Quarterly report

Prepared for Antares Core Opportunities Model Portfolio

September 2014

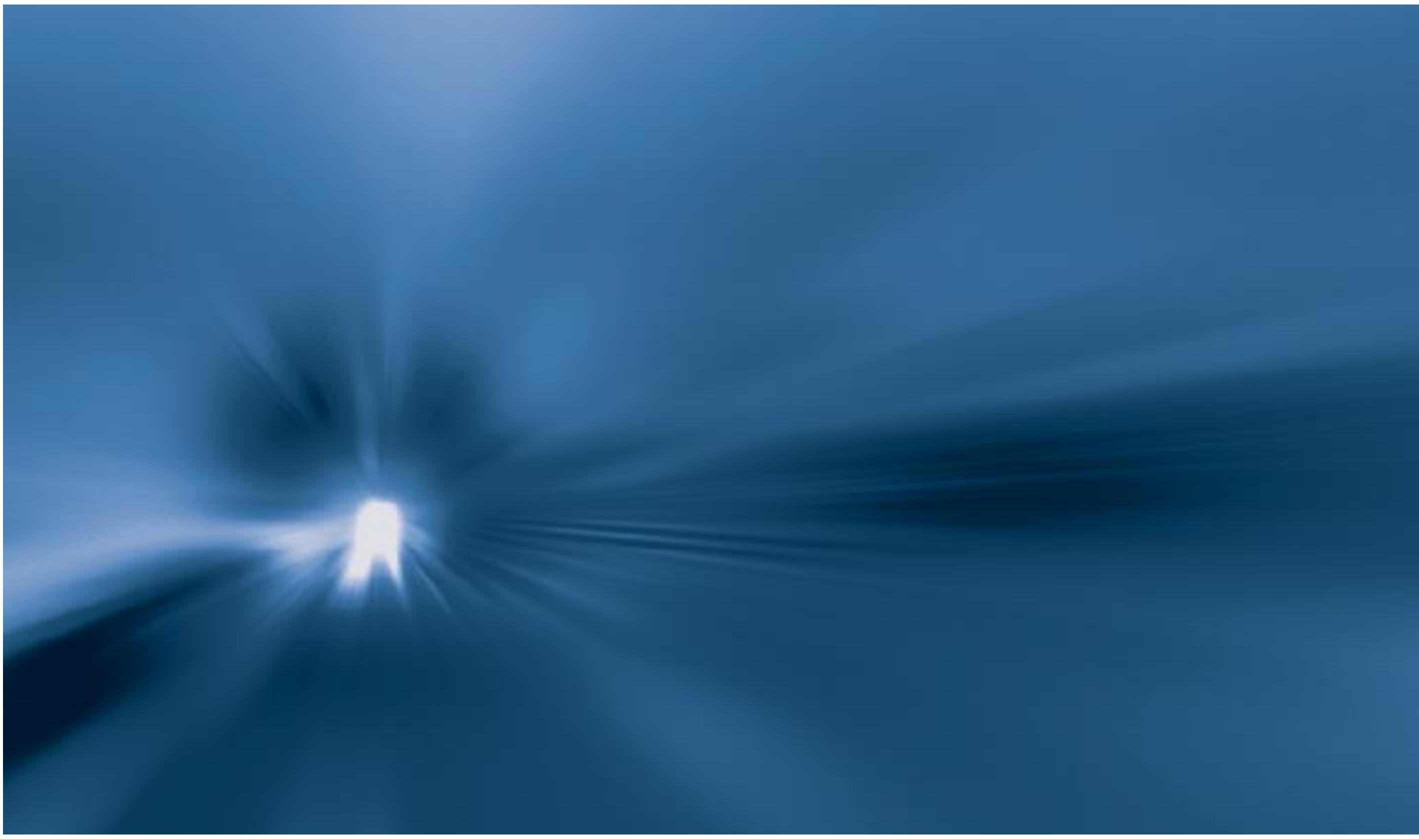

Table of contents

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Quarter in review

The Australian sharemarket ended the quarter modestly weaker, despite performing quite well in July and August. The S&P/ASX 200 Accumulation Index was down 0.6%, led by weakness in the bank sector (-4.5%) due to concerns about the possibility of regulatory intervention in lending markets (particularly housing) and possible changes to capital requirements. The materials sector (-2.8%) also underperformed in response to weak Chinese economic data and the 17.4% fall in the iron ore price. Defensive sectors performed relatively well, including consumer staples (+0.5%), REITs (+1.1%) and telecoms (+5.5%). The healthcare sector (+9.4%) outperformed, supported by the fall in the Australian dollar that boosts the foreign currency denominated earnings of these companies.

