Professional Selection

Quarterly Review

Investment opportunities emerge from structural change

September 2017

Financial markets are influenced by both cyclical and structural investment themes. Whilst the importance of various cyclical forces tends to wax and wane with the economic cycle, structural forces usually result in permanent changes to the investment environment. As bottom-up stock pickers, Antares' investment managers are particularly interested in structural investment themes as they have disparate and far reaching effects on industries and companies and this creates new investment opportunities.

The information contained within this article is intended as factual information although we acknowledge that there is a reasonable likelihood of doubt and the information is not intended to imply any recommendation or opinion about a financial product.

Cyclical versus structural impacts on markets

Markets can be impacted by both cyclical and structural investment themes. So what's the difference?

Cyclical investment themes are those that move with the economic cycle. They tend to come into play for a period of time and then become less important as the economic cycle progresses to another phase. Examples of cyclical forces that impact markets include tightening and easing phases of monetary policy, periods of upswing or slowing in the housing cycle or consumer spending, accelerating or decelerating inflation or policy decisions to increase or reduce government spending in response to the economic environment. The key thing to remember about cyclical forces is that whilst their impact can be very important, it is usually temporary.

Structural investment themes occur when economic, political or social forces shift the existing status quo to such an extent that it results in a change in the way an economy, industry or company functions. These themes are longer term in nature and usually involve doing things differently. History is littered with examples of structural change and many of them involve technological innovations - the telephone, the advent of the railways, digital cameras all but eradicating film based photos, Wikipedia wiping out encyclopedias and email replacing letters. From an investment perspective, structural themes are very important for bottom-up stock pickers like Antares as they often result in permanent changes to the investment environment and this creates investment opportunities.

Investment implications of structural change

From an investment perspective, analysing the potential impacts of structural investment themes is an important part of the research process as it has such far reaching implications for multiple companies. For example:

- *The Beneficiaries* – which companies can leverage the structural change and will they do it successfully?
- *New entrants* – will new companies enter the market to take advantage of the new environment and will they be successful?
- *The Losers* – which companies stand to lose the most and will they respond fast enough to avoid being left behind? Such questions are important as they highlight that structural investment themes don't just create investment opportunities, they create investment risks as well. Working out which companies stand to lose is just as important from a portfolio perspective as investing in those companies that have the potential to gain!

So what are some of the important structural investment themes currently impacting the Australian market?

Demographics – the aging population

There is no denying the Australian population (and that of other major developed economies) is aging. Australian Bureau of Statistics (ABS) data show that the percentage of the population aged 65 years and above has risen from 8.5% in 1960 to over 14% in 2012. ABS projections suggest this cohort will grow to around 22% of the Australian population by 2061[1]. This has a myriad of investment implications of which we will outline a couple.

Continued strong demand for yield based investments

As investors, retirees (ie those 65 years and over) generally have a higher demand for yield based strategies, given their desire to preserve capital and use it to generate a stable income. People are also living longer, as generally better health and medical breakthroughs are extending life expectancy. So retirees today often need to generate a stable income for a longer period of time. Finally, the "baby boomer" generation (born 1946-64) are now entering retirement, with the first group turning 65 in 2011. These well-off retirees tend to have a relatively high demand for yield focused strategies as they wish to generate sufficient income to maintain the lifestyle to which they are accustomed.

This has implications for yield stocks within the Australian share market. In recent years there has been much debate over whether the strong performance of Australian yield stocks is just a cyclical phenomenon, with historically low interest rates causing investors to seek out alternative sources of yield, or whether there is a structural component - the aging population – which is becoming more dominant. Antares' believes that there has been a strong cyclical component that should start to unwind once interest rates rise to more "normal" levels but the exact timing of this shift is hard to predict. More importantly, the structural shift towards an aging population is undoubtedly happening and this should provide ongoing demand for high dividend yield stocks on a longer term view.

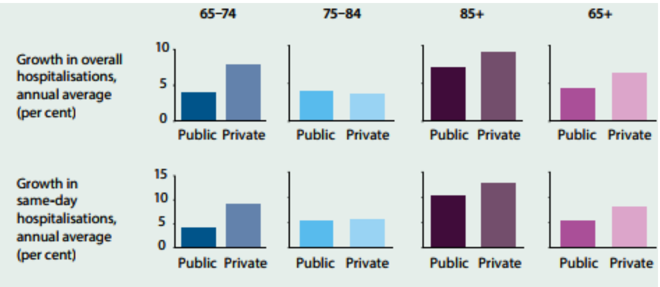
1 Australian Bureau of Statistics, 3222.0 – Population Projections, Australia, 2012.

