Quarterly Investment Update

Antares Dividend Builder– March 2020

For adviser use only

Highlights for the quarter

Performance: The Fund's focus on delivering dividend income continued in the March quarter. With many companies announcing changes to their dividend payments in the wake of the coronavirus pandemic we emphasize the importance of not using past performance as a guide to future performance. However, we do reiterate that it is our objective to deliver income in excess of our benchmark. The annual income yield to 30 June 2019 was 6.2% versus the benchmark's yield of 4.5%.

Contributors to performance: Positive contributors – Metcash, Treasury Wine Estates, Coles, cash; Negative contributors – CSL (not owned), Scentre Group and Star Entertainment.

Fund snapshot

Inception date	6 September 2005
Benchmark	S&P/ASX 200 Industrials Total Return Index
Investment objective	Deliver higher levels of tax effective dividend income than the S&P/ASX 200 Industrials Total Return Index, and moderate capital growth

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
Portfolio[3,4] income yield %	-	6.21	5.31	4.83	4.48	4.26
Benchmark[5,6] inc yield %	-	4.45	4.33	4.20	4.05	-
Net return[2] %	-25.6	-20.6	-7.8	-3.4	5.2	4.9
Benchmark return %	-21.9	-12.0	-1.7	0.8	6.9	6.0
Net excess return %	**-3.7**	**-8.6**	**-6.1**	**-4.2**	**-1.7**	**-1.1**

[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] Calculated as the sum of the income yields over the period where the yield is income distributed during the period divided by the unit price (before fees) at the start of the distribution period. [4] Income yield at 30 June. 5 Calculated as the sum of the monthly returns of the S&P/ASX 200 Industrials Total Return Index minus the monthly returns of the S&P/ASX 200 Industrials Index (price index). [6] Income yield at 30 June.

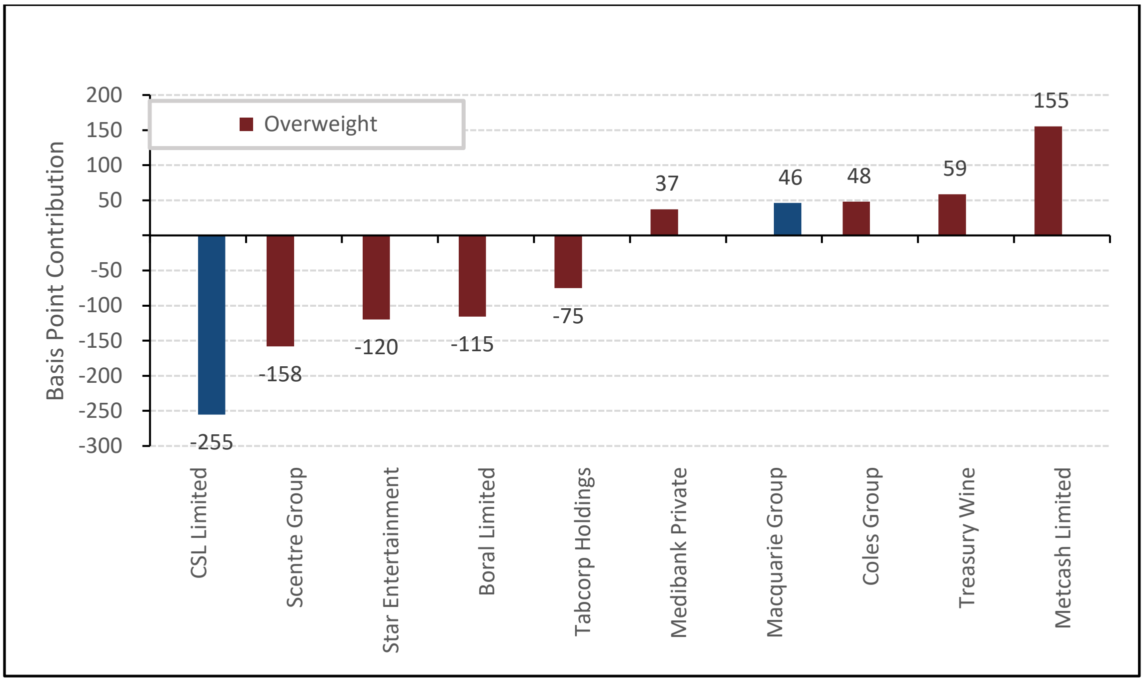
Contributors to performance

Positive

Major contributors to Fund performance over the quarter included:

- **Metcash** (MTS, overweight) – MTS 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.
- **Treasury Wine Estates** (TWE, overweight) – TWE was one of the first companies to announce a guidance downgrade largely on the back of the coronavirus as well as an oversupply of commercial product in the US market. But with alcohol sales increasing according to credit card data, plus TWEs key export market China, likely to be first to emerge from the pandemic, the stock performed relatively well.
- **Coles Limited (**COL, overweight) – Coles was also a beneficiary of panic induced buying from supermarkets.

