Quarterly Investment Update

Antares Dividend Builder– March 2021

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Highlights for the quarter

Performance: 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.

Yield: The annual income yield to 30 June 2020 was 4.38% versus the benchmark's yield of 3.21%. During the March quarter, dividends were paid by Alumina, Amcor, APA Group, Aurizon, CBA, Coles, GPT, IAG, Iress, Medibank, Metcash, Scentre Group, Tabcorp, Telstra, Transurban and Wesfarmers.

Contributors to capital returns: Positive contributors – CSL (not owned), Telstra, ANZ, Westpac; Negative contributors – Medibank private, IRESS, Viva Energy, Coles.

Stock Activity: Buys – IAG, Transurban; Sells – Nine Entertainment, Amcor, ANZ, Westpac

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 2021[1]

Period	3 months	1 year	3 years pa	5 years pa	10 years pa	Since inception pa
Portfolio[3,4] income yield %	-	4.38	5.05	4.80	4.45	4.13
Benchmark[5,6] inc yield %	-	3.21	3.90	3.99	3.94	-
Net return[2] %	7.6	41.4	5.4	5.4	8.6	6.9

[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.

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.

Contributors to income and returns

Income

During the March quarter, dividends were paid by Alumina, Amcor, APA Group, Aurizon, CBA, Coles, GPT, IAG, Iress, Medibank, Metcash, Scentre Group, Tabcorp, Telstra, Transurban and Wesfarmers.

