Quarterly Investment Update

Antares Australian Equities Fund – March 2021

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Highlights for the quarter

Performance: The Fund returned 8.4% (net of fees) for the March quarter, ahead of its benchmark by 4.1%.

Contributors to performance: Positive contributors – Incitec Pivot, Nine Entertainment, Telstra, Westpac; Negative contributors – Northern Star, Ampol, Medibank Private.

Stock activity: Buys/additions – Bank of Queensland, Downer EDI, IGO Limited, Origin Energy, QBE Insurance; Sells/reductions – A2 Milk, Coca Cola Amatil, Healius, Nine Entertainment, Seek.

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 2021[1]

Period	3 months	1 year	3 years pa	5 years pa	7 years pa	10 years pa	Since inception pa
Net return[2] %	8.4	47.5	6.9	8.6	6.8	6.8	9.1
Gross return[3] %	8.5	48.4	7.5	9.4	7.6	7.7	10.0
Benchmark return %	4.3	37.5	9.7	10.2	7.7	8.0	9.2
Net excess return %	**4.1**	**10.0**	**-2.8**	**-1.6**	**-0.9**	**-1.2**	**-0.1**
Gross excess return %	4.2	10.9	-2.2	-0.8	-0.1	-0.3	0.8

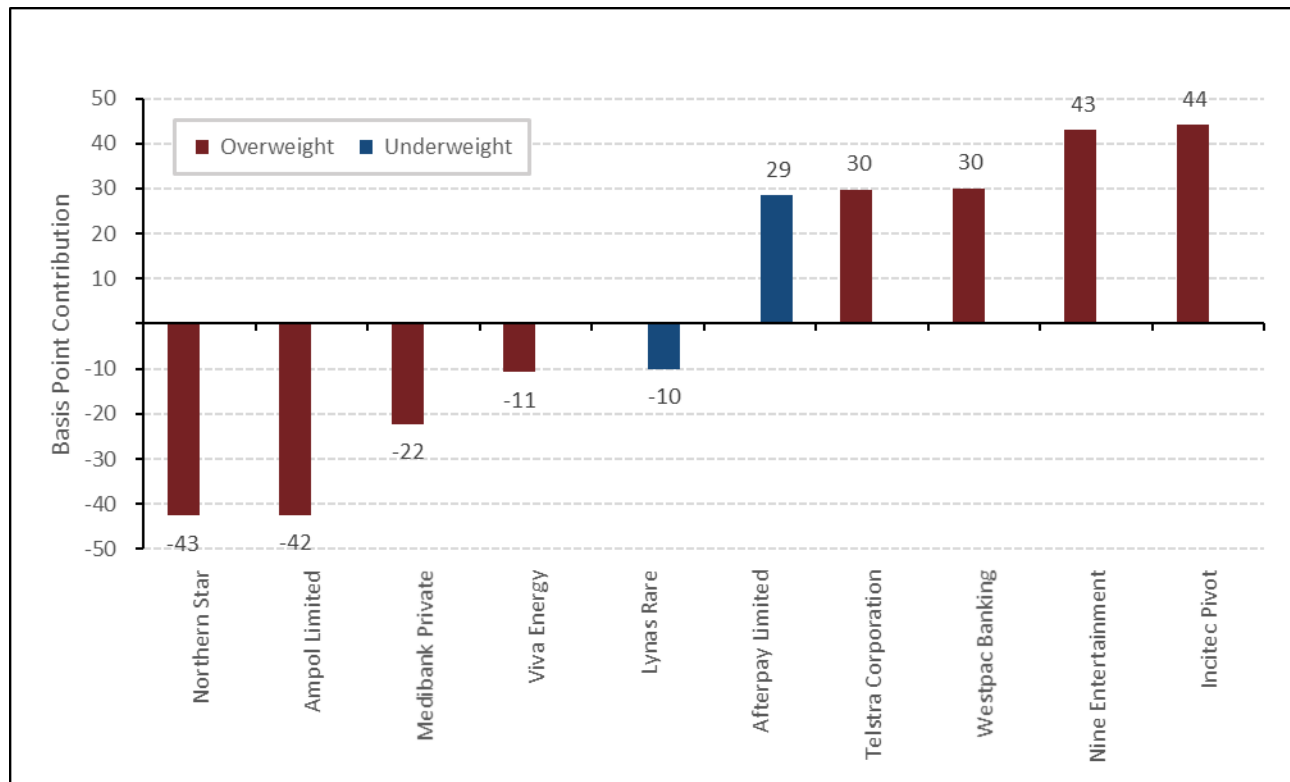
[1] Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document.
[2] Investment returns are based on exit prices, and are net of management fees and assume reinvestment of all distributions.

