PM Capital

PM Capital Quarterly Update - June 2017

Financial year in review – a note from the CIO

Transcript

July 2017

Pul Moore, Chief Investment Officer, Chairman

"Financial year 2017 was another extra-ordinary period for investment markets. It started with Brexit, fears of economic fragility and scepticism that the FED would in fact increase interest rates, witnessed the phenomena of Trump and ended with strong equity returns, increased global economic momentum and higher short and long-term rates.

"Pleasingly, I can report that funds using our Global Equities investment strategy were not only ranked first out of 207 peer group funds for the 1 year to June 2017 but that it also ranked number 1 over 3, 5. 7 and 8 years. Our Australian equity fund likewise was ranked number 1 for the financial year and our Asian fund is ranked number 1 since its inception. I would hope that this is testimony to the adherence to our philosophy and process, seeking out genuine long - term anomalies, that we have and always will employ, irrespective of market circumstances.

"Our focus on genuine long-term anomalies was the central theme of our recent investor roadshow, where we used the *Moneyball* movie to provide a platform to give a deeper insight into why we do what we do. For those who were unable to attend, I would encourage you to watch the video of the presentation on our web site, as I do believe it gives a proper insight into the fundamentals that form the framework for our investment approach.

"The most memorable moment for me from the roadshow was the fact that for the first time in 30 years, at our presentation in Melbourne, I was actually asked, what I believe to be the most important question any adviser should ask of their fund manager; "Excluding your home, what % of your net worth is invested in the funds that you manage". In my case it would be close to 100%. Co-investment is not a guarantee but it should be mandatory.

"With respect to markets, we have transitioned from the post GFC era to what I now describe as the post Trump era. The absolute level of risk has clearly changed. Post GFC one wanted to be at the limits of their maximum invested levels. Post Trump, it is more appropriate to be below those levels and my expectation is that our net invested exposures in our equity funds will on average be in the range of 85-90%.

"The investment themes that dominate our global portfolio are no longer undiscovered and have been rewarded by the market. But we still believe that they are yet to fully recognize their underlying fundamentals and until they do, we will continue to hold these investments.

"Our domestic banking stocks have caught the attention of investors, but the dominant focus still appears to be the macro – "it's all about the yield curve"'. During the quarter, regulators confirmed what we have always believed, that our US bank holdings were significantly over capitalised and approved payout ratios (return of capital via dividends and buybacks) in excess of 100% of 2017 profits. Our dividend story has come true but the market is still slowly recognizing it. Price earnings

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ratios on 2018 earnings are approximately 12.5 which is at the lower end of the 12.5-15 PE range that we suggested in our original investment summary. Implied dividend yields are now 6-7% and we should see earnings growth from loan growth, higher interest rates on their loans and potentially tax cuts. If we do in fact re-rate to a 14-15 forward price earnings ratio, then potential returns are still very attractive.

"The ultimate upside potential will also be influenced by the macro-economic trajectory of the banking jurisdiction and in that regard, I still suspect that investors are underestimating the sustainability of the global economy. Having spent time in both Europe and the United States over the last quarter, activity levels were solid. In fact, Ireland and Spain were in stark contrast to the ghost towns that we encountered 2- 3 years ago. The impact of low rates is clearly being seen in their property markets and in Spain, one can lock in a thirty year fixed rate mortgage for 1.8%. Even more astounding was the fact that I was recently told by a client that they had a variable rate home loan in France with HSBC and the current rate was -0.3%! Rates are too low and they need to go up.

"The most interesting comment of all though, was a comment from the management team of a US Home builder that we are invested in. Visiting their operation in California, they noted, that at a time when per capita housing starts are still at an all time low, it is very difficult to find the labour to meet the demand from the upswing that they are currently seeing. So what would happen if starts returned to a more normalised level? I suspect underlying tension in wages is a bit higher than what may be appreciated.

"This is one of the reasons why we have been thinking a lot about what may be swept up by "Bondnado" and our belief that an investment in long term government bonds may not be a good experience from this point on, much like the experience from viewing the infamous film *Sharknado*. We are looking for ways to exploit what we see as a glaring anomaly and would suggest that businesses that have been beneficiaries of the property and infrastructure cycles could be obvious candidates to avoid. One anecdote that caught my eye was a recent report that households in Sydney are now spending 50% of their household income on mortgage repayments. I have not verified the source of the data, but it is consistent with what I suspected. So if home loan rates doubled, which would still be about half the 17% high in standard variable rates back in 1989, close to 100% of household income would be eaten up by mortgage payments. Puts the risk in property into perspective (and the economy).

"Finally, a quick note on passive investing. I doubt equity