This suggest dividend yields are set to remain a significant component of expected equity market returns in coming years even if the cyclical demand for yield eventually becomes less significant as interest rates normalise.

Healthcare as the population ages

Healthcare is another area that seems destined to benefit from the aging population. It makes intuitive sense that the higher proportion of older people there are in society, the higher the demand for medical and hospital services will be. Statistical data tend to support this hypothesis. Chart 1 shows just how much Australian hospital admissions have grown in recent years for those aged 65 years and older, largely due to strong growth in same-day procedures in private hospitals.

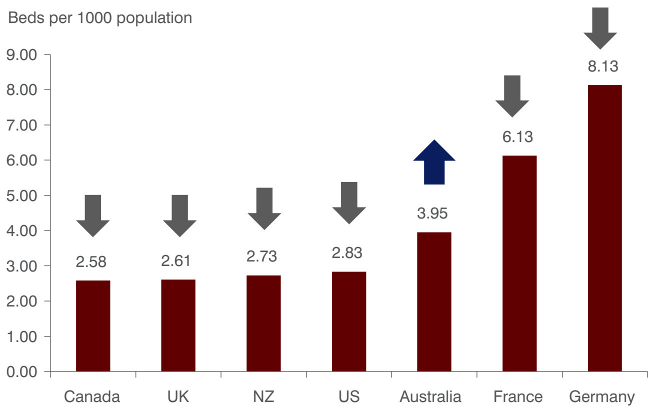
Chart 1: Hospitalisations, 2004-05 to 2013-14



Source: AIHW, NHMD, September 2017

Whilst we subscribe to this positive view of private hospital providers as a long term investment theme, we think there are some short term hurdles that first need to be overcome.
The most significant of these is increasing capacity. In anticipation of more hospital usage by older patients, many private hospital providers have increased capacity by building new hospitals in recent years. This is true of both Healthscope (HSO) and Ramsay Healthcare (RHC). So Australia now has a relatively high and increasing number of beds per 1000 of population compared to other developed nations as shown in Chart 2. Interestingly, Australia is the only major developed economy where hospital bed numbers are rising. This increased capacity will likely constrain the profitability of the listed hospital providers in the near term.

Chart 2: Australia the outlier on hospital beds



Source: Shaw & Partners, September 2017

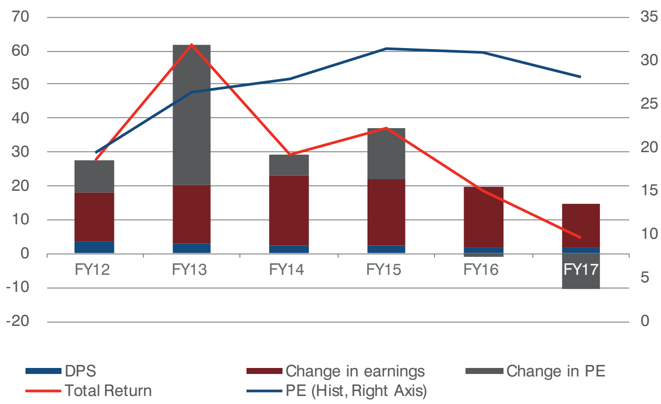
Secondly, a significant change is occurring in the relationship between the private hospital providers and the private health insurers which has implications for hospital revenues. Historically, the private health insurers have operated in a pretty easy environment. Australia's tax system forced consumers to buy health insurance so there were lots of customers and as long as a company had some brand presence, there would be earnings growth. So the insurers didn't really need to focus on costs or manage their businesses very closely. But this has now changed in response to two developments:

- *The float of Medibank Private (MPL)* – The public listing of MPL has opened the industry up to more investor scrutiny and forced management to improve the way they operate. MPL is now a for-profit company with a much stronger focus on cost control and this includes trying to limit the growth in the amount it pays out to private hospitals to cover claims.
- *Consumers reaching a "pain point" with health insurance premiums* - The rapid growth in health insurance premiums in recent years has made them less affordable for the average consumer whose wages have been virtually static. So many consumers are now choosing to opt out of private health insurance altogether or trade down to cheaper policies. This has significantly reduced the revenues of the private health insurers and put pressure on their ability to increase claim payments to the private hospitals.