Contributors to performance

Positive

- **Incitec Pivot** (IPL, overweight) – IPL rallied on macro issues, as the DAP and Ammonia price rallied strongly over the quarter.
- **Nine Entertainment** (NEC, overweight) – NEC benefited from several factors. Housing saw a strong rebound which helped Domain, advertising picked up on the reopening of the economy and Stan achieved strong subscriptions. All of which saw very strong earnings growth.
- **Telstra Corporation** (TLS, overweight) TLS rallied strongly in March as the market began to have more confidence in value creation opportunities that might be realised from selling parts of the group's infrastructure assets, and after the CEO of an aggressive competitor unexpectedly departed.

Figure 1: Fund attribution – March quarter



Source: Antares, March 2021

Negative

- **Northern Star** (NST, overweight) – Gold shares have performed very poorly in the market rally. The fund remains underweight gold stocks, but our holding in Northern Star performed poorly, and was not helped by the retirement of the Executive Chair form the board.
- **Ampol** (ALD, overweight) - Ampol remains one of the most disappointing holdings in the portfolio in that we believe the company and its assets are very substantially undervalued, and the share price is now trading at a huge discount to Antares estimation of value, and indeed to the rebuffed Couche Tarde bid at $35.25 per share which lapsed last year as covid hit.
- **Medibank Private** (MPL, overweight) - MPL's 1H20 result was very good and lead indicators for the business (e.g. policyholder growth) look positive. But this did not translate to an increase in MPL's share price because at the same time MPL's highly respected MD, Craig Drummond announced he will retire on 30 June 2021. There is also an expectation that volumes of elective surgeries have been accelerating as Covid restrictions ease and consequently MPL would likely see claims normalising from the low levels of 2020.

Overview and Portfolio activity

Introduction

The portfolio had another good quarter as the value and cyclical sectors of the market improved relative to the longer duration "growth" segments.

In particular the market has started to look through covid disruptions, with the primary issue for investors now being the spectre of rising inflation. In Australia, according to Bloomberg data, the 10-year bond yield started the quarter at 0.97% and finished at 1.786%. Longer bond rates rose globally reflecting a combination of strong economies, continued large government stimulus programs and very loose monetary policy that ignited market concerns about inflation and interest rates.

We have written previously about interest rates, inflation and equities and have noted that the relationship is complex, with changes in rates having differing impacts on equities depending on what other factors coexist. In short, there are times that interest rates rise and the market rallies, and vice versa.

Currently we think slightly higher rates can be absorbed by equity markets as long as the rate of increase is slow. Any sudden large changes in bond rates could make investors in "risk" assets very jumpy. Some stimulus programs in Australia are rolling off. But in the US, which is the economy that tends to drive sentiment about world markets, more stimulus has been added to

already loose monetary policy, creating an environment where we could see some large GDP numbers in the middle of the year, which may trigger further inflation concerns. Even some Fed members expect US inflation to significantly spike above target, albeit temporarily.

Interest rates are currently a big deal for equity markets as valuations remain historically very high for equities, which have been fuelled by the belief interest rates will stay low for many years. Any sentiment that starts to change that implied market presumption could lead to substantial dislocations in asset markets.

