Quarterly Report

Antares Ex-20 Australian Equities Model Portfolio – March 2021

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Highlights for the quarter

Performance: The Model Portfolio returned 2.7% (gross of fees) for the March quarter, outperforming its Benchmark by 1.3%*

Contributors to performance: Positive contributors – Lynas Rare Earth, Nine Entertainment, OZ Minerals ; Negative contributors – Freedom Foods, Afterpay, Northern Star Resources .

Stock activity: Buys/additions – IGO Limited, Paladin, Treasury Wine Estates; Sales/reductions – a2 Milk, Aurizon, Freedom Foods, Santos.

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 March 2021

Period	3 months	1 year	3 years pa	5 years pa	Since inception pa
Gross return %	**2.7**	**62.7**	**14.7**	**14.7**	**14.0**
Benchmark return %	1.4	41.1	8.1	10.4	9.1
Gross excess return %	**1.3**	**21.6**	**6.6**	**4.3**	**4.9**

**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 delivered a positive March quarter, returning 2.7% (gross of fees) which compared to our benchmark of 1.4%. It is pleasing to have posted some solid numbers against the backdrop of a noisy February reporting season, as well as some interesting changes in bond markets which have seen value stocks taking over market leadership during the period.

March 2021 effectively marked 12 months since the impact of COVID 19 became manifest on markets, and, of course, societies. We have been pleased with the results of our strategy during this time, given the disruption and impact COVID has had. As we look forward, however, we see more challenges looming. In our December 2020 quarterly we wrote about some of these risks we saw facing markets in the next twelve months.

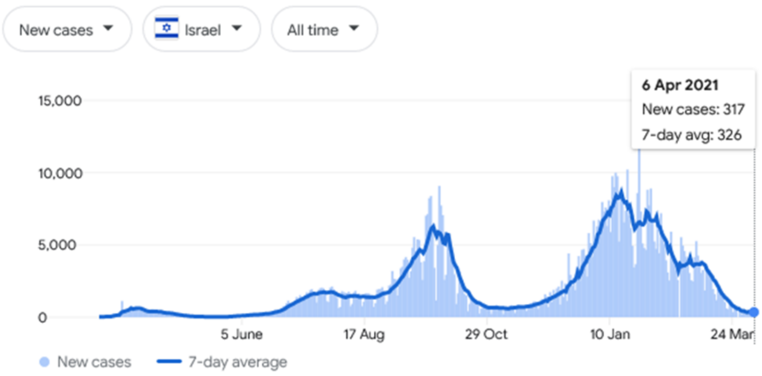
For our outlook we revisit these and broaden the discussion to include some further risks we see developing. We are focusing on the risks in our discussion as our portfolio is actually positioned for an extended period of strong growth, both domestically and off-shore. While this may seem counterintuitive, it is how we negotiate these risks that will determine the outcomes for our investors.

Outlook

Risk One: COVID 19

In December we noted that, while there was vaccine optimism, it may have extended a little too far, too quickly. Three months later, that risk remains valid. Results from Israel, the first country to embark on a major vaccination effort are encouraging. Infections and related illness have dropped to negligible levels. Yet Israel retains significant restrictions, particularly around travel.

Chart 1: Israel COVID Cases



Source: JHU CSSE COVID-19 Data; April 2021

Vaccination efforts in Great Britain and the United States have also shown early success and indicate that many of the logistical issues with which we were concerned can be overcome, at least in a developed economy. On the other hand, the roll-out has been very slow in Europe, as political squabbling has limited supply, coupled with concerns around side-effects from the Astra Zeneca vaccine. Australia, too, is lagging the targets set by the government. Hence sectors like travel and leisure remain at risk from further delays to re-opening.

