Quarterly Investment Update

Antares Australian Equities Fund – March 2020

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Highlights for the quarter

Performance: The Fund returned -30.4% (net of fees) for the March quarter, underperforming its benchmark by 7.3%.

Contributors to performance: Positive contributors - Northern Star, Metcash, Amcor, Telstra; Negative contributors – CSL, Santos, Star Entertainment, Worley

Stock activity: Buys/additions – AGL, Aurizon, Computershare, CSL, Metcash, Oil Search, Treasury Wine; Sells/reductions – Caltex, Graincorp, Healius, Link Administration, Woodside, Newcrest, QBE, Qantas, Transurban

Fund snapshot

Inception date	3 July 1995
Benchmark	S&P/ASX 200 Total Return Index
Investment objective	To outperform the benchmark (after fees) over rolling 5-year periods

Investment returns as at 31 March 2020[1]

Period	3 months	1 year	3 years pa	5 years pa	10 years pa	Since inception pa
Net return[2] %	**-30.4**	**-24.2**	**-6.0**	**-1.8**	**3.3**	**7.7**
Gross return[3] %	-30.3	-23.7	-5.3	-1.0	4.2	8.7
Benchmark return %	-23.1	-14.4	-0.6	1.4	4.9	8.2
Net excess return %	**-7.3**	**-9.8**	**-5.4**	**-3.2**	**-1.6**	**-0.5**
Gross excess return %	-7.2	-9.3	-4.7	-2.4	-0.7	0.5

[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.