In the US, the initial covid stimulus package seemed to be aimed more at individuals, whereas previous packages seemed to involve huge amounts of money ending up in asset markets. If this money is spent there will be a change in how the stimulus flows into the economy. Previous policies were not inflationary, but perhaps current policy, which in some ways is more aligned to Modern Monetary Theory, may have a different impact.

Should inflation become a larger issue for the markets, it will be one of the most significant changes to the investment landscape in a generation. Hence this issue deserves constant vigilance.

A related theme is the belief that Central banks can control and manipulate interest rates for as long as they want. We note that over long periods of time, the fixed income markets, as measured by bonds and bills, almost always move in advance of Central Bank policy. At the current time with targeting at the short end out to three years, the most undisturbed rate is probably for the 10 year bond. As such we believe large moves in this rate should not be considered irrelevant to what the future holds for shorter rates. As we write at quarter end after such a large move, it is likely some consolidation will take place, after which it will be important to determine if rates have peaked, or if a new upward trend continues.

A non-exhaustive list where asset prices appear to have benefited from a flood of liquidity and low interest rates includes all types of bonds and interest rate related instruments (including junk), growth stock valuations, general equity valuations, residential property, fine art (and arguably some not so fine art), collectables, antiques, classic cars, old coins, stamps, bitcoin and other digital currencies, and recently NFT's, ie non fungible tokens.

Recently we have also witnessed three hedge fund / financially geared structured businesses fail, which may be warning signs of the outworkings of the higher leverage that low rates and the search for yield have encouraged.

February Reporting Season key takeaways

- It was arguably one of the best reporting seasons ever measured by the number of companies exceeding forecasts, and by the actual growth achieved. For all of that the market finished close to flat for the month of February, with the S&P / ASX 200 up 1.45%, the All Industrials down by 0.12%, and the ex 20 index down by 0.09%. (This market increase was driven by banks and miners).
- Australian retail sector covid beneficiaries have not just been strong, but have experienced some of the best trading conditions ever.
- Some large company earnings were aided by jobkeeper payments. Unsurprisingly, many have been coy to expand on this subject.
- Cost cutting was significant. (According to ABS data in the Reserve Bank of Australia chart pack, Australian business investment as a proportion of GDP is back to the levels of the early 1990's. It had declined significantly over the past decade.)
- An interesting feature was the stock performance of covid winners and losers. Some covid winners announced spectacular results, but failed to rally as this was perceived to be as good as it gets. Conversely some covid losers disappointed, but in several cases the stocks rallied as this was seen as a transition to better times ahead on reopening.
- We are now in the period where 12 month comps will cycle the covid panic buying in the case of covid winners, meaning that although business may be strong during the year, the reported results may be weaker than the pcp, which may create issues for share price performance.

Portfolio Characteristics

The portfolio has above market forecast growth, and an above market price earnings ratio, yet below market price to book ratio, which are directionally similar to last quarter.

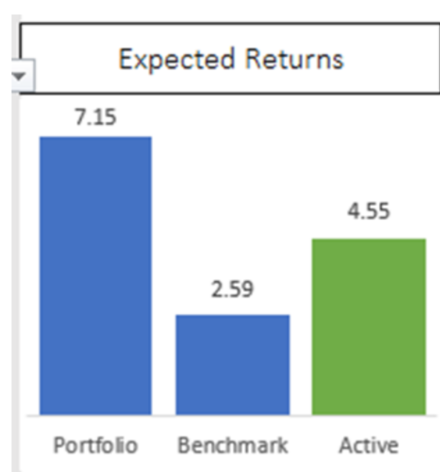
Table 1: Portfolio metrics

Earning Statistics			
	Portfolio	S&P/ASX 200 Total return	Active
PE (x)	17.03	15.90	1.13
EPS Growth (%)	6.37	5.06	1.31
ROE (%)	13.82	16.06	-2.24
Div yield (%)	3.73	3.75	-0.02
Payout ratio (%)	57.73	65.77	-8.04
Price to Book (x)	2.33	2.61	-0.27
Raw Beta (x)	1.06	1.04	0.02

Source: Bloomberg, Antares Equities; March 2021

The portfolio expected returns over 12 months to 31 March 2022, based around Antares fundamental research shows modest upside exists for the portfolio.

