Professional Selection

Quarterly Review

Antares Ex-20 Australian Equities SMA

September 2015

Welcome to an overview of our new strategy, the Antares Ex 20 Australian Equities SMA portfolio. It is an exciting strategy, offering the liquidity of the larger part of the market, combined with the growth and diversification offered by smaller companies. It is designed to be blended with your existing large company investments to provide some genuine diversification. It targets where the economy is going, not just where it has been.

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.

What is an "Ex-20" strategy?

An "Ex-20" strategy is one that invests in companies listed on the Australian Securities Exchange (ASX) that are outside the S&P/ASX 20 Index (ASX 20). In other words, it excludes the very largest companies listed on the Australian sharemarket.

Why is Ex-20 a good place to invest?

There are three reasons why Antares believe an "Ex-20" strategy is a good one for many of our investors:

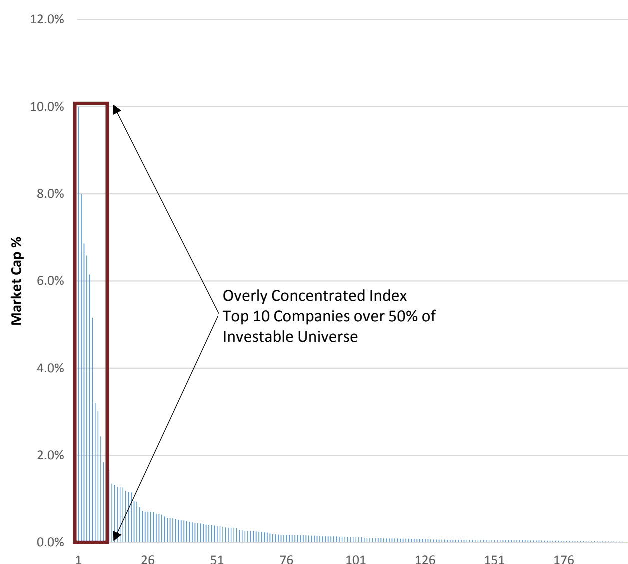
- differentiation;
- diversification;
- growth & disruption – aggressive not defensive holdings.

Let us now spend a little time discussing each of these points.

Differentiation

The Australian sharemarket is quite unusual by global standards as a relatively small number of very large companies dominate our market by their size. As the following chart shows, the top 10 companies by market capitalisation make up over 50% of the investable universe in terms of dollars.

Chart 1: ASX 200 universe by market capitalisation



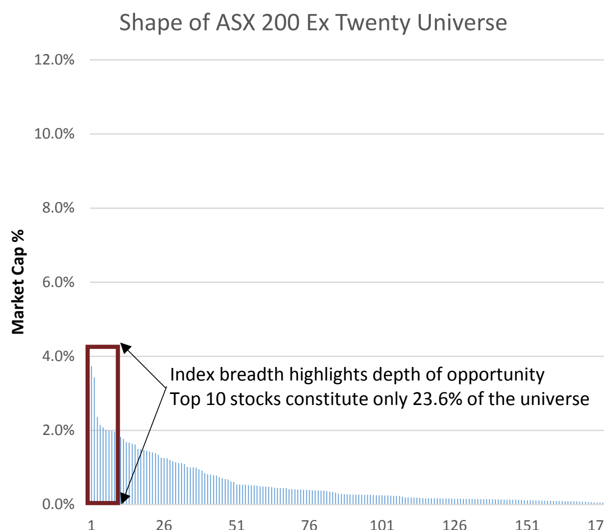
Source: Antares, ASX

Why is this important? Well, it means that while investors are expecting active management of their portfolios, fund managers can be forced to deploy large chunks of capital into "passive" positions determined more by a company's size than its expected return.

This makes it quite difficult to differentiate returns for investors. As is well-known, most Australian share strategies measure success in terms of differentiating their returns against an index, typically the S&P/ASX 200 Accumulation Index (ASX 200). This provides the "average" return generated by the market over a given period. As Chart 1 shows, this index is dominated by a few very large companies.

Chart 2 shows that the investable universe excluding the top 20 stocks is much more even when it comes to size. Far less is invested into passive positions demanded by very large unequal weightings. Hence management of an Ex-20 strategy is far more "active" and so reliant on the skill of our team.

Chart 2: ASX 200 ex 20 universe by market capitalisation



Source: Antares, ASX

For this reason, we believe that an Ex-20 strategy offers genuine differentiation of returns in a blended portfolio.