Chart 1: Fund attribution – March quarter



Source: Antares, March 2020

Negative

Major detractors from Fund performance over the quarter included:

- **CSL** (not owned) – The healthcare sector was generally seen as having defensive earnings characteristics. As we write, CSL has not withdrawn guidance although many other companies have done. Not owning CSL continues to detract from performance but we note that CSL has a low yield and therefore does not meet our yield criteria.
- **Scentre Group** (SCG, overweight) - SCG was one of the worst performers in March as shutdowns broadened across the retail sector. There is no doubt distributions will take a short term hit, but the Westfield shopping centres are the pre-eminent shopping centres in Australia. We expect once social distancing measures are relaxed, shopping centres will provide valuable foot traffic for retailers. We also note physical stores are being used by retailers to fulfill online shopping orders.
- **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.

The Fund's twin objectives are to provide a yield above that of the S&P/ASX 200 All Industrials Total Return index, as well as moderate capital growth over the medium term.

Stock activity

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

Buys / Additions

- **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 which over the medium term will assist in the dividend growth of the fund.

- **Telstra (TLS)** - Telstra was added to the portfolio for several reasons. In the first instance its share price had fallen back to attractive levels and we believe the yield of 5% fully franked is safe. We purchased after Telstra announced a small downgrade during the quarter. Our assumptions, after stress testing earnings, support the view that TLS will be able to maintain their dividend. Secondly, another part of this investment was reinvesting proceeds from the reduction in our Metcash position, (discussion follows). While supermarkets have been the glamour safe haven sector in March we expect elevated supermarket sales are likely to have shorter duration than companies and individuals needs to have communication certainty for primary and remote locations. Thirdly, as it became clear that large parts of the market will need to rebase earnings and dividends, we switched some stock positions where we expect dividends may be cut into Telstra in order to try and protect the overall yield profile of the fund for investors.
- **Tabcorp Holdings (TAH)** - We added to our holding as the share price fell over the quarter. While we recognise that earnings will be hurt in the short term due to venue closures and racing restrictions, and lotteries will be impacted by lower foot traffic around newsagents, we think the severe fall in the share price has over-compensated for what we believe will be a short term earnings hit, as opposed to a permanent reduction in value.
- **Star Entertainment (SGR)** - We added to the position in February and early March. As the month of March evolved, the SGR share price fell extremely quickly and hard. We made a decision around the trade-off between long term value versus short term yield, and decided to hold onto the position, even though SGR postponed the March dividend. At the end of the quarter the stock traded at $2.15, which is around half book value. When SGRs Queens Wharf project is completed we expect the stock to trade well above book value, implying substantial upside.
- **Medibank Private (MPL)** - We added to our position mostly in late February, after the share price had fallen as a result of reporting a rise in claims. We expected this rise to be addressed by both company and government action, hence we believed it was not a permanent step change in claims. Subsequently the stock performed well in March as claims are expected to be benign, initially due to consumers reduced inclination to venture out for treatments that would be eligible for extras cover. This was further helped later in the month when elective surgeries were closed. Medibank have said they do not intend to keep all of this windfall, which will be reinvested into patient care and reduced premium rate rises.
- **Boral (BLD) -** We added to our BLD position over the quarter as the share price fell. While it seems like a long time ago, it was only midway through the quarter that a highly regarded ex-investment banker, now investor, challenged the company to spin off some businesses as he believed the $4 share price significantly undervalued the business, which he believed was worth at least $6 per share or more. During the coronavirus sell-off BLD traded below $2 per share, which was an outcome we certainly did not expect.
- **Aurizon Holdings (AZJ)** - We added to the AZJ position with the proceeds from reducing our positions in Transurban and Sydney Airport. In comparison, Aurizon has a better balance sheet, trades on a lower earnings multiple and higher yield, which we believe can be maintained as coal exports remain robust. In short, we attempted to improve the yield and and debt characteristics of the overall portfolio by undertaking these actions.
- **Scentre Group (SCG)**-We initially reduced early in the quarter, but purchased stock after the substantial share price fall. We also switched some of the proceeds of the Stockland (SGP) sale in Scentre. At the time SCG had a forward yield of over 8%, which was 1.5% higher than SGP. We view this as more stable and with the potential to grow over time.