Figure 2: Expected Returns (%)



Source: Antares Equities, Bloomberg; April 2021

The stock activity section provides more detail about recent portfolio positioning, with sector weights largely being the result of bottom up stock selection decisions.

Major stock activity

(Note no commentary is provided on positions where we may be active in the market)

Purchased / added

- **IGO Limited** (IGO) - We added to a small existing position. IGO has exposure to metals required to supply clean energy (eg batteries) such as Lithium, Copper and Nickel.
- **Origin Energy** (ORG) – We added ORG after its years of significant underperformance. The catalyst for us this year is the potential for capital management and the prospect of asset monetisation at ORG's LNG joint venture (APLNG) which should lead to more cash flows going back to ORG. The electricity and gas markets remain tough but this is widely understood and likely to be "in the price", and the current state of the wholesale electricity market looks unsustainable (with potential for wholesale price improvement, to the benefit of the likes of ORG).

  ORG is trading at a large discount to its "sum of parts" break-up value, and a large discount to Antares' DCF valuation. Further, it remains very cheap on various valuation multiples (eg Price/Book Value and EV/EBITDA) and it offers a free cash flow yield that is much higher than the broader market.

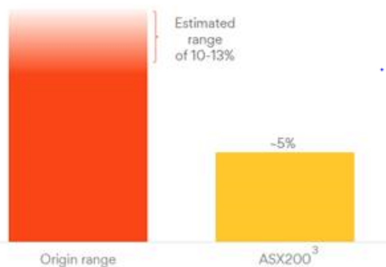
Figure 3: Origin EV-EBITDA (12m Forward)

Source: Antares Equities, Bloomberg; April 2021

Figure 4: Origin price to book value (x)

Source: Antares Equities, Bloomberg; April 2021

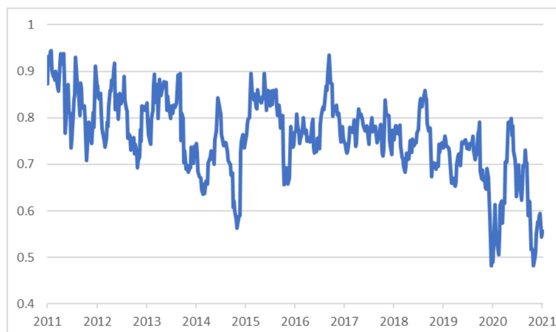
Figure 5: Estimated free cashflow yield



Source: Origin 1H21 Results Presentation; February 2021

- **Downer EDI** (DOW) – The company is transitioning from a cyclical business to more of a contracting business, with many of the businesses service and maintenance related. Based on global comparatives, this company should trade on a much higher multiple.
- **QBE Insurance** (QBE) - QBE underperformed badly during 2020, and has been a multi-year underperformer that looks to be turning the corner. The FY20 result showed that GWP is growing by in excess of 10% which should substantially outpace claims in 2021. In particular, US commercial GWP growth is very strong. We should see strong earnings momentum at the half year, which could also lead to a rerating. Insurance stocks also provide a factor diversification benefit to the portfolio in that they benefit from rising interest rates, primarily due to their large book of policy holder funds which is invested in cash and short dated bills and fixed income securities. There appears to be significant valuation support, based on the QBE PE relative to the All Industrials.

Figure 6: QBE PE relative to ASX All Industrials



Source: Antares Equities, Bloomberg; April 2021

- **Bank of Queensland** (BOQ) - We took up our entitlement and bid for more stock at $7.35 per share in the capital raising as a result of the ME bank transaction, which look to be transformative. (After the stock relisted so strongly and traded around our valuation we reduced some of the stock acquired for a return in excess of 20%.)