Diversification

We all agree that diversification is a good thing for investing. It helps smooth out the bumps and provides access to growing returns while reducing the risk of an industry going bad. An interesting aspect of the ASX 20 is the concentration of particular industries included in it.

At present, the ASX 20 includes 4 banks, 3 insurance companies, 2 mining companies, 2 supermarkets and a giant telecommunications company. It is heavily weighted to financial services, as well as incumbent monopolies or duopolies.

Hence a mainstream ASX 200 fund will inadvertently expose itself to a high level of correlated risks. For instance, financial services, which constitute seven of the top twenty stocks, are heavily regulated, so government action can really impact a large proportion of the market. Indeed, banks have recently come under heavy selling pressure as regulators force them to hold more capital on their balance sheets to protect them from shocks such as those seen in 2007/2008.

Thus far, we have focused on these risks associated with the ASX 20. By contrast, the Ex-20 Index is not nearly as concentrated in its exposure, and offers far more diversification than a conventional Australian Equities Fund. However, to this point, we have ignored a major benefit of the Ex 20 space. Growth.

Growth and disruption

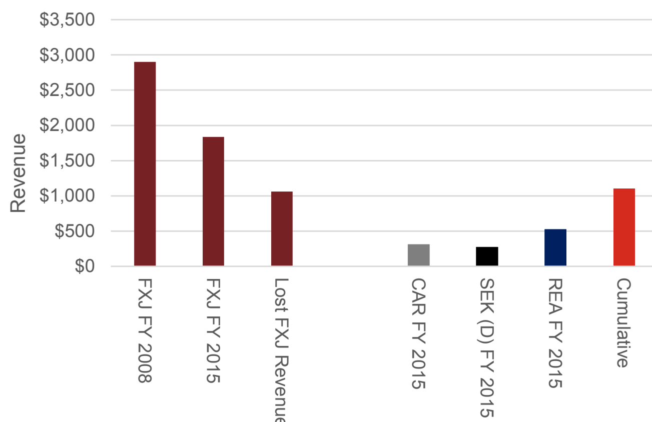
How do large companies grow? How do they make that growth meaningful to their investors? These are important questions for investors in equity markets because it is growth that is being sought. Investors take more risk in exchange for potentially better returns over time, driven by growth.

Companies rise and fall - that is the nature of our system. As is well-known, only GE has been in the Dow Jones Industrial Index since its inception in 1896. Over time, incumbents are challenged. Some rise to the challenge, others fall by the wayside.

It is in the Ex-20 space that an investor is most likely to find the challengers to today's incumbents. Over the past 5 years would an investor have done better in Fairfax Media (FXJ) or the companies that challenged FXJ's once dominant position in classified advertising?

As the following chart highlights, since 2008, revenues at FXJ have fallen by just over A$1.0bn. The decline is due to the loss of FXJ's dominant position in classified advertising, the so-called "rivers of gold." FXJ, like most large incumbent businesses, did not recognise the threat to its business model. In this case, the internet.

Chart 3: Classified case study - revenue



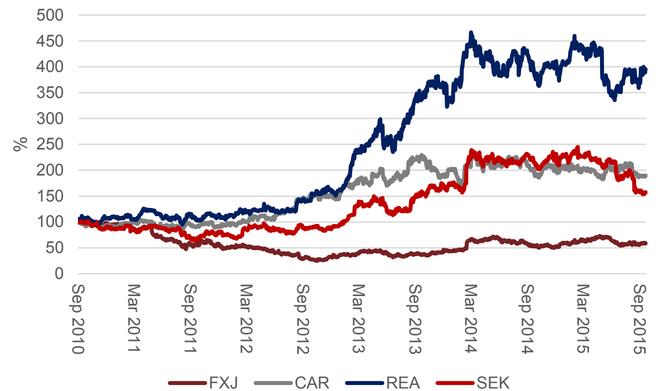
Source: Antares, Company data

Its three dominant classifieds categories, car sales, job ads and real estate, were attacked by new challengers with purely on line advertising models. Not only were these adverts cheaper to produce, they provided more scope for content, and better accessibility for those looking to buy the product. In addition, accessibility was free.

As we can see from Chart 3, these challengers - Carsales.com, REA Group (real estate) and Seek - had cumulative revenues equivalent to the revenue lost in the same period by FXJ. Hence now all three are successful businesses while FXJ is still looking to understand its role in the world.