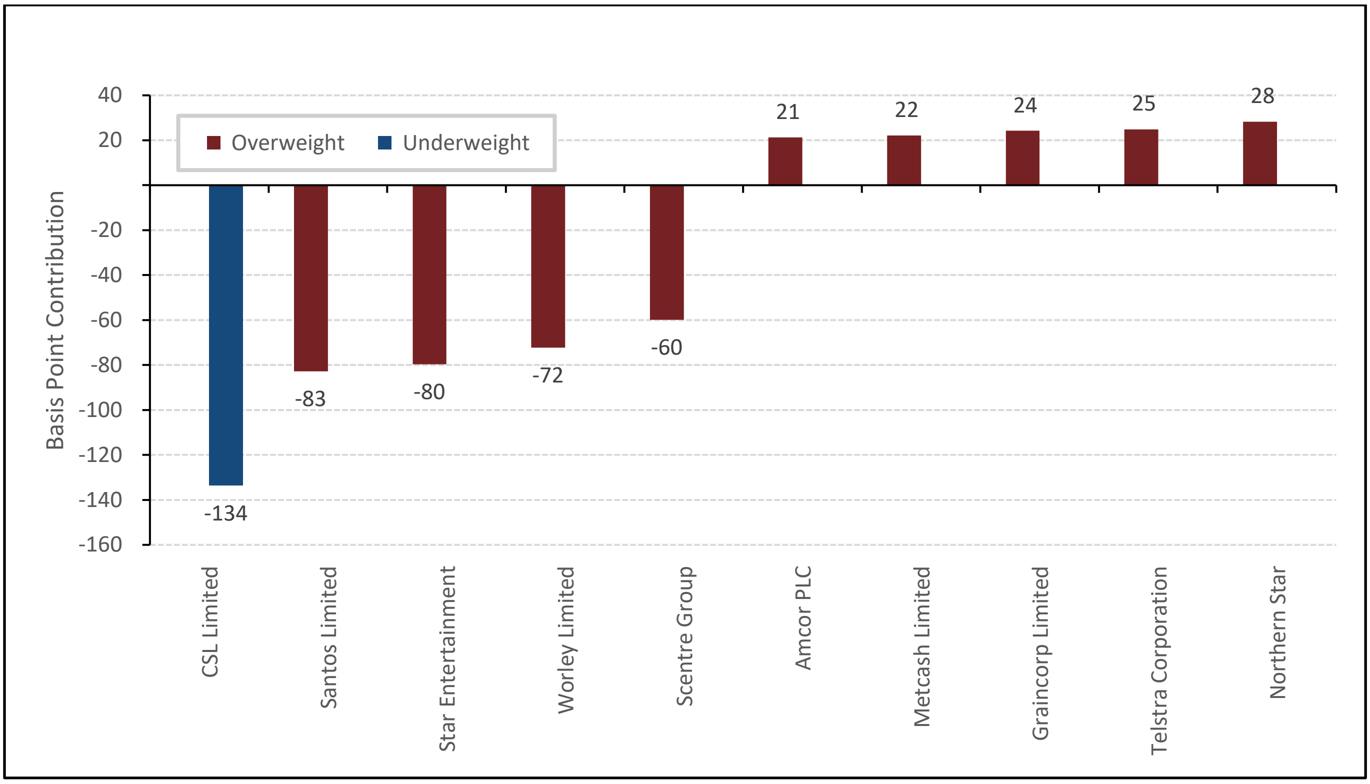
Contributors to performance

Over the quarter as a general principle, our best performing stocks were those we owned with defensive earnings, and the stocks that detracted were those we owned with cyclical earnings, especially where they were exposed to the covid-19 shutdown. Other stocks that detracted were those we did not own that have defensive earnings streams.

Positive

- **Northern Star Resources (NST,** overweight) - The gold bullion price held over the quarter as equity markets were tumbling.
- **Metcash (MTS,** overweight**)** - Metcash rerated over the quarter in the panic induced buying frenzy at supermarkets. Even at current multiples Metcash looks reasonable value, but we do expect last quarter to be peak supermarket sales for quite some time.
- **Amcor (AMC,** overweight**)** - AMC came into favour due to defensive earnings as most of their packaging is for consumer staples and healthcare products.

Chart 1: Fund attribution – March quarter



Source: Antares, March 2020

Negative

- **CSL Limited (CSL, underweight)** - The Fund's underweight position in CSL detracted from performance over the quarter as the healthcare sector was the only sector to post an increase, being generally seen as having defensive earnings characteristics. As we write, CSL has not withdrawn guidance although many other companies have done.
- **Santos (STO, overweight)** - Santos is our preferred oil exposure, however, the disagreement between Saudi Arabia and Russia, which saw both announce expanded production, occurred at a time when global oil demand was falling like a stone. As such the crude price halved in March. We view the current crude price as unsustainably low, however, we have no certainty about when some kind of supply discipline will return.
- **Star Entertainment (SGR, overweight)** - SGR actually reported a good result in February, however, this quickly became irrelevant as rolling bad news impacted overseas players, then domestic players, until finally the gaming rooms were closed. We view the stock as trading at a massive discount to its long term value when gaming returns to the new normal (which is likely to be somewhat lower levels than previous expectations). In the short term substantial uncertainty remains.

Stock activity

Stocks were purchased across diverse sectors. Buying was concentrated in Antares analysts preferred stocks in particular where our analysis revealed substantial valuation upside and where the stocks were trading on low earnings multiples.

Portfolio activity – March 2020	
Buys/additions	• **AGL Energy (AGL)** - We added AGL towards the end of March after its share price fall created attractive fundamentals. The company's earnings are somewhat defensive. • **Aurizon Holdings (AZJ)** - AZJ was sold down very heavily, yet we believe its earnings are fundamentally sound particularly as coal export volumes remain strong. • **Computershare (CPU)** - We added CPU after a guidance downgrade, but before the market sold off sharply. We believe it is a sound business, with a large part of revenue that is not overly cyclical. Given the large share price fall we may further add to this position. • **CSL** - We added to the existing position, to help balance the "risk" characteristics of the portfolio. It nonetheless remains a large underweight.

- **Metcash (MTS**) - Metcash is a wholesale supplier and major retailer in Food, Liquor and Hardware. MTS is capital light as a wholesaler albeit it carries inventory risk, highlighting the high levels of operational leverage. We purchased at an attractive valuation relative to the market. Also, we expect margins are probably at cyclical lows. MTS is a beneficiary of food inflation, should it evolve. It is still trading at a relatively low PE, and currently offers a high yield with defensive earnings.
- **Oil Search (OSH)** - We switched the proceeds of the Woodside sale into Oil Search. Antares views Oil Search as having very high quality assets with good growth options at a fundamentally more attractive valuation.
- **Treasury Wine Estates (TWE)** – We bought TWE after the company gave downgraded guidance prior to releasing their 1H20 result. The downgrade came predominantly from the US commercial business, with Australia and Asia showing growth. Even after the downgrade, TWE is trading on a PE discount to the broader industrials market based on our valuation and still has growth in 2021 and beyond - the long term growth story is intact. While the short term earnings outlook will be impacted by shutdowns, the return to work in China will help exports. We added to the position further in the March sell-off. In addition to the above factors, TWE adds some more international growth exposure to the portfolio.

