Professional Selection

Quarterly Review

It's lucky that luck is two-sided

December 2016

As bottom-up investors that primarily focus on stock selection, Antares is often asked about the impact of macro developments on our investment decisions. The events of the past six months provide a great example of how we navigate the unpredictability of the macro environment (which involves some element of luck!) whilst focusing on where we think we have a comparative advantage – in-depth research and insights into individual companies.

UK Brexit vote and US election - a volatile six months

The past six months has delivered considerable macro volatility to equity markets, with the UK Brexit vote and the US election being the two key drivers. Several interesting observations that can be made about these two events:

- In both cases, the low probability outcome – a 'yes' vote in the UK and a Trump victory – became reality. So investors were not anticipating the outcomes and equity markets had not 'priced in' the implications. Such unexpected events often generate heightened market volatility.
- Investor sentiment (ie investors' emotions) towards these outcomes was strongly negative in the lead up to decision time - Brexit was viewed as a 'disaster' for the UK, as was a Trump victory in the US. For example, in the lead up to the Presidential election, equity markets were clearly pricing in a Clinton victory as markets rallied when this seemed more likely and sold off when negative news towards Clinton (eg FBI email investigation) increased the probability of a Trump victory.
- Amazingly, equity markets then rallied strongly after both these low probability events became reality. Whilst this seems odd, it appears that negative sentiment (ie human emotions) had to give way to economic reality, as the subsequent fall in Sterling was viewed as a huge stimulus to the UK economy and Trump's fiscal policies (infrastructure spending, tax cuts) are expected to boost US growth. So sentiment dominated before the event but when faced with the reality of each outcome, investors looked to economic theory for guidance.

Misleading markets - perfect foresight wouldn't have helped

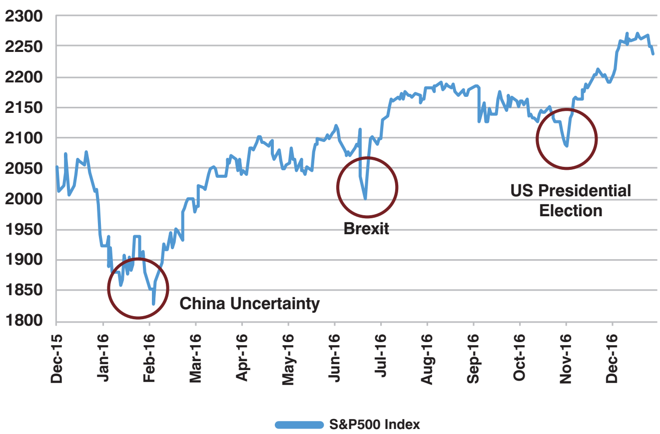
As bottom-up stock pickers, Antares does not generally forecast macro events or attempt to position our portfolios for expected macro outcomes and here is a major reason why. The Brexit and Trump experiences show that even if we had perfect foresight into these macro outcomes – ie we knew ahead of time that the UK would vote to leave the EU and Trump would win the Presidential election - it would not have benefited our investment decisions as market movements around these events were so misleading. Our experience suggests that macro events are very hard to predict and equally hard to trade around

Two-sided luck

So how did we fare in our Portfolios? Brexit negatively affected relative performance as we had positions in several stocks with UK exposure and it caused bond yields to fall, which impacted our underweight position in interest rates sensitive stocks. But the element of luck associated with macro outcomes is two-sided. Trump's victory was positive for our relative performance as we are overweight several stocks that should benefit from higher US infrastructure spending and stronger US growth, and underweight interest rate sensitive stocks that sold off in response to higher bond yields.

So over time we benefit from some macro outcomes and not others, and luck can go our way or not. What persists however, is our strength and insights into bottom-up stocks selection and this is what ultimately drives our investment performance.