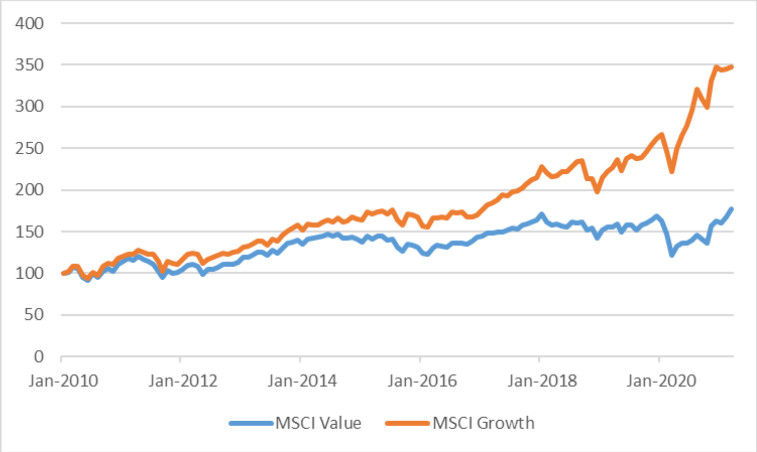
All of this also ignores the acceleration of cases in nations like Brazil and India, as well as closer to home in Papua New Guinea and Indonesia. This creates an imbalanced world, where developing nations lag the recovery. This only adds to the emerging geopolitical risks which we will discuss later in this report.

Risk Two: Inflation

Much of the macro-oriented discussion in the March quarter in markets was around inflation. With such strong rebounds occurring in major economies globally, there is a growing discussion about whether we could see a bout of inflation. As we discussed in December, there has been a great deal of fiscal and monetary stimulus provided by governments to steer their economies through the pandemic. Could this see a boom, similar to that which followed the Spanish-flu pandemic in the 1920's?

We are well-aware of the risk posed by inflation – should inflation break out in a material fashion, central banks will respond by tightening monetary policy which will hit equity markets hard. Further, as we have seen in the past quarter, even the threat of such rate rises can see the market change leadership quite quickly. Globally, we saw value markedly outperform growth in the March quarter, and the magnitude of this reversal was substantial by recent standards.

Chart 2: Value v Growth



Source: Bloomberg; April 2021

This is an important discussion in any outlook for midcap stocks, given they can be more growth-oriented than other segments of the market. Growth stocks are typically "longer duration" as more of their valuation lies in the future. Value stocks are typically more cyclical with more of their valuation nearer term. Hence interest rates play a significant role in determining the market's preference for "growth" or "value". If rates are expected to increase, then the market applies a higher discount rate to future earnings, impacting the valuation of growth stocks more than value stocks. This explains the partial reversal highlighted in the previous chart.

So what is the market actually expecting? One way of examining market expectations for inflation is to look at so-called "breakeven" rates. These measure the yield of US treasuries adjusted for inflation expectations to give a "real yield." This is a proxy for the market's inflation expectations. As the chart below highlights, these rates are now back in the middle of the range they have occupied since the financial crisis ended.

Chart 3: Inflation Expectations as measured by US 10 year breakevens (%)

Source: Bloomberg; April 2021

This is also reflected in 10 Year bond rates generally, where nominal rates have recaptured the lower end of the range in which they have traded since the GFC.

Chart 4: US Ten Year Bond Rate (%)

