Personal Choice

Investor Update

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

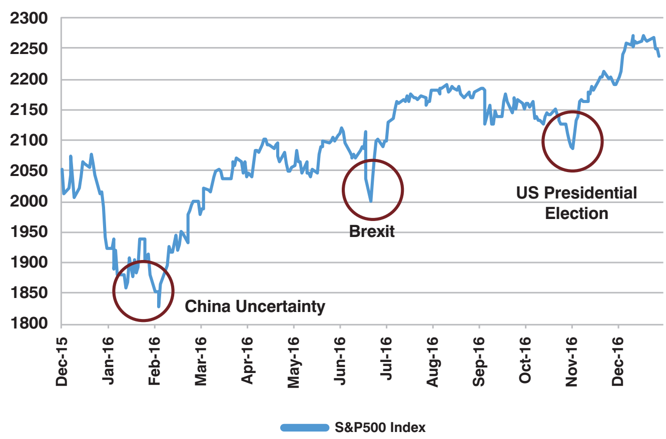
As bottom-up stock pickers, Antares does not generally forecast macro events or attempt to position our portfolios for expected macro outcomes and here is a major reason why. The Brexit and Trump experiences show that even if we had perfect foresight into these macro outcomes – ie we knew ahead of time 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

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

2016 Calendar Year – Market and Fund Reviews

Global and Australian economies

Although the US economy continued to strengthen in 2016, the Federal Reserve delayed tightening monetary policy due to uncertain global events including China's share market volatility, the UK's decision to exit the European Union (Brexit) and the US Presidential election. The Fed eventually increased official interest rates by 0.25% in December, to a new target range of 0.5%-0.75%. The election of Donald Trump as US President shifted the focus back to fiscal policy given Trump's infrastructure spending plans.

In Europe, the focus was on much lower than expected inflation data that prompted the European Central Bank to deliver a much larger than expected policy easing in March that included interest rate cuts, more quantitative easing and four new long term financing operations. The UK's vote to leave the European Union in June caused widespread economic uncertainty for the region. However, the Bank of England subsequently cut UK interest rates and announced a £170b stimulus package to reduce the economic impact of Brexit and this help improve sentiment.

Japan remained disappointingly weak, despite an unexpectedly large policy easing in late January. Later in the year, the government postponed the consumption tax rise and announced a ¥29t fiscal stimulus package to boost growth. The Bank of Japan also altered its monetary policy framework to target 10 year interest rates instead of money base growth.

Australia continued to grow moderately, with policy shifts driven lower than expected inflation data. The Reserve Bank of Australia announced two 0.25% interest rate cuts in May and August, taking the official cash rate to an historic low of 1.5%. The Australian dollar had a volatile year given movements in commodity prices. The currency ended the year down 1.1% at around 72 US cents.

Global share markets

Global share markets strengthened in 2016 despite the uncertainty surrounding Chinese growth, the UK's decision to leave the European Union (Brexit) and the US Presidential election. Oil market machinations were also a focus, with the oil price rallying 45%, partly due to OPEC's deal to reduce production. The US S&P 500 Index rose 9.5% as the Federal Reserve delayed tightening monetary policy until December and Trump's election victory promised stronger growth in response to infrastructure spending plans. The EuroStoxx 50 Index rose x% as investors shrugged off Brexit and focused on the economic recovery and supportive central bank policies. Japan's Nikkei Index rose just 0.4% as a significant yen depreciation late in the year was offset by continued weak economic data. China's Shanghai Composite Index fell 12.3% as disappointing growth data early in the year undermined confidence.

Australian share market

Australian shares performed well in 2016, with the S&P/ASX 200 Accumulation Index rising 11.8%. The resource sector (+38.9%) was a major contributor, as stronger iron ore (+81%), coal (+75%) and oil (+45%) prices improved the outlook for resource company earnings. There was also a significant shift away from defensive and interest rate sensitive sectors (health care, telecoms, REITs) in response to expectations of higher US interest rates, the 80 basis point rise in domestic 10-year bond yields and indications that cyclical earnings may be starting to improve. Bank stocks had a mixed year, with early weakness in response to regulatory changes and concerns about the debt cycle being offset by stronger performance into year-end as investors rotated out of interest rate sensitive stocks and the outlook for bank earnings improved.

All returns are net of fees. * Closed to new investments

Below are short commentaries on each Antares fund, outlining their net performance and the main contributors to performance.#

Australian Shares Fund*

The Antares Australian Shares Fund delivered a return of 14.0% (net of fees) for the six months to December 31, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 10.6% by 3.4%. Over the past 12 months, the Fund returned 13.6% (net of fees), outperforming its benchmark by 1.8%.

The main contributors to relative performance over the past year were overweight positions in South32, Rio Tinto and Sims Metal Management and an underweight position in CSL. Overweight positions in Caltex Australia and AMP detracted from yearly performance, along with an underweight position in BHP Billiton.