The August reporting season was generally favourable for the market, with JP Morgan estimates suggesting that 35% of ASX 200 companies beat expectations whereas only 24% disappointed. The ratio of positive to negative earnings surprises rose to 1.46 from 0.94 in the February reporting season. The main themes from the reporting season included:

- challenging trading conditions in the domestic economy that are continuing to make top line growth hard to achieve;
- companies remain focused on cost cutting to achieve earnings growth given the sluggish domestic economy;
- returning cash to shareholders remains a priority with companies choosing to lift dividends rather than reinvest for growth (Goldman Sachs data shows dividend growth in FY14 of 6.4% which is more than double earnings per share growth of 2.9%);
- significant capital management announcements, such as Telstra's $1 billion off-market share buy-back and Wesfarmers returning $1.1 billion to shareholders along with a special dividend.

Fund performance

The following table shows the performance of the Core Opportunities Model Portfolio relative to its benchmark.

Period	Net fund return[1] %	Benchmark return[2] %	Performance differential %	Gross fund return %
Quarter	-0.4	-0.6	0.2	-0.3
6 months	0.3	0.3	0.0	0.6
1 year	3.8	5.9	-2.1	4.4
3 years p.a.	12.9	14.8	-1.9	13.5
Since Inception p.a. (22/11/2010)	7.5	8.3	-0.8	8.1

[1] Returns are calculated using the market value and income of the Model Portfolio and is net of fees. The performance of individual portfolios may differ to the performance of the Model Portfolio due to cash flows, portfolio reweighting and timing issues.
[2] S&P/ASX200 Accumulation Index.

Quarterly attribution analysis

The major factors **positively** contributing to performance were:

Stocks	Positioning	Basis point contribution[3]
QBE Insurance Group	Overweight	24
Aristocrat Leisure	Overweight	23
Asciano	Overweight	20
Brambles	Overweight	17
Qantas Airways	Overweight	16
Suncorp Group	Overweight	15
Telstra Corporation	Overweight	14
Westpac Banking Corporation	Underweight	13
AMP	Overweight	12
ALS	Not owned	11

The major factors **negatively** contributing to performance were:

Stocks	Positioning	Basis point contribution[3]
CSL	Not owned	-31
ANZ Banking Group	Overweight	-18
Oil Search	Overweight	-17
Coca-Cola Amatil	Overweight	-11
WorleyParsons	Overweight	-11
Amcor	Not owned	-11
Insurance Australia Group	Not owned	-10
Lend Lease Group	Not owned	-7
Caltex Australia	Not owned	-7
Alumina	Not owned	-7

[3] Approximate basis point contributions and are not additive.

Major factors contributing to performance

Performance

The Core Opportunities Model Portfolio returned -0.4% (net of fees) for the September quarter, outperforming its benchmark, the S&P/ASX 200 Accumulation Index that returned -0.6%.

Contributors to performance

Major contributors to performance over the quarter included:

- **QBE Insurance Group** (QBE, overweight) – QBE pre-announced an earnings downgrade in July (reserve increases in Latin America, downgrades to gross written premium and insurance margins) and then performed well after its earnings were finally released in August. The main reason for the strong performance was the announcement of a discounted institutional placement to raise $650 million which was strongly subscribed and has performed well. The placement was used to replace some of the company's convertible bonds on issue hence it also improved the strength of QBE's balance sheet.
- **Aristocrat Leisure** (ALL, overweight) – The Portfolio benefited from its overweight position in ALL which announced the sale of its Lotteries division to UK based Playtec for €10.5 million in cash. S&P also announced that it had assigned ALL a credit rating of BB with a stable outlook which will support the debt facility that ALL required for its recent acquisition of Video Gaming Technologies.
- **Westpac Banking Corporation** (WBC, underweight) – The Portfolio is underweight Westpac Banking Corporation and this contributed positively to performance as the bank sector was very weak, falling 4.5% in the quarter. This was mainly due to investor concerns about the possibility of regulatory intervention in lending markets (particularly housing) and possible changes to capital requirements in the wake of the Murray Inquiry.