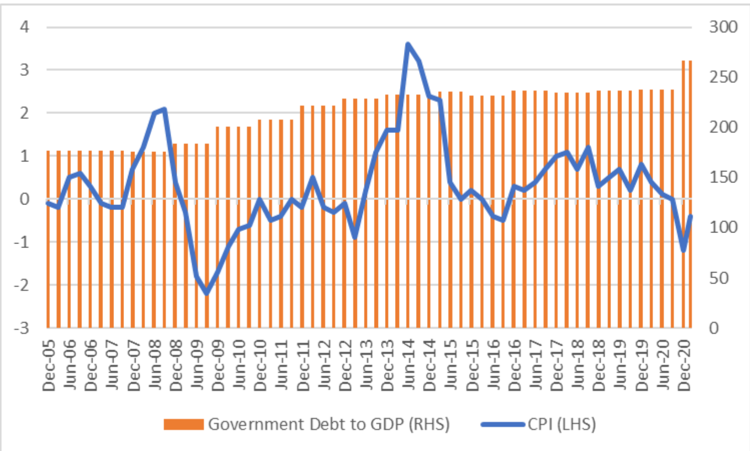
Source: Bloomberg; April 2021

We would note that thus far, interest rates have only actually recaptured the bottom of the ranges in which they were trading prior to COVID. Many are keen to proclaim the stimulatory response to COVID will drive inflation higher, thus marking the end of the 40-year bull market in bonds. Famously, this has driven interest rates negative in some instances. While we don't subscribe to a view that bond rates will resume their downward trajectory, we are more nuanced in our views. We reiterate, for instance that rates have only recaptured the bottom end of pre-covid ranges. And there is evidence to suggest any inflationary issues are likely to be transitory.

Debt and the Developed World

Many developed countries, including Australia, have built up large debt levels in order to protect their economies. We have empirical evidence from Japan and the Eurozone of the impact of this on inflation. As the chart below shows, despite all the borrowing to stimulate the Japanese economy since its bust in the late twentieth century, inflation remains tepid, at best. A chart for the eurozone looks very similar. We believe this is because large levels of public sector debt are disinflationary – they lead to a lack of confidence in investment and higher taxes.

Chart 5: Japanese Public Debt (x) and Inflation (%)



Source: Bloomberg; April 2021

Employment

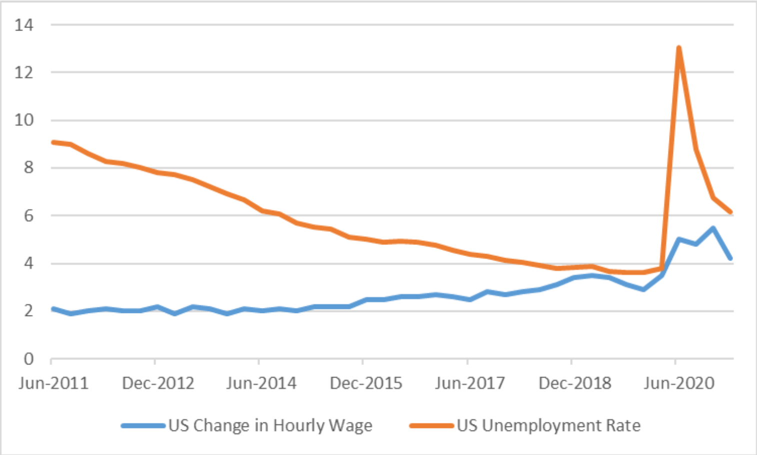
The shock of COVID 19 saw a great number of people lose their jobs, and for many of us, has permanently changed how we work. The impact of long-standing structural changes around technology, in particular, were sped up. This is particularly the case in the services industries, most hit by COVID given lock downs and fears of transmission.

Retail is an example – we now shop on line for so many more things. This has sped up a longstanding transformation and the impact is dramatic. In the US, Investment Banks like UBS and Bank of America expect around 10% of retail space to close. Permanently. And with that will be lost jobs. Retail is semi-skilled and well-paid after commissions and tips are considered. Those sales have moved to automated distribution centres with little labour. Last mile delivery is low skilled and more efficient than retail service on average. These jobs will not re-appear.

Similarly in other service industries technology has displaced people. We are all familiar with the COVID required check-in at restaurants and cafes. What is also possible with these now is to download the café menu and order online directly to the kitchen. Again the café will need less staff.

These are but two areas impacted by the changes brought forward by COVID. This is important in the debate on inflation because, as the chart below shows, despite the very low unemployment achieved in the US prior to COVID, wages barely rose. Why? Technology was a key driver as it kept wages down – it could replace higher priced workers.

Chart 6: US Wages growth v Unemployment Rate (%)



Source: Bloomberg; April 2021

So to conclude on inflation – the risk remains and near term, as we cycle the deflation of early COVID, we expect to see some more noise. Yet the drivers for a sustained pick-up in inflation do not, as yet, seem apparent to us. We think rates will remain range bound.