Finally, there are investigations underway into over-servicing by doctors, particularly excessive numbers of procedures (eg knee arthroscopies), following media coverage of the issue. If this leads to more cautious prescribing by doctors, it has the potential to reduce private hospital utilisation rates.

A quick look at Ramsay Health Care's share price returns in recent years illustrates these points well. RHC delivered shareholders stellar returns over FY12-FY15 as earnings grew strongly and investors re-rated the stock (increased its price/earnings (P/E) ratio) as it was a perceived beneficiary of the aging population theme. However, increasing capacity and pressure on pricing has seen the company's P/E ratio stabilse in FY16 and decline in FY17.

Chart 3: Ramsay Health Care total return metrics



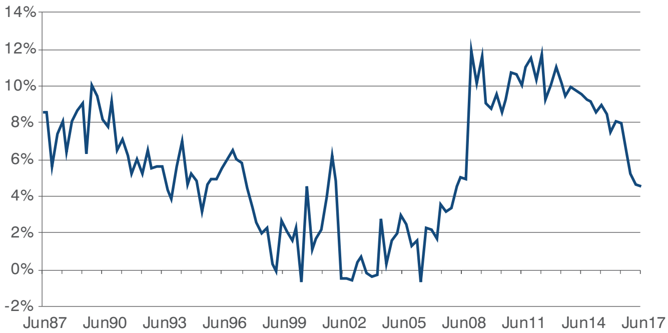
Source: Antares, September 2017. FY ending 30 June.

So whilst we believe in the long term structural theme that the aging population will consume much more healthcare in coming years, the industry needs to get through a cyclical increase in capacity and downward pressure on prices before more compelling investment opportunities arise.

Retail and the smart phone – very disruptive technology

The business of retailing in Australia reflects how Australians spend their money. This is self-evident but it's worth noting that Australia's savings rate has been falling since the aftermath of the global recession of 2007-08. Australians still spend all they earn and more. But how we spend it has been changing.

Chart 4: Australian savings rate

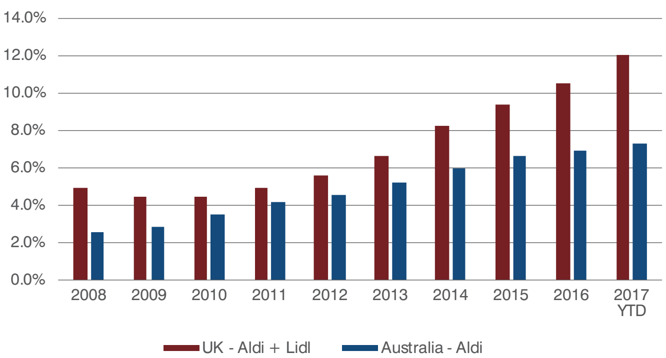


Source: Australian Bureau of Statistics, October 2017

The rise of the so-called "experiential" over the "consumer" economy is integral in this change. This has been driven by demographics and technology. Let's look briefly at technology first and its role in better informing consumers of the costs and benefits of their choices, through the lens of the largest consumer market, humble groceries.

Since 2007, German discount supermarket chain, Aldi, has taken its market share in Australia from 5% to 10%. It is now in the midst of rolling out over one hundred additional stores in South and Western Australia. Likewise in Britain and other so-called consumer economies, the rise of discounters like Aldi has been meteoric.

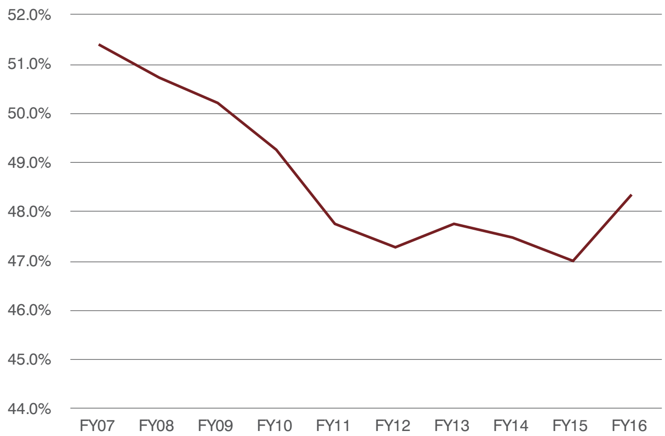
Chart 5: Aldi market share in Australia and the UK



Source: ABS, media articles, JP Morgan estimates, Kantar UK, October 2017

Aldi, like other discount grocery stores, offers a range which is predominantly private label versions of similar branded products, but without the various "bells and whistles" of the branded version. As a result, they cost considerably less. The rise of these products has coincided with declining profitability for the manufacturers of traditional branded products, such as Nestle or Unilever.

