Australian Equities Income Portfolio

Q1 FY19 Quarterly Investor Letter | September 2018

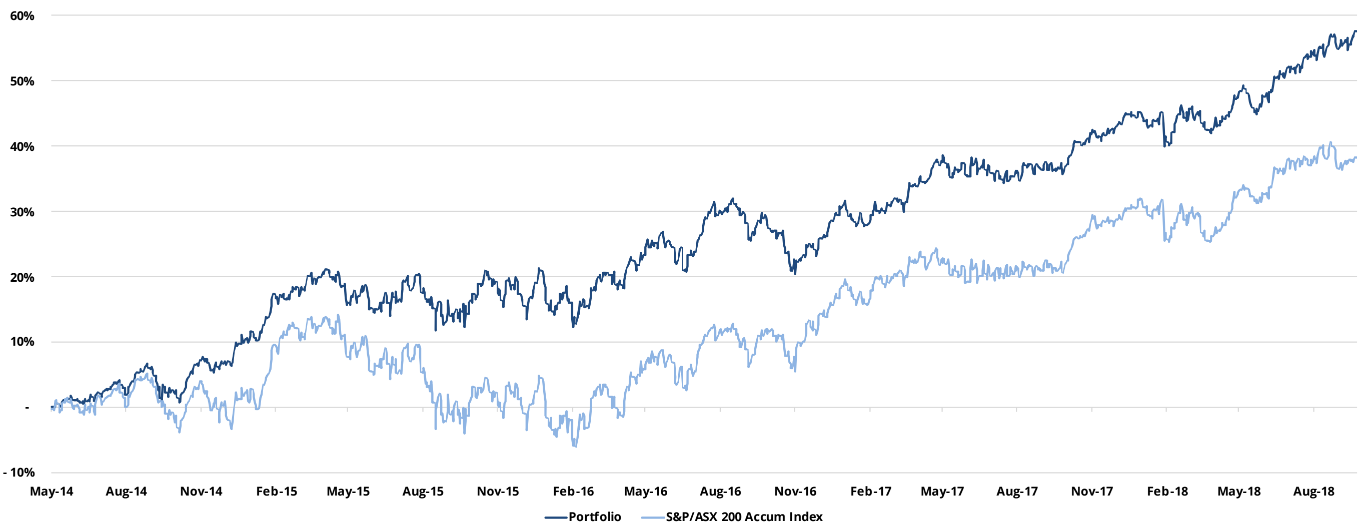
> "The US economy is operating at full potential. When flying at maximum altitude, the view in all directions slopes downward, sometimes gently and sometimes precipitously. For the time being, however, the predominant belief remains that economic growth is steady or even climbing."
>
> **Al Wojnilower 2018**

Over the September Quarter developed equity markets remained in a sanguine mood, despite the escalation of a myriad of geo-political challenges. Buoyed by a robust US economy and a company reporting season that delivered earnings growth broadly in line with market expectations, the Australian share market recorded another quarter of positive returns.

The Australian Income Portfolio finished the September Quarter up 4.43% (including franking credits) compared to the ASX 200 Accumulation Index up 1.53%. The major positive contributors to the investment performance were Washington H. Soul Pattinson (SOL), Brambles (BXB), Qube Holdings (QUB), and Coca-Cola Amatil (CCL). The main detractors to performance were Adelaide Brighton (ABC), IAG, and Caltex (CTX). The investment performance was also constrained by a cash weighting of c.14%, as valuations remain broadly elevated and finding value in an absolute sense remains challenging.

The Australian Income Portfolio commenced investing in May 2014. Since its inception, the portfolio has a compound annual return of 10.93% (including franking credits) compared to the ASX 200 Accumulation Index of 7.65%.

Investment Performance since Inception (%)



Source: Praemium Ltd

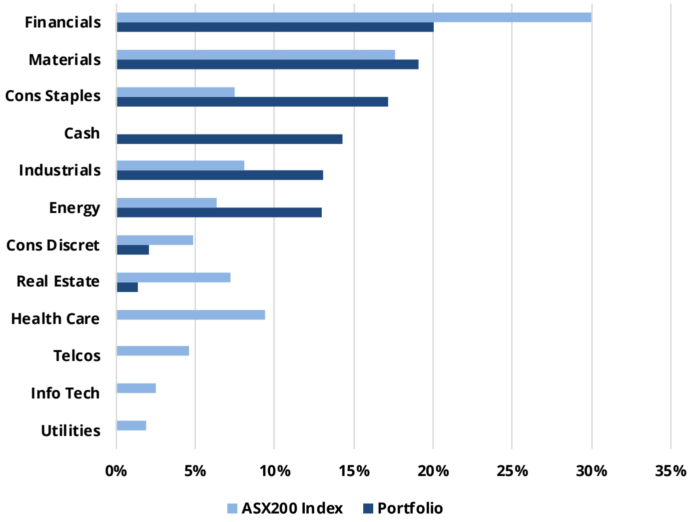
Performance Table - Income Portfolio

Historical Return	Australian Equities Income	ASX 200 Accumulation	Relative
Financial Year 2015	13.6%	5.7%	7.9%
Financial Year 2016	7.7%	0.6%	7.1%
Financial Year 2017	10.5%	14.1%	-3.6%
Financial Year 2018	10.8%	13.0%	-2.2%
Financial Year to Date	4.4%	1.5%	2.9%
Since Inception (p.a)	10.9%	7.7%	3.2%
Risk Adjusted Return	0.92	0.92	
Dividend Yield	6.01%		