Sold/reduced

- **Coca Cola Amatil** (CCL) - A takeover bid saw the share price spike. Proceeds were reinvested elsewhere.
- **A2 Milk** (A2M) - We became concerned from channel checks that sales problems were continuing. We sold before A2M reported, which meant that we avoided another substantial price fall.
- **Seek** (SEK) - We sold the small position in Seek once it achieved our target price.
- **Healius** (HLS) - Our HLS position had performed well on the back of covid testing, however, we believe going forward this will reduce as vaccines eventually have an impact.
- **Nine Entertainment** (NEC) - NEC has been a great performer for the fund. We reduced the size of the position as the fund approached our target price. The management change also creates a layer of uncertainty as we believe media businesses can be very difficult to manage.

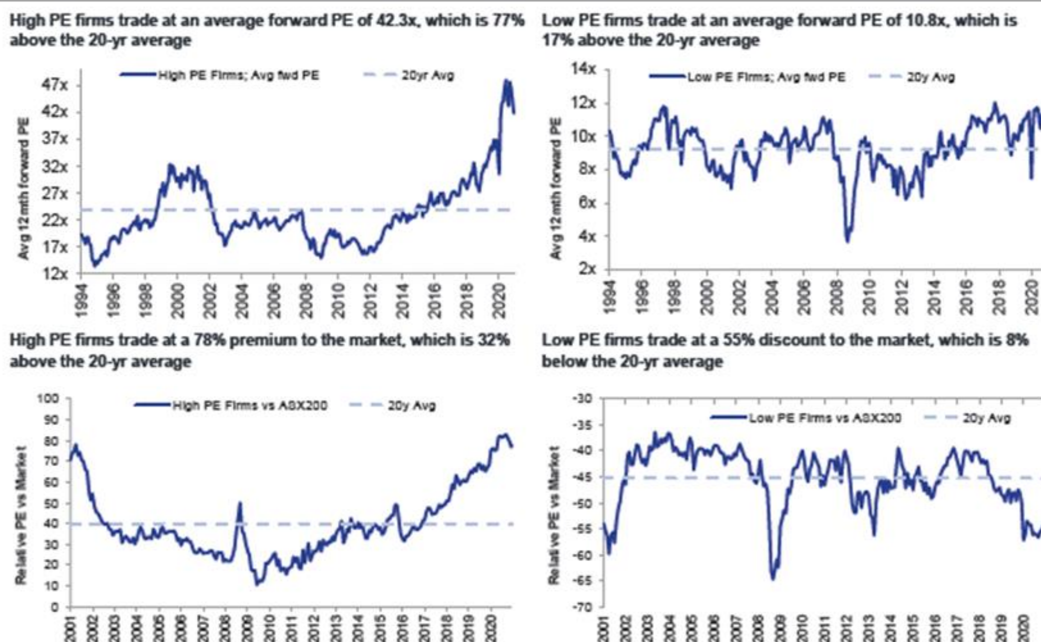
Outlook and Strategy

The past six months has been a very good period for the portfolio, with value and cyclicals outperforming growth. After the recent performance, we would expect some consolidation in the market, if not a rotation back in the other direction. Our view is to remain with our bottom up valuations, and we expect that somewhere in the middle of the year, more concern about inflation may emerge, especially in the US from both the reopening rebound, which looks to be very strong, and additional monetary stimulus, some of which went directly to households and therefore much of it is likely to find its way into consumption.

With overall valuations at historically high levels, we now look to identify stocks that may benefit from reopening, where that benefit is not fully captured in the price, and likewise attempt to identify previous covid beneficiaries, that might see earnings moderate further than the market now expects as behaviour normalises. As an example we built up the fund position in AREITs as commercial and retail exposure was trading at a significant discount to NTA, and both segment areas should benefit from reopening. The stock commentary discusses some other bottom up stock ideas that we believe still offer significant upside.

