun. Second, coal generated power is not as cheap as it appears. Large coal-fired base load stations have to run at high capacity to be efficient. The trouble is, the demand for electricity in the middle of the night is much lower than in the day, and so this electricity is typically sold at a loss. This leads to a situation where massive infrastructure is being built for the peak load (during the day). Obviously this is grossly inefficient, and it means that the common assertion that coal fired electricity is cheap is overstating the truth.

The solar power was turned on in the week ended 22 August 2014. In the meantime the endeavour has led to additional opportunities for similar investment projects.