Risk 3: The US Dollar

We feel the US dollar has stabilised. Despite the US' large stimulus and its borrowing requirements now becoming public knowledge, the US dollar appears to have stabilised against peers, thus removing a systemic risk to the global financial system. Chart 7 shows the USD vs a trade weighted index.

Chart 7: US Dollar Index

Source: Bloomberg; April 2021

Risk 4: Geopolitics

With the swearing in of the Biden administration, we now have a clearer picture of the view of the new US administration on some key areas. Most important of these is the attitude to China. It would seem from actions and words thus far that the Biden administration is attempting to pursue a modern version of the doctrine of containment towards China.

This strategy was coined by US diplomat, George F. Kennan in the aftermath of the Second World War, and described the US' (and its allies) approach to the Soviet Union (and so communism generally) and its expansionary ambitions. Essentially it was to meet the push wherever it came with a counterforce at least equal to that of the threat encountered. This could extend from soft power (influence) and aid, through to the so-called cold war in covert operations to full-scale battle where required – most infamously in Vietnam.

This seems now to be the US strategic approach towards China. It has accepted that China is a rival, rather than a partner. This is a bipartisan view in the US. As it did in the post war period, the US is now attempting to build alliances to check China's political power encroaching on traditional areas of US influence. Australia, as a key US ally, is central to this. It puts Australia's trade links with China in a difficult situation, one we already see with the tariffs on certain products, such as barley and wine.

What does this mean for investment? We think it heightens volatility. The world expanded its wealth immeasurably through the 1950's and 1960's. Geopolitics didn't impact that. But it does add complexity and risk. What is interesting is that China is far more integrated into the global economy than was the Soviet Union at the time. Excluding it, as was done with the Soviet Union is simply not possible. China is attempting to step into the void left by the US in many developing countries and offering its vaccine in exchange for strategic advantage. This was most notably done in Iran recently. This again has potential impacts on the flow of goods and oil through major shipping routes.

Hence geopolitics is increasingly an area of focus for us. China's actions in Hong Kong indicate a more assertive and confident position internally. This is a possible precursor to a change of its approach to Taiwan which could lead to more direct confrontation. We believe that markets are a little too sanguine about this situation and it is worth monitoring.

Conclusion:

Our view remains 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. While the US dollar has stabilised, the step up on geopolitical risk adds a level of "safe-haven" appeal to gold.

We are wary of investments which depend on in-country investment in China. In addition to tariffs on barely, coal and wine, the recent sale by Seek of its Zhaopin business for a seemingly low price suggests that all Australian transactions there are increasingly difficult.

We note that inflation remains a risk, which could drive bond yields higher and disrupt equity valuations accordingly. If this inflation comes from stronger economic growth, then the market will absorb it, albeit with a change of leadership as economically sensitive stocks take the lead. If it is more like stagflation, then the market will struggle to move forward.

At this stage we see strong growth with slack in major economies to absorb increasing demand driven by the vaccine roll-outs. This should be good for markets but it is a fluid situation.

Portfolio activity

Additions

IGO Limited (IGO)

We added IGO to the portfolio in February based on our internal research showing increasing demand for nickel and lithium, coupled with the company's organic production growth profile. Nickel is a key component of lithium ion batteries for electric vehicles, which is a theme already established in the portfolio via our investments in Lynas, Mineral Resources and Oz Minerals. IGO, via its acquisition of Tianqi Lithium, is now a pivotal player in lithium ion battery supply chains. It produces significant proportions of both components and has a low cost of production relative to peers. We like exposure here as the world pivots towards decarbonisation but, as with all our mining investments, there must be a good cost position and increasing production – which IGO now has.

