Quarterly Review

Understanding Antares' selectively contrarian investment approach

March 2017

There are hundreds of companies listed on the Australian Stock Exchange but most Antares portfolios invest in less than 50 stocks. So how do we determine what stocks "make the cut"? This article details Antares' "selectively contrarian" investment process that is applied to our large capitalisation share strategies and illustrates the main points with stories about stocks that we have held in our portfolios.

Antares investment philsophy

Antares focuses on actively managing our large capitalisation portfolios as we believe we can add value by exploiting market inefficiencies. Antares investment philosophy is based on the belief that the pricing of individual stocks on the Australian share market is at times inefficient.

Stocks sometimes trade away from what we believe to be their underlying valuation for a period of time. We believe it is possible to exploit these inefficiencies to deliver potentially superior investment returns. This is primarily achieved by identifying stocks trading away from their underlying valuation by taking a longer term view than the average investor in the market, systematically conducting detailed bottom-up research and ensuring the risk taken is commensurate with the expected return.

We believe mispricing occurs for a number of reasons, including the following:

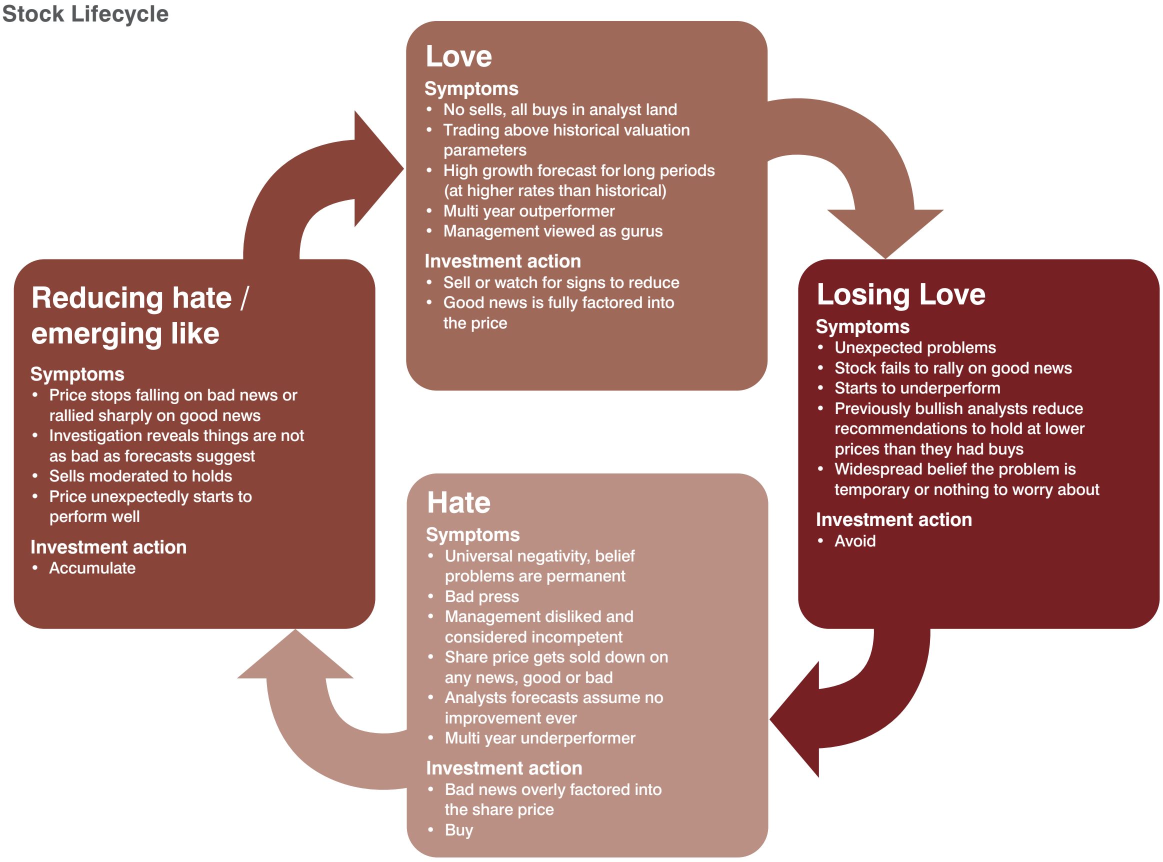
- Investors take a short term view.
- Investors do not have a systematic process for assessing environmental, social and corporate governance (ESG) issues.
- Investors over or under react to changes in a company's operating environment.
- Stock analysis from brokers can be conflicted, leading to ill-informed stock recommendations.
- Investors make incorrect generalisations about similar companies or companies in the same industry.
- Investors often extrapolate short term observations to the longer term.

