Quarterly Report

Antares Ex-20 Australian Equities Model Portfolio – December 2020

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Highlights for the quarter

Performance: The Model Portfolio returned 17.7% (gross of fees) for the December quarter, outperforming its Benchmark by 6.0%.*

Contributors to performance: Positive contributors – Afterpay, Polynovo, Mineral Resources; Negative contributors – a2 Milk, Ansell, Aurizon.

Stock activity: Buys/additions - Megaport, Orora, Steadfast; Sales/reductions – JB HiFi.

Portfolio snapshot

Inception date	27 May 2015
Benchmark	S&P/ASX 200 Total Return Index excluding the S&P/ASX 20 Total Return Index
Investment objective	The Model Portfolio's objective is to outperform the Benchmark over rolling 5 year periods.

Investment returns* as at 31 December 2020

Period	3 months	1 year	3 years pa	5 years pa	7 years pa	Since inception pa
Gross return %	**17.7**	**16.2**	**12.7**	**15.1**	**-**	**14.1**
Benchmark return %	11.7	1.2	6.3	10.9	-	9.3
Gross excess return %	**6.0**	**15.0**	**6.4**	**4.2**	**-**	**4.8**

*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. The value of an investment may rise or fall with the changes in the market.
Investment returns for the Model Portfolio are based on a notional model portfolio constructed by Antares and are gross of administration (platform) and investment management fees, net of estimated transaction costs, and assume all dividends remain in the Model Portfolio.
*Performance is based on the income and market value of the notional model portfolio.

Performance and Portfolio Positioning

The Portfolio enjoyed a strong December quarter, returning 17.1% (gross of fees) which compared to our benchmark of 11.7% and capped a good year for investors in our strategy. We have been confident that COVID would assist the mid-cap space in our market for two reasons. The first was that there are many more disruptive business models in this space than in the mainstream, larger end of the market, and this has proven to be so, with stocks such as Afterpay (APT) and Xero (XRO) amongst the best returns in the market for calendar year 2020. The reason? COVID has encouraged disruption and innovation, more suited to the nimble and entrepreneurial businesses in the mid cap space.

The second is more technical, and it is to do with a combination of the higher growth mid cap stocks can expect and the reaction by central banks to the COVID pandemic. With QE instituted around the world, interest rates are at historic lows in nearly all

countries. This helps the valuation of growth stocks as their future prospects are not discounted as heavily compared to a higher interest rate scenario. This discussion about the market's "valuation" leads naturally to our outlook.

Outlook

A key risk to the equities' market is, indeed, this elevated level of valuation. While we have been comfortable with it, given the fall in interest rates which thereby reduces discount rates, we believe it is prudent to review this and ask: "what might go wrong?".

Risk One: COVID 19

This might seem self-evident, as we are in the middle of dealing with the pandemic right now. Financial markets, however, especially the equity markets, have been "looking through" the near term impacts of the virus and attempting to value companies on earnings they are likely to generate once the pandemic is over. The assumption is that 2021 will be that year given the various vaccines being deployed around the world.

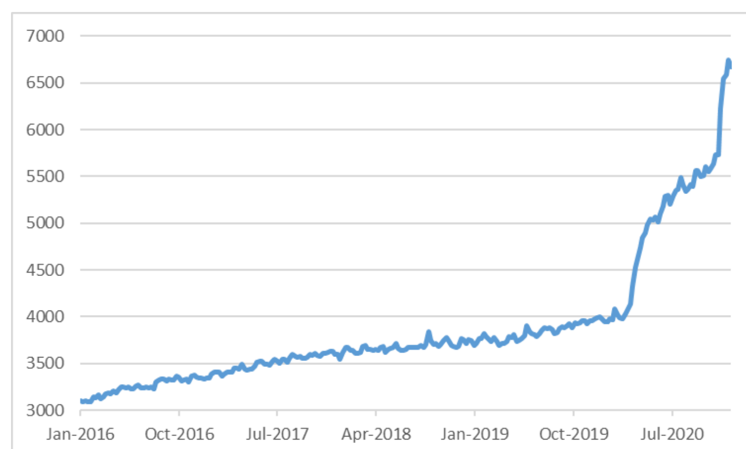
We think there might be a little too much optimism here. This is not to question the efficacy of the vaccines, or the recent mutations. Rather, as longstanding transport analysts, we see issues with logistics and the sheer scale of the task. Even to vaccinate what was once called "the first world" would require nearly 1bn people to be administered two shots of the vaccines. This is a massive task and faces innumerable risks, not least of which is the complex cold-chain compliance required to manufacture and deliver such a huge number of doses.