Paladin (PDN)

We added a small position in PDN during the month, taking advantage of the discounted price presented by the company's capital raising. There are a number of reasons we have done this. We note that uranium stockpiles globally have fallen materially as a lack of mine development over recent decades has run these down to near zero. Hence power utilities will need to re-enter the market to find new supply. PDN raised capital in order to have a strong negotiating position with these utilities. We also note that with the world focusing on a zero carbon emission target, we think nuclear energy will have a role to play. Simply, renewables and batteries cannot supply the baseload power required. Historically coal or gas could play that baseload role but these are now unlikely solutions given their emissions. While nuclear is controversial, development in nuclear reactor technology has taken quantum leaps forward, which appears to have been lost in the popular debate.

Treasury Wine Estates (TWE)

We added TWE back to the portfolio in a contrarian investment. The market is very familiar with the punitive tariffs on Australian wine in China. This had been the great driver of TWE's growth as volumes could be shipped there for higher prices, and tightening the supply in other markets. We think the market is now effectively assuming that TWE will not be able to replace the Chinese market and that other wine companies in a similar position will flood the Australian market. We disagree. We think TWE can broaden and diversify its geographic distribution, thereby improving the business. Further, the market overlooks the poor local vintages in 2019 and 2020 which leaves the local market in short supply. Hence we see the market being overly pessimistic about the TWE business.

Removals

A2 Milk Company (A2M)

We exited our position in A2M in February as we do not have any conviction that the company can modify its business model sufficiently to overcome the loss of the daigou channel into China. While daigou will return, as air travel returns, the issue for A2M is that it is missing sales in China and thereby losing relevance in its biggest market. With local brands gaining more and more traction in China, we feel that the road back is very long for A2M with success difficult to achieve.

Aurizon Holdings (AZJ)

We exited our shares in Aurizon based on a review of how we value the business. We now believe that current thermal coal contracts will be peak profitability from that business given the issues are exporting thermal coal to China and the reluctance of some other south east Asian nations to extend the lives of their coal fired power stations. This reduces the valuation of the coal haulage business but also puts pressure on the valuation of the company's major asset: the Central Queensland Coal network. Hence, while near term earnings are solid, we are focused more on the longer term capital appreciation issues, which look increasingly impaired.

Freedom Foods (FNP)

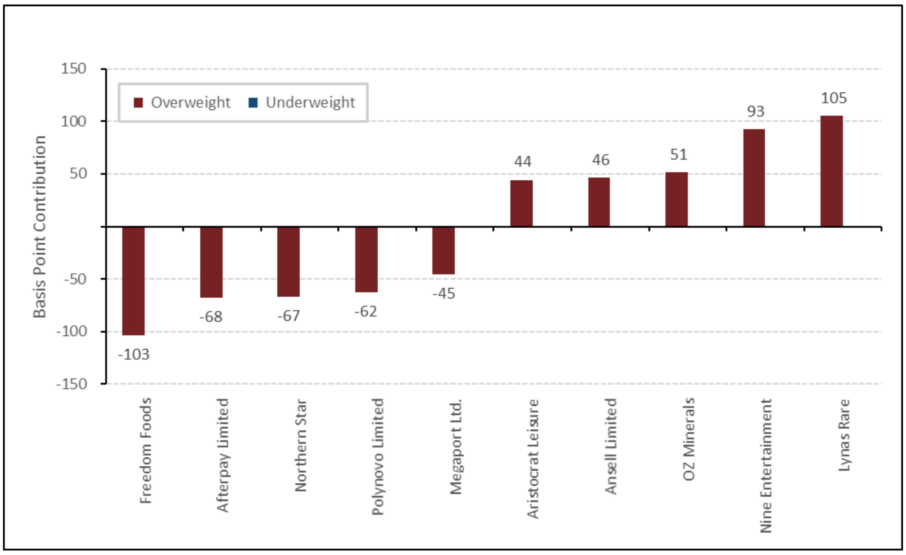
We exited our position in Freedom Foods in March once the stock re-commenced trading. We have written previously about FNP but its demise is a salutary lesson in governance to investors. The seeming mis-statement of results may yet have some way to play out beyond the share market.