When stocks trade away from their underlying valuations we see investment opportunities. We can take overweight positions in companies that we believe are undervalued by the market or avoid investing in companies whose valuations exceed our in-house estimates.

The stock lifecycle

To better understand the types of companies that Antares seeks to invest in, it is helpful to look at the "stock lifecycle" that is detailed in Chart 1.

Chart 1: Stock Lifecycle



Source : Antares

Ideally, Antares looks for opportunities amongst stocks that are trading in the "hate" and "reducing hate/emerging like" phases of the lifecycle. This is when other investors have lost faith in the company and the share price has underperformed for some time. The "hate" phase is the ideal time to invest as the share price is often near its lows.

When we analyse a company with a view to potential investment it generally exhibits some characteristics which have caused it to be "out of favour" with the market. By this we mean such stocks are often universally disliked by investors who view the company's current problems as permanent. They tend to be experiencing bad press and management are viewed as incompetent. The share prices of such "unloved" companies are often sold down on any news, good or bad. Hence they end up as multi-year underperformers.

By conducting detailed bottom-up analysis of the future prospects of such companies we are able to come up with our internal valuations which are sometimes different from the consensus view or the current share price. Our research seeks to understand:

- why the stock has been so weak;
- whether the factors causing the share price weakness are temporary or permanent;
- possible catalysts for an improvement in share price performance – eg temporary issues resolved, management change, new product launch, change in industry structure, takeover potential and so on; and
- how likely these catalysts are to occur and over what timeframe.

Investing in companies which are unloved by the market clearly has its risks, but often these companies are trading at such low levels that many of the perceived risks of the investment are already factored in. So the risk of losing money (ie the share price falls further) is less than many investors believe.

Conversely, Antares generally avoids companies in the "love" and "losing love" phases of the lifecycle as their valuations tend to be significantly above our in-house estimates, a lot of good news is priced into relatively high share prices (priced for perfection) and they are widely held by the market.

We are selectively contrarian

We like to describe our broad investment philosophy as "selectively contrarian". This means we like to be contrarian - we go against the market by investing in companies that most investors are avoiding - but we are selective in which ones we choose.

It is always important to remember that not all out of favour companies make good investment opportunities. Sometimes there are legitimate reasons why the share price has fallen and we can't identify any catalysts for change. This is why being selective is also critical to our process. Our experience, insight, detailed analysis and peer discussions are our guides when determining which out of favour companies are the most compelling investment opportunities.

Antares investment process in action

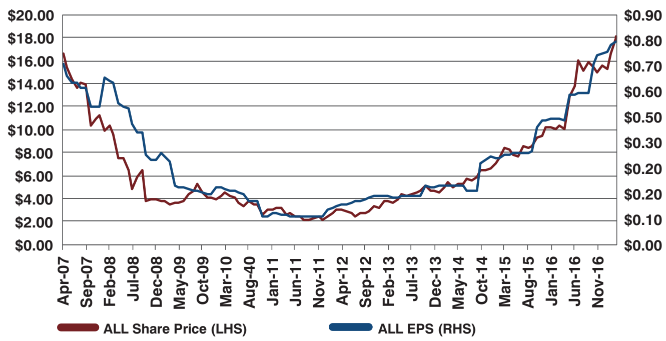
The best way to explain how we pick stocks is with examples – companies we have actually invested in over the years and the rationale for our decisions.