Risk Two: Inflation

While the risk that the vaccine roll-out disappoints is real, so too it the risk that, should it prove successful, then the global economy may overheat. The vast quantities of fiscal and monetary stimulus have done more than "preserve" global economies. They provide a significant store of "ammunition" that could fuel a very strong rebound. With global savings rates high and monetary policy to remain accommodative for some time, all that is required is confidence from consumers and businesses that the pandemic's impacts are behind us.

With money supply at record levels, (See Chart 1) a resumption in more normalised activity may see this turn into supercharged nominal economic growth. In part, this is by design, with central banks globally hopeful that once the recovery begins, it will push inflation beyond normally targeted ranges. This is to help inflate away some of the debt burden taken on by governments in providing fiscal support during the pandemic.

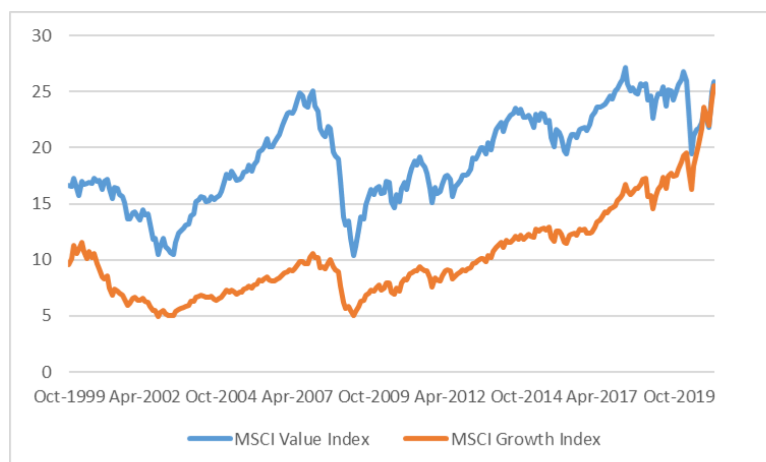
Chart 1: US Money Supply (USDTn)



Source: Bloomberg January 2021

The risk is that inflation gets out of control - it can be difficult to stop once it is established. Another risk is that, despite the reassurances of central bankers globally, markets may move to reprice longer duration debt in anticipation of a lift in inflation. As is well-known, globally "growth" shares have materially outperformed so-called "value" stocks over the pandemic (think NASDAQ v Energy and Financial stocks). The causes of this are varied but a key one in our mind is the valuation benefit enjoyed by longer duration stocks as interest rates are falling. If this were to reverse, the market would see a significant change in leadership. The expansion in valuation of growth stocks has been the key driver for the equity market rising. Hence if it were to reverse, we believe markets would struggle to move forwards given the proportion of market value now embedded in these businesses.

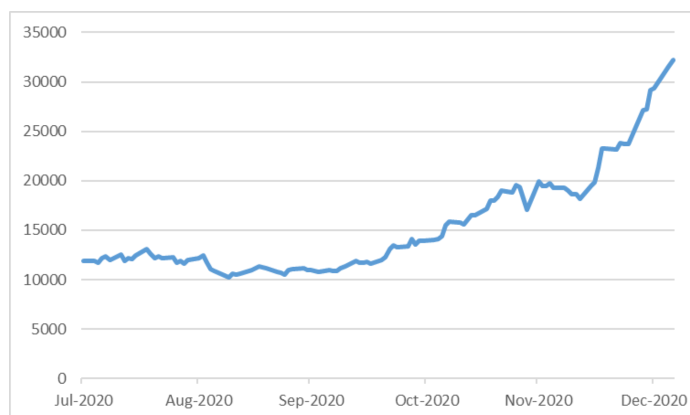
Chart 2: MSCI Growth v Value by Market Capitalisation