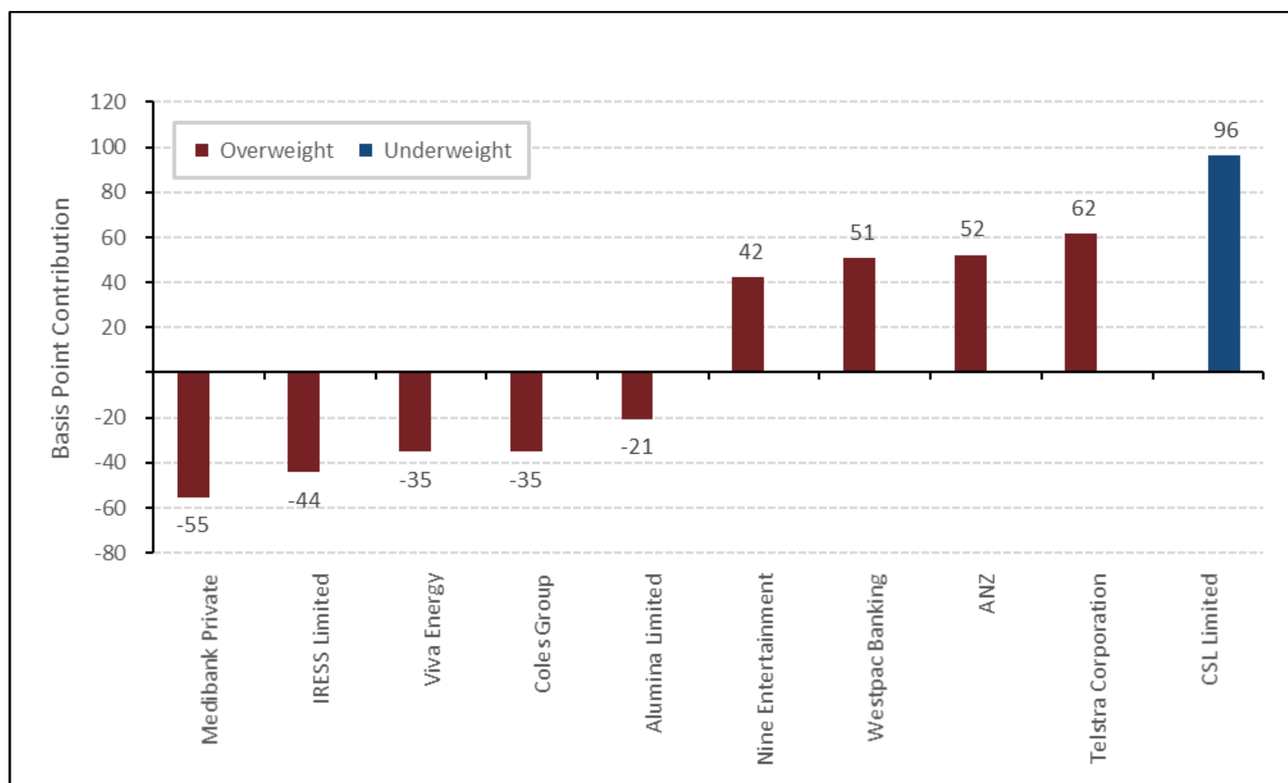
Returns

Major contributors over the quarter included:

- **CSL** (not owned) - The imperative for low income earners to donate plasma (for which they are paid a donation fee) was softened by the announcement of USD1400 per individual Covid support payments by President Biden. This will further delay a recovery in plasma collections for CSL and the whole industry, thereby lowering growth expectations for FY22.

- **Telstra** (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 groups infrastructure, and after the CEO of an aggressive competitor unexpectedly departed.
- **ANZ** (overweight) – ANZ's positive quarterly update suggests the half year result will be very strong on the back of provision releases, favourable funding rates and reasonable mortgage growth. Banks are also seen as beneficiaries should rates rise.
- **Westpac** (WBC, overweight) - WBC also delivered a strong quarterly update that suggests the half year result will be very strong.

Figure 1: Fund attribution – March quarter



Source: Antares, March 2021

Major detractors over the quarter included:

- **Medibank Private** (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.
- **Iress** (IRE, overweight) – IRE produced a really solid result which initially saw the stock price move up 5%. But it subsequently got caught up in the macro information technology sector sell-off which occurred in the second half of the quarter.

Portfolio fundamentals and characteristics

The portfolio has reasonable growth forecast, although below benchmark, while the PE ratio and P/Book ratio are significantly below benchmark. The below profile should allow for solid distribution growth in the year ahead.

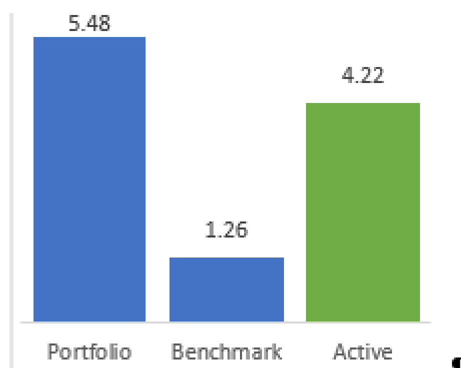
Table 1: Portfolio metrics

Earning Statistics			
	Portfolio	S&P/ASX Industrials 200 Total return	Active
PE (x)	18.78	23.05	-4.27
EPS Growth (%)	5.73	8.42	-2.70
ROE (%)	12.29	14.73	-2.45
Div yield (%)	4.50	3.26	1.24
Payout ratio (%)	102.97	64.5	38.47
Price to Book (x)	1.93	2.61	-0.68
Raw Beta (x)	0.95	1.07	-0.12

Source: Bloomberg, Antares Equities; March 2021

The portfolio expected returns based around Antares fundamental research shows modest upside exists for the portfolio.

Figure 2: Expected Returns (12 month forward estimate %)



Source: Antares Equities, Bloomberg; March 2021

The stock activity section provides more detail about recent portfolio positioning.