Major detractors from performance during the quarter included:

- **CSL** (CSL, not owned) – CSL performed strongly after reporting a better than expected earnings result, strong guidance for FY15 and a $950 million share buy-back. The stock also benefited from the weaker Australian dollar which increases the value of its offshore earnings. This detracted from performance as the Fund does not hold a position in CSL given it looks very expensive on our valuation metrics.
- **ANZ Banking Group** (ANZ, overweight) – The Portfolio's overweight position in ANZ detracted from performance as the bank sector was very weak, falling 4.5% in the quarter. This was mainly due to investor concerns about the possibility of regulatory intervention in lending markets (particularly housing) and possible changes to capital requirements in the wake of the Murray Inquiry.
- **Oil Search** (OSH, overweight) – The Portfolio's overweight position in Oil Search underperformed despite the company releasing a favourable 2Q14 product update and a better than expected 1H FY14 earnings result. Production rose 120% relative to the previous quarter, with revenue almost doubling. This reflects the early start-up of PNG LNG. The stock was negatively affected by weakness in the oil price (-16.9% in the quarter) as supply constraints eased with two oil fields being re-opened in Libya and the possibility of more oil being exported from Northern Iraq.

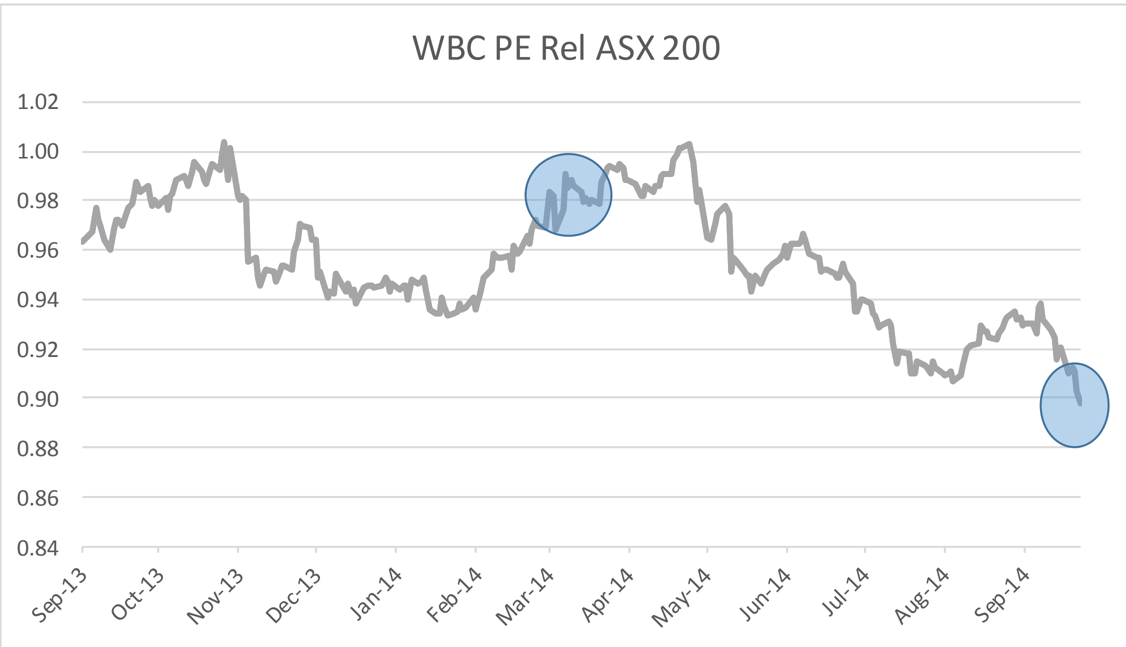
Portfolio Activity

Major purchases / additions to the portfolio:

Exposure to **QBE Insurance Group** (QBE) was increased as the Portfolio participated in QBE's discounted institutional placement to raise $650 million which was strongly subscribed and has performed well. The placement at $10.10 was used to replace some of the company's convertible bonds on issue hence it also improved the strength of QBE's balance sheet.