Source: Bloomberg January 2021

There is already some evidence that some in the market are preparing for a sharp lift in inflation – hence the surge in the value of Bitcoin. We do not pretend to have any understanding of the metrics of Bitcoin, but it does seem to play a role akin to that of gold, albeit more volatile. A chart of the gold price, the more traditional currency alternative, tells a similar tale. Inflation debases the value of FIAT currencies, hence the traditional appeal of gold in an inflationary environment. Bitcoin seems to be the modern version.

Chart 3: Bitcoin price (US$)

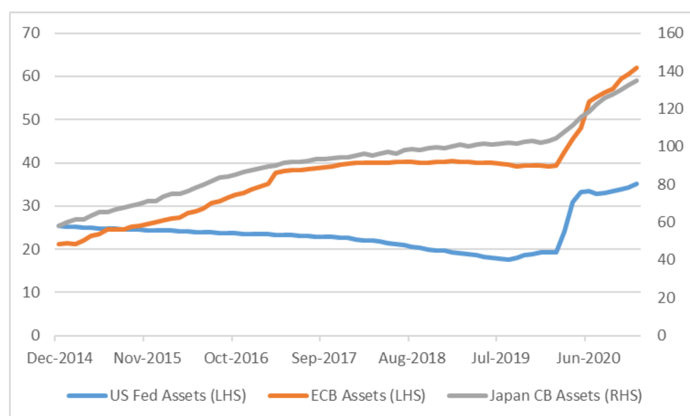


Source: Bloomberg January 2021

Risk 3: The US Dollar

As the Bitcoin chart highlights, faith in FIAT currencies has been challenged by the unprecedented levels of monetary stimulus provided by the world's central banks. The following chart highlights the level to which central banks of the world's three largest liberal economies have stimulated their economies via bond purchases – a form of money creation.

Chart 4: US, EU and Japan Central Bank Balance Sheets (% of GDP)



Source: Bloomberg January 2021

With the election of Joe Biden as President in the United States, and his Democratic Party potentially having control of both houses of parliament in the US, markets are anticipating a major stimulus and spending package to be unveiled early in his term. This would further undermine confidence in the US dollar.

While this is normal to an extent, as the following chart of the US dollar shows, it has been in a weakening trend for a considerable time. This has the potential to destabilise the global financial system, as an extreme outcome. Even if it does not go that far, it will lead to a much stronger Australian dollar, which will have a significant impact on much of our market given the earnings base of so many companies is in US dollars. A weaker US dollar also leads to commodity price inflation, which will impact living standards and potentially drive up longer term bond rates.

Chart 5: US Dollar vs other currencies

Source: Bloomberg January 2021

Conclusion:

Our view is that diversification remains essential. As we have highlighted, we see risks from a number of areas, but their timing and impact are difficult to calibrate. One thing that seems apparent is that the appeal of gold seems set to be strong. Be it a weaker US dollar or the risks from COVID or inflation, gold is a thematic that runs through all the risks outlined.

It is also a period which we think we will require a portfolio manager to be nimble. If economies do boom, then the cyclical parts of the market will do well – but this may be delayed given the logistical issues with vaccine manufacture and distribution. Hence we think it is best to be more defensive in the near term but with a close eye on vaccine success and related mobility data as to when to become tactically bullish on the recovery.

The conundrum are commodities, given the attention being paid to renewable energy as a solution to rebuilding COVID-damaged economies. Copper, rare earths, lithium and nickel are all critical to this effort. They also benefit from US dollar weakness, and while it may seem strange to be investing industrial metals when the global economy is weak, we think there are good reasons to maintain our positions in these businesses at present.

Portfolio activity

Additions

We added **Orora** (ORA) to the portfolio in December. We like its valuation and defensive profile. Further, we believe it has been overlooked in the market given its Asian glass divestments and the perception its Australian business may suffer a loss of sales given China's clampdown on Australian wine – ORA being the major supplier of glass wine bottles. We understand the risk around China's demand for our wine is more about the value rather than the volume it imports, and ORA is a volume supplier. Hence the opportunity.

