# Contact Australian Ex-50 Fund

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## QUARTERLY LETTER: SEPTEMBER 2020

Dear Investors,

We hope this update finds you and your families well.

It has been a busy quarter with several important Fund developments as well as the August reporting season. This letter seeks to provide an update on the Fund and offer some of our insights into the results of key portfolio holdings. The absolute returns from the Fund have been strong since we launched in mid-March at the peak of the market panic around COVID-19. As at 30 September, the Fund has delivered a return (after all fees and costs) of 15.2% since inception.

Below, we also share some of our thoughts on the disconnect between earnings and valuations for many segments of the market. Fast action from Governments and Central Banks certainly softened the blow of lockdowns and restrictions, however uncertainty remains.

## FUND DEVELOPMENTS

Firstly, some important Fund developments:

i. In late June, we decided to decrease the Management Fee of the Fund from 0.75% to 0.60% - we remain very focused on providing a fee that is amongst the lowest in the market. The Responsible Entity has released an updated Product Disclosure Statement to reflect this.

ii. In early August, Lonsec announced an "Investment Grade" rating for the Fund, which indicates that Lonsec has conviction that the Fund can generate risk adjusted returns in line with relevant objectives. The group noted several strengths including the experience of the managers, the investment process and the low-cost nature of the Fund. Given the short track record of the Fund, we are pleased with this initial rating.

iii. We have started engaging with several platform providers to make the Fund more easily accessible. It is now available on Hub24 platform and will soon be available on Netwealth. We continue discussions with several other groups.

## REVIEW OF REPORTING SEASON

The August 2020 Reporting Season was as tempestuous as they come from an earnings perspective. Unexpectedly, it was the best August in eleven years from a share market performance perspective. Economic conditions changed drastically in the six months since companies last presented their results. In February, COVID-19 was a potential but oft dismissed threat. With the August results, COVID-19 was omnipresent.

There were several pleasing results from companies within the Fund.

**Harvey Norman (HVN).** HVN delivered one of the best results of the period. The rebound in activity from the depths of the March lockdown has been quite remarkable and this has been mirrored in its stores internationally. The free cash flow generation was a highlight – up almost 200% on FY19. The business is now net cash and has a significant property portfolio that underpins the valuation. This founder-led business continues to be well managed and continues to have compelling growth options offshore. HVN boasts a very attractive dividend yield and has a strong balance sheet.

Following the solid FY20 result, in late September Harvey Norman's (HVN) update on FY21 trading to date was strong. Profit before tax for July and August was $178 million – up 186% on the same period last year. This implies that HVN has achieved half of consensus' 1H21 Profit before Tax estimate in just two months of trading.

**ARB Limited (ARB).** The FY20 result emphasised the strength of ARB's brand and business. The Company managed to deliver positive earnings growth which was better than the withdrawn guidance of NPAT down by a similar amount to the first half (1H20 -7.4%). Despite COVID-19 the outlook for the business has improved with Government stimulus and border closures driving an increase in domestic travel. In early October, ARB provided a very positive trading update with sales up almost 18% for the first quarter of fiscal 2021. This is well ahead of expectations and has been driven by excellent growth in export markets.

Furthermore, the strengthening of the Australian Dollar, particularly against the Thai Baht, will lead to an improvement in margins. ARB is net cash positive, which has allowed the Company to pay its deferred interim dividend and a final dividend highlighting the benefit of a strong Balance Sheet and an aligned management team.

**Reece Limited (REH)** REH reported a record result that was ahead of expectations. REH is a well-run, high quality business with a market leading position in Australia and decent growth prospects in the US. The near-term outlook has improved, largely driven by Government stimulus with fourth quarter sales ahead of the prior year and economic forecasts suggesting 9% growth in the alterations and additions market in 2021. With a focus on innovation and technology we expect REH to maintain its market leading position. We are positive on the long-term growth prospects in the US where the Company currently has 184 branches servicing a population of over 300 million compared with Australia with over 600 branches servicing a population of only 25 million. Management's long-term approach and alignment provides us with comfort in their ability to execute the US strategy. The recent capital raising has strengthened the Balance Sheet providing financial flexibility to pursue growth opportunities.

**ResMed (RMD).** RMD delivered a solid result driven by higher ventilator sales more than offsetting the decline in CPAP (continuous positive airway pressure) sales. COVID-19 has highlighted the importance of digital health and accelerating home testing and patient's engagement with the cloud network as well as the value of out of hospital healthcare and respiratory medicine. The Company's progress in the SaaS component of the business bodes well for future growth, particularly in a post COVID-19 world. With 900 million people globally suffering from sleep apnea and only 20% diagnosed the long-term thesis remains intact. Furthermore, free cash flow generation is impressive, the Balance Sheet is in good shape and the Company is run by an experienced and aligned management team.