Aristocrat Leisure - undervalued gains from content investment

Aristocrat Leisure is essentially a gaming company. Its main operations include the design, development, manufacture and marketing of electronic gaming machines, video lottery terminal systems and casino management systems. The company also has online social gaming and operates in the real money wager markets.

When we analysed Aristocrat in early 2010, the share price was languishing in response to weaker earnings. In Ariostocrat's main businesses, content drives revenue and it was clear to us that previous management had under invested in content. The number of new patents for unique content that the company had lodged had fallen dramatically and we believed a significant catch up was required.

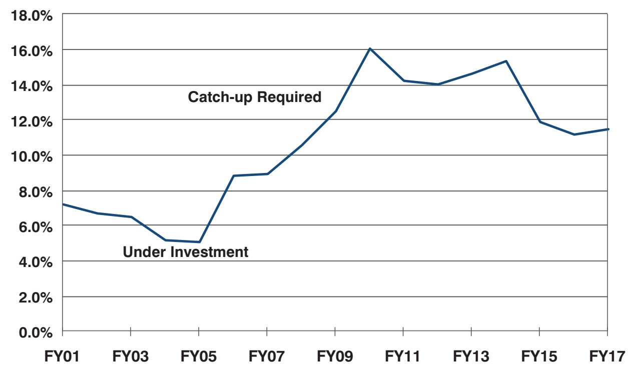
Chart 2: Aristocrat's share price and earnings per share



Source: Antares, March 2017

After underspending for many years, thus bolstering short term profit at the expense of the company's longer term future, ALL began to spend heavily as Chart 3 below shows. As revenue was falling from its previous underinvestment, content spend as a percentage of total revenue shot up and the profit declines were magnified by this double negative content leverage. This resulted in significant share price weakness which provided us with an investment opportunity.

Chart 3: ALL design costs as a percent of revenue



Source: Antares, March 2017

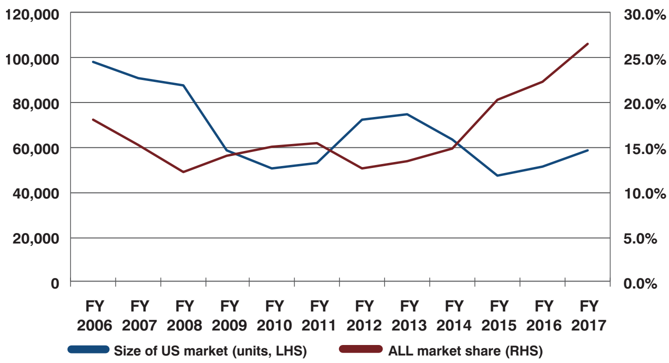
The mistake the market made was to assume that Aristocrat's lower level of earnings would continue even after the reinvestment in content was undertaken. The market capitalised this level of loss - as it tends to do in these situations - without thinking there might be a revenue benefit in time from actually having something new to sell. Games are like movies and songs. You always need something new. We felt there was a high probability that investing in new content would result in significant revenue gains. And we were right.

As revenue began to recover, ALL also enjoyed a slice of good luck. Its main rival, International Gaming Technology (IGT) was acquired by Gtech, an Italian lottery company. This provided all sorts of problems for the old IGT business as regulatory approvals are required in all markets, and for a foreign buyer of a US company, they can be quite onerous. Further, GTech was not focused on gaming machines, hence competition from IGT disappeared almost completely.

At the same time, a complicated series of transactions saw its other rivals, Bally and WMS merge, then get taken over in a leveraged buy-out. Hence the distractions of the merger, coupled with the restrictions of such high debt levels on the new entity, have subdued the output from this competitor too.

ALL's market share in both Australia and the US, the world's biggest markets, has soared (see Chart 4 below), underpinning the earnings recovery illustrated in Chart 2 above. While ALL continues to take market share, we believe investors will continue to under appreciate its earnings growth as neither of its main rivals looks anything like the competitors of years gone by.