Chart 6: Fast moving consumer goods (FMCG) margins



Source: Company Reports June 2017. *Cumulative gross margins of Proctor & Gamble, Unilever and Reckitt Benckiser, measured in $US

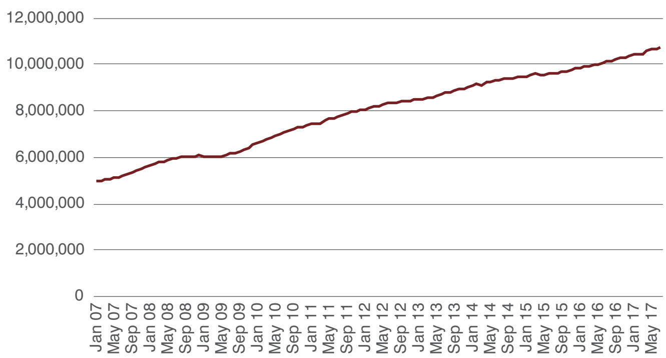
So what does technology have to do with this? Well, the rise of these businesses in western consumer economies has coincided with that of the now ubiquitous smart phone. Essentially, consumers have in their hands access to an instant review of any product they wish to buy, its costs and its benefits. This allows for them to understand many of the so-called benefits of the highly branded and marketed product.

Mobile technology has empowered the consumer in their understanding of the range of products available and the result has been a surge in demand for the more commoditised versions of groceries, from either discounters or from supermarket. The heavily marketed benefits of the branded product and the trust they once had have been eschewed. They are increasingly seen as unnecessary as the consumer has access to all the information they need to make their own choice. Previously the marketing departments of the large fast moving consumer goods companies controlled that information.

So consumers can now save on the basics but as we have observed, the savings rate has fallen in the last decade. This suggests people are still consuming. So where is the money being spent?

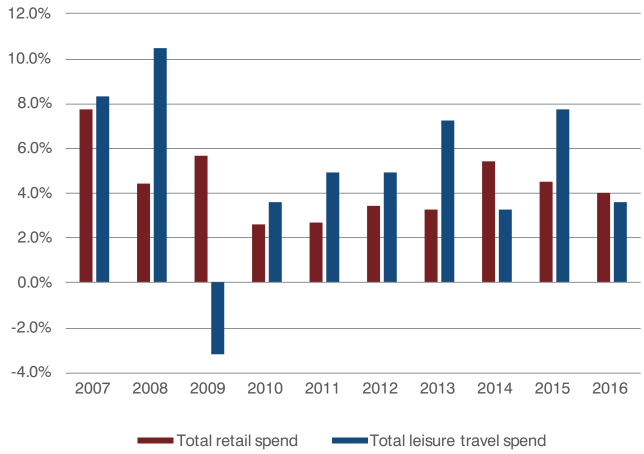
Australia's issues with sharply higher utility prices have been well discussed and it is not our intention to add to that debate. Suffice to say this has chewed up a small but growing proportion of incomes. The big mover, however, has been the "experiential" economy: leisure, travel, restaurants and cafes, even technology itself.

Chart 7: Short-term resident departures – rolling 12-months



Source: Australian Bureau of Statistics, October 2017

Chart 8: Retail versus leisure travel spending growth



Source: ABS Data, Tourism research Australia (Austrade)

Since the global recession of 2007-08, Australians have changed the way they spend their money. As Chart 7 above shows, Australians have been embarking on foreign travel in increasing numbers, with short-term resident departures increasing by 7.8% pa since 2007. Leisure travel spending has also outstripped the growth of total retail spending in recent years as shown in Chart 8.

This growth in leisure demand has been driven by two factors. One is preference (as highlighted in the above grocery market discussion), whilst the other is demographic. As the population ages, more Australians are becoming free of traditional responsibilities such as school fees and the like. With the additional money, they are choosing to travel. This demographic pattern is only part way through as the so-called baby boomer generation is only a few years into the retirement period. Hence they remain wealthy and mobile.

Asian industrialisation

Being located in the Asia-Pacific region gives Australian companies the opportunity to benefit from the ongoing industrialisation of large markets such as China and India. Two significant structural themes that interest us here are:

- the emergence of relatively wealthy middle class consumers that are increasingly using Australian services; and
- potential opportunities for Australian companies to sell their products into these large markets as they become more open.