Sales / reductions

- **Wesfarmers (WES)** - We trimmed our position when then the stock was trading on a price earnings ratio that was three standard deviations above its long term average, and on a modest yield.
- **Transurban Holdings (TCL)** - We discuss TCL in the Strategy and Outlook section.
- **Sydney Airport (SYD)** - We discuss SYD in the Strategy and Outlook section.
- **Stockland Group (SGP)** - We sold Stockland in February and early March after excellent performance post the re-election of the liberal government last year. Our biggest concern, apart from a full valuation, was their holding in lower quality regional shopping centres. These were likely to come under valuation pressure, even before the covid-19 related shutdowns.
- **Metcash Holdings (MTS)** - MTS has been one of the portfolio's best performers over the quarter, but due to its relative outperformance the size of the holding had grown from around 4% of the portfolio to around 6%. As such we decided to sell one third of the position and switched the proceeds into Telstra. We view the high turnover in supermarkets as temporary, and most of it will likely be future sales brought forward, whereas arguably Telstra will be a longer term beneficiary of the need for remote work.
- **Harvey Norman (HVN)** - We reduced the position in February after a strong share performance. Hindsight suggests we should have sold the lot at that time.

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.

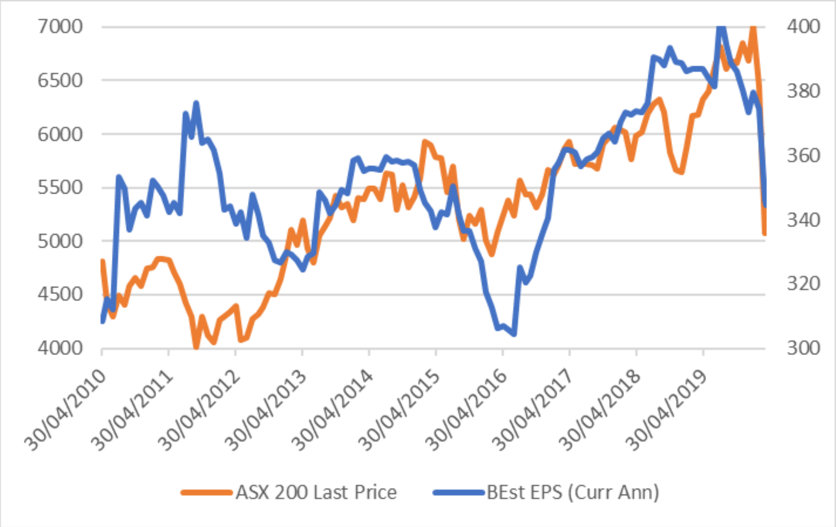
Markets

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.

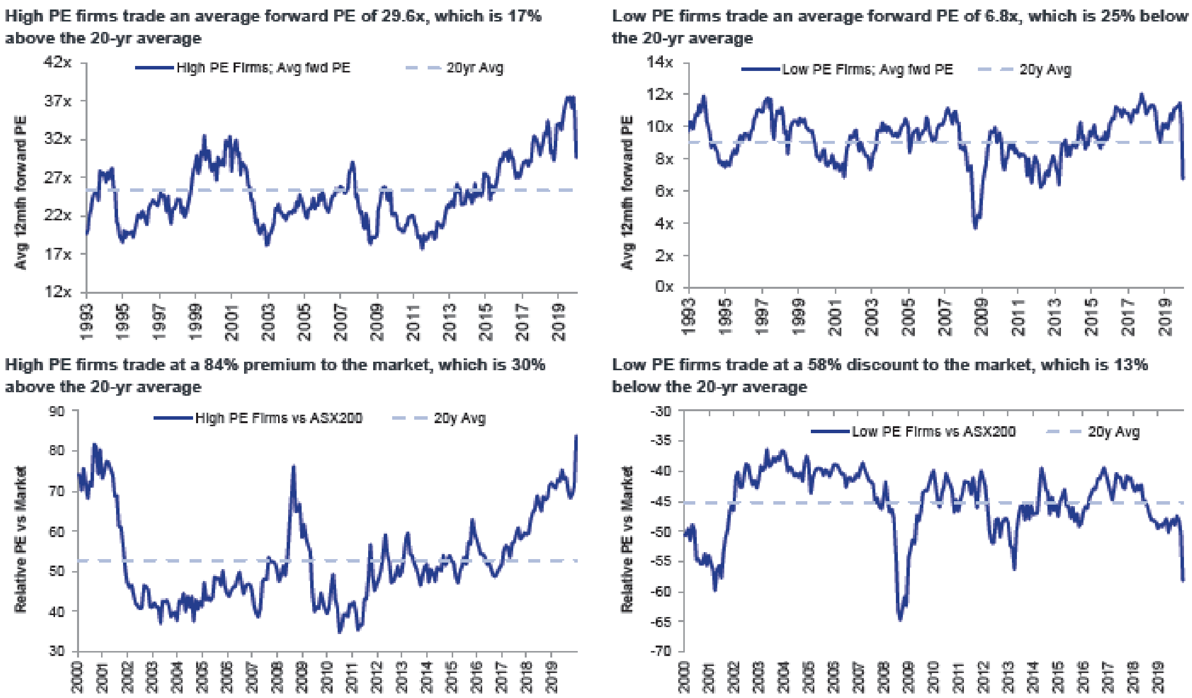
Our portfolios have been positioned with a heavy tilt to the style factor of “value”, which is an outcome of our investment process. Unfortunately in the risk averse sell off, this strategy performed poorly, as investors became more worried about earnings certainty, at any price, (which was somewhat 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 (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.