We also added **Megaport** (MP1) to the portfolio in October. We are attracted to the virtual network that MP1 is building across multiple countries that allows companies and other users to link their various data centres and data collection points. While the use of data grows ever more important and its storage is a major growth industry, the data needs to be linked and accessible from multiple points and operations. Further, with differing software providers using different clouds to house their software, connectivity is crucial to businesses seeking to use cloud computing rather than the traditional main frame linked operations. MP1 is the leader in this rapidly emerging space.

We initiated a position in **Steadfast Group (**SDF) based on our views of hardening premium rates cycles extending beyond FY21. The impacts of COVID-19 on insurance claims has yet to flow through renewals and we expect further increases in rates

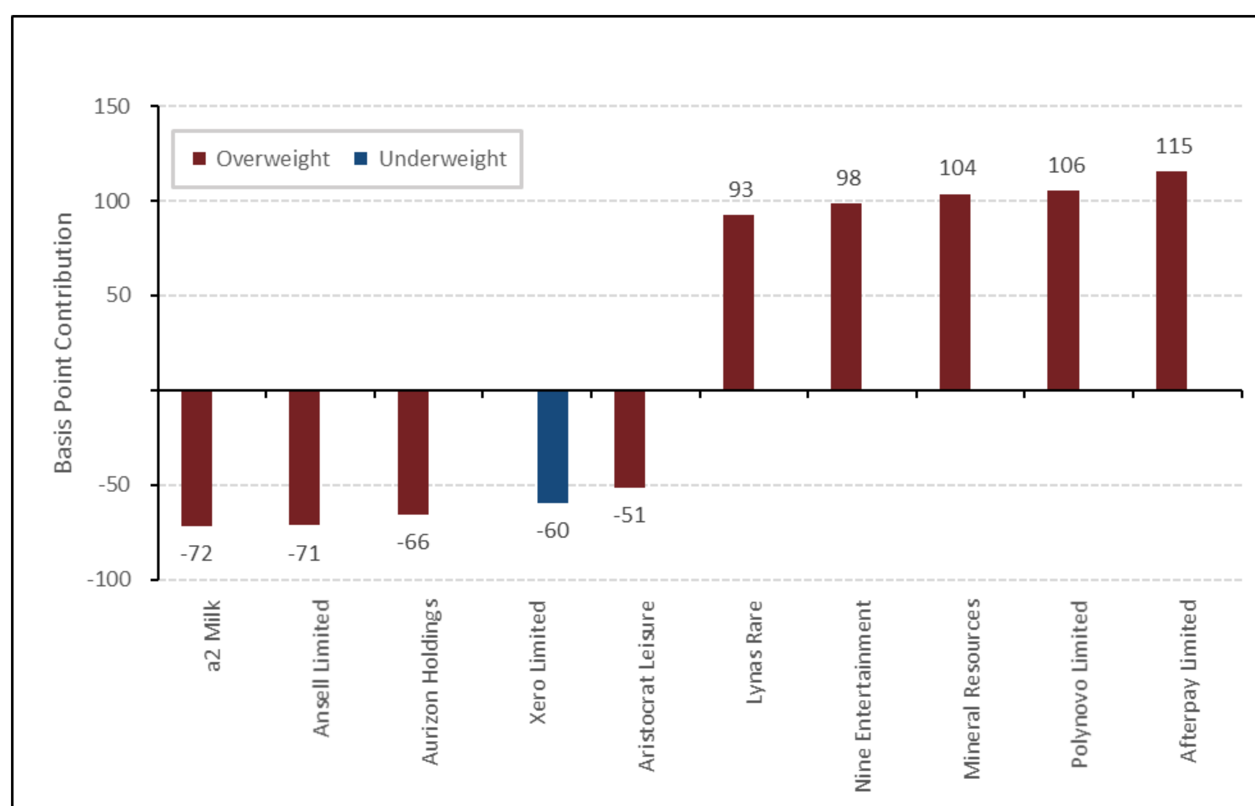
to come through against a backdrop of low insurance industry profitability in the Asia Pacific region. In this context, we believe the company's earnings guidance remains conservative with higher premiums currently not resulting in any volume declines. Steadfast also continues to have further opportunities to deploy balance sheet capability to value accretive acquisition opportunities.