The obvious outcome of this revenue swap is to be seen in the share price performance of all four businesses. While FXJ shares have fallen consistently, all three online classified providers have delivered significantly positive results. Not only was revenue exchanged, so was shareholder value.

Chart 4: Classified media share prices

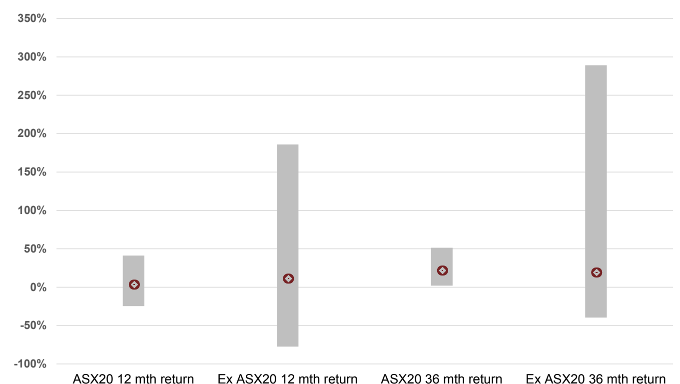


Source: Bloomberg

This is the exciting thing about the Ex-20 universe. It contains the companies most likely to be the leaders of the future. They tend to take market share, not have to defend it. And the sharemarket will always reward companies that take market share, and punish those that lose it.

It is true that on average over recent years the returns of smaller companies have been outstripped by those available from larger ones. There are reasons for this, but as the following chart shows, with quality research and skilled stock picking, returns from the Ex-20 space that were available were demonstrably higher than for the mainstream ASX 20.

Chart 5: Minimum, maximum and average returns



Source: Antares, ASX

The Antares Ex-20 strategy and why it works

There are two reasons why Antares has created an "Ex-20" strategy for our investors:

- we believe it is a good place to invest;
- we believe our management of this strategy will deliver superior results to our clients.

We have discussed our beliefs in the merit of the Ex-20 space above. We believe it is an exciting option for our clients. But why Antares?

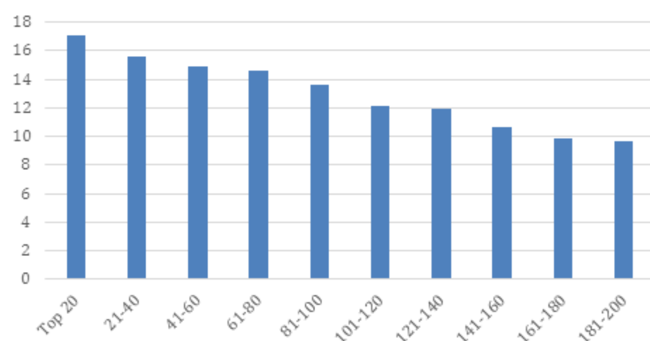
Competitive advantage

Antares has a large team of dedicated analysts. We offer investors deep and universal coverage of all stocks in the top 120 listed companies on the ASX. In addition, we have a dedicated small company team. Both teams are highly regarded and have the results to prove it.

Investing outside the top 20 stocks means that there is far more reliance on internal research and stock picking.

As the following chart highlights, commonly-available external sources of research into companies, such as stock broker research, declines as the size of a company declines.

Chart 6: Average sell-side analyst coverage of stocks



Source: Bloomberg

Given our deep and experienced team, combined with a long track record of good results, across both the large and small company sectors, we believe we offer a competitive advantage in this space. We have the resources to find and research these ideas properly.

Antares investment philosophy

Markets are imperfect and this provides opportunities for excess returns. Participants often display herd-like tendencies. This herding is the source of much imperfection and corresponding opportunities if you are prepared to invest against it.

Absolute return mindset

Our philosophy is to invest only where we believe a positive return is available for our investors. While we are benchmarked to the S&P/ASX 200 ex 20 Accumulation Index, this is because it is our belief that equity markets rise in value over time.

Fully invested

We remain fully invested as we do not believe it is appropriate for us to try to “time the market” on our clients’ behalf. If we believe equities offer better returns than cash, why would we reduce our expected return with cash? And secondly, our investors are paying us to find stocks for them, not to hoard cash.

