Contact Australian Ex-50 Fund

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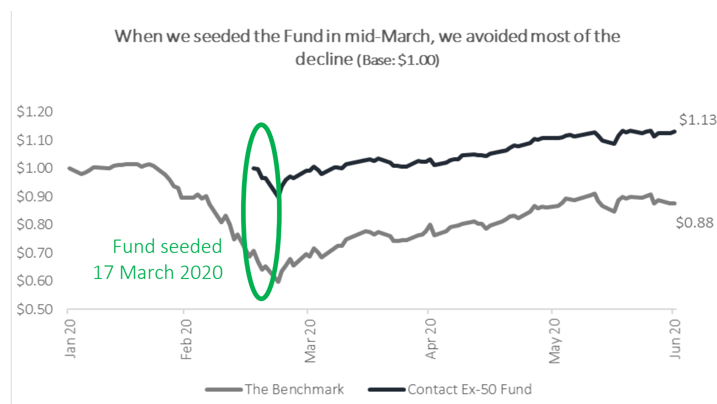
CONTACT
ASSET MANAGEMENT

Dear Investors,

We established the Contact Australian Ex-50 Fund (**the Fund**) on 17 March 2020 and have witnessed a remarkable period in the Australian (and Global) stock market. As we close off the June 2020 financial year, we believe that Ben Inker of GMO puts it well when he writes *"Uncertainty has seldom been higher – oddly, neither has the stock market"*.

Having watched from the sidelines from January to when we decided to seed the Fund in mid-March, we had witnessed a fall of almost 40% in the S&P/ASX Mid Cap 50 Index (**the Benchmark**). Panic was near unprecedented levels as COVID-19 numbers increased, economic data tanked and Governments globally moved to shut down cities, countries and economies. This was quickly followed by massive, and again unprecedented, Central Bank stimulus.



We have maintained a cash level in the Fund of approximately 30% since inception. In a relative sense, we have perhaps been too prudent given the ferocity of the short-term recovery. Yet we remain cautious, particularly given an Australian economy that is being held up by an extraordinary level of Government stimulus, combined with an equities market trading on record multiples.

GENERAL COMMENTARY ON MARKETS

We are finding it difficult to justify the (so far) V-shaped recovery in Global Equities Markets. The often-cited theories for the rally include:

- "Don't fight the Fed!" – that is, the US Federal reserve has undertaken to do "whatever it takes" to stem the impact of COVID-19 on the US economy. This involves maintaining near-zero interest rates for several years and significant liquidity injections through money printing;
- The stimulus cheques are being punted in the market by short-term traders; and
- The "fiscal cliff" will be avoided through more stimulus.

Domestically, we cannot fault the swift decisions by the Australian Federal Government in stemming both the healthcare crisis and economic uncertainty with policy action in mid-March. At the time of writing, Australia had suffered 104 deaths – significantly below original fears. To date, the stimulus measures have contained what would have been a disastrous unemployment scenario. However, it is not without cost. The Morrison Government is expected to spend close to $260 billion in stimulus initiatives in the six months to September 2020. Of note, these include Jobkeeper (c.$70 billion), Employer cash flow boost (c.>$30 billion), Early Super Withdrawal (c.$25 billion) and Debt repayment deferral (c.$20 billion). But as Geoffrey Chaucer said, *"All good things must come to an end."* Unfortunately for Australia, the end of the stimulus is likely to hit in October 2020. With business activity still well below normal, we worry what this means for economic activity and employment.

A few weeks ago, my ten-year old son was asking me about shares. Admittedly, this was not our normal type of conversation. As he likes playing Monopoly, I tried to explain what was going on in the economy in Monopoly terms:

> "Imagine that you are playing Monopoly and you own a couple of properties but then all of a sudden the rules of the game change," I said. "The new rules are: if someone lands on your property, they don't have to pay rent if they don't want to. If you mortgage your property, you don't have to pay the mortgage for a little while. So, on one hand, you have no money coming in, but you also don't have to pay any rent either."
> "That is a bit strange," said my son.
> "Yes, but at the moment, that is exactly what is happening to some people who own a building and there is a shop in it that has been forced to close due to the coronavirus." I responded.
> "Now imagine, that one of the players lands on "Chance" and picks up a card. The card says, "Everyone in the game gets $2,000."
> "That's cool," says my son.
> "Yes, you'd think so, but it changes everything. All the players will probably start buying whatever they can with the "free money". Whitechapel Road should cost $60 but people might pay $150 because they have all this free cash. They still only get $4 rent and may not get any rent for a while. The whole dynamics of the game change."
> "How does it end Dad?" he asked.
> "I don't know mate," I said. "I don't think anyone knows".

That anecdote is how we feel about the broader stock market currently. There is a tug-of-war between liquidity and fundamentals. Liquidity is winning. Our benchmark is trading at almost exactly the same level as it was in June 2019, however the earnings outlook for most businesses in the index has deteriorated. We believe that sooner or later the market will focus on company valuations and come to realise that they do not correspond with the earnings profile being delivered. We maintain a high cash position as we wait for reality to set in.

