Contact Asset Management

INSIGHTS

MAY 2022

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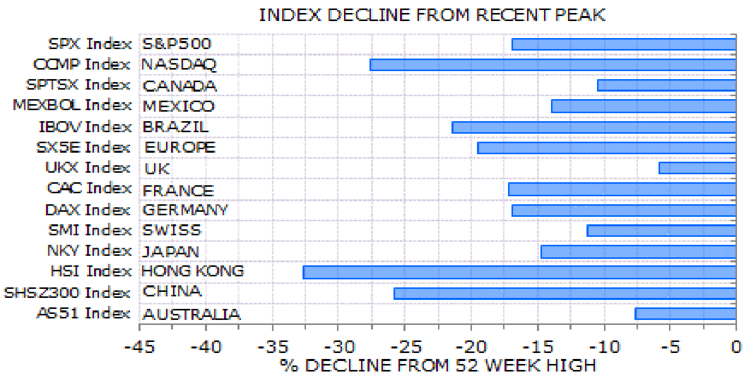
Contact's Australian Equities Portfolios – Ports in a Storm

Australian equities have proven to be a rare beacon of calm during recent global volatility that has engulfed all asset classes. Most of these drivers, and other differentiating factors, remain supportive and could encourage sustained interest from international investors.



Source: Minack Advisors

This defensiveness and an attractive outlook are due to:

1. Greater exposure to buoyant commodity prices;
2. Less exposure to high multiple growth style tech companies;
3. Greater exposure to banking;
4. Lower inflationary pressures;
5. Greater household indebtedness which limits the rate rises required to slow the economy;
6. Higher savings rates;
7. A$ weakness;
8. Higher dividend yields; and
9. Relatively cheap valuations.

1. Commodities

The ASX has an almost 27% weighting to resources commodities comprised of nearly 23% in metals and almost 4% to energy. This compares to the S&P 500 with just 0.5% in metals and about 4% to energy for a total of c.4.5%. This relativity has been an ongoing reason for disparate performance, even more so recently where the space has largely avoided being impacted by the instability.

Commodities relative strength has been due to:

- Secular under supply due to sustained underinvestment
- At least medium-term supply disruption due to realignment of logistics to improve resiliency post CV19
- At least short-term disruption due to Russia's invasion of Ukraine
- Cost pressures across labour, energy and transportation.
- Perceptions of these hard assets as inflationary hedges

Support for metals prices has occurred despite weak demand indicators from China which are due to a mix of renewed CV19 lockdowns and underlying softness due to unfavourable monetary conditions and credit impulse. Commodities probably implicitly assume the clear backflip in Chinese policy from tightening in 2021 to outright stimulatory this year, successfully supports demand via the infrastructure and property sectors. Failure by the socialist command economy system (that market participants generally eschew) would undermine the commodities narrative.

The unusual weakness of the A$ in this environment, due to a flight to the safety of the US$ (while crypto-currencies have again collapsed), is inflating cash flows for domestic miners and the general economy.

Contact remains well positioned in the BKI Investment Company portfolio with holdings including BHP, NHC, WPL, APA and RIO. We have been unable to identify as many undervalued high quality names in the Contact Ex-50 portfolio's universe, but have exposure via DRR, OZL and ALD. Despite underweights in both portfolios (heavily so in the Ex-50), Contact has still delivered exceptional outperformance calendar year to date.

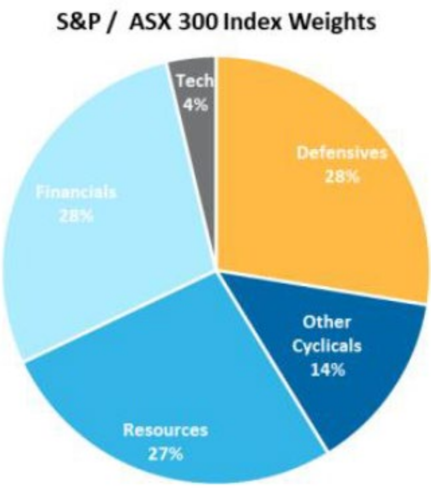
Source: Evans & Partners

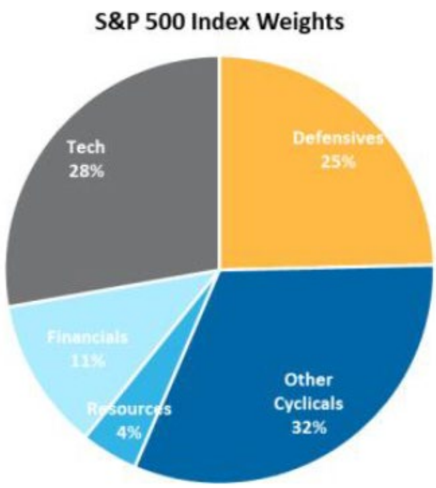
2. Technology - Growth

The massive and familiar US tech sector, known by various acronyms, was the key driver of US outperformance following the GFC, including since CV19. While there is some dispute about how much was driven by EPS growth vs pure re-rating, it is clear the expansion in the dispersion of multiples, reflects the greater benefit of collapsing bond yields for long duration growth companies.