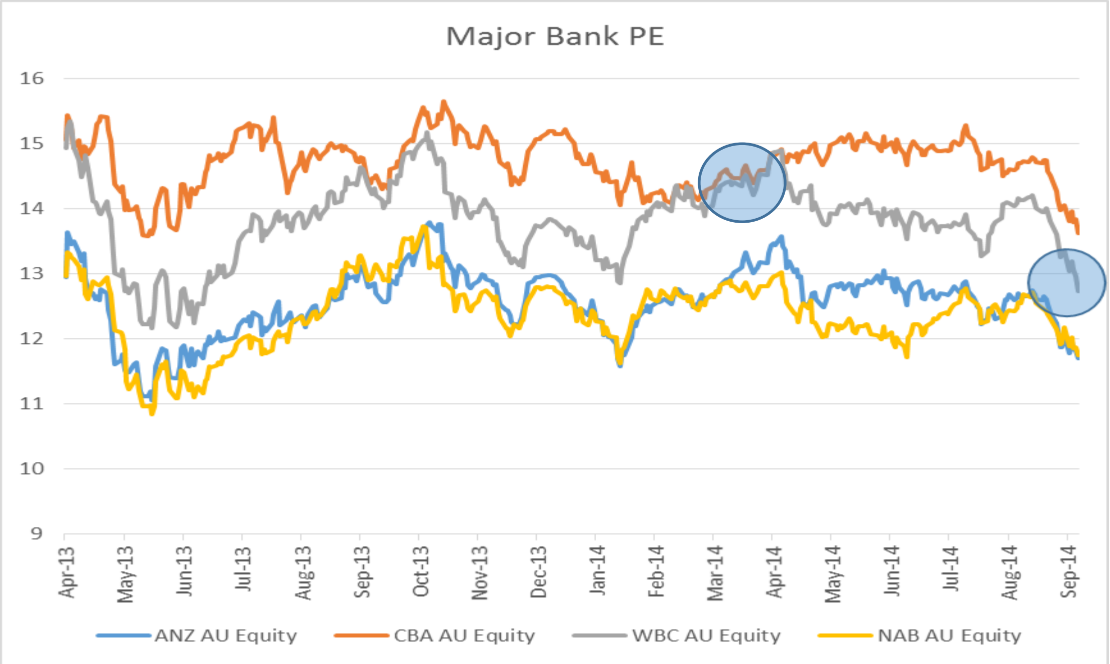
We took advantage of the sharp fall in bank shares during the month, to re-purchase a position in **Westpac Banking Corporation** (WBC), however the Portfolio remains significantly underweight in WBC. We sold WBC earlier in the year when its PE was trading in line with the overall market (see Chart 1 below) and at similar levels to Commonwealth Bank which is viewed as the premier bank of the four majors (see Chart 2 below).

Chart 1: Westpac PE relative to the ASX 200



Source: Bloomberg

Chart 2: PE of the four major banks



Source: Bloomberg

Since then, the weakness in WBC's share price has seen its PE fall to a discount relative to the market and CBA (Charts 1 & 2) hence we purchased some stock on valuation grounds to reduce the size of our underweight position.

Major sales / reductions to the portfolio:

Exposure to **BHP Billiton** (BHP) was reduced. BHP delivered an earnings result that was broadly in line with expectations but the big news was the company's decision to spin off a number of smaller (non-core) businesses into a new listed entity that will potentially have dual listing on the ASX and in South Africa. This spin off leaves BHP to focus on its large, core iron ore, copper, coal, petroleum and potash divisions. Whilst we view this as a positive development, we were disappointed that the management team in the new entity are not operating staff. We (and the market) also expected BHP to announce other capital management initiatives which did not occur. This prompted us to move from an overweight to an underweight position in BHP.