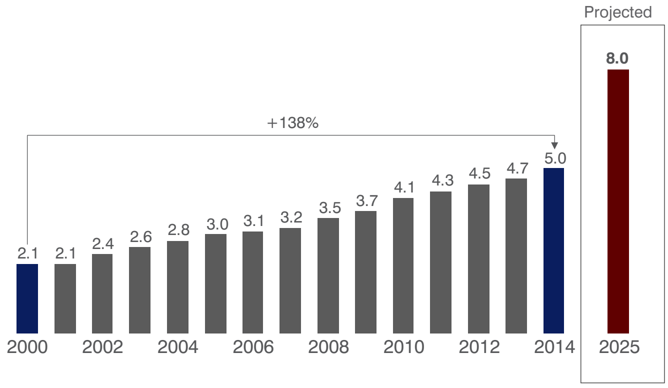
Asian middle class - education and tourism

Data suggest that by 2030, there will be over 3 billion middle class people in the Asia Pacific region. This represents growth of around 600% on 2009[2]. The emergence of this relatively wealthy Asian middle class (particularly in India and China) is creating investment opportunities in Australian companies offering education services to offshore students (eg Navitas) and those involved in in-bound tourism (eg Sydney Airport, Qantas Airways).

Chart 9 below, from Navitas' April Investor Day Presentation, shows that international student enrolments have been steadily growing for several years and that this is expected to continue towards 8 million by 2025 as a burgeoning middle class seeks better education.

[2] Navitas Investor Strategy Day Presentation, 4 April 2017, p.29.

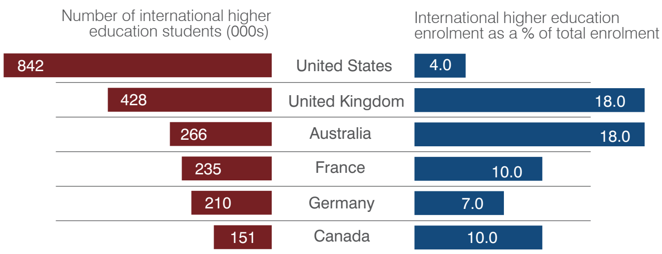
Chart 9: International student enrolments (m)



Source: Navitas, April 2017. Global Trends and Disruptors in International Student Mobility, ICEF, Aug 2015; UNESCO Institute of Statistics, 2016; Education at a Glance, OECD 2015.

The lucky thing for Australia is that there is a clear preference amongst these students to study in English speaking countries as shown in Chart 10. Significantly, Australia is ranked third after the US and UK by student numbers and ranks equal top with the UK in terms of international students as a percent of total enrolments at 18%.

Chart 10: Key destinations of global international students

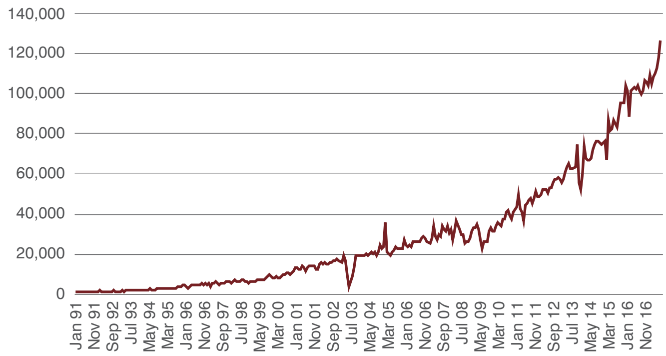


Source: Navitas, April 2017. Education at a Glance, OECD 2015/16, i-Graduate survey 2015.

Antares holds Navitas in its Elite Opportunities Fund as we like this structural growth story and we think it has further to run in coming years.

In-bound tourism is also a structural opportunity for companies like Sydney Airport (SYD) and Qantas Airways (QAN) as the Asian middle class starts to travel more widely. Chart 11 shows the growth in Chinese tourists coming into Australia over the past 25 years. The sharp pick up evident in the past five years suggests this structural theme is already in play, however the absolute number of tourists is still a miniscule percent of the Chinese population. So it is probably just the start of a much longer term trend.

Chart 11: Chinese tourist arrivals



Source: Australian Bureau of Statistics

SYD's published data on international passenger growth continues to be very strong at over 8% year-on-year for August 2017. The following chart, from SYD's Annual General Meeting Presentation in May, also highlights just how linked the company's international market is to the Asia Pacific region and its ongoing development.