Removals

We exited our position in **JB Hi-Fi** in November. We continue to see JB Hi-Fi as a high quality retailer that has a strong track record of execution. Sales trends have remained elevated for longer than the market expected and we still see upside to Consensus estimates. However, we believe these earnings upgrades are already factored into the share price given the stock's valuation and took the opportunity to exit at this point ahead of sales trends normalising, in particular being mindful of the negative operating leverage that tends to be underestimated by the market.

Stock attribution

Chart 6: Portfolio attribution – December quarter



Source: Antares, December 2020

Positive contributors

Afterpay (APT) also enjoyed a solid quarter of performance. APT was promoted in to the S & P/ASX 20 in December, which aided sentiment. APT also provided an upbeat November trading update, albeit the release did not include a numerical update, only commentary. Finally, the RBA revealed it had concluded its investigations into the prevention of surcharging by buy-now pay-later operators, and concluded it was in consumers' interests. This removed some of the regulatory concerns that some people have about the APT business model.

Mineral Resources (MIN) was also strong driven primarily by the strength of the iron ore price. China's demand for iron ore has been fuelled by its large COVID-driven stimulus and supply remains constrained due to continuing issues in Brazil. Also helping MIN were the first signs that the Lithium market may have bottomed with demand beginning to recover. Alongside its mining services iron ore mining businesses, MIN is a major lithium producer.

Polynovo (PNV) surged during the quarter as the company provided a number of small, but positive updates on various trials and markets. In particular, it provided an update on a critical Investigation Exemption Device trial in the United States, which, if successful, will help its NovoSorb product meet the Standard of Care certifications required for mainstream acceptance in the US. It also announced entry into the Benelux and Swedish markets in Europe.

Negative contributors

Shares in **A2 Milk Company** (A2M) fell after the company released downbeat earnings guidance in December. While the market had been expecting some weakness in A2M's sales in 2021 as it struggled to replace the lucrative Daigou channel into China, the update revealed that the Daigou channel weakness has also found its way into the e-commerce channel in China, a bigger hit than had been previously anticipated.

Detracting from performance was **Aurizon Holdings** (AZJ). AZJ provided an update on its quarterly railing volumes. These were weaker than the market may have expected, although AZJ had flagged at its full year results in August that it expected a slow start to the year. The coal market is itself weak, with diminished demand in South East Asia as industrial production there has struggled to accelerate post the COVID-induced disruptions. Further, while AZJ is trading at a substantial discount to its traditional earnings multiples, many investors are assessing the sustainability of its coal-linked business model.

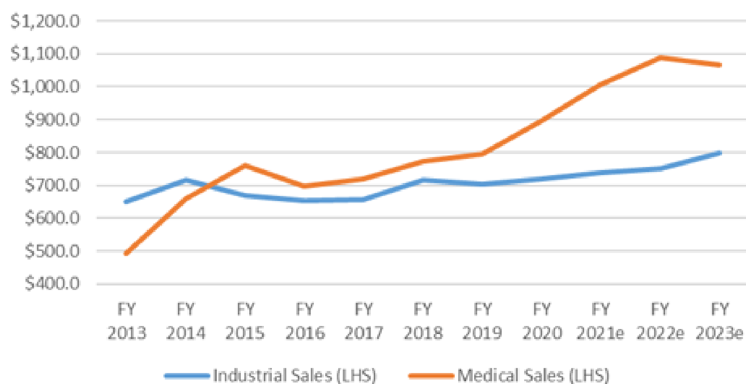
Also detracting from performance was Ansell (ANN) which we discuss in depth in the following section.

Stock Story

Ansell (ANN)

ANN is known as a manufacturer of gloves, especially gloves used in industrial processes such as Hyflex and Alphatec. ANN gloves are used in industries from food production to chemical processing, car manufacturing and beyond. What is not often appreciated about ANN is that it is also a major manufacturer of medical gloves, especially single use and surgical gloves.