Chart 1: The ups and downs of the US share market in 2016



Source: Bloomberg, Jan 2017

Managing quirky, risky small caps

One of the key challenges in small cap investing is balancing the inherent risks associated with smaller companies with the desire to generate solid excess returns. Small caps can be stellar performers but finding the best investment opportunities amongst the myriad of options requires in-depth research, and constructing a portfolio that reflects the true risk profile of the sector requires a disciplined investment approach. It is a market that clearly illustrates the benefits of an actively managed approach implemented by investment professionals.

The quirkiness of small caps

Relative to large cap companies, small cap companies are quirky – they have peculiar traits that present a wider range of potential investment outcomes, namely:

- less diverse earnings streams, often relying on a single line of business;
- businesses that are highly leveraged to the domestic economy;
- often exhibit higher growth rates off lower earnings bases; and
- thinner management teams, often with limited experience as a listed public company.

These factors often result in small cap earnings being more volatile and vulnerable to small changes in economic and product market conditions. Operating leverage can also result in relatively minor top-line earnings disappointments flowing through into large profit downgrades.

Investors also have less information about smaller companies from primary and secondary sources as there is less disclosure by these companies and the broker 'sell side' analysis is less extensive and thorough. While this means the probability of finding a 'hidden gem' is higher, it also significantly increases the research effort and skill required. Capturing high growth rates into a static valuation also introduces more forecasting risk.

The riskiness of small caps

The above factors also alter the risk profile of small caps relative to their large cap peers and this is where professional portfolio management becomes so important. Stock specific risk is higher for small caps as even small events can significantly impact earnings outcomes – some small cap companies actually go broke, a rare event amongst larger companies.

Overall portfolio risk is also an issue as the risk spectrum across the small cap universe is much wider than large caps but the lure of potentially high returns is strong. Inexperienced investors often construct small cap portfolios that put more focus on the high expected returns than the actual risks involved. Managing overall portfolio risk requires a systematic approach to portfolio construction which enables some positions in high risk/potentially high reward companies without allowing them to dominate (or damage!) portfolio returns.

Honing a small cap portfolio

Without broad coverage of the small cap universe and in-depth professional research, constructing a small cap portfolio with sensible, monitored risk levels is difficult to achieve. At Antares, we manage the overall risk in our small cap portfolios through our Core, Growth and Blue Sky framework (see Table 1). This enables us to analyse the risks we are taking and whether or not each one stacks up in the context of the overall portfolio.

Core stocks provide stability and underpin the performance of the portfolio, offsetting the risk inherent in the other categories. Growth stocks have more risk but they have some earnings track record, so our research is underpinned by evidence. Blue Sky stocks are the most risky and hard to analyse, hence their relatively small portfolio weight. But they provide a large and welcome performance 'kicker' when we call them correctly!

Table 1: Antares Core, Growth and Blue Sky Framework

Stock type	Portfolio weighting range	Typical portfolio weight	Maximum investment per stock	Characteristics
Core	40-75%	~45%	10%	Established earnings track records and relatively deep management teams. More efficiently priced and relatively liquid. Core stocks provide stability and underpin the performance of the portfolio, offsetting the risk inherent in the other categories.
Growth	25-50%	~45%	5%	Smaller size, with a more limited earnings track record, making analysis more difficult but possible. Thinner management teams and less liquid so the risks are higher, but so are the potential returns.
Blue Sky	0-20%	~10%	2.5%	Either innovative products or technologies, or promising exploration potential but are yet to establish strong earnings streams. Clearly they are high risk and illiquid but possess excellent potential.

Source: Antares Equities Research

Antares market & fund updates

Below is a brief review of how the Australian share market performed during the quarter as well as short commentaries on each Antares Fund, outlining their net performance and the main contributors to performance.#

Australian sharemarket review

The Australian share market performed well in the December quarter, with the S&P/ASX 200 Accumulation Index rising 5.2%. The main driver was Trump's US election victory as the prospect of stronger global growth led by infrastructure spending was viewed as positive for commodities. The resource sector (+8.7%) outperformed in this environment, along with the energy sector (+7.5%) that was boosted by the 11% rally in the oil price following OPEC's agreement to cut production.