Elite Opportunities Shares Fund*

The Antares Elite Opportunities Shares Fund returned 11.4% (net of fees) for the six months to December 31, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 10.6% by 0.8%. Over the past 12 months, the Fund returned 12.3% (net of fees), outperforming its benchmark by 0.5%. Overweight positions in Rio Tinto, Fortescue Metals Group, Aristocrat Leisure and WorleyParsons were the main positive contributors to relative performance over the year. Being overweight Vocus Communications and Mantra Group detracted from relative performance, along with the decision not to hold a position in BHP Billiton that performed well.

High Growth Shares Fund*

The Antares High Growth Shares Fund returned 11.7% (net of fees) for the six months to December 31, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 10.6% by 1.1%. Over the past 12 months, the Fund returned 10.2% (net of fees), underperforming its benchmark by 1.6%. The main contributors to relative performance over the year were overweight positions in South32, Aristocrat Leisure and Fortescue Metals Group. Detracting from annual performance were overweight positions in Vocus Communications and Caltex Australia and an underweight position in BHP Billiton.

Listed Property Fund*

The Antares Listed Property Fund delivered a return of -4.7% (net of fees) for the six months to December 31, underperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index return of -2.7% by 2.0%. Over the past 12 months, the Fund returned 8.8% (net of fees), underperforming the benchmark index by 4.4%. Overweight positions in Asia Pacific Data Centre Group, Viva Energy REIT and Goodman Group contributed positively to relative performance over the year. Being underweight Dexus Property Group, and Mirvac Group detracted from performance. The Fund's cash holdings also detracted from performance given the rise in the market.

Small Companies Fund*

The Antares Small Companies Fund delivered a return of 3.3% (net of fees) for the six months to December 31, underperforming the benchmark S&P/ASX Small Ordinaries Accumulation Index return of 5.8% by 2.5%. Over the past 12 months, the Fund returned 4.5% (net of fees), underperforming the benchmark by 8.7%. The main contributors to relative performance over the year were overweight positions in Fletcher Building and WorleyParsons and an underweight position in Blackmores. Detracting from annual performance were overweight positions in Mantra Group and iSentia Group and the Fund's cash holdings, given the strength in the share market.

Antares Investment Returns
Performance to 31 December 2016[1]

		6 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Since Inception % p.a.
Australian Equities							
Australian Shares Fund Inception date: 28/02/1987	Net return[2]	14.0	13.6	6.2	10.7	4.3	8.6
	Gross Return[3]	15.2	15.9	8.3	12.9	6.3	10.6
	Benchmark Return	10.6	11.8	6.6	11.8	4.5	8.8
	Net Excess Return	**3.4**	**1.8**	**-0.4**	**-1.1**	**-0.2**	**-0.2**
	Gross Excess Return	**4.6**	**4.1**	**1.7**	**1.1**	**1.8**	**1.8**
Elite Opportunities Shares Fund * Inception date: 29/11/2002	Net return[2]	11.4	12.3	6.9	10.9	5.5	10.4
	Gross Return[3]	12.1	13.9	8.4	12.4	7.0	11.9
	Benchmark Return	10.6	11.8	6.6	11.8	4.5	9.2
	Net Excess Return	**0.8**	**0.5**	**0.3**	**-0.9**	**1.0**	**1.2**
	Gross Excess Return	**1.5**	**2.1**	**1.8**	**0.6**	**2.5**	**2.7**
High Growth Shares Fund * Inception date: 02/12/1999	Net return[2]	11.7	10.2	6.8	11.6	5.9	10.2
	Gross Return[3]	12.8	12.3	8.9	13.8	8.1	12.6
	Benchmark Return	10.6	11.8	6.6	11.8	4.5	8.1
	Net Excess Return	**1.1**	**-1.6**	**0.2**	**-0.2**	**1.4**	**2.1**
	Gross Excess Return	**2.2**	**0.5**	**2.3**	**2.0**	**3.6**	**4.5**
Small Companies Fund * Inception date: 05/01/1998	Net return[2]	3.3	4.5	1.6	5.0	3.5	9.8
	Gross Return[3]	4.4	6.6	3.6	7.1	5.5	12.0
	Benchmark Return	5.8	13.2	6.2	4.9	-0.3	5.3
	Net Excess Return	**-2.5**	**-8.7**	**-4.6**	**0.1**	**3.8**	**4.5**
	Gross Excess Return	**-1.4**	**-6.6**	**-2.6**	**2.2**	**5.8**	**6.7**
Listed Property							
Listed Property Fund * Inception date: 20/01/1998	Net return[2]	-4.7	8.8	15.0	15.9	0.9	6.9
	Gross Return[3]	-3.7	10.9	17.2	18.2	2.8	8.9
	Benchmark Return	-2.7	13.2	18.0	18.5	0.4	7.2
	Net Excess Return	**-2.0**	**-4.4**	**-3.0**	**-2.6**	**0.5**	**-0.3**
	Gross Excess Return	**-1.0**	**-2.3**	**-0.8**	**-0.3**	**2.4**	**1.7**

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.

*Closed to new Personal Choice investments.

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