Antares holds both SYD and QAN in several portfolios, with the structural increase in Asian based in-bound tourism being one of the main factors underlying our investment thesis.

Opportunities for Australian companies in developing Asian markets

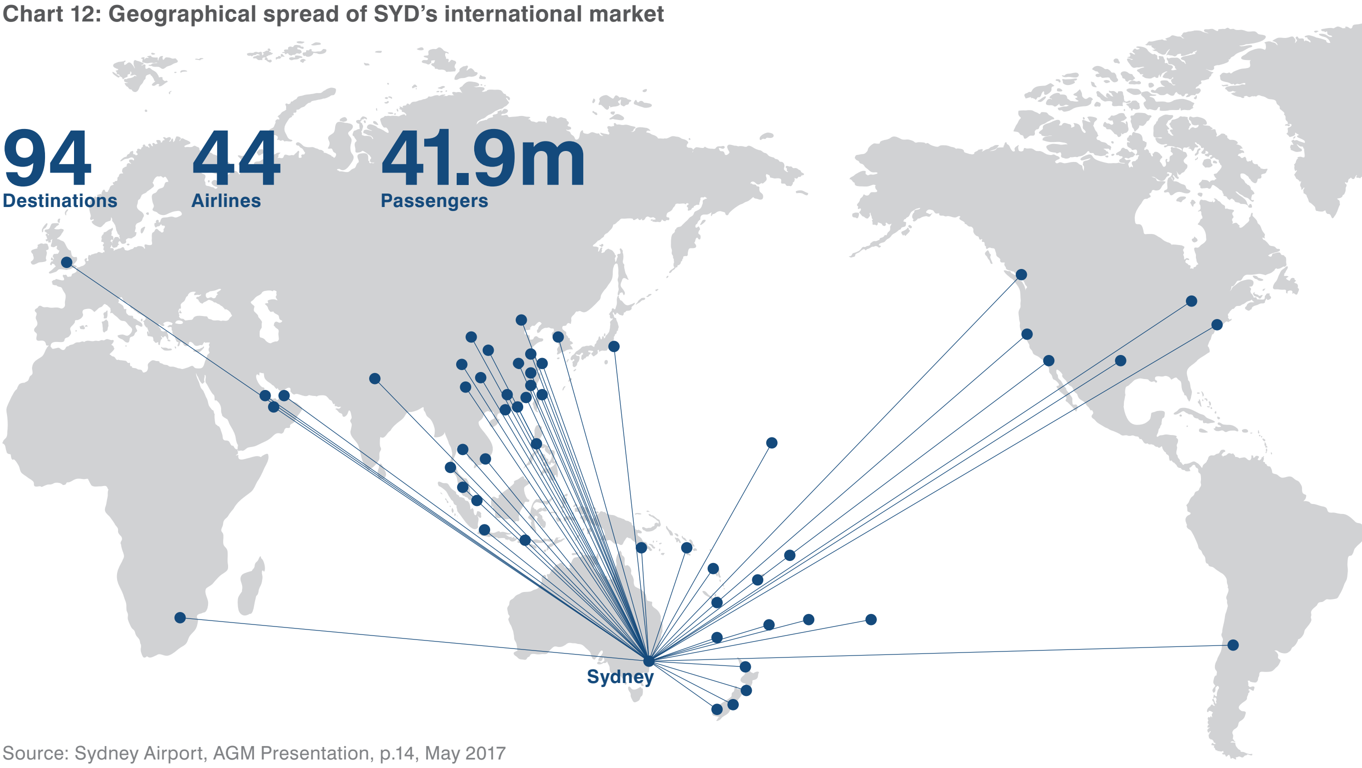
Australia's proximity to Asia also suits Australian companies that want to take advantage of the huge markets on offer. The obvious Australian example is resource companies like iron ore giants, BHP Billiton, Rio Tinto and Fortescue Metals Group, that sell into China to facilitate steel production but this has been going on for years.

More recently, consumer goods and services companies have been trying to penetrate the Chinese market, with varying success. Notable examples include health supplement company, Blackmores (BKL), and infant formula producer, Bellamy's Australia (BAL), that have both attempted to distribute their products through various channels in China; online employment agency, Seek, that purchased a local Chinese operator to expand its business; and Crown Resorts (CWN) that owned a casino in Macau targeting the Asian gambling market.