The bank sector (+13.8%) was supported by the continued move out of traditional interest rate sensitive stocks as 10-year bond yields rose around 80 basis points during the quarter. Several defensive sectors lagged the rally, including health care (-8.8%), telecoms (-4.3%) and consumer staples (-1.7%).

Corporate activity was widespread across the market and included the following significant deals:

- Tatts Group (TTS) and Tabcorp Holdings (TAH) announced a proposed merger in which TTS shareholders would receive $4.34 per share from TAH.
- Boral (BLD) announced a circa $2.1b capital raising, with the proceeds to be used to help fund the acquisition of Headwaters.
- South32 (S32) entered into an agreement to buy Metropolitan Colliery and a 16.7% interest in the Port Kembla Coal Terminal from Peabody for around US$200m.
- Qube Holdings (QUB) announced that it was buying a 50% interest in AAT from Brookfield for $150m.
- Woolworths (WOW) announced it was selling its petrol stations to BP for $1.8b.
- Origin Energy (ORG) announced its intention to spin-off its E&P business in mid-2017.
- Santos (STO) announced plans to further reduce its gearing via a $1.5b capital raising.
- A consortium led by Cheung Kong Infrastructure (CKI) announced a takeover bid for DUET Group offering $3 cash per share which was a 29% premium to the prevailing share price.

Australian Equities Fund

The Antares Australian Equities Fund returned 6.5% (net of fees) for the December quarter, outperforming its benchmark S&P/ASX 200 Accumulation Index return of 5.2% by 1.3%. The main contributors to quarterly performance relative to the benchmark were overweight positions in Sims Metal Management and Incitec Pivot. Overweight positions in Healthscope and Crown Resorts detracted from relative performance.

Dividend Builder

Antares Dividend Builder delivered a return of 5.0% (net of fees) for the December quarter, outperforming the benchmark S&P/ASX 200 Industrials Accumulation Index return of 4.5% by 0.5%. The main contributors to quarterly performance relative to the benchmark were overweight positions in ANZ Banking Group and Tatts Group. The main detractors from relative performance were the Fund's cash holdings, given the market performed well, and an overweight position in Wesfarmers.

Elite Opportunities Fund

The Antares Elite Opportunities Fund returned 5.3% (net of fees) for the December quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 5.2% by 0.1%. The main contributors to quarterly performance relative to the benchmark were overweight positions in Incitec Pivot and Rio Tinto. The main detractors from relative performance were overweight positions in Vocus Communications and Healthscope.

High Growth Shares Fund

The Antares High Growth Shares Fund returned 3.7% (net of fees) for the December quarter, underperforming its benchmark S&P/ASX 200 Accumulation Index return of 5.2% by 1.5%. Contributing positively to quarterly performance relative to the benchmark were overweight positions in Computershare and Incitec Pivot. The main detractors from relative performance were overweight positions in Vocus Communications and Healthscope.

Small Companies Fund

The Antares Small Companies Fund delivered a return of -5.4% (net of fees) for the December quarter, underperforming the benchmark S&P/ASX Small Ordinaries Accumulation Index return of -2.5% by 2.9%. The main contributors to quarterly performance relative to the benchmark were overweight positions in Beach Energy and BT Investment Management. Detracting from relative performance were an overweight position in Mayne Pharma Group and the decision not to hold a position in Oz Minerals given the stock performed well.

Australian Shares Fund*

The Antares Australian Shares Fund delivered a return of 6.5% (net of fees) for the December quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 5.2% by 1.3%. The main contributors to quarterly performance relative to the benchmark were overweight positions in Sims Metal Management and Incitec Pivot. Overweight positions in Healthscope and Crown Resorts detracted from relative performance.

