Contact Asset Management

INSIGHTS

NOVEMBER 2021

CONTACT

ASSET MANAGEMENT

Positioning for Tougher Growth and the Bondcano

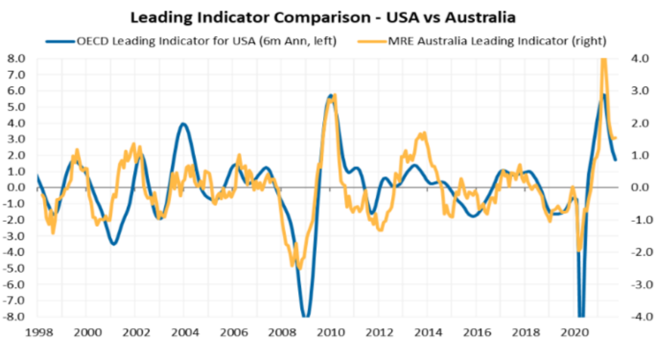
Bondcano: the impact a sudden surge in bond yields can have on equities

While we don't pretend to have a crystal ball on the macroeconomic environment, we are cognisant that the outlook for inflation and interest rates are at the front of investors' minds. In this edition of Contact insights, we present several economic indicators that we are watching. We consider these indicators pertaining to the Contact Australian Ex-50 Portfolio, which we consider well placed to deliver sustainable growth over the long-term. Our process is based on finding high quality, financially strong businesses run by capable management (preferably Founders).

Economic signals are coming off stimulus driven highs

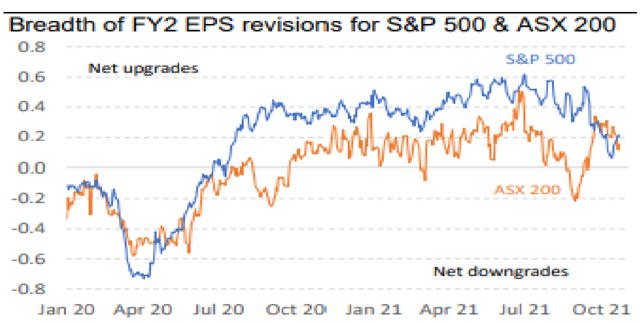
Key lead indicators are normalising following the acceleration in activity induced by policies in response to COVID-19. Chinese authorities are intentionally withdrawing stimulus and indeed suppressing certain targeted industries, which is creating inconsistencies. In the United States and Australia, we are seeing the early signs of slowing in economic signals as support payments wind down.

Source: Macquarie Research 20 October 2021



Source: Macquarie Research 20 October 2021

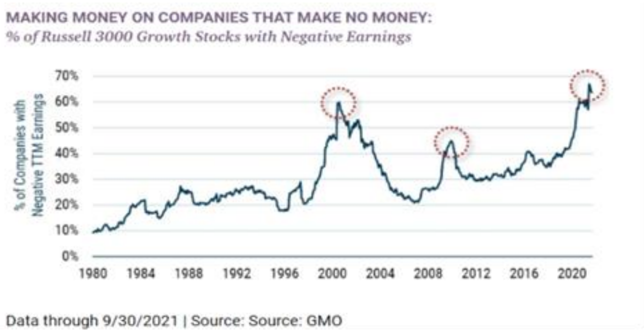
Investors in Australia typically look to the US for guidance in several economic indicators. As depicted in the following charts, the correlation between the two economies is high, both in terms of breadth and aggregate. We believe that earnings growth is an important driver of returns over the long-term.



Source: MST Marquee 25 October 2021

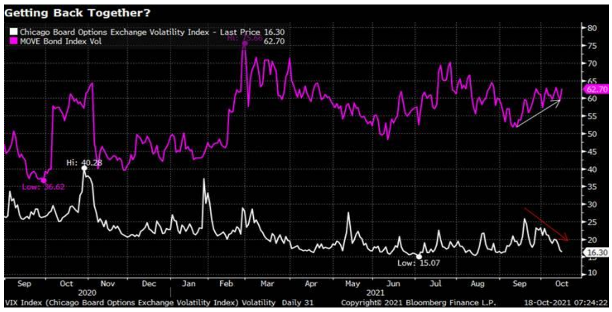
Source: Macquarie Research 20 October 2021

Despite this weakness in what is normally the main driver of share markets, prices in general remain well supported, even for a growing number of loss-making businesses. However, while the equity market remains relaxed as indicated by forecast volatility, the comparable indicator for the bond market is testing highs.



Source: Evans & Partners 18 October 2021

VIX (expected equity volatility) – white & MOVE (expected bond volatility) - pink

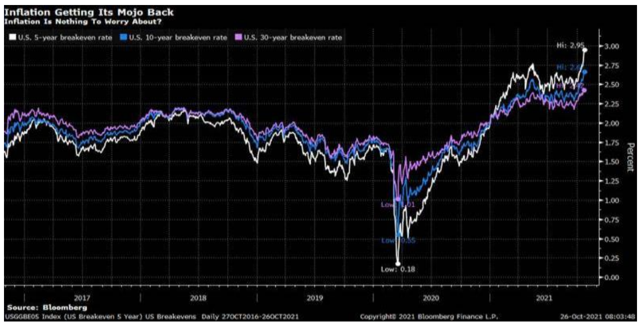


Source: Evans & Partners 18 October 2021

A concern for the bond market is the challenging of the "transitory" inflation narrative with indicators reflecting sharp pressures and yield markets themselves beginning to factor in that inflation may be more permanent.