Notwithstanding the rally in “value”, in aggregate, “growth” valuations remain historically high. The charts below show the divergence between “value” and “growth” remains historically high.

Figure 7: Valuation dispersion



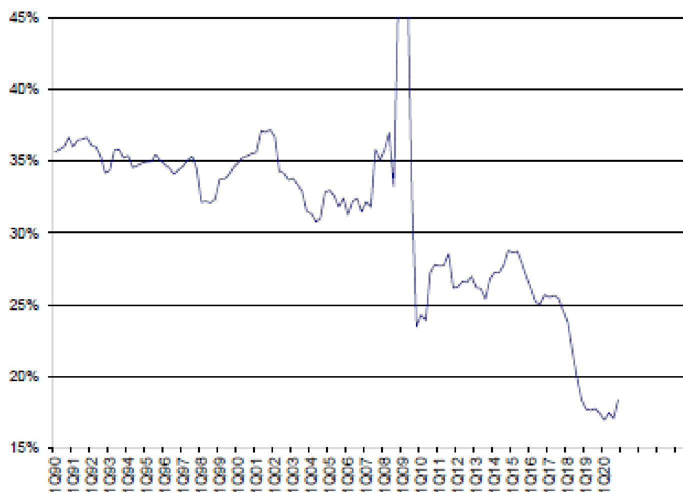
Source Goldman Sachs weekly Kickstart 9/ March 2021

Three of the big four banks report in the coming quarter. They should show strong earnings growth, dividends and capital positions, all driven by bad and doubtful debts (BDD) provision releases, strong housing growth and low funding (deposit) costs. This is well known and the banks have already rallied strongly. For example in a little over six months from its September low of

$16.46 per share, ANZ has rallied by 70% to $28.18. As such we think most of the good news is in the price and the valuation rerating has largely occurred.

We note the US so called infrastructure bill, is to be funded in part by higher corporate tax rates, from 21% to 28%. (And we note from a political perspective, is in line with a current philosophy that seems to wish to reverse most Trump reforms.)

Figure 8: S&P 500 Tax Rate

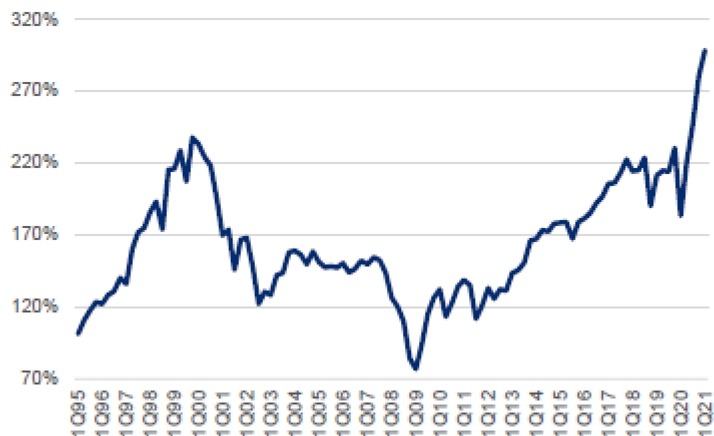


Source Citi, US Equity Strategy, Feeling a 1999 Vibe; 7 April 2021

Tax increases was a clear election policy and therefore should not be considered a surprise. Thus far, perhaps surprisingly, the market has ignored any implications and seems to be discounting this as though it will not happen. Should it proceed, Australian companies with a large percentage of US earnings will be hit. These same companies received a strong earnings benefit when the Trump administration dropped the tax rate.

The following chart highlights the current lofty historical valuation of US stocks, which would suggest that, on average, they are not priced for disappointment.

Figure 9: S&P 500 Market Capitalisation as a % of Sales



Source: Citi, US Equity Strategy, Feeling a 1999 Vibe; 7 April 2021

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