**Magellan Financial Group (MFG).** Magellan delivered another solid result that was described by management as "more than satisfactory". There was solid growth across the business with average FUM up 26% to $95.5billion. Management fee revenue was 25% higher (to $592 million) and Performance fee revenue was $81million. Strong investment performance despite volatile markets was again a feature. The company noted that "Downside protection is a key component of our investment objectives and something that we discuss with our clients. We continue to manage our portfolios to protect capital of investors."

In September, MFG announced a foundation investment in Barrenjoey Capital Partners, a new Australian-based full-service investment bank which will be majority staff-owned (50.01%), MFG owning 40%, and a partnership with Barclays (9.99%). MFG will invest $155 million for its 40% stake. Whilst this is a small outlay in the context of the broader group and mildly dilutive near-term, it nevertheless provides longer-term optionality if the venture proves successful.

## DISCONNECT BETWEEN EARNINGS AND EXPECTATIONS FOR MANY SEGMENTS OF THE MARKET

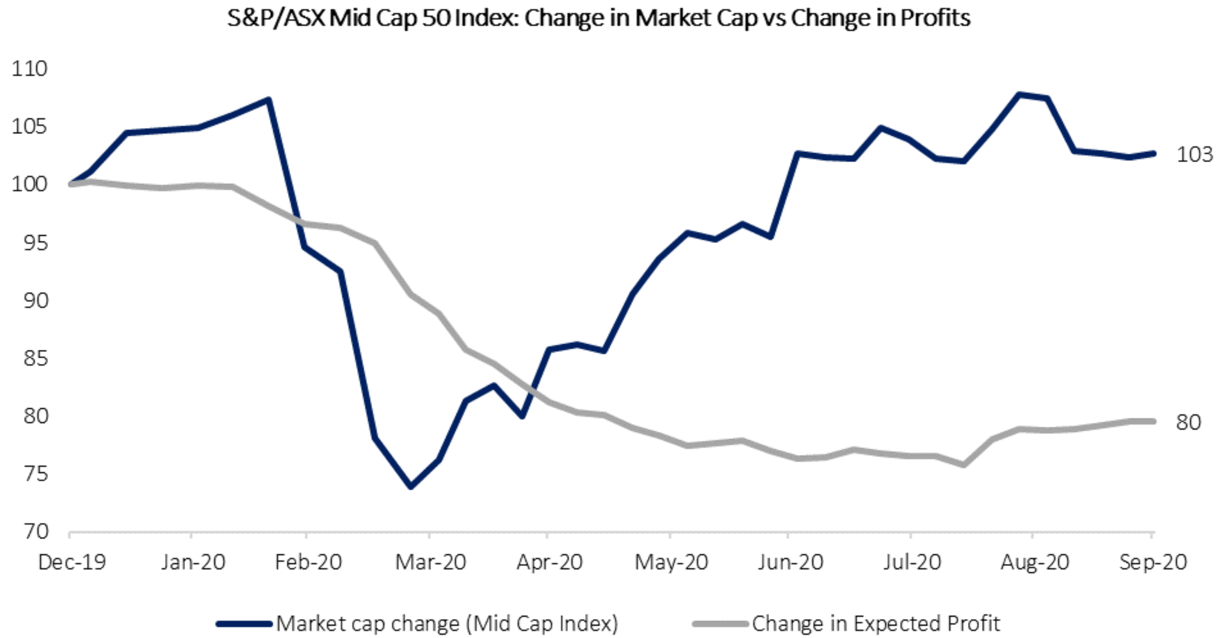
We remain cautious on many segments of the Australian market. Given what is transpiring in economies across the world and particularly at home, we find it remarkable that the S&P/ASX 300 Accumulation Index is only 6% lower than it was at the start of the calendar year.

This is not a "buy the market" scenario and not every business will necessarily survive. To highlight how quickly things can change, consider:

- At the start of the year, Flight Centre was forecast to generate profits of $236 million in FY20. The company reported losses of $510 million,
- Combined, the WAAAX (WiseTech, Afterpay, Altium, Appen and Xero) stocks are expected to generate profits of $280 million. For context, this is a similar level of profit that a BlueScope Steel, a TPG Telecom or Crown Limited typically produces on their own. The combined market capitalisation of the WAAAX stocks moved from $34 billion on 1 January to $24 billion in mid-March to $58 billion at end August. The WAAAX stocks are currently trading on a combined PE multiple of 280 times!