Concentrated

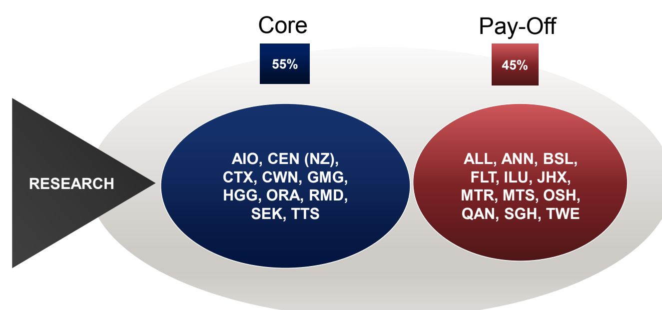
Our portfolio is concentrated, with no more than 25 stocks, but typically 20. Again, we are looking for companies we believe are undervalued in an absolute sense. We are not investing into a company because it is in our benchmark. If we have no conviction that the share price is going to go up, why waste capital on it?

How we build the Antares Ex-20 portfolio

Core and pay-off stocks

The Antares Ex-20 Australian Equities SMA portfolio is built around a selection of core names. These companies exhibit higher quality attributes and provide a lower risk core around which we can invest into higher returning but potentially more risky stocks without being imprudent. We term these latter stocks “pay-off” as they are seen as a risk-return payoff. There is no strict allocation of capital between these groups, rather, it is determined by the expected returns of each subset relative to the risk involved.

Chart 7: Ex-20 core and pay-off stocks



Source: Antares, Investments as at 30 September 2015

Core stocks

These stocks are in our portfolio to underwrite returns to our investors through the cycle. We expect turnover of these names to be low. They have been identified by our research as having attractive expected returns but also displaying higher quality attributes. These include, but are not limited to, the following:

Industry Structure

A core stock will typically operate in industries that offer reasonable returns but importantly, they should be stable, not cyclical.

There should be reasonable barriers to entry if the business is an incumbent or the stock will have some form of competitive advantage that allows it to disrupt the status quo and take the attractive return profile for itself. We are open to either scenario.

We also consider other risks when looking at industry structure, such as where there is evidence of disruption in other markets like the one we are focusing upon, or whether there are likely to be any macro industry changes, e.g. around regulation.

Revenue stability

We would expect these companies to display stability at the revenue line – costs can be managed with competent management but volatile revenue is low quality. Ideal is of course some form of exclusive licence but these can be very expensive and not always worth it from a returns perspective. So we look at revenue history.

Volatility in particular lines of revenue can be overcome via diversification. Whilst a company may operate in a volatile industry, it may be that it has sufficient diversification to ensure a more stable revenue line.

Operating leverage and cash conversion

We would expect the company to be geared but not heavily – the exact amount would depend on the stability of its revenues and returns.

We would also expect a core company to have little issue converting its profits into cash – accruals and cash conversion (operating cash flow to EBITDA) are used to assess this.

Environmental, social and corporate governance (ESG)

We would expect a core company to have stable management, with depth in senior ranks. We would also prefer moderate tenure – too long can be worse than insufficient experience.

A core company should have an independent board, with appropriate experience and structures to oversee our investors' capital.

We would also expect a core company to have few risks to its social licence to operate. It should be a core skill to manage this.

Pay-off stocks

The balance of the portfolio is used to generate higher returns by investing with more of a focus on expected returns, with higher risk tolerance.

These companies will typically be of a more contrarian nature featuring unloved and turn around names. The role of these companies is to provide significant excess returns in exchange for higher risk. Hence "pay off". Turnover of these names is likely to be high.

Portfolio construction

Idea generation

Our ideas are generated organically: valuation – when our internal research identifies undervalued stocks; though meetings – with either the company itself, its peer, its competitor etc. There is no limit to how this can generate ideas for us as we are research intensive in our process. Finally, ideas can be generated by third-parties, such as the traditional source of investment banks.

Stock weightings

We have a theoretical starting position of equal weighting across all stocks ("par weight") but the actual weighting of each stock will be determined by Portfolio Manager.

Key factors in determining stock weightings include:

- expected returns
- liquidity

Secondary factors in determining stock weightings include:

- volatility
- risk correlation
- change in circumstance is a sell-trigger

Chart 8: Ex-20 portfolio construction

Process

- Simple process that is benchmark agnostic, keeping with the stock driven philosophy

Stock selection considerations

- Ideas generated organically: valuation / meetings / third-parties
- Theoretical starting position of equal weighting across all stocks (par weight)
- Actual weighting of each stock will be determined by Portfolio Manager

Key Factors in weightings

- Expected returns
- Liquidity

Secondary Factors

- Volatility
- Risk correlation
- Change in circumstance is a sell-trigger

Small companies

- Small, volatile companies will be lower weighted despite higher expected returns to manage risk

Source: Antares

Positioning

While it is our preference to build the portfolio around stock-picking and bottom up, we are also conscious of investing with certain trends, and not against them. If things are working in our favour in a macro sense, it is easier to find winners.