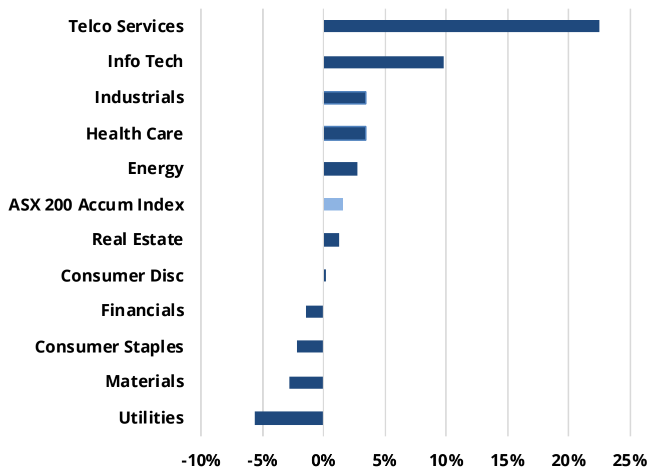
Source: Bloomberg & Praemium Ltd

Figures shown are before fees and inclusive of franking credits.^ Gross yield including franking credits for the previous 12 months.
Past performance is not an indication of future performance

Relative sector weights - September 2018



Sector returns - Q1 FY19



Source: IRESS Ltd

A heightened consciousness of regulatory risk is playing a greater role in re-shaping our investment portfolios. A maelstrom of regulatory risk is encroaching on the banking, energy and health care sectors. Our portfolios remain underweight in financial services, regulated energy markets, and to the providers of healthcare services in the aged care and private health sectors.

This mercurial political landscape has largely contributed to a dysfunctional national energy market, whereby neither climate change nor investment considerations are being adequately addressed.

> "If governments continue to escalate their interventions to change the rules after investments have been made in export projects, they increase the prospect of investors assessing Australia as being too risky a destination for their funds."
>
> **Kevin Gallagher CEO Santos**

During the Quarter the Australian Income Portfolio added to its positions in Caltex and Woolworths. Both stocks were "sold off" after they announced their FY18 results, which provided an opportunity to build our positions in companies which we believe offer long term attractive investment metrics.

Woolworths recent share price weakness can be attributed to a mildly softer than expected FY18 result (Big W) and slower 1H19 sales growth in its Australian Food division (c.70% of Group EBIT).

Interestingly, the transition of phasing out single use plastic bags has been problematic for the major supermarkets, as consumers purchased fewer items per basket. Nevertheless, based on similar programs executed by supermarkets internationally, we expect this to be a temporary adjustment.

Holistically, our investment thesis in Woolworths is supported by the likelihood of further capital management. WOW recently announced a 10-cent special dividend and a successful divestment of both its pubs investment in ALH Group and its petrol sites business should underpin further capital management initiatives.

The Caltex 1H18 profit of $296m was a record result but at the lower end of guidance due to a weaker than expected refiner margin in June. However, the decline in the share price was driven by disappointment in the lack of restructuring to enable the return of the company's significant franking credit balance to shareholders.

The strategic review resulted in plans to "explore" forming a partnership with a property company and the ultimate sale of 15-25% of the site portfolio which is valued at c.$2bn. Whilst acknowledging this as a positive first step, its quantum was underwhelming. It may, however require greater investor activism to realise this value. Unambiguously, we see potential strategic value in the company's assets and took advantage of the share price reaction.

Company & Industry Analysis

During the FY18 company reporting season we attended investor briefings and held one-on-one meetings with senior management & industry participants that provided an invaluable source of detailed knowledge, the key highlights included:

- The re-rating of Australia's most expensive stocks is typical of a late phase bull market. Strong momentum of fund flow has driven a sharp re-rating of **high price earnings ratio (PER) stocks**. The top quintile for the ASX 200 is now trading at 50% premium to the median stock on the ASX 200, this is the highest premium in almost 20 years. [1] This is representative of valuations for CSL, COH and RMD in the healthcare sector and Cleanaway Waste Management in the industrial sector.

- **High PER vulnerability** when earnings growth begins to slow. This is typified by the retracement in the share price of Ramsay Healthcare whereby earnings per share growth has slowed from 12%-14% in FY16 to the company forecasting c.2% in FY19.

- The chilling effects of **regulatory intervention** across a growing list of industries including: aged care, banking/financial services, retail energy markets, private health insurance.