The key lesson that has been learnt from these opportunities is that whilst these new markets may contain a huge number of willing consumers, they are not always easy for offshore operators to navigate. The sting of unexpected regulatory change was almost a game changer for both BKL and BML, with both companies having to significantly re-engineer their strategies in order to continue to trade in the Chinese market. More worryingly, 18 of CWN's employees were arrested in October 2016 for allegedly promoting VIP gambling in China and some have only just been released from custody in August 2017.

So whilst opportunities abound in developing markets due to their sheer size and rising consumer wealth, the risks are certainly higher and evidence suggests the political structures can make the trading environment significantly more unpredictable.

Chart 12: Geographical spread of SYD's international market



Source: Sydney Airport, AGM Presentation, p.14, May 2017

Antares market & fund updates

Below is a brief review of how the Australian share market performed during the quarter as well as short commentaries on each Antares Fund, outlining their net performance and the main contributors to performance.#

Australian share market review

The Australian share market rose modestly in the September quarter, with global geopolitical tensions surrounding North Korea being an overriding concern. The S&P/ASX 200 Accumulation Index rose 0.7% but this masks quite strong divergence between sectors. The resource sector (+9.3%) was boosted by favourable growth data in China and rising commodity prices early in the quarter, whilst energy stocks (+7.3%) were supported by a 7.5% rise in the oil price. Consumer staples (+4.4%) also outperformed.

By contrast, healthcare stocks (-5.2%), and other industrial companies that have significant US dollar earnings, came under pressure as the Australian dollar ($A) rose to 80 US cents, undermining the $A value of these companies' offshore earnings. Utilities (-5.9%) and telecoms (-15.4%) also underperformed, impacted by higher bond yields and ongoing perceptions of earnings and dividend risk amongst telecom stocks due to fierce competition in the sector.

The August reporting season was reasonable but not spectacular. According to Citi Research data, around 58% of companies met expectations, whilst 18% were better than expected and 24% disappointed. The resource sector was the standout, delivering better than expected earnings and strong cash flow. Healthcare and telecoms experienced some of the most disappointing results. Capital management remained a theme, particularly share buy-back announcements and the shift towards declining payout ratios, albeit from very high levels. There was also a marked improvement in the capital expenditure (capex) outlook, with Credit Suisse data suggesting that aggregate capex upgrades rose 5.8%, the largest rise since the GFC.

Corporate deals during the quarter included Japanese company, Persol, making a takeover offer for Programmed Maintenance Services (PRG) of $3.02 per share. Beach Energy also acquired Lattice Energy from Origin Energy for $1.585b.

Australian Equities Fund

The Antares Australian Equities Fund returned 1.1% (net of fees) for the September quarter, outperforming its benchmark S&P/ASX 200 Accumulation Index return of 0.7% by 0.4%. The main contributors to quarterly performance relative to the benchmark were overweight positions in Santos and Rio Tinto and an underweight position in Commonwealth Bank. The main detractors from relative performance were underweight positions in BHP Billiton and South32 and an overweight position in Vocus Group.

Dividend Builder

Antares Dividend Builder delivered a return of 0.1% (net of fees) for the September quarter, outperforming the benchmark S&P/ASX 200 Industrials Accumulation Index return of -0.9% by 1.0%. The main contributors to quarterly performance relative to the benchmark were overweight positions in Iron Mountain and Wesfarmers and an underweight position in Commonwealth Bank. The main detractors from relative performance were overweight positions in Crown Resorts, Suncorp Group and AMP.

Elite Opportunities Fund

The Antares Elite Opportunities Fund delivered flat performance (net of fees) for the September quarter, underperforming the benchmark S&P/ASX 200 Accumulation Index return of 0.7% by 0.7%. The main contributors to quarterly performance relative to the benchmark were overweight positions in Santos and Rio Tinto and an underweight position in Commonwealth Bank. Being underweight BHP Billiton detracted from relative performance along with the Fund's overweight positions in Vocus Group and Healthscope.

High Growth Shares Fund

The Antares High Growth Shares Fund returned 1.7% (net of fees) for the September quarter, outperforming its benchmark S&P/ASX 200 Accumulation Index return of 0.7% by 1.0%. Contributing positively to quarterly performance relative to the benchmark were overweight positions in Santos and South32 and an underweight position in Commonwealth Bank. The main detractors from relative performance were overweight positions in Healthscope and Vocus Group and an underweight position in National Australia Bank.