In summary, most of the sales could be categorised as fully valued. We deployed the funds in stocks with better expected returns, or to help minimise risk in the portfolio by reducing exposure to highly geared or opaque earnings.

Sales/reductions

- **Caltex Australia (CTX)** - We trimmed our overweight position in February. And in hindsight it would have been better to sell more.
- **Graincorp (GNC)** - We were holding Graincorp for the value extraction we expected to be derived from the spin-off of its United Malt business. Once this event occurred we exited the position.
- **Healius (HLS)** - We reduced the position early in the quarter on the announcement of a non-binding indicative takeover proposal by Partners Group. Healius eventually dismissed the proposal, and the share price has fallen substantially in the March sell off.
- **Link Administration Holdings (LNK)** - We reduced our position in Link early in February ahead of its 1H20 results as we were concerned about short term earnings. We switched the proceeds into Computershare to maintain portfolio diversification.
- **Newcrest Mining (NCM)** - With gold stocks holding up well relative to the rest of the market, we took the opportunity to sell out of Newcrest. We have previously discussed NCMs likely declining earnings profile as gold production will fall significantly over the next three years.
- **Woodside Petroleum (WPL)** - We switched from Woodside into Oil Search for better prospective returns after Woodside had substantially outperformed Oil Search.
- **Qantas Airlines (QAN)** - We sold Qantas during March. While we are confident there will be an Australian airline industry, we are just not sure how the future capital structure of the industry will look. In particular, Qantas traditionally hedges a large part of their oil exposure, but the crude price has fallen and Qantas has slashed its flights which means it can not use the fuel. As a result we would expect QAN is holding a large mark to market loss on this position.
- **QBE Insurance Group (QBE)** - We reduced our QBE position to underweight early in March after the stock had performed strongly and was trading close to our valuation. QBE has a large and diverse investment portfolio which in the current environment might contain some negative valuation surprises.
- **Unibail-Rodamco-Westfield (URW)**. Balance sheet concerns meant that the financial risk of holding URW began to outweigh the likely expected returns.
- **Transurban Holdings (TCL)** In this environment, we believe TCL carries gearing that is unsuitable for normal companies. They have been allowed to gear up massively due to the perceived stability and growth of their cashflows. Recent events are likely to eventually change lenders' views about what a suitable balance sheet should look like going forward. Indeed, they were already partly paying distributions out of capital and

they have now guided that distributions will be paid only out of operating cashflow. This could lead to a derating of the stock. We have exited our position.

NB: commentary may not be provided on smaller trades or some positions where we have an imminent intention of buying or selling.

Strategy and Outlook

Overview

At the time of writing at the end of March, the world we find ourselves in is almost unimaginable from that of only two months ago. Among the many extraordinary events, we note:

- A large number of countries around the world are in lockdown, as ordered by their governments.
- International travel has all but ceased and country (and within Australia some state) borders are closed.
- Unprecedented global fiscal and monetary stimulus, to combat the impact of the unprecedented global government-mandated lockdowns and business shutdowns.
- The US Federal Reserve has announced unlimited Quantitative Easing (QE).
- In the space of one month, Australia has gone from a balanced budget, to having a budget deficit that is now expected to be between 7% to 15% of GDP, depending on how long the lockdown remains. Included in these numbers is the “jobkeeper” employment wage subsidy which may cost $130b over six months.
- Random winners and losers have emerged, as government action helps some businesses, but not others. For example, the announcement of non means-tested free childcare for six months.
- Anecdotal evidence suggests hospitals and doctors are seeing a noticeable uptick in mental health issues.
- The Army has been deployed to guard Australians who have returned home from overseas and been required to be quarantined in hotels.
- There are instances of individuals not being allowed to sit in a park by themselves without being moved on by police.
- In the US, a lone paddle boarder was apprehended by the US Coast Guard and charged for breaching curfew.
- ESG. Some companies appear to be operating with government and working somewhat as arms of government. This has earnings implications. In some cases we have seen variations in corporate behaviour with some seen as better corporate citizens which will help their social license to operate, and some the opposite.