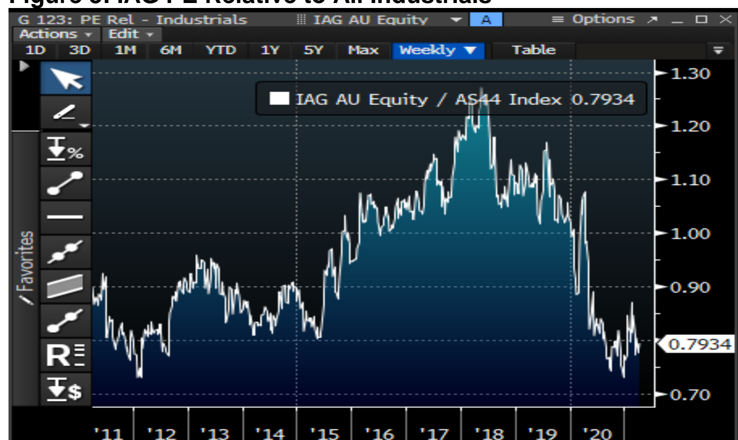
Stock Activity

Buys / additions

- **Insurance Australia Group** (IAG) - We added to the position using proceeds from the sale of other financials. IAG has heavily provided for uncertain claims issues such as business interruption and potential social inflation in the US during last year's capital raising which strengthened the balance sheet. Over time, we would expect more certainty over the quantification of claims which will allow a rerating. In addition, the rate cycle is very strong, and insurers are large beneficiaries of higher interest rates, as their policy holder funds are held in short dated fixed interest securities and cash.

  IAG's PE ratio relative to the industrial market is trading around 10 year lows, which provides plenty of rerating potential should improvement in earnings provide the market with more confidence.

  Figure 3: IAG PE Relative to All Industrials



Source: Bloomberg; April 2021

- **Transurban** (TCL) - We added to the Transurban position for reasons explained last quarter. We are aware that interest rate sensitivities underperformed during the inflationary thematic, but Transurban has inflation protected tolls, which we believe is slightly underappreciated. In particular, we think the reopening of CBD's and travel is not yet fully reflected in estimates for cash flow and distributions.

Sells / reductions

- **Nine Entertainment Group (NEC) -** NEC has been a great performer for the fund. We reduced the size of the position as the stock rallied and approached our target price. Management change also creates a layer of uncertainty as Nine has come through an extremely successful period and we believe media businesses can be very difficult to manage.

  While we expect the business to remain strong, valuation support has now deteriorated significantly (see Figure 4), warranting a lower weighting in the portfolio.

  Figure 4: Nine Entertainment Group PE(x) with standard deviations

  Source Bloomberg; April 2021

- **Amcor (AMC) -** We remain overweight but reduced the size of the position as it is trading around our valuation, and has a large exposure to North America and therefore may be impacted by changes in the US tax rate. This would impact the dividend stream.
- **ANZ and Westpac (WBC) -** We reduced some of the large overweight positions into price strength, in order to broaden the portfolio's risk exposures. Over 27% of the portfolio remains in banks, which is a sizeable exposure.

