The Contact Australian Ex-50 Fund

Annual Letter – June 2024

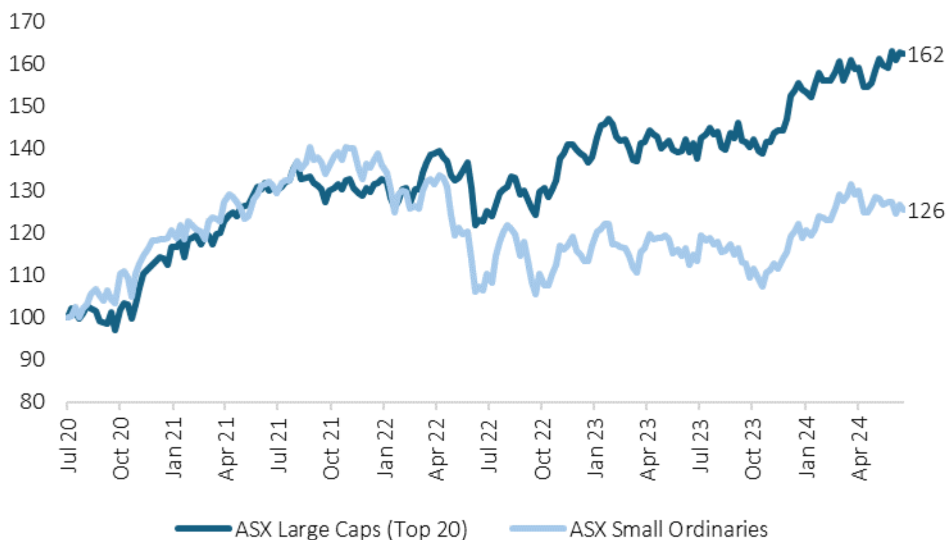
Dear Investor,

In the face of several economic headwinds, global equities markets edged higher in fiscal 2024. This was a pleasing outcome as the returns build on solid gains in FY2023. Similar themes have permeated markets for a couple of years now. That is, an environment of stubborn inflation, global tensions, wage pressures, tighter margins and higher interest rates. More recently, there have been concerns around a cost-of-living crisis and energy (both the cost of energy and security of energy supply).

Yet, for most corporates, earnings increased and so did stock prices. The S&P/ASX 300 Accumulation Index increased by almost 12%. A strong performance notwithstanding it was well outpaced by the Indian market (+31%), the NASDAQ (+30%), the S&P500 (+25%) and the Nikkei (+21%). Again, in a similar vein to FY2023, only the Chinese / Hong Kong market closed lower in FY2024 as much needed Chinese Government stimulus has failed to materialise.

Closer to home, we witnessed a continuation of a theme over the past few years, whereby large ASX stocks have outperformed their smaller counterparts. In FY2024, the S&P/ASX Top 20 Accumulation Index increased by 15%, whereas the S&P/ASX Small Ordinaries Accumulation Index increased 9%. The following chart highlights the divergence of performance over the past two years in particular.

Significant outperformance of ASX Large Caps versus Small Caps



Source: Factset, Contact Asset Management

We were satisfied with the Fund's performance given the volatile investing environment and the abovementioned underperformance of small and mid-cap stocks. For the year to 30 June 2024, The Fund return was 8.9%, outperforming the blended Mid Cap / Small Cap Index which returned 8.0% over the same period.

We maintained optimism in October 2023 amid investor pessimism. Most management teams we spoke to remained constructive and we stayed consistent in our preference for Quality. The next six months from October saw the Fund rally over 15%. We remain upbeat on the prospects for the Fund as we believe that the overall valuation metrics for the portfolio remain compelling given its Quality metrics.