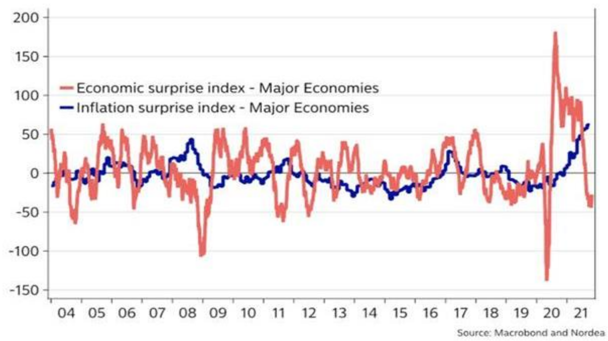
Source: Evans & Partners 18 October 2021

US Breakeven (implied inflation) rates: 5 yr – white, 10 yr – blue & 30 yr - pink

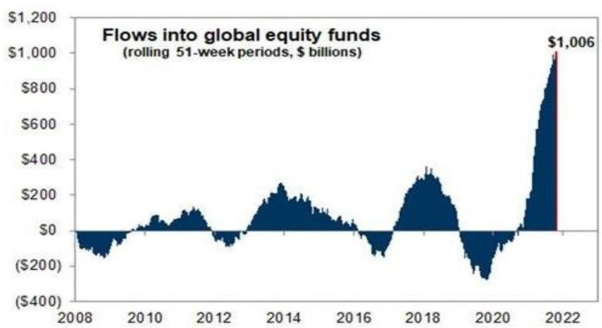


Source: Evans & Partners 26 October 2021

In aggregate, weaker growth together with inflationary stress create the risk of a stagflationary scenario. Exposed and unprepared businesses, share prices not factoring in this possibility, and investors ignoring any probability, could suffer materially.



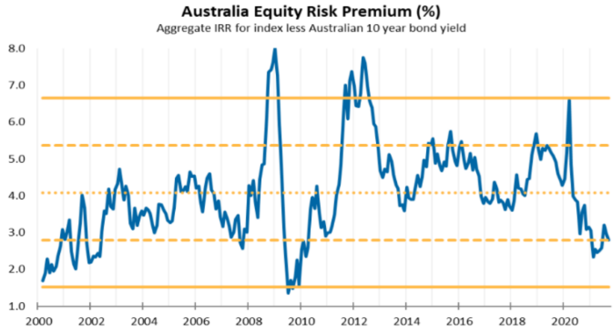
Source: Evans & Partners 2 November 2021



Source: Evans & Partners 2 November 2021

The equity market's lack of alarm with the prospect of a rising cost of capital is further shown by historically high multiple dispersion and low risk premium.

Source: Macquarie Research 20 October 2021



Source: Macquarie Research 20 October 2021

We remain confident in our Portfolio Positioning

Contact builds portfolios from the "bottom-up". We believe that achieving good returns in stocks requires keeping a long-term focus and a disciplined investment strategy. Our investment process is grounded on six fundamental pillars, whereby we analyse Principal Activity, Income, Financial Strength, Management, ESG considerations and Valuation in finding our investments. However, as noted above, we are cognisant of macro or "top-down" factors. We consider our portfolio positioning to be strong, even in the abovementioned environment, which can be daunting for short-term investors. For example:

- The Ex-50 portfolio is almost completely exposed to industrials, largely avoiding cyclical commodity businesses that would suffer from weak broader growth, particularly from China.
- The fund's Net Debt/EBITDA is ~33% lower than the market index at a time when funding financial leverage is set to rise. The favourable relative position is also reflected in an almost zero exposure to bond proxies like infrastructure and passive property. Despite this defensive stance, the portfolio's yield is a healthy 4% while the P/E at ~18x is about 1/3 lower than that for industrials benchmarks.
- In what could be a challenging period for growth, the portfolio is expected to deliver near double digit earnings growth vs low single digits for the market. This will be driven by a diverse group of founder-led and strategic partner businesses that comprise more than 70% of the Fund. We remain big believers that founder or family led businesses outperform. History continues to teach us that there are few better determinants of human behaviour than alignment and incentives.

Expanding on the Founder led point, three of our largest positions are ARB Corporation, Harvey Norman and Reece Limited. We are very optimistic on the organic growth prospect for ARB, the niche vehicle accessories player. ARB is net cash and has ambitious growth prospects domestically and offshore. We believe that Harvey Norman has the potential to be debt free within a year given its free cash flow generation. We also recognise the strength of the asset base – Harvey Norman's property portfolio is worth well over 50% of its market cap. Reece Limited just provided a very strong update at its AGM, comfortably exceeding market forecasts and it too may become debt free in just over 12 months.

Overall, Contact is aware of the potential "top-down" headwinds. Nevertheless, we remain confident in the high quality, bottom up and strongly aligned stocks in our Ex-50 Fund.

CONTACT
ASSET MANAGEMENT