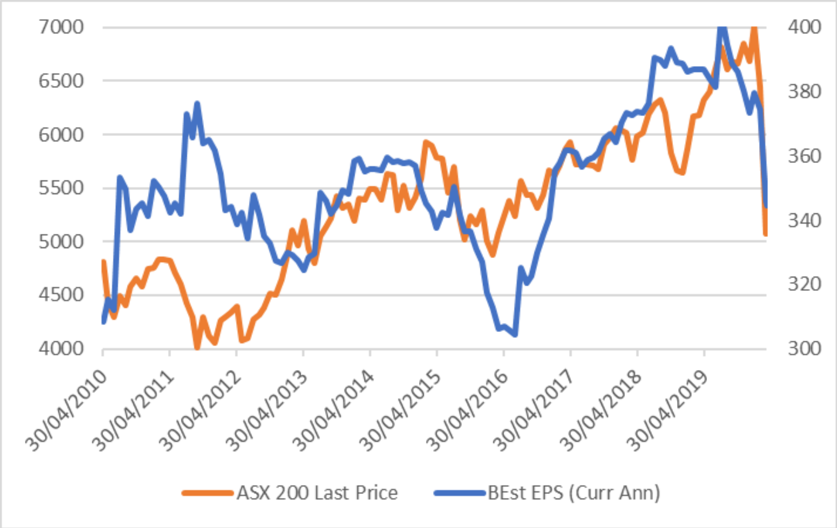
We could go on.

Markets

Another unusual aspect of this crisis has been the speed of the loss of wealth which has occurred across several asset classes simultaneously. Catastrophic rises in unemployment have been accompanied by global falls in equity markets and bond markets- in particular high yield bonds, industrial commodities, and the listed property sector. Unlisted markets have no doubt fallen but the asset values are less transparent.

For Australia, post the sharp fall in equities over the quarter, valuations look more reasonable. - the index has moved more in line with reduced earnings expectations. But how accurate are the current earnings estimates?

Chart 2: S&P/ASX 200 Index vs Bloomberg Consensus Earnings Forecasts



Source: Bloomberg; April 2020

Looking at the past 10 years of the S&P/ASX200 PE we can see the market is trading at around the average PE of the last 10 years.

Chart 3: S&P/ASX 200 - BEst P/E Ratio (x)

Source: Bloomberg; April 2020

The speed of the sell-off has been unusual, yet some of the implications from the downturn we expect to be long lasting, namely:

- Leverage and credit markets have moved quickly to reprice lower quality credits. We expect recapitalisation of balance sheets will continue well after lockdowns are eased.
- Government deficits will be astronomical. Will these be financed by
    1. printing money (In Australia, state governments cannot do this hence if they wish to pump prime the economy it will be a cocktail of 2 and 3). Also it seems to be becoming acceptable that governments can print money with no consequences. If this were true why is Zimbabwe not the richest country on earth?
    2. dilution by inflation, ie the hope that inflation will rise increasing government revenue, and at the same time reduce the purchasing power of the dollars to be repaid in the future.
    3. higher taxes, or
    4. left to continually expand and be financed by central banks keeping selected interest rates artificially low.

    All of these options carry differing risks for investors.

- Over time there will be some restructuring of global supply chains, just in time inventory, and diversification of production, in particular, the manufacture of “essential” products.
- Work habits may have been permanently changed.
- The extent of the slowdown could seed further serious social unrest, which was already evident in many large countries prior to the slowdown.

Another quite profound event that coincided with the COVID-19 issue over March was the collapse in agreement between oil producers. The Brent crude price halved in March. This also had a deleterious impact on the portfolio which we will discuss.

COVID -19 shutdown induced sell-off and the impact on the portfolio.