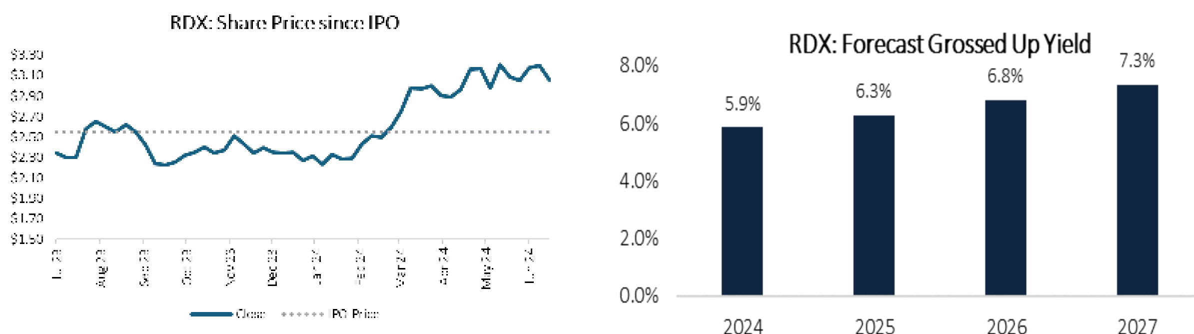
Portfolio Developments

We are investors not day traders. Our portfolio turnover is generally lower than our peer group. Experience has taught us that only over the long run can a company truly benefit from a company's superior fundamentals. The challenge is trying to balance long-term investing with constantly seeking superior investment returns from reinvestment opportunities. While we often went long periods without trading at all in FY2024, we actively repositioned the portfolio when we did.

The Fund has increased in size over the past year. Each inflow of cash provides an opportunity to reweight. Notable new additions include Aurizon Limited, Carsales, LGI Limited, Redox Limited and Yancoal Australia. We exited five positions for different reasons including Allkem, Bank of Queensland and Smartgroup Limited (all primarily on more challenging industry outlook), PSC Insurance (takeover), HUB24 Limited and Netwealth Group (solid businesses but we couldn't justify the valuation). We have discussed the rationale for the majority of these portfolio decisions in our prior Monthly Reports or *Contact Insights* notes. However, we thought it useful to provide more context into Redox Limited (RDX), Yancoal Australia (YAL) and LGI Limited (LGI) which some readers are perhaps less familiar with.

We added Redox Limited to the portfolio in early July 2023 as the company listed on the ASX. Redox is a traditional Industrial company – it is a leading supplier of chemicals, ingredients and raw materials to a myriad of industries. It was established in 1965 and is still managed by the founding Coneliano family, which owns 46% of the listed company. RDX generates a high proportion of recurring revenue, strong returns on capital and has growth opportunities via market share gains. Over time, we expect RDX to generate steady EPS growth and offer a compelling dividend yield. The IPO was priced just under 14x P/E multiple, which we considered attractive.

The first few months of RDX listed life coincided with the negative investor sentiment (across the whole market) discussed above. We gradually added more RDX. Importantly, with the February result, RDX delivered on expectations and continues to build investor confidence. The business is well-managed, has strong financials and an excellent runway for growth given the fragmented market that it competes in. Our forecasts imply continued earnings and dividend growth and a compelling dividend yield. The stock is still trading at a forward P/E multiple of 14 times.



Source: Factset, Contact Asset Management

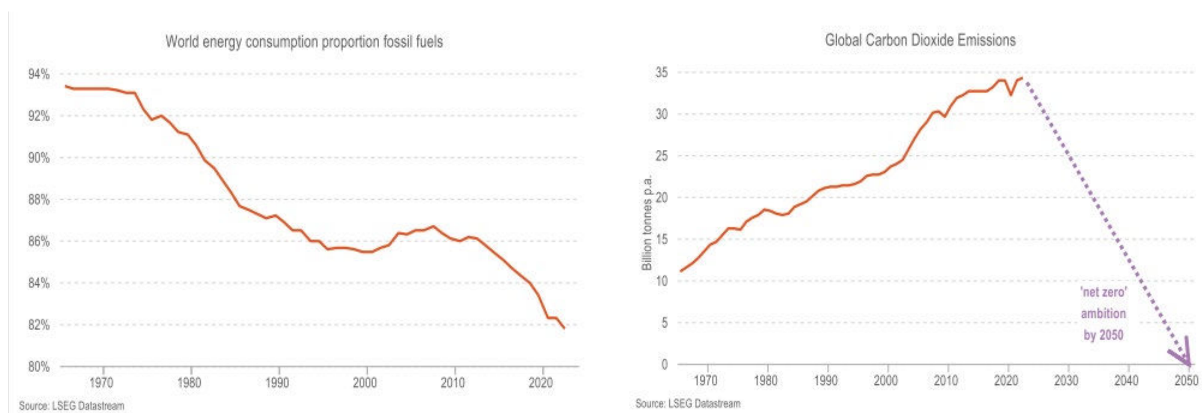
We added Yancoal Australia to the portfolio in September 2023. Like RDX, we gradually increased its weighting in the portfolio. It is now a top 3 position. In January 2024, when we bought more stock, we wrote in the Monthly Report that:

> YAL is a leading Australian coal producer in the global seaborne market, producing a mix of premium thermal, semi-soft coking and PCI coals for export. YAL is printing cash. In the December quarter alone, YAL added almost $500 million to its cash balance. It now has $1.4 billion in the bank (having also paid out $1.4 billion in dividends in the prior twelve months). YAL delivered on production guidance for the year, with over 33 million tonnes of saleable coal. Across the thermal coal and metallurgical coal markets,

supply and demand appear relatively well balanced. While prices for thermal and metallurgical coal are off the record highs of recent years, they remain well above operating cash costs. We believe that the stock is extremely cheap with a P/E multiple of just 3.5x. We expect the company to continue to offer compelling fully-franked dividends for some time yet, with a current expected dividend yield of >15%.

We remain bullish on coal given the tightness of supply and the lack of new investment. Demand for energy and electricity continues to increase. In the United States, we are already seeing this as Artificial Intelligence, data centres and the boom in clean-tech manufacturing are pushing America's aging power grid to the brink. A recent article in the Washington Post[1] supported our thesis that the transition to renewables will take longer than policy makers hope. In the near-term, renewables simply cannot keep up with the increased demand for power. The article notes: *"It is all happening at the same time the energy transition is steering large numbers of Americans to rely on the power grid to fuel vehicles, heat pumps, induction stoves and all manner of other household appliances that previously ran on fossil fuels. . . . Planners are increasingly concerned that the grid won't be green enough or powerful enough to meet these demands. . . .Already, soaring power consumption is delaying coal plant closures in Kansas, Nebraska, Wisconsin and South Carolina."*

In recent months, we have seen the start of this in Australia with the decision to delay the closure of the Erarang coal fired power plant. But beyond that, many countries, notably India and China, continue to build coal-fired power plants or increase steel production. They will source much-needed coal from Australia. We consider the following charts to be powerful. The proportion of world energy still being produced by fossil fuels is over 80%. It has only dropped 4% in 15 years. And this is a percentage of total energy consumed and that total number is only going up.



All told, we think the investment case for investing in coal companies is intact. There is favourable demand / supply equation, the stocks are on single digit P/E multiples and double-digit dividend yields. While coal prices have retreated from the highs in recent years, the cash being generated is large.

Finally, and still on an Energy-related industry, we established a small position in LGI Limited in March 2024. LGI is a profitable green energy producer that is converting methane from landfill into energy. It is a founder-led business established in 2009. LGI generates revenue via (i) its generators supply energy to the National Electricity Market (NEM); and (ii) it creates valuable ACCUs (Australian Carbon Credit Units), which it can sell.

In recent years LGI has experienced strong revenue and earnings growth. It is a high margin business, and we are optimistic on its growth prospects. We expect LGI to recover more gas from signing up additional landfills around the country. Secondly, LGI is investing in adding batteries to more sites, which allows it to take advantage of the huge swings in electricity prices. This is important and builds on the discussion above. Australian electricity prices are the most volatile globally. Volatility in intra-day electricity prices is rising with the retirement of coal-fired generation in favour of renewables. LGI is well-placed to implement its strategy of supplementing electricity generation with batteries to maximise revenue. The Bunya Battery Project, a pilot for future battery rollout, has