Outlook and Strategy

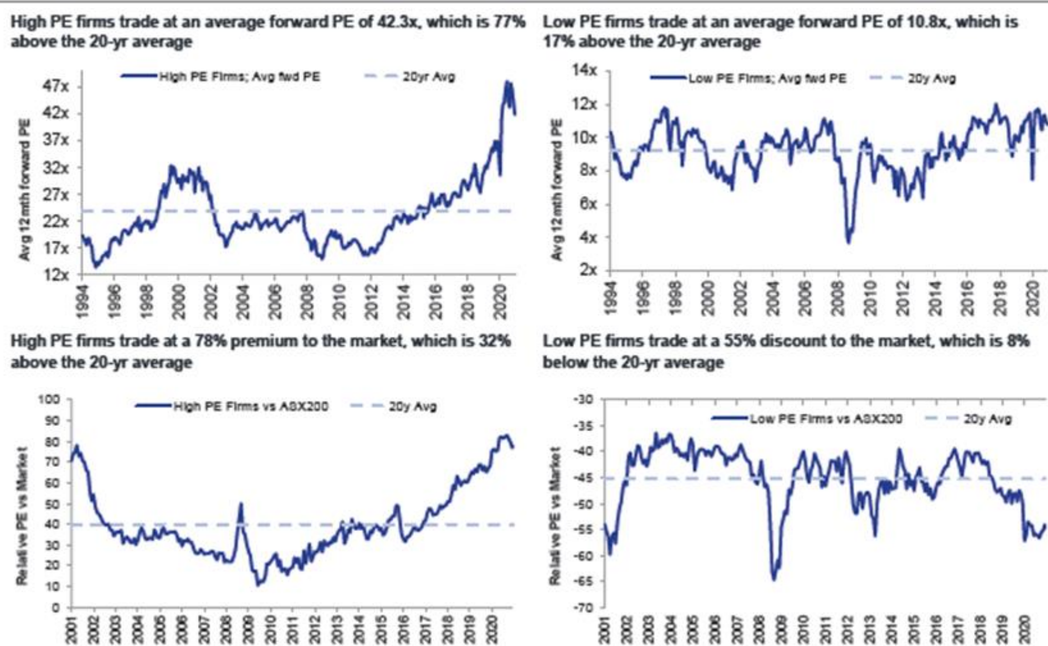
The past six months has been a very good period for the portfolio, with value and cyclicals outperforming growth. After the recent performance, we would expect some consolidation in the market, if not a rotation back in the other direction. Our view is to remain with our bottom up valuations, yield focus and growth in yield. 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 (providing growth in yield opportunities) and likewise attempt to identify previous covid beneficiaries, that might see earnings moderate further than the market now expects as behaviour normalises. The stock commentary highlighted our portfolio activity.

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 5: Valuation dispersion

Valuation dispersion

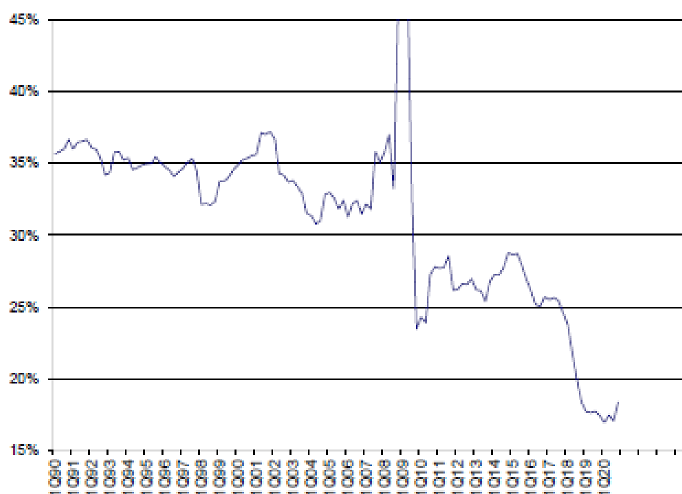


Source Goldman Sachs weekly Kickstart 9/ March 2021

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 6: S&P 500 Tax Rate

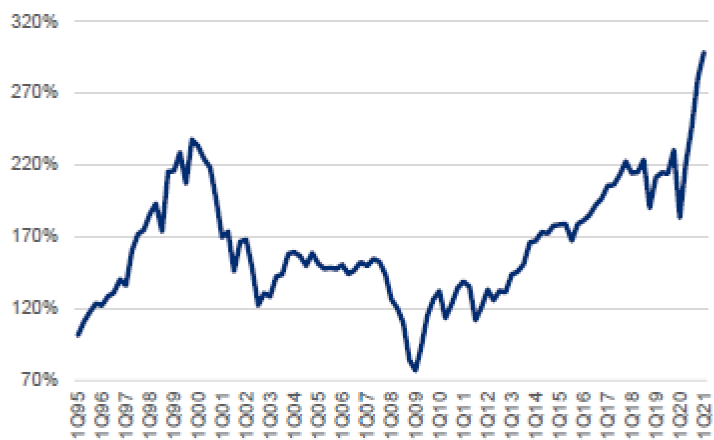


Source Citi, US Equity Strategy, Feeling a 1999 Vibe; 7 April 2021

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 7: 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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