While the technology and communications sectors are about 4% each of the ASX, these total about 37% in the US. Contact has 1 bp of tech exposure across the two portfolios. The traditionally high multiple Healthcare sector is another 9% in Australia but almost 14% in the S&P500. Overall Contact estimates our large cap index has a total Growth style exposure of approximately 20% and the MidCap benchmark about 37%. The BKI and Ex-50 portfolios are over 700 bps and 2,000 bps underweight the style respectively.

Rising yields have disproportionately impacted these higher multiple names which has been a headwind for the American market but tailwinds for the relative outperformance of Australian shares and Contact's portfolios.





Source: Macquarie

3. Banking

At over 20% of the ASX, Banking has a weighting over 16% greater than in the US. While share market weakness often portends economic downturns, which threatens banks that are highly financially geared while also operationally leveraged to the cycle, relatively strong balance sheets undoubtedly buoyed by various supportive governments policies are for now preventing an upswing in bad debts.

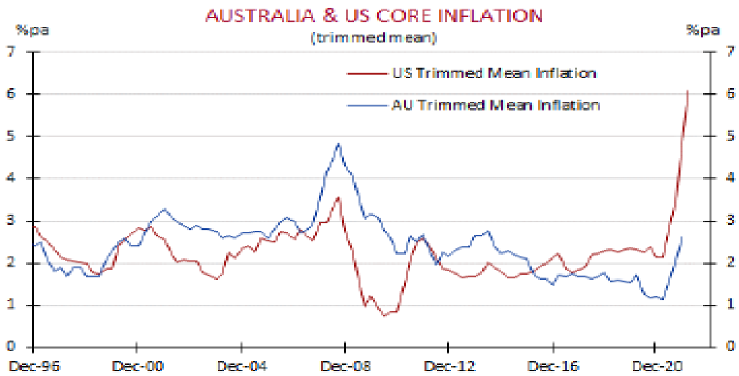
In fact, rising interest rates offer relief to net interest margins that have been suppressed by extended loose monetary policy and quantitative easing. Together with Australian banks' traditionally high and fully franked yields, this has attracted investors struggling for options.

Sector Weights	ASX 300	+/- vs	S&P 500
Metals & Mining	22.8%	22.3%	0.5%
Banks	20.5%	16.4%	4.1%
Real Estate	6.9%	4.3%	2.6%
Insurance	2.7%	0.6%	2.1%
Basic Materials	2.6%	0.5%	2.1%
Consumer Staples	4.7%	0.2%	4.5%
Energy	3.9%	0.0%	3.9%
Diversified Financials	5.2%	(0.2%)	5.3%
Utilities	1.2%	(1.4%)	2.6%
Industrials	5.7%	(2.3%)	7.9%
Health Care	9.1%	(4.5%)	13.6%
Consumer Discretionary	7.1%	(5.0%)	12.1%
Communication Services	4.0%	(5.4%)	9.4%
Technology	3.7%	(24.0%)	27.8%

Source: Macquarie

4. Inflation

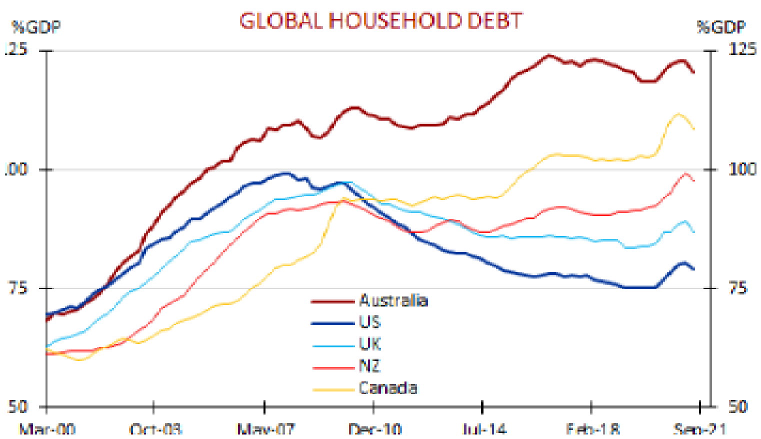
Markedly lower inflationary pressures in Australia, suggest less central bank urgency to act aggressively. The main underlying driver behind the divergence are differing wage pressures. Despite a more mobile labour force, costs are rising faster in the US (~5%) with economists surprised by the number exiting the work force (the so-called Great Resignation). The lower rate in Australia (~3%) is potentially inflated by the CV19 inspired drop in immigration. This suggests the wedge could remain or possibly expand in Australia's favour when borders open up. Contact's investments in companies exposed to cost pressures, have either passed through impacts due to their business models (AMC, AQZ, KLS) or are well positioned to exercise pricing power (ARB & REH).