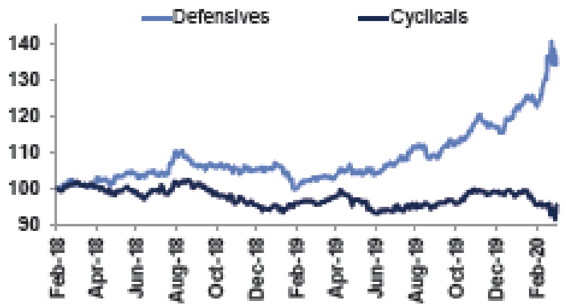
The blowout in the divergence between growth and value, which has seen the portfolio underperform the market, is shown in the following charts. The charts show that the high PE firms have been rerated upwards relative to the market in the sell off, whereas the low PE firms have been downrated. We understand 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.



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.

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

Table 2: Antares Dividend Builder Fund vs Consensus

	Portfolio	Consensus
P/E	14.0x	17.0x
P/CF	7.8x	9.9x
P/B	1.15x	1.7x
Debt/Equity	197%	215%

Source: Bloomberg, Antares Equities; 31 March 2020

As March developed, it became clear that the dividend expectations we had at the beginning of March would need to be wound back. As such we felt it was necessary to change some stock positions where we thought companies may

- reduce the dividend permanently; and / or
- have a balance sheet that was no longer appropriate for the environment, meaning that it was unlikely when the economy reopens that their dividends would reach previous expectations.

In particular, we reduced two exposures we have held in the fund for a long time, being Sydney Airport (SYD) and Transurban (TCL). We switched the proceeds partly into Telstra and Aurizon, both of which we think should be able to maintain dividends.

While SYD and TCL won't be the only companies in the portfolio to cancel dividends, we think this slowdown will have a more permanent long term impact on them because:

- Both of these companies have gearing that would be regarded as 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.
- In the case of Transurban, they were already partly paying distributions out of capital and they have now guided that distributions will be paid only out of operating cashflow.

An unknown risk is the possibility that investors now trade these vehicles as having cashflows that are more risky than was previously thought, leading to a more permanent derating.

Shortly after quarter end, the surprise news came out that New Zealand regulators instructed their banks not to pay dividends. This came on top of similar decisions in Europe and the UK. The relevance for Australia is that the four Australian major banks earn between 10% - 20% of their earnings from New Zealand. This was extremely troubling as we have often seen APRA and the RBA follow international policies. At the time of writing, no such policies have been announced, but our view is that even if banks are not forced to cancel their dividends, they will make big dividend cuts that otherwise might not have occurred. As such, given the fund's large bank exposure, we reduced our bank positions in order to try to further protect the funds dividend stream during this difficult period.

Companies in the portfolio where dividends have been cancelled or postponed include Star Entertainment (postponed) and Harvey Norman (cancelled despite having a strong balance sheet).It is likely going forward the fund may see some other companies reduce, postpone or cancel their dividend. However, we have taken the view these will be temporary, and that there will be a bounce back when the economy resumes. In the case of these cyclical stocks, their share prices have fallen massively, so we have taken the view it is inappropriate to sell at such a large discount to long term value. In short, we have had to make some trade-off between short term dividend stream and expected total returns.

Usually we provide dividend expectations versus consensus, however at this time the landscape is moving too quickly to have any certainty around the accuracy of these forecasts. But we do expect that the yield on the fund will exceed that of the benchmark.

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 randomized 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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