Chart 4: US market size and Aristocrat's market share



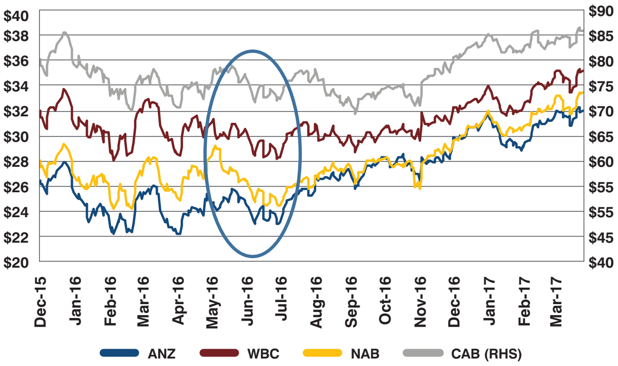
Source: Antares, March 2017

Bank stocks in mid-2016 - significantly undervalued relative to our research

In the firsh half of 2016, investors were generally negative on bank shares for a number of reasons:

- The sector had recapitalised in 2015, putting significant downward pressure on share prices. Investors were concerned about further regulatory change that could result in another round of rights issues.
- The sector remained in a low revenue environment which was increasing competition and putting pressure on margins. This was unlikely to change until the interest rate cycle turned and enabled the banks to widen margins again.
- Competition in the mortgage market was very aggressive, driven by large discounts being offered by Commonwealth Bank (CBA). This increased CBA's market share and reduced the profitability of mortgages for the other major banks.
- All four major banks were competing strongly in the small and medium enterprise market. This reflected a decision to move away from offshore businesses and refocus back on the domestic market. For example, National Australia Bank (NAB) divested its UK operations and ANZ Banking Group (ANZ) was reducing offshore assets.

Chart 5: Bank share prices



Source: Bloomberg, March 2017

Bank share prices fell sharply in May and June 2016 (see Chart 5) making them very attractive when viewed from the perspecive of our investment philosophy. Several Antares funds moved overweight selected stocks within the sector at this time for the following reasons:

- Bank valuations were cheap in absolute terms and relative to the overall market. This was very significant as the rest of the industrial market was generally trading quite expensively at the time. Table 1 shows how far each bank's share price would need to rise to reach Antares fairly conservative target prices based on our in-house research as at June 2016. This suggested to us that the banks were presenting quite an attractive investment opportunity.

Table 1: Potential upside for major bank share prices – June 2016

Bank	ANZ Banking Group	Commonwealth Bank	National Australia Bank	Westpac Banking Corporation
Price rise required to reach Antares target price	35.1%	9.8%	30.6%	18.4%

Source: Antares, as at June 2016

- Banks were still delivering relatively high yields. For example, at that time, the indicative Bloomberg 1-year forward yield estimates for the major banks are around 6.7% for ANZ, 7.4% for NAB (but there is a high chance this will be reduced), 6.4% for Westpac Banking Corporation (WBC) and 6.0% for CBA. We believed investors still had a high demand for yield given the current very low interest rate environment and the structural shift to an aging population.
- Bank management were continuing to focus on cost cutting to achieve earnings growth and there was also interest in generating efficiencies through next generation technology and systems.
- The major banks had recently repriced their mortgage books and we believed this would provide some earnings growth in the year ahead.
- Provisioning was generally stable, suggesting no worsening in the bad and doubtful debt situation. This was a welcome development.
- Whilst there was a possibility that the banks would be forced to raise more capital for regulatory reasons, we believed the prevailing low level of bank valuations was already pricing in at least some of this risk.

Overweight positions in ANZ, WBC and NAB performed well for Antares in the second half of 2016, with the undervaluation of these shares being close fully unwound by the end of the December quarter.

Asciano take-over - when industry players see the value that we see

Sometimes when we invest in an undervalued company, other companies in the same industry or with related businesses can also see the inherent value and the stock gets taken over. An example of this was our investment in Asciano (AIO).

Asciano was an Australian freight logistics company that operated railway freight, shipping and port facilities. AIO's main subsidiaries included Patrick Corporation and Pacific National (rail).

Several Antares portfolios had exposure to AIO when it was taken over by a consortium led by Qube Holdings and Canadian based Brookfield Infrastructure Partners in early 2016.