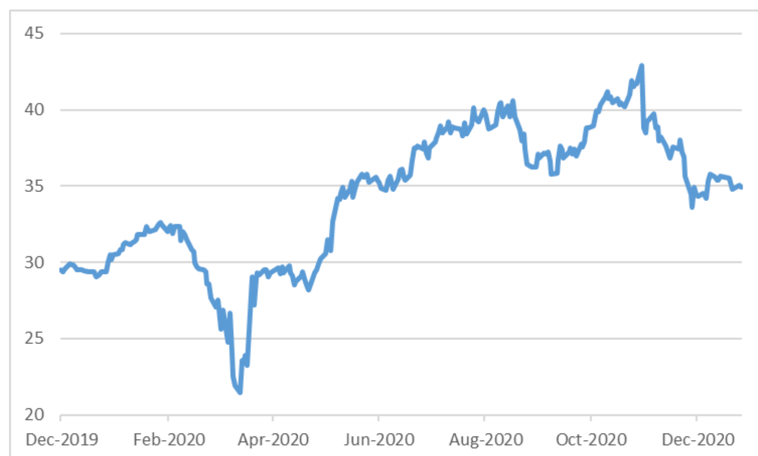
Chart 7: Ansell Sales by Division ($m)



Source: Ansell FY 20 Results Presentation and Antares

As Chart 7 highlights, ANN has higher sales of medical gloves than it does industrial. This has been important during the recent twelve months. At the commencement of the pandemic, the stock was sold off heavily by the market in March (see Chart 8), as global lockdowns imposed on the back of the COVID pandemic saw much industrial production around the world curtailed. The associated falls in demand for its Industrial gloves would lead the company to downgrade its guidance, so it was believed.

Chart 8: ANN Share Price Chart ($)



Source: Bloomberg January 2021

This did not happen, as demand for medical gloves, especially single use gloves, sky-rocketed. These became crucial components of personal protective equipment (PPE) for front line workers in the struggle with COVID. Further, some of ANN's Industrial products, especially gloves for use in the chemical industry, saw demand lift appreciably as they could be used multiple times and still offer the wearer COVID resistance.

Not only did the company re-affirm its 2020 guidance in May, it went on to provide an outlook for FY 21 which was above (then) market expectations, an outlook which it has subsequently lifted at its AGM in November. Yet the company's share price has floundered.

Why? It is true that other medical glove manufacturers, especially those in certain ASEAN countries, took the opportunity to profiteer from the panic buying of single use medical gloves. ANN did not do this, so it is not now facing the same unwind of artificial earnings strength.

It is also true that significant additional capacity is being planned for the manufacture of single use medical gloves. ANN estimates that the world is able to meet only around two-thirds of the actual demand for such gloves. So additional supply is required; indeed ANN itself is participating. The role of PPE in managing highly infectious contagions like COVID is being increasingly recognised and demand is more likely to increase than to fall, regardless of the vaccine. Further, key components in the manufacturing process, such as Butadiene, are increasingly difficult to source, which leaves ANN well-placed to capitalised on long-term off-take agreements with suppliers.

Finally, ANN earns the majority of its revenues in US$ and the weakness of that currency relative to the A$ has hurt many offshore earners, but ANN has fallen more than most.

The answer, we think, is that ANN is in the basket of so-called "COVID winners", that is, stocks that benefitted from unprecedented levels of demand which the market does not believe to be sustainable. A case of "buy the rumour, sell the fact".

We have already made the case that we think demand for ANN's single use gloves will be sustained given the importance of PPE. We also see a strong rebound in time for its surgical gloves, given postponement of elective surgery during COVID globally. Finally, sales in the Industrial division should also benefit from the anticipated global recovery associated with the vaccine roll-out. On the flip-side, should the vaccine be less effective or delayed, demand for PPE will likely strengthen further. So we see ANN as well placed in the current environment and most importantly, with an undemanding valuation and a strong balance sheet.

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