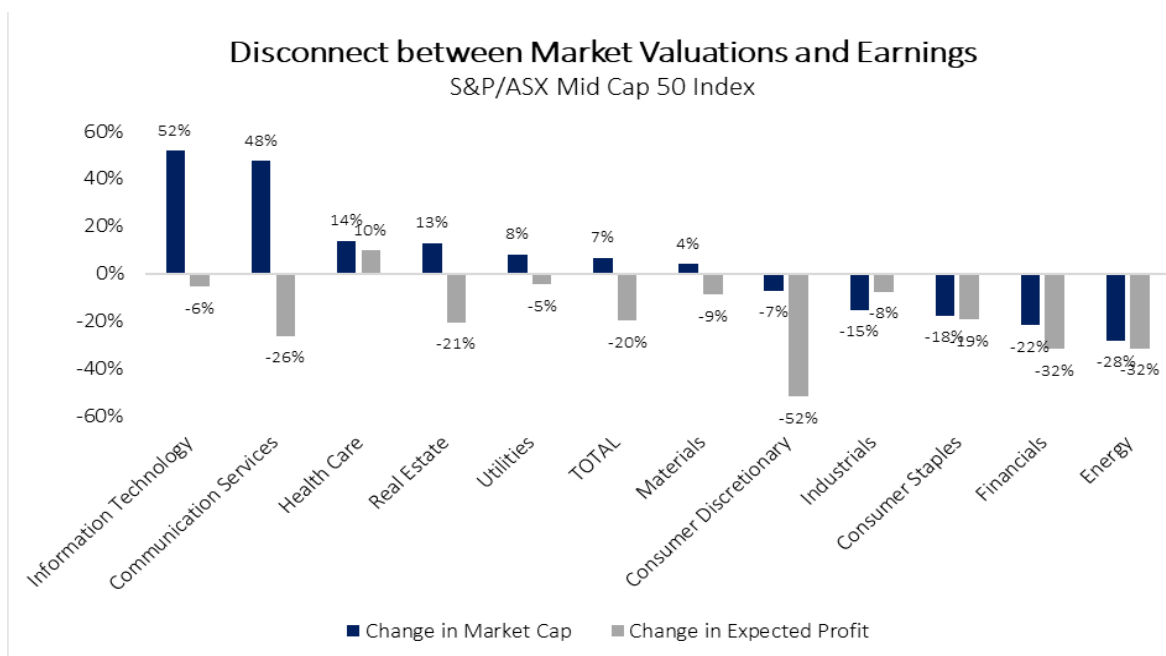
In the following charts, we illustrate some interesting dynamics – particularly the disconnect between earnings expectations and market valuations.

The chart below focuses on the S&P/ASX Mid-Cap 50 Index. Since the start of the calendar year, consensus earnings expectations have been cut by 20%. The market has rallied from its March lows notwithstanding a lack of any clear recovery in profits. The rally has been more pronounced in this segment of the market given the high proportion of Tech-related stocks.




If we dive deeper, we find that there are a few themes playing out.

- As is widely known, Tech stocks are leading the market higher notwithstanding no increase in earnings expectations.
- The Consumer Discretionary sector is a tale of extremes. Many businesses are thriving under COVID-19 conditions (e.g. Harvey Norman, JB Hi-Fi and ARB Limited) yet others are struggling (especially the casinos and travel related stocks).



## LOOKING FORWARD

As noted above, we remain cautious on many segments of the Australian market – particularly the valuations for many tech stocks. However, we are optimistic on our portfolio. We continue to see attractive long-term prospects in our high quality, income producing companies. We believe in a sensible approach. We invested more cash into the portfolio in September and the cash weighting for the Fund is now below 10%.

We continue to advocate that the best investments come from the best companies. In our opinion, the best companies are those that generate high returns on capital, generate economic value, boast attractive margins and are run by capable people.

We also believe that a long-term horizon provides an additional edge. John Huber of Saber Capital makes a good point: *"The longer your holding period, the more important it is to own quality businesses. If you are only owning a business for a year or two, you think more about what someone might pay you for it. If you are thinking about owning for ten years or more, you start to think about what the business will look like. Time is the friend of the great business over time."*

The great businesses are also safer – it is our opinion that they will come out of the crisis stronger or at least take market share.

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

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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