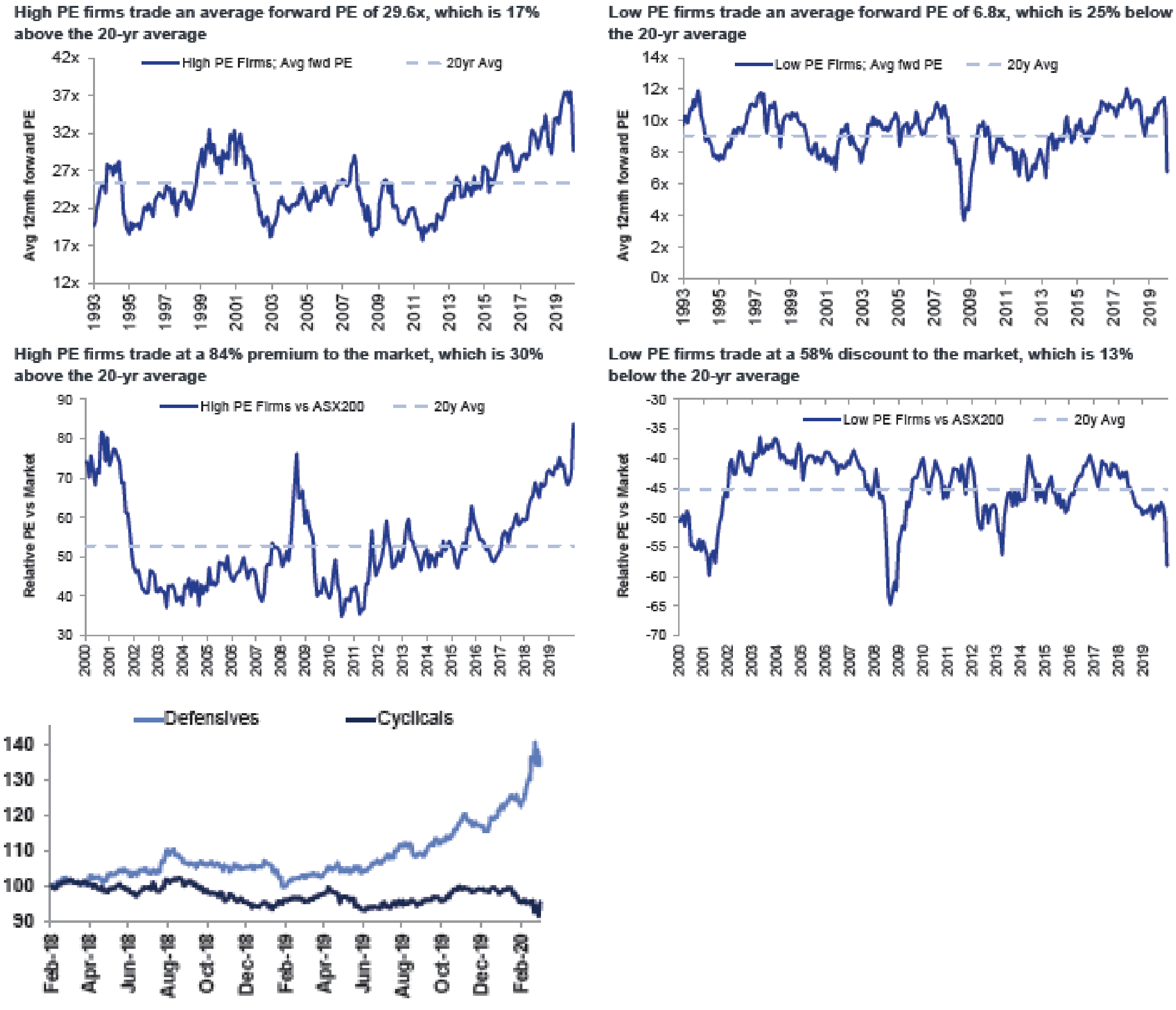
Our portfolios have been positioned with a heavy tilt to the style factor of “value”, which is an outcome of our investment process. Unfortunately in the risk averse sell off, this strategy performed poorly, as investors became more worried about earnings certainty, at any price, (which was somewhat of a continuation of the recent few years of market activity where “growth” had been repriced up, ie to say companies with perceived high growth have traded (and continue to trade) at historically elevated levels).

Our tilt to value saw the portfolio owning many cyclical-type exposures, which were savaged in March as short term earnings expectations quickly changed.

The blowout in the divergence between growth and value, which has seen the portfolio underperform the market, is shown in the following charts. The charts show that the high PE firms have been rerated upwards relative to the market in the sell-off, whereas the low PE firms have been downrated. We understand that much of this movement will be related to earnings falling.

We note though, that even several high multiple stocks that were thought to be steady and safe earnings growers, such as Cochlear and Seek, have warned that depending on the length of shutdowns they may experience a reporting period of severe EBITDA falls.

Chart 4: Valuation dispersion



Source Goldman Sachs, Kickstart, 30 March 2020.

To further highlight the extent of the portfolio headwinds facing value strategies, the MSCI Australia Value vs Growth indices, as taken from Bloomberg, show the magnitude of the performance differential.