One macro trend we have identified that is a key component of our portfolio is the experiential economy. We believe consumers are increasingly preferring experiences to consumer goods. To give an example, we have reasonable positions in Crown Resorts, Flight Centre, Mantra Group and Qantas Airways. All these stocks help provide experiences to their clients.

We have also witnessed a 10-year bull market in commodities come to an end. Supply has finally caught up to, and superseded, demand. Hence we have invested into companies that use commodities and should benefit in margins from their falling prices. These include Ansell (raw materials such as cotton and latex), Aristocrat Leisure (US consumers and falling oil prices), BlueScope Steel (falling iron ore and coal prices into Colourbond) and, of course, Qantas Airways.

Otherwise, we prefer to avoid too many macro themes. These can become crowded trades and we are not experts in macro trends.

Antares market & Fund updates

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

Australian sharemarket review

The Australian sharemarket followed global markets lower, with the S&P/ASX 200 Accumulation Index ending the quarter down 6.6%. The market was impacted by growth fears in China, the sell-off in emerging markets and uncertainty over monetary policy tightening in the US. The weakest sectors were energy (-24.1%) and resources (-16.3%) in response to further falls in commodity prices. The banks (-11.3%) also underperformed significantly as the announcement of more large capital raisings weighed heavily on sentiment.

The weakness in the Australian dollar (-9.0%) supported the industrial (+3.4%) and healthcare (-0.5%) sectors. Defensive sectors such as utilities (+2.4%), consumer staples (+1.5%) and REITs (+1.1%) also outperformed given the uncertain global environment.

The August reporting season was mixed, however, there was a clear trend towards earnings downgrades for FY16 as companies are continuing to find the current trading environment very tough. Capital management remained a dominant theme, particularly capital raisings and share buybacks.

Merger and acquisition activity was a focus, with Asciano (AIO) agreeing to a takeover bid launched by Canadian based Brookfield Infrastructure Group valued at $8.9 billion. This comprises cash of $6.94 and 0.0387 Brookfield shares for each AIO share. Utility company DUET also announced its proposal to acquire 100% of the shares in Energy Developments (ENE) which would be financed via a $550 million placement.

Corporate activity was also evident in the energy sector, with Woodside Petroleum (WPL) launching a takeover bid for Oil Search (OSH). The all stock bid (0.25 WPL share per OSH share) was valued at $11.6 billion but it was rejected by the OSH Board. Origin Energy (ORG) went into trading halt at the end of the quarter and announced a $2.5 billion equity raising in response to the weak oil price environment.

Australian Equities Fund

The Antares Australian Equities Fund returned -7.9% (net of fees) for the September quarter, underperforming its benchmark S&P/ASX 200 Accumulation Index return of -6.6% by 1.3%. The main contributors to performance for the portfolio over the quarter were an overweight position in Asciano and an underweight position in Origin Energy. Overweight positions in Santos and Orica detracted from performance.

Dividend Builder

Antares Dividend Builder delivered a return of -6.2% (net of fees) for the quarter, underperforming the benchmark S&P/ASX 200 Industrials Accumulation Index return of -4.8% by 1.4%. The main contributors to performance for the portfolio over the quarter were an overweight position in Sydney Airport and an underweight position in Commonwealth Bank. The main detractors from performance over the quarter were an overweight position in ANZ Banking Group and the decision not to hold a position in CSL.

Elite Opportunities Fund

The Antares Elite Opportunities Fund returned -5.4% (net of fees) for the quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of -6.6% by 1.2%. The main contributors to performance for the portfolio were overweight positions in Asciano and Qantas Airways. The main detractors from performance over the quarter were an overweight position in Santos and the decision not to hold a position in CSL.

High Growth Shares Fund

The Antares High Growth Shares Fund returned -3.7% (net of fees) for the quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of -6.6% by 2.9%. Contributing positively to performance during the September quarter were overweight positions in Asciano and Sydney Airport. The main detractors from performance were an underweight position in CSL and an overweight position in Santos.