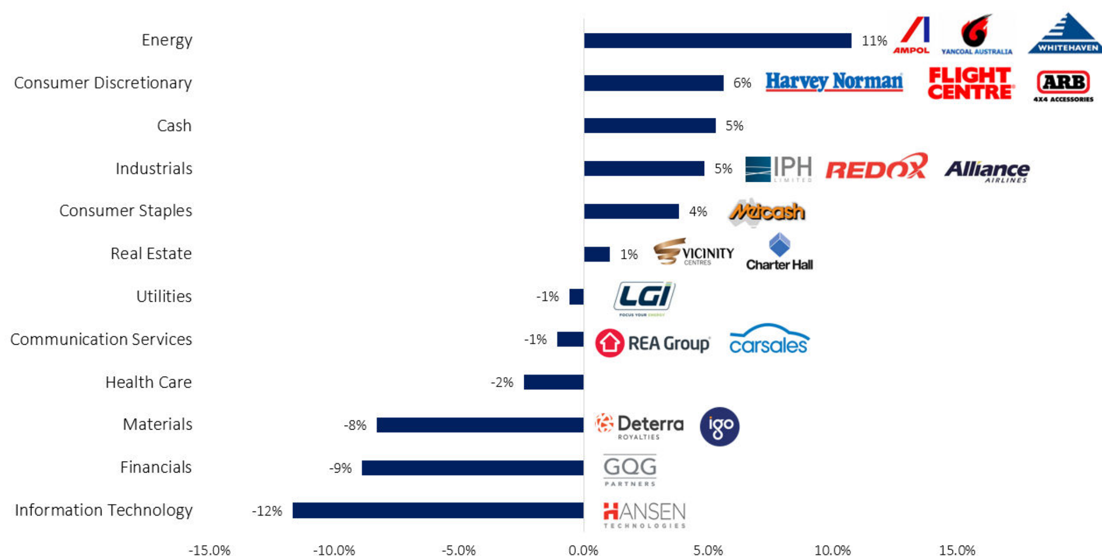
[1] Washington Post: "Amid explosive demand, America is running out of power", Evan Halper, 7 March 2024

shown promising results. Combining electricity generation with a battery yielded revenue that was 77% above benchmark prices. We consider LGI to be attractively priced given its potential for high growth.

Sector Exposure

On the whole, we believe that the Portfolio is well positioned with a cross section of high-quality businesses across a range of sectors. We aim to own the best companies, and this may result in us having no exposure to a sector at all. For example, while the ASX boasts some outstanding Healthcare businesses amongst the mega-caps, we currently find it difficult to find outstanding investment opportunities in the healthcare sector among the small and mid-caps. The following chart provides some insight into portfolio exposure by sector, highlighting some of our higher conviction investments.

Fund sector exposure (vs S&P/ASX Midcap Index) and key investments per sector



Source: Factset, Contact Asset Management

As we discussed briefly above, we are bullish on Energy. We intend to provide more detail on this in an upcoming Quarterly Report or *Contact Insights* piece. This is a complex area with a lot of (often competing) stakeholders.

Our assessment of the Outlook

Inflation continues to be the biggest focus in global economies. We continue to expect further challenges to emerge in our local market following high inflation and rising interest rates over the short to medium term. However, more recent inflation numbers in the US and Europe may see Central Banks within these markets begin to cut rates prior to Christmas 2024. This should be well received by equity markets. Australia is a little behind as we were initially slower to lift rates as inflation emerged post COVID-19. Australia is still printing a CPI number that is larger than our Reserve Bank is comfortable with, and with that we believe that our local official cash rate may stay higher for longer.

Despite this we continue to find pockets of opportunities to invest within our equity market. There are many high-quality companies that have strong balance sheets not affected by higher interest rates. They continue to have a clear competitive advantage with pricing power enabling them to pass on higher costs and many are managed by capable and trustworthy people who think and act long term. Most of these quality businesses have Boards and Executives who have skin in the game and own shares in the companies they manage proving time and time again that they have a real focus on paying shareholders an attractive and sustainable dividend stream throughout each cycle.

Given the current backdrop, we are very curious as to the outcome of the last six months which will be shown in the various half and full year company results during the upcoming July/August 2024 reporting season. We will have a particular interest in the following topics:

- **The consumer discretionary sector** – can this sector continue to show resilient top line sales relative to previous conservative assumptions?
- **The materials sector** – major miners including BHP, Rio Tinto and Woodside are again recycling large profits. Will the impact of commodity and energy cost curves steepening and challenging labour conditions be softened by increased volumes and a low Australian dollar?
- **Interest costs** – These will remain a headwind for many companies with excessive debt. Will companies with stretched balance sheets reduce dividends to pay down debt?
- **Artificial Intelligence** – AI has become an increasing talking point, will tech continue to dominate?