Source: Evans and Partners

5. Debt

While UK and US household debt to GDP ratios have trended down since the GFC (from just under 100% to 80-85%), Australians have increased their leverage from about 110% to almost 125%. Although much of this is home mortgages, it makes the domestic economy more sensitive to rate increases. Therefore, the RBA is more likely to slow growth and gain control over inflation with smaller lifts in interest rates. This reduces the relative discount rate headwind for domestic equities.



Source: Evans & Partners

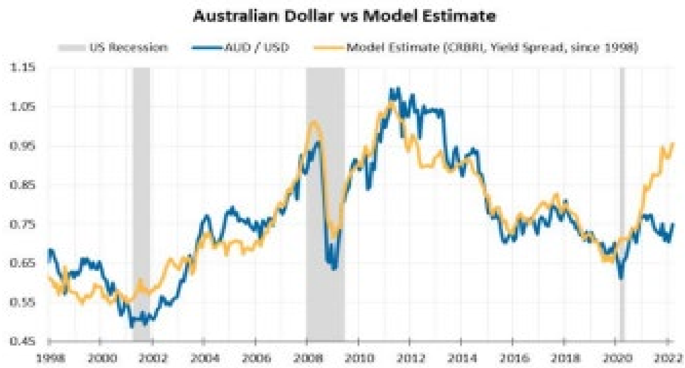
6. Savings

The helicopter money dropped by governments to support consumers stood down during CV19, was so large that it produced a massive boost to and pull forward of retail demand, while still leaving individuals with historically high balances. This at least partially de-risks the equity investment thesis.

Source: Goldman Sachs

7. Currency

The abovementioned surprising A$ weakness, makes the investment case into Australia even cheaper. While the currency could revert back to the historic relationship with commodities, lower inflation and lower yields in response, could exert downward pressure for longer. Beneficiaries in Contact portfolios other than resources companies include AMC, ARB, GMG, MQG and SHL.



Source: Macquarie

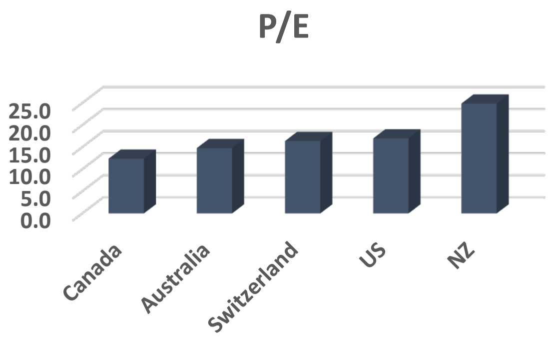
8. Yields

The cash flow bonanza for domestic resource companies from higher commodity prices but a soft A$, and a broader upward creep in payout ratios, has again returned Australia to the top of the global dividend yield table. As earnings growth faces headwinds from cycling brought forward revenues and due to cost pressures, a solid yield above 4% is major head start. Contact's portfolio yields are comfortably ahead of their benchmarks.

Source: MST Marquee

9. Valuations

The fall in the premium for industrial stocks while resources P/Es remain depressed due to buoyant commodity prices, sees Australia remain cheap relative to the US despite the drop in its higher growth market multiple. If local resource company earnings were marked to market, the Australian multiple below would be at least ½ a P/E turn lower again.



Source: MST Marquee

Conclusion

While the long-speculated correction has arrived, Australian equities offer resiliency driven by a variety of supportive factors including:

- Greater exposure to strong commodity prices
- Less exposure to high multiple tech and growth
- Our banking oligopoly
- Lower bond yield and discount rate upside due to lower inflationary pressures and greater household indebtedness
- High savings rates
- Softness in the Australian Dollar
- Leading dividend yields
- Attractive valuations

Contact's portfolios have delivered greater security still and we expect to continue to produce strong relative and absolute returns. Investments within our portfolios are underpinned by:

- Solid earnings growth
- Attractive valuation multiples
- Strong balance sheets
- Pricing power
- Strong operating returns
- Attractive dividend yields
- Good management alignment (substantial exposure to founder led businesses of over 70% in the Contact Ex-50 fund)
- Heavy underweight to interest rate sensitives including premium multiple growth stocks and passive property (Contact Ex-50 fund more than 20% underweight)

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