Small Companies Fund

The Antares Small Companies Fund delivered a return of 0.4% (net of fees) for the quarter, outperforming the benchmark S&P/ASX Small Ordinaries Accumulation Index return of -3.9% by 4.3%. The main contributors to performance for the portfolio was the decision not to hold a position in Liquefied Natural Gas that performed poorly. An overweight position in APN Outdoor Group also contributed positively to performance. Detracting from performance were overweight positions in Drillsearch Energy and Western Areas.

Australian Shares Fund*

The Antares Australian Shares Fund delivered a return of -8.1% (net of fees) for the quarter, underperforming the benchmark S&P/ASX 200 Accumulation Index return of -6.6% by 1.5%. The main contributors to performance for the portfolio over the quarter were an overweight position in Asciano and an underweight position in Origin Energy. Overweight positions in Santos and Orica detracted from performance.

Listed Property Fund

The Antares Listed Property Fund delivered a return of 1.8% (net of fees) for the quarter, outperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index return of 1.1% by 0.7%. Positively contributing to performance during the quarter were overweight positions in Sydney Airport and Westfield Corporation. The Fund's performance was negatively impacted by an overweight position in Stockland and an underweight position in Scentre Group.

All returns are net of fees. Please refer to page 6 of the Quarterly Review for a summary of returns which are gross of fees.
* Closed to new investments

Quarterly Review

Antares Investment Returns

Performance to 30 September 2015[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]	-7.9	-0.9	8.3	6.1	5.9	9.2
	Gross Return[3]	-7.7	-0.1	9.2	7.1	6.8	10.2
	Benchmark Return	-6.6	-0.7	9.4	6.5	5.3	9.0
	Net Excess Return	**-1.3**	**-0.2**	**-1.1**	**-0.4**	**0.6**	**0.2**
	Gross Excess Return	**-1.1**	**0.6**	**-0.2**	**0.6**	**1.5**	**1.2**
Dividend Builder Inception date: 06/09/2005	Net return[2]	-6.2	4.8	13.8	11.8	7.2	7.5
	Gross Return[3]	-6.0	5.4	14.5	12.5	7.9	8.2
	Benchmark Return	-4.8	6.1	14.6	11.7	6.7	7.1
	Net Excess Return	**-1.4**	**-1.3**	**-0.8**	**0.1**	**0.5**	**0.4**
	Gross Excess Return	**-1.2**	**-0.7**	**-0.1**	**0.8**	**1.2**	**1.1**
Elite Opportunities Fund Inception date: 18/11/2002	Net return[2]	-5.4	-0.1	9.4	6.4	6.8	10.5
	Gross Return[3]	-5.2	0.6	10.1	7.1	7.5	11.4
	Benchmark Return	-6.6	-0.7	9.4	6.5	5.3	8.8
	Net Excess Return	**1.2**	**0.6**	**0.0**	**-0.1**	**1.5**	**1.7**
	Gross Excess Return	**1.4**	**1.3**	**0.7**	**0.6**	**2.2**	**2.6**
High Growth Shares Fund Inception date: 07/12/1999	Net return[2]	-3.7	4.3	10.4	7.4	7.1	10.7
	Gross Return[3]	-3.4	5.4	11.6	8.5	8.4	12.3
	Benchmark Return	-6.6	-0.7	9.4	6.5	5.3	7.5
	Net Excess Return	**2.9**	**5.0**	**1.0**	**0.9**	**1.8**	**3.2**
	Gross Excess Return	**3.2**	**6.1**	**2.2**	**2.0**	**3.1**	**4.8**
Small Companies Fund Inception date: 19/11/1999	Net return[2]	0.4	-7.3	2.3	3.3	6.5	9.1
	Gross Return[3]	0.7	-6.4	3.3	4.3	7.5	10.2
	Benchmark Return	-3.9	-4.9	-1.2	-2.5	0.4	3.4
	Net Excess Return	**4.3**	**-2.4**	**3.5**	**5.8**	**6.1**	**5.7**
	Gross Excess Return	**4.6**	**-1.5**	**4.5**	**6.8**	**7.1**	**6.8**
Listed Property							
Listed Property Fund Inception date: 28/02/1994	Net return[2]	1.8	19.8	15.4	13.5	4.1	8.1
	Gross Return[3]	1.9	20.7	16.3	14.4	4.9	8.9
	Benchmark Return	1.1	20.3	16.2	13.7	2.2	7.4
	Net Excess Return	**0.7**	**-0.5**	**-0.8**	**-0.2**	**1.9**	**0.7**
	Gross Excess Return	**0.8**	**0.4**	**0.1**	**0.7**	**2.7**	**1.5**

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.

NOTES

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