PORTFOLIO DEVELOPMENTS

There are still many big questions to be answered from a macroeconomic perspective. However, our approach to investing remains unchanged. We aim to buy high quality dividend paying companies and hold onto them. We believe that the quality businesses continue to surprise you on the upside. We consider that investing in businesses with identifiable completive advantages, strong financials, and capable management teams, is the best way to navigate through difficult market conditions.

We believe we have established a portfolio in the Ex-50 Fund that has superior return metrics, stronger financials and more attractive growth prospects than the broader market. We also built positions in many companies that are either founder led or managed by people whose interests are aligned with ours. We have made minimal changes to the make-up of the portfolio since inception.

Our largest position is TPG Telecom Limited (TPG). We welcomed the final court approval which sees TPG Telecom merge with VHA (Vodafone Hutchinson Australia). The merger will create Australia's third largest telecommunications company, bringing together two highly complementary businesses and creating economies of scale to compete with Telstra and Optus. The merged company, to be called TPG Telecom Limited, will have an enhanced network which leverages quality backhaul infrastructure and opportunities to capitalise on the 5G market opportunity without issues of a legacy mobile network.

We have already been rewarded with a $0.49 special dividend following implementation of the Scheme. The combined group will be chaired by TPG founder David Teoh, who has significant wealth tied up in the company and a ruthless approach to costs. This is important as the group will service the price conscious end of the market. Technology and convenience continue to be increasingly important for consumers – TPG is well placed.

The other bonus of the TPG/VHA merger was the spin-off of Tuas Limited (TUA). While currently a small part of the overall portfolio, we have high hopes for growth. TUA is the fourth and newest mobile network operator in Singapore, having secured 4G spectrum a few years ago. On 25 June 2020, TUA was also allocated 800 MHz of mmWave spectrum by the Singapore Infocomm Media Development Authority (IMDA) allowing a roll out of next generation 5G services in support of new consumer and enterprise use cases. Under the terms of the allocation TUA do not require any material upfront payment for the spectrum. While still in start-up phase, the business will have no debt and S$130m of cash which they anticipate will be sufficient to get to EBITDA breakeven.

Another founder-led business that is an important portfolio position is Magellan Financial Group (MFG). MFG's business model is attractive, with high (and industry leading) margins, a focus on scalable investment strategies, extremely strong distribution channels and proven, aligned management. MFG manages close to A$100 billion across seven strategies. It is led by co-Founder Hamish Douglass, who is Chairman and Chief Investment Officer of MFG and is the face of the brand. He is a very capable leader and proven investor. MFG has no debt and continued growth prospects. Sometimes in investing, it makes sense to simply bet on a company that has already won. We think MFG continues to win in the market for Australian investors looking for global investment solutions.

Our investment process puts a significant amount of importance on understanding company dynamics and aligning ourselves with capable managers who are often business owners. We think it important to adopt the mentality of a business owner and we try to "walk the tiles" where possible of our investment companies. As Sydney emerged from the lockdown in May, we took the opportunity to visit several retail operators, REITs and major infrastructure projects. We think there is only so much one can learn by staring at a spreadsheet.

Our store walks in May were influential on our thoughts towards the Consumer Discretionary sector and the broader economy. While it was no secret that retailers such as Bunnings were a huge beneficiary of the lockdown, we had not appreciated just how much of the stimulus was being spent on other household goods. Our visit to a Nick Scali store in Penrith unveiled an anecdote where staff members had not had a lunch break for three days due to massive demand as consumers escaped lockdown. Harvey Norman (HVN) was no different. Alongside the quantitative work we had undertaken, the visits gave us conviction to increase our position in both companies. We have since been rewarded with earnings upgrades for both.

LOOKING FORWARD

We have only just begun our journey managing the Fund following the recent launch and we appreciate the support of our early investors.

We are excited about the prospects for our portfolio holdings but remain cautious on the near-term outlook for both the economy and market valuations. We seeded the Fund with our own capital and remain the largest investors in the Fund. We are focused on capital preservation.

Over the long-term, we expect to be more fully invested in equities relative to cash, however we remain convinced that, at this time, patience will pay. We cannot help but think that so many things are so much worse than previously that there is no rational way that current market levels are sustainable. Our concern is heightened given the A$100 billion fiscal cliff ahead.

We are managing the portfolio with a defensive tilt, and as it stands, it feels like we are too defensive. However, on the way down, it will feel like not enough!

We are confident that our investment process, which has been honed over generations, will stand the test of time. We expect several opportunities to emerge in the years ahead. But for now, we wait.

We appreciate the opportunity to manage your assets and we look forward to reporting to you in the quarters ahead.

Yours sincerely,

Will Culbert
Director/Portfolio Manager

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