- The banking sector is facing mounting **headwinds** of higher compliance costs, credit contraction and higher wholesale funding costs. Earnings quality is at risk as property prices decline and borrowers move from "interest only" loans to "principle and interest" repayments.

- The impact of **reduced credit availability** is impacting the property development sector. Specifically, Brickworks cited a slowing of property development pipeline due to lack of bank finance.

- Technology **disruption** in the banking sector. We spoke with a major retailer who is replacing its point of sale (both online & offline) with a global payments system that avoids bank merchant fees, historically a rich source of revenue for the banking sector.

- A greater focus by large companies incorporating **technology** to better understand its customer base and improve competitiveness using data analytics, digitalisation & automation.

- Industrial companies citing the significant impact of **cost inflation** of rising energy prices, labour scarcity and higher transport costs. Most notable with Australian companies operating in the US where the strongest economy in 30 years is placing unprecedented cost pressures on supply chains.

- Companies increasing pay-out ratios via **special dividends**. Our portfolios were beneficiaries of special dividends from Adelaide Brighton, IAG, QUB and Woolworths.

- Early signs of an uplift in **capital expenditure** by the major resource companies.

Investment Conclusion

As the Australian equity market is close to decade highs finding value in an absolute sense is proving to be challenging. Hence, at this point in the equity market cycle we are increasingly looking for stock ideas with a value bias. Our portfolios are weighted toward companies that provide a "margin of safety" either through holding companies that have already rebased their returns to more sustainable levels (Brambles, Coca-Cola Amatil, QBE & Woolworths) and/or companies focused on capital discipline and healthy balance sheets (ASX, BHP, & Wesfarmers).

Our investment process of an active company and industry visitation program continues to underscore the value of identifying catalysts and inchoate themes in the Australian share market.

Marcus Bogdan
Chief Investment Officer

Richard Colquhoun
Portfolio Manager

[1] *Hasan S Tevik, Australian Investment Strategy, MST Marquee.*

Appendix

Portfolio Objective

The portfolio seeks to deliver long term growth in both capital and income by investing in Australian listed equities. The portfolio aims to do so with lower volatility and greater downside protection relative to the S&P/ASX 200 Accumulation Index.

Investment Principles

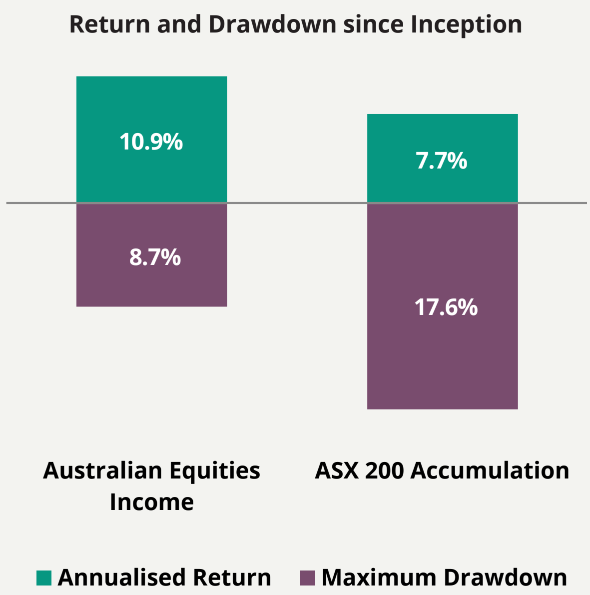
Our investment approach aims to generate long-term risk adjusted returns, by investing in companies that focus on producing high-quality earnings and operate in industries that exhibit favourable long-term growth prospects. More broadly, we consider a range of attributes which we view as important qualities in the companies we invest in. We construct and manage the Australian Equities Income Portfolio with eight consistent guiding principles:

- Grow capital and income over the long term;
- Focus on the quality of company earnings;
- Identify quality assets at an attractive valuation;
- Generate a suitable return on capital employed;
- Invest in companies operating in robust industry structures;
- Select for balance sheet latency and sustainability of dividend income;
- A corporate governance structure that actively promotes alignment with key stakeholders; and
- A vigilant process of portfolio risk analysis.

Benefits of Active Management

A key benefit of active portfolio management is the recognition that return, and risk are inseparable. A core portfolio objective of the Australian Income Portfolio is to generate returns that exhibit lower volatility and greater downside protection relative to the ASX 200 benchmark index. The accompanying chart illustrates the value of understanding the interlocking nature of return and risk.

The chart below shows both the annualised return (green bar) generated by the Australian Income Portfolio compared with ASX 200 Accumulation Index, and the maximum loss/drawdown (orange bar) in the value of the portfolio compared to the ASX 200 Accumulation Index since the inception of the portfolio in May 2014. Maximum drawdown measures the magnitude of the worst loss an investor would have incurred by investing in the portfolio or benchmark. Drawdown is a useful measure of risk management, as it indicates the portfolio's response to periods of market stress as well as the relative sensitivities to market risk.



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