It is worth noting again that while the headline P/E multiples for the market appear elevated, there are still opportunities within sectors and certainly for stock pickers. Relative to global peers, we continue to believe that the Australian market looks attractive. Even in a rising interest rate environment, it is highly likely that Australian equities can keep delivering reasonable earnings growth in FY2025 on the back of a stable unemployment rate, a very strong housing market, tight global commodity markets, and strong migration and population growth.

Closing

A patient, cost-effective, long -term approach is where we believe we have an edge as investors. We are not chasing a short-term performance fee against some arbitrary index. Instead, we target a 10% p.a. total return over the long-term. We think that this is an admirable return target and one that is likely to outperform the broader equities market in any case.

We remain true to Contact's investor-focused approach, notably through our low fees. Low fees boost the ability to effectively compound capital over time. Our fees are at industry low rates, and we do not believe in performance fees. Our headline rate of 0.60% is among the lowest in the Australian Funds Management Industry.

In all markets, we are fortunate to rely on an investment philosophy that has been honed for generations. We believe that:

- **Patience pays off:** time in the market beats timing the market. We invest for the long-term and minimise portfolio turnover.
- **Dividends don't lie:** companies need to have strong financials and prospects to pay a sustainable dividend stream. They must be profitable and generate cash. The market often underappreciates the high proportion of returns that are generated by dividends.
- **Fees dilute returns:** low fees boost the ability to effectively compound capital over time. Our fees are at industry low rates, and we do not believe in performance fees.
- **Alignment is crucial:** we seek to invest in founder-led businesses. We invest alongside our shareholders and unitholders in all products that we manage. History has taught us that the success of a business comes down to its people.
- **Invest in good companies:** if we get the research into the company right, the share price will take care of itself.

At the end of June, the Portfolio characteristics of the Fund remain robust. From a valuation perspective, the Fund was trading on a P/E of 12.7 times (based on 2024 earnings estimates). This is attractive by historical standards. We aim to buy businesses at above average rates of return and the ROIC (return on invested capital) of the Portfolio was 24.7%. By comparison, the ROIC on the S&P/ASX Mid-cap 50 index was 11.7%. We believe this is a high-quality portfolio and the companies within it also deliver greater cash flow generation and stronger balance sheets than the broader market.

The June distribution has been finalised. The total cash distribution for the FY24 year was 6.1 cents per unit. Based on an ex-distribution price of $1.19, the historical distribution yield for the Fund is 5.1%, which we consider to be

attractive. Our goal is to provides investors with a reasonable yield which is complemented by capital growth over the long-term.

Please let us know if you have any questions or require additional information. In the meantime, we encourage you to visit the Insights section of our website at https://contactam.com.au/insights/ where we collate interesting thought pieces.

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

Yours sincerely,

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Appendix 1: Full portfolio disclosure as at 30 June 2024

Company	Code	Weight
Metcash Limited	MTS	6.7%
IPH Limited	IPH	6.7%
Yancoal Australia	YAL	6.4%
Ampol Limited	ALD	6.1%
GQG Partners	GQG	4.9%
Vicinity Centres	VCX	4.4%
Flight Centre Travel	FLT	4.3%
Charter Hall Group	CHC	4.0%
Harvey Norman	HVN	3.8%
Alliance Aviation	AQZ	3.7%
Whitehaven Coal	WHC	3.6%
Aurizon Holdings Ltd	AZJ	3.6%
Deterra Royalties	DRR	3.5%
REA Group	REA	3.4%
Redox Limited	RDX	3.2%

Company	Code	Weight
Orora Limited	ORA	3.1%
Service Stream	SSM	2.9%
ARB Corporation	ARB	2.8%
CAR Group Limited	CAR	2.6%
Reliance Worldwide	RWC	2.6%
Hansen Technologies	HSN	2.4%
Kelsian Group Ltd	KLS	2.3%
Nine Entertainment	NEC	1.7%
IGO Limited	IGO	1.6%
Lindsay Australia	LAU	1.5%
LGI Limited	LGI	1.3%
E&P Financial Group	EP1	1.0%
TPG Telecom Limited	TPG	0.6%
Cash	AUD	5.3%
Total		100.0%

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