Whilst we had several reasons for initially investing in AIO and we were long-term holders of the stock, we always believed the market was under estimating the strategic value of infrastructure assets, particularly its port facilities. The industry was essentially structured as an oligopoly (so competition was limited) and AIO's subsidiary, Patrick Corporation, had a significant competitive advantage due to its dominant position in Sydney. Through Patricks, AIO handled nearly half of all the container traffic entering and leaving Australia.

Whilst the takeover of AIO was a messy affair - a bid from Brookfield Infrastructure in August 2015, a counter bid from Qube soon after and finally a joint bid from Brookfield and Qube in March 2016 – the strategic nature of AIO's assets were always the main driver of the deal.

Whilst we did not initially purchase AIO on the basis that it could be taken over, we viewed its assets as undervalued and over time industry players, such as Qube and Brookfield, arrived at the same view.

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 delivered strong returns in the March quarter, with the S&P/ASX 200 Index rising 4.8% and hitting a two year high. The best performing sectors were the defensives, including healthcare (+14.9%), consumer staples (+10.8%) and utilities (+10.7%). The banks (+6.6%) also outperformed following the announcement of interest rate rises by the major banks which have improved the earnings outlook. The only sectors to deliver negative returns were REITs (-0.3%) and telecoms (-4.6%). The latter was impacted by ongoing concerns about weaker profitability across the sector due to the competitive impacts of the NBN rollout.

There was a strong focus on the February reporting season which was generally positive. Company profits rebounded, mainly due to strength in resource sector earnings that were boosted by higher commodity prices. High dividend pay-outs and the focus on cost cutting continued to be dominant themes and there were early signs of improvement for companies exposed to infrastructure and capital spending. There were consensus upgrades to aggregate FY17 earnings, driven by resources and banks, although the outlook for industrial earnings was more subdued.

Significant corporate activity included Premier Investments acquiring around 10% of the issued shares in Myer Holdings and Downer EDI making a takeover bid for Spotless Group. The $1.15 per share offer represented a 59% premium to the previous closing price of Spotless shares. The retail sector weakened late in the quarter due to the pending entry of Amazon into the Australian market. Investors are concerned that Amazon will take market share away from more traditional retailers.

Australian Equities Fund

The Antares Australian Equities Fund returned 4.9% (net of fees) for the March quarter, outperforming its benchmark S&P/ASX 200 Accumulation Index return of 4.8% by 0.1%. The main contributors to quarterly performance relative to the benchmark were an underweight position in BHP Billiton and an overweight position in Qantas Airways. The main detractors from relative performance were the Fund's cash holdings, given the market performed well, and an underweight position in CSL.

Dividend Builder

Antares Dividend Builder delivered a return of 5.0% (net of fees) for the March quarter, underperforming the benchmark S&P/ASX 200 Industrials Accumulation Index return of 5.3% by 0.3%. The main contributors to quarterly performance relative to the benchmark were an overweight position in Crown Resorts and the decision not to hold a position in Brambles. The main detractors from relative performance were the Fund's cash holdings, given the market performed well, and the decision not to hold a position in CSL..

Elite Opportunities Fund

The Antares Elite Opportunities Fund returned 5.3% (net of fees) for the March quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 4.8% by 0.5%. The main contributors to quarterly performance relative to the benchmark were an overweight position in Computershare and the decision not to hold positions in Telstra Corporation and BHP Billiton that weakened. The main detractors from relative performance were an overweight position in Brambles and the decision not to invest in CSL.

High Growth Shares Fund

The Antares High Growth Shares Fund returned 5.0% (net of fees) for the March quarter, outperforming its benchmark S&P/ASX 200 Accumulation Index return of 4.8% by 0.2%. Contributing positively to quarterly performance relative to the benchmark were an overweight position in Treasury Wine Estates and an underweight position in Brambles. The main detractors from relative performance were an underweight position in CSL and an overweight position in Caltex Australia..

Small Companies Fund

The Antares Small Companies Fund delivered a return of -0.5% (net of fees) for the March quarter, underperforming the benchmark S&P/ASX Small Ordinaries Accumulation Index return of 1.5% by 2.0%. The main contributors to quarterly performance relative to the benchmark were overweight positions in NIB Holdings and IDP Education. Detracting from relative performance were overweight positions in Western Areas and Fletcher Building.