Outlook and strategy

Outlook

The US economy now appears to be on a more solid footing, with most recent key data releases being generally stronger than expected. Although the August employment report was on the weak side, other labour market indicators remain robust. Quantitative easing (QE) is set to end in October hence investors will remain focused on the timing of the first interest rate rise. After its last policy meeting, the US Federal Reserve (Fed) stated the following with respect to its outlook for monetary policy:

"...it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase programme ends, especially if projected inflation continues to run below the Committee's 2% longer-run goal."

This suggests inflation developments will be particularly important in determining the future path of official US interest rates.

The outlook for the Australian economy is little changed, with the subdued consumer presenting a risk to demand in the second half of the year. Although very low domestic interest rates will continue to support growth, any slowing in consumer demand will make current growth forecasts hard to achieve given the likelihood of significantly weaker business investment as a result of the slowdown in the mining sector. The Reserve Bank of Australia (RBA) has held a neutral policy stance since its February Board meeting and this was reiterated in early October.

Whilst the August reporting season was generally favourable, most Australian companies are not experiencing any pick-up in revenue growth and the main driver of earnings – cost cutting – is not sustainable over the longer term. High dividend payouts and capital management initiatives continue to suit investors but ultimately revenue growth is required for the market to perform well on a longer term view.

The main driver of profit growth continues to be cost cutting but it appears that most of the major cost-out initiatives have already been announced. In this reporting season, cost announcements tended to be about smaller, incremental cost savings, rather than massive cost reduction plans. There is a limit to how far costs can be cut in any organisation. If cost cutting goes too far, it can ultimately affect a company's ability to do business and/or hinder its prospects for future growth. Whilst most Australian companies are not yet at this point, cost cutting has been a major feature of the reporting season for several years now, hence it is less likely that it will remain so dominant in the future.

Whilst the Australian share market will continue to be supported by very low domestic interest rates, the situation in China is causing uncertainty for the resource sector, particularly those companies exposed to iron ore. If the domestic trading environment remains challenging and cost reduction initiatives are close to exhaustion, we would question whether companies will achieve current FY15 earnings forecasts. Some downgrades to FY15 earnings have already commenced in the broker market as continued weak revenue growth, coupled with more limited cost cutting opportunities, are expected to put downward pressure on margins.

Strategy

The Portfolio's main overweight position continues to be in **resource stocks** including **Rio Tinto** and **Iluka Resources**. The Portfolio also has exposure to the mining services sector through an overweight position in **WorleyParsons**.

Companies that have a high proportion of their revenues denominated in US dollars are the main beneficiaries of $A weakness as a falling $A increases the value of revenues from an Australian accounting perspective. Within the Portfolio we currently have significant overweight positions in **Computershare** and **Brambles** which should benefit from this theme as they all have at least 50% of their revenues denominated in $US. Our overweight positions in Australia's major resource stocks should also benefit from ongoing $A weakness for the same reason.

The Portfolio is overweight selected **industrial cyclical stocks** such as **BlueScope Steel, Brambles** and **Qantas Airways** that will benefit from stronger growth and are also experiencing significant structural changes which have improved their fundamental valuations.

The Portfolio is overweight market linked earners with our main positions being in **Computershare** and **AMP**. These stocks are highly leveraged to stronger equity market performance and rising risk appetite. These stocks should also benefit from any increase in demand for equities as institutional and retail investors re-weight their portfolios back in favour of equities.

The Portfolio is largely underweight defensive stocks. The main exceptions are **Wesfarmers** and **Telstra** where we remain overweight as these stocks have strong businesses that we believe will continue to perform well over the longer term for stock specific reasons.

The Portfolio remains underweight **bank stocks**. At this stage of the cycle we feel that the banks are over earning and, although it is difficult to predict when earnings will normalise, we feel that they inevitably will. The main area of over earning stems largely from provisions, which have now been reduced to well below long term averages.

We feel there is better value in the **insurance sector** where we are now over 5% overweight, driven by our holdings in **AMP, Suncorp Group** and **QBE Insurance Group**.

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