Santos (STO)

We also exited our position in Santos (STO). With the strong rebound in oil prices, we believe that our oil stocks have priced in a continuation of the same. We are not sure that oil will continue to recover as quickly given the longer term impact of electric vehicle take up. We also see risk to demand from the aviation sector as countries struggle with their COVID 19 vaccine roll-outs. Further, we note that Iranian oil is poised to re-enter the market following negotiations with China, further denting prices.

Stock attribution

Chart 8: Portfolio attribution – March quarter



Source: Antares, March 2021

Positive contributors

- **Lynas Rare Earths** (LYC) was our best contributor in the quarter. While its February earnings release was strong, of more note has been the surging price of the rare earth commodities LYC mines and processes. This is supported by increasing demands for renewable energy and electric cars for which rare earths are critical components. LYC is both a miner and processor of rare earths, and it is this processing capacity which makes the company strategically valuable given the difficulties in processing this material in countries with meaningful environmental oversights.

- Another major contributor for the period was **Nine Entertainment** (NEC) which reported strong earnings, especially from the more valuable subscription and digital businesses, such as Stan. We see NEC's content advantages continuing to drive share gains, while an improving TV advertising market provides another revenue tailwind. The market finally seems to be coming round to the view that NEC is no longer just an old-fashioned reach media business, rather one increasingly reliant on digital and subscription content
- Finally, **Oz Minerals** (OZL) likewise reported a strong profit for the year ended December 2020, but it was the underlying price rise of its key commodity, Copper, that led to strong share price gains. Like LYC, these gains are driven by demands from increasing use of renewable energy, which is copper intensive.

Negative contributors

- **Freedom Foods** (FNP) also detracted from performance. FNP finally relisted after a long suspension while it recapitalized its balance sheet. This was caused by the ongoing overstatement of results in prior years. The recapitalization was heavily dilutive, and we have written previously about this issue and exited FNP.
- **Afterpay** (APT) also struggled in the quarter despite a very strong February result. The stock seems to have consolidated after posting record highs in January while the market absorbs the risk of higher interest rates on the stock and new competition on the business. Interest rates are more about valuation than any operating impact as high growth companies like APT suffer disproportionately with the impact of higher rates on valuation. Further, with several major new competitors launching, including Affirm and PayPal, many in the market are waiting to see how the APT model responds to these challenges. And with vaccine success in the US accelerating the re-opening trade, APT may be regarded as a COVID winner given its links to online shopping. We note that COVID has slowed the adaptation of its instore business in the US, which has been a key-enabler of its success here in Australia.
- Gold-miner **Northern Star Resources** (NST) also detracted. The gold price has been weaker in 2021 as the markets look to price in a more certain economic recovery from COVID and this has been a drag on NST. Further NST is in some ways a victim of its own success. It is now too large for the world mid cap gold indices and saw it ejected from these. Hence we saw passive selling from such index funds at a time when the gold price itself was weak.

Stock Story

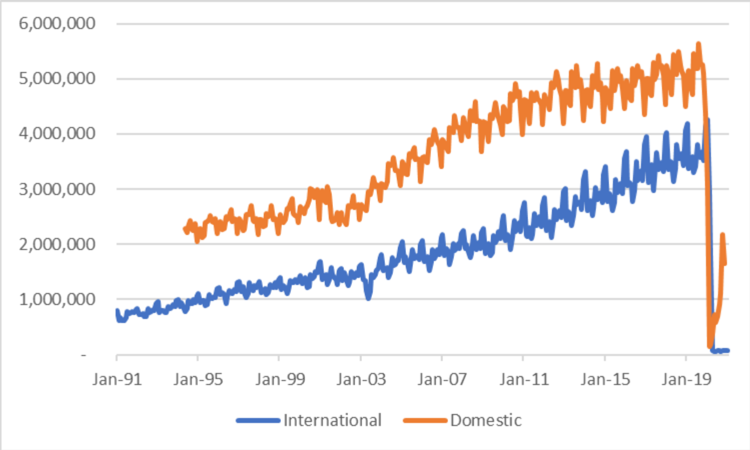
Qantas (QAN)

QAN is a household name in Australia. It is also one of the largest holdings in the ex-20 strategy, one in which we have built increasing conviction through the pandemic. This may seem a little strange at face value – with borders closed and domestic travel severely impaired, why would a rational investor take a large position in an airline?