Listed Property Fund

The Antares Listed Property Fund delivered a return of -2.8% (net of fees) for the December quarter, underperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index return of -0.7% by 2.1%. Positively contributing to quarterly performance relative to the benchmark were an overweight position in Asia Pacific Data Centre Group and an underweight position in Vicinity Centres. The Fund's relative performance was negatively impacted by an underweight position in Dexus Property Group and an overweight position in Iron Mountain.

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#All returns are net of fees. Please refer to page 6 of the Quarterly Review for a summary of returns which are gross of fees.
*Closed to new investments

Antares Investment Returns

Performance to 31 December 2016[1]

		3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Since Inception % p.a.
Australian Equities							
Australian Equities Fund Inception date: 03/07/1995	Net return[2]	6.5	15.0	7.6	12.1	5.4	9.7
	Gross Return[3]	6.7	16.0	8.5	13.1	6.3	10.6
	Benchmark Return	5.2	11.8	6.6	11.8	4.5	9.4
	Net Excess Return	**1.3**	**3.2**	**1.0**	**0.3**	**0.9**	**0.3**
	Gross Excess Return	**1.5**	**4.2**	**1.9**	**1.3**	**1.8**	**1.2**
Dividend Builder Inception date: 06/09/2005	Net return[2]	5.0	8.6	9.0	15.4	6.4	8.2
	Gross Return[3]	5.1	9.3	9.6	16.1	7.1	8.8
	Benchmark Return	4.5	7.5	9.0	16.0	5.6	7.8
	Net Excess Return	**0.5**	**1.1**	**0.0**	**-0.6**	**0.8**	**0.4**
	Gross Excess Return	**0.6**	**1.8**	**0.6**	**0.1**	**1.5**	**1.0**
Elite Opportunities Fund Inception date: 18/11/2002	Net return[2]	5.3	13.6	8.0	12.1	6.2	11.1
	Gross Return[3]	5.5	14.4	8.7	12.9	7.0	12.0
	Benchmark Return	5.2	11.8	6.6	11.8	4.5	9.3
	Net Excess Return	**0.1**	**1.8**	**1.4**	**0.3**	**1.7**	**1.8**
	Gross Excess Return	**0.3**	**2.6**	**2.1**	**1.1**	**2.5**	**2.7**
High Growth Shares Fund Inception date: 07/12/1999	Net return[2]	3.7	11.2	7.8	12.7	6.8	11.0
	Gross Return[3]	4.0	12.4	8.9	13.8	8.0	12.6
	Benchmark Return	5.2	11.8	6.6	11.8	4.5	8.1
	Net Excess Return	**-1.5**	**-0.6**	**1.2**	**0.9**	**2.3**	**2.9**
	Gross Excess Return	**-1.2**	**0.6**	**2.3**	**2.0**	**3.5**	**4.5**
Small Companies Fund Inception date: 19/11/1999	Net return[2]	-5.4	5.5	2.6	6.0	4.5	9.5
	Gross Return[3]	-5.2	6.6	3.6	7.1	5.5	10.6
	Benchmark Return	-2.5	13.2	6.2	4.9	-0.3	4.5
	Net Excess Return	**-2.9**	**-7.7**	**-3.6**	**1.1**	**4.8**	**5.0**
	Gross Excess Return	**-2.7**	**-6.6**	**-2.6**	**2.2**	**5.8**	**6.1**
Listed Property							
Listed Property Fund Inception date: 28/02/1994	Net return[2]	-2.8	10.1	16.4	17.4	2.1	8.3
	Gross Return[3]	-2.6	10.9	17.2	18.2	2.8	9.1
	Benchmark Return	-0.7	13.2	18.0	18.5	0.4	7.9
	Net Excess Return	**-2.1**	**-3.1**	**-1.6**	**-1.1**	**1.7**	**0.4**
	Gross Excess Return	**-1.9**	**-2.3**	**-0.8**	**-0.3**	**2.4**	**1.2**

Disclaimer:

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 Gross returns are provided to show performance against the investment objective.

*Performance is based on the income and market value of the Antares Ex-20 Australian Equities SMA Model Portfolio.

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