Table 1: Performance of Value vs Growth (%)

MSCI data from Bloomberg to 31 March 2020. (returns are cumulative not compound and exclude dividends)

	March quarter	1 year	3 years	5 years
Value index (excl dividends)%	-29.3	-27.8	-35.9	-39.1
Growth index (excl dividends)%	-19.3	-8.9	10.9	14.2

Source: MSCI, Antares Equities; April 2020

These are staggering numbers, and highlight the extent of the multi-year style performance differential.

Why do we think it is appropriate to persist with our investment style in the face of such poor recent results?

Because style has tended to be a mean reverting factor. But it can last for long periods in both directions. In Australia, we have data from 1995. The data shows long periods of style performance which can last five to seven years. While we cannot be certain that now is the time style reversion will occur, history suggests we are at an historical low point and that when reversion does occur it will most likely be profound in its impact on portfolios.

Chart 5: Value vs Growth Australia

Source: MSCI, Antares Equities; April 2020

The general view in the equity market is that it will take either strong economic growth, a return of inflation or both for "value" as a factor to perform. We would suggest that often when markets reach extremes, tipping points can occur outside accepted and expected norms. For example given the massive dislocations we have seen in valuations, perhaps signs of stability going forward may be more important to normalising valuations than actual reported numbers.

In short, we think value will eventually return to favour.

Portfolio activity

As shutdowns increased throughout March, the potential damage to the economy worsened. Our base case for investing is a three month or thereabouts shutdown in Australia, with a visible pathway to a relaxation of restrictions. A pathway to return to work for the economy, even with social distancing in place would likely see a huge relief rally.

Our base case implies a return to growth of modest proportions:

- Lower overall economic growth than would have been the case before the coronavirus as we expect many businesses will not survive the shutdown;
- There may be a scarring of the public psyche with regard to debt, which may mean individuals and companies may want to reset their personal balance sheets and behaviour so they are not as exposed to another shock;
- And government debt will be so high that taxes will likely rise.

There is a prospect that supply and demand miss-matches may create inflation in some goods and services, yet growth remains extremely low.

If the lockdown in Australia lasts six months, we will need to progressively reassess our investment case as the outlook for a very bad recession would likely turn into a depression.

We will concentrate commentary here on what we did over the month of March, as the rationale for trades pre Covid -19 are less relevant. (They can be found in the stock commentary section of this report).

Generally, we have not sold our cyclical exposures. Our logic was that share prices had fallen way ahead of the likely long term impact on valuations. However, this is a testing time as businesses do not plan for potentially massive revenue falls in such a short time frame. We expect our cyclical exposures will bounce back strongly when the economy reopens as they are substantial businesses with strong market shares and pre-eminent positions.

Where we have sold stocks our decisions have been based around

- balance sheet strength;
- if the loss of cashflow could imperil the viability of the business, or require a large capital raising that would likely significantly dilute expected returns to shareholders; and
- improving the overall quality of the portfolio.

At the end of the quarter, the “value” and “debt” characteristics of the portfolio compared favourably to the market based on Bloomberg consensus forecasts:

Table 2: Antares Australian Equity Fund vs Consensus

	Portfolio	Consensus
P/E	14.5x	15.7x
P/CF	6.9x	8.5x
P/B	1.2x	1.6x
Debt/Equity	155%	176%

Source: Bloomberg, Antares Equities; 31 March 2020

Of the above valuation measures, perhaps P/B (Price to Book Value) is the most useful in times of such earnings volatility.

Summary

At the time of writing, the rate of increase globally of Covid-19 seems to be declining, particularly in Australia. During the SARS market sell off, the market bottomed as infections peaked.

Nonetheless some politicians are still forewarning of even more draconian restrictions being implemented. Should this occur, it will become even more difficult for the economy to recover as large swathes of small business will be decimated. We have not heard governments, other than President Trump, attempt to outline an exit strategy for the shutdown policy. Any guidance, such as a list of key performance indicators to be achieved around this would help reduce uncertainty. The duration of the shutdown is critical for both short and medium term growth expectations as the longer the economy is locked down, the more difficult it will be to emerge strongly.

At the time of writing, a number of doctors around the world have expressed optimism about the benefits of hydroxychloroquine, possibly in conjunction with antibiotics, (admittedly not researched to the gold standard of randomised double blind controlled studies, but we know it is being used widely around the world “off label”). Also convalescent plasma transfusions have been approved by the FDA for use in reducing symptoms, yet the market is not displaying any optimism for success.

More proof of probable efficacy would be a positive for markets.

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