Australian Shares Fund*

The Antares Australian Shares Fund delivered a return of 1.2% (net of fees) for the September quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 0.7% by 0.5%. The main contributors to quarterly performance relative to the benchmark were overweight positions in Santos and Rio Tinto and an underweight position in Commonwealth Bank. The main detractors from relative performance were underweight positions in BHP Billiton and South32 and an overweight position in Vocus Group.

Listed Property Fund

The Antares Listed Property Fund delivered a return of 2.6% (net of fees) for the September quarter, outperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index return of 1.7% by 0.9%. Positively contributing to quarterly performance relative to the benchmark were overweight positions in Asia Pacific Data Centre Group, Abacus Property Group and Iron Mountain. The Fund's relative performance was negatively impacted by an overweight position in Westfield Corporation and underweight positions in Mirvac Group and GPT Group.

All returns are net of fees. Please refer to page 7 of the Quarterly Review for a summary of returns which are gross of fees.
* Closed to new investments

Antares Investment Returns

Performance to 30 September 2017[1]

		3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Since Inception % p.a.
Australian Equities							
Australian Equities Fund Inception date: 03/07/1995	Net return[2]	1.1	10.0	7.6	9.8	3.9	9.5
	Gross Return[3]	1.4	11.0	8.6	10.8	4.8	10.4
	Benchmark Return	0.7	9.2	7.1	10.1	3.1	9.2
	Net Excess Return	**0.4**	**0.8**	**0.5**	**-0.3**	**0.8**	**0.3**
	Gross Excess Return	**0.7**	**1.8**	**1.5**	**0.7**	**1.7**	**1.2**
Dividend Builder Inception date: 06/09/2005	Net return[2]	0.1	6.5	7.6	11.8	5.8	7.8
	Gross Return[3]	0.3	7.1	8.2	12.5	6.4	8.4
	Benchmark Return	-0.9	7.5	8.6	12.7	4.8	7.5
	Net Excess Return	**1.0**	**-1.0**	**-1.0**	**-0.9**	**1.0**	**0.3**
	Gross Excess Return	**1.2**	**-0.4**	**-0.4**	**-0.2**	**1.6**	**0.9**
Elite Opportunities Fund Inception date: 18/11/2002	Net return[2]	0.0	10.2	8.5	10.8	5.0	10.9
	Gross Return[3]	0.1	11.0	9.3	11.6	5.8	11.7
	Benchmark Return	0.7	9.2	7.1	10.1	3.1	9.1
	Net Excess Return	**-0.7**	**1.0**	**1.4**	**0.7**	**1.9**	**1.8**
	Gross Excess Return	**-0.6**	**1.8**	**2.2**	**1.5**	**2.7**	**2.6**
High Growth Shares Fund Inception date: 07/12/1999	Net return[2]	1.7	10.0	9.5	11.1	5.1	10.9
	Gross Return[3]	2.0	11.2	10.6	12.3	6.4	12.4
	Benchmark Return	0.7	9.2	7.1	10.1	3.1	7.9
	Net Excess Return	**1.0**	**0.8**	**2.4**	**1.0**	**2.0**	**3.0**
	Gross Excess Return	**1.3**	**2.0**	**3.5**	**2.2**	**3.3**	**4.5**
Australian Shares Fund Inception date: 25/01/2000	Net return[2]	1.2	10.1	7.4	9.7	3.9	8.3
	Gross Return[3]	1.4	11.0	8.3	10.6	4.8	9.2
	Benchmark Return	0.7	9.2	7.1	10.1	3.1	8.0
	Net Excess Return	**0.5**	**0.9**	**0.3**	**-0.4**	**0.8**	**0.3**
	Gross Excess Return	**0.7**	**1.8**	**1.2**	**0.5**	**1.7**	**1.2**
Listed Property							
Listed Property Fund Inception date: 28/02/1994	Net return[2]	2.6	-3.0	11.5	12.2	1.2	8.1
	Gross Return[3]	2.8	-2.3	12.3	13.0	1.9	8.8
	Benchmark Return	1.7	-2.8	12.2	13.0	-0.3	7.5
	Net Excess Return	**0.9**	**-0.2**	**-0.7**	**-0.8**	**1.5**	**0.6**
	Gross Excess Return	**1.1**	**0.5**	**0.1**	**0.0**	**2.2**	**1.3**

Disclaimer:

[1] Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document.

[2] Investment returns are based on exit prices, and are net of management fees and assume reinvestment of all distributions.

[3] Gross returns are provided to show performance against the investment objective.

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