The answer is at the core of our strategy for investing during the pandemic – looking for companies that benefitted from a significant change in industry dynamics due to the virus. Put simply, QAN's major competitor, Virgin (VAH), was in a very weak financial position going into the crisis. It did not survive, falling into administration in June 2020. VAH had incurred too much debt during a failed strategy to match QAN as the premium Australian airline, and it had built too big a cost base to compete effectively. As it did in many situations, COVID merely sped up industry changes that would have occurred otherwise.

Bain Capital emerged as the successful bidders for VAH, which further enhanced our conviction. As a private equity player, Bain is not a perpetual owner, it is looking to make profit and sell the asset, usually in a pre-planned timeframe, which is typically 5-7 years for private equity investments. Bain restructured VAH to reduce its size by 30% - aircraft were returned from leases and staff made redundant. The airline was permanently shrunk. Yet history shows that Australians' appetite for travel has always bounced back, as the chart highlights – Ansett's failure, SARS, MERS and 9/11 have all seen a temporary slowing then a strong recovery.

Chart 9: Australian Airline Passenger Numbers



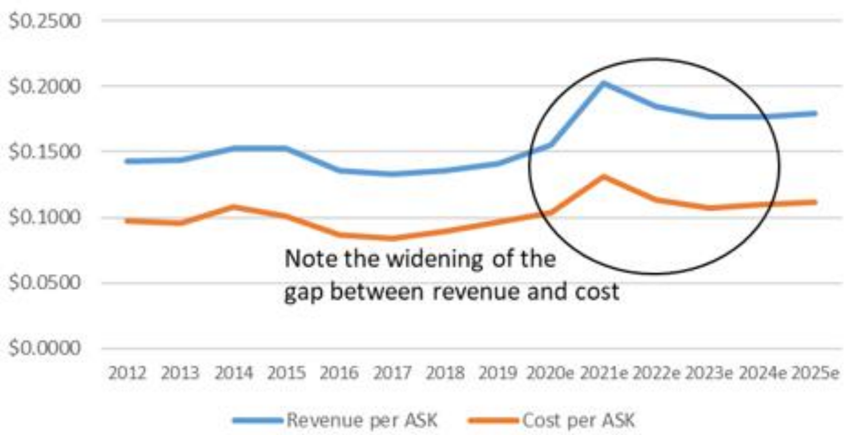
Source: Jeffrey's Research; April 2021

Hence VAH's new owners were effectively handing QAN some free market share. On top of this, Bain will need to raise prices to achieve the return hurdles that are part of private equity mandates. While cost reduction is one thing, yield on ticket prices is the other determining factor on returns. This further helps QAN as it too can be more "rational" on domestic pricing.

QAN has a very experienced management team, one which has used a past crisis in 2014 to reduce the cost base. QAN matched VAH's cost base reductions, predominantly staffing, ensuring the competitive dynamics remained similar. This was why QAN raised approximately $1bn of equity in 2020 – to pay redundancies.

Hence QAN now finds itself with structurally increased market share, a lower cost base and a competitor that needs to maximise profit on a shorter-term basis, requiring ticket price hikes to pay for this. As the chart shows, this will enhance the return on every kilometre flown domestically by QAN.

Chart 10: Qantas revenue and cost per kilometre flown (ASK= Available seat kilometres)



Source: Company Reports and Antares Equities; April 2021

We have not commented on International travel, as the horizon to resumption there is both more uncertain and long dated. But it is an added bonus when it does come. Our investment case is premised on the substantial uplift from the domestic business' returns.

DISCLAIMER

Get in contact

antarescapital.com.au

Toll free: 1800 671 849
Email: investorservices@antaresequities.com.au
Mail: GPO Box 2007 Melbourne VIC 3001