Australian Shares Fund*

The Antares Australian Shares Fund delivered a return of 5.0% (net of fees) for the March quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 4.8% by 0.2%. The main contributors to quarterly performance relative to the benchmark were an underweight position in BHP Billiton and an overweight position in Qantas Airways. The main detractors from relative performance were the Fund's cash holdings, given the market performed well, and an underweight position in CSL.

Listed Property Fund

The Antares Listed Property Fund delivered a return of 0.7% (net of fees) for the March quarter, outperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index return of -0.3% by 1.0%. Positively contributing to quarterly performance relative to the benchmark were overweight positions in Peet and Goodman Group. The Fund's relative performance was negatively impacted by an overweight position in Westfield Corporation and the decision not to hold a position in Charter Hall Group.

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 March 2017[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]	4.9	23.1	8.8	11.3	5.1	9.8
	Gross Return[3]	5.1	24.1	9.8	12.3	6.0	10.7
	Benchmark Return	4.8	20.5	7.5	11.1	4.3	9.5
	Net Excess Return	**0.1**	**2.6**	**1.3**	**0.2**	**0.8**	**0.3**
	Gross Excess Return	**0.3**	**3.6**	**2.3**	**1.2**	**1.7**	**1.2**
Dividend Builder Inception date: 06/09/2005	Net return[2]	5.0	17.7	10.0	14.9	6.4	8.5
	Gross Return[3]	5.1	18.4	10.7	15.6	7.0	9.1
	Benchmark Return	5.3	17.4	9.8	15.2	5.6	8.1
	Net Excess Return	**-0.3**	**0.3**	**0.2**	**-0.3**	**0.8**	**0.4**
	Gross Excess Return	**-0.2**	**1.0**	**0.9**	**0.4**	**1.4**	**1.0**
Elite Opportunities Fund Inception date: 18/11/2002	Net return[2]	5.3	20.1	9.4	11.5	6.0	11.3
	Gross Return[3]	5.5	21.0	10.2	12.3	6.8	12.2
	Benchmark Return	4.8	20.5	7.5	11.1	4.3	9.5
	Net Excess Return	**0.5**	**-0.4**	**1.9**	**0.4**	**1.7**	**1.8**
	Gross Excess Return	**0.7**	**0.5**	**2.7**	**1.2**	**2.5**	**2.7**
High Growth Shares Fund Inception date: 07/12/1999	Net return[2]	5.0	20.2	9.7	12.0	6.6	11.1
	Gross Return[3]	5.2	21.4	10.9	13.2	7.8	12.7
	Benchmark Return	4.8	20.5	7.5	11.1	4.3	8.2
	Net Excess Return	**0.2**	**-0.3**	**2.2**	**0.9**	**2.3**	**2.9**
	Gross Excess Return	**0.4**	**0.9**	**3.4**	**2.1**	**3.5**	**4.5**
Small Companies Fund Inception date: 19/11/1999	Net return[2]	-0.5	7.7	1.6	3.1	3.9	9.3
	Gross Return[3]	-0.3	8.7	2.6	4.1	4.9	10.4
	Benchmark Return	1.5	13.7	6.4	2.3	-0.8	4.6
	Net Excess Return	**-2.0**	**-6.0**	**-4.8**	**0.8**	**4.7**	**4.7**
	Gross Excess Return	**-1.8**	**-5.0**	**-3.8**	**1.8**	**5.7**	**5.8**
Listed Property							
Listed Property Fund Inception date: 28/02/1994	Net return[2]	0.7	5.1	15.6	15.8	2.2	8.3
	Gross Return[3]	0.9	5.9	16.5	16.6	3.0	9.1
	Benchmark Return	-0.3	6.0	16.7	16.9	0.7	7.8
	Net Excess Return	**1.0**	**-0.9**	**-1.1**	**-1.1**	**1.5**	**0.5**
	Gross Excess Return	**1.2**	**-0.1**	**-0.2**	**-0.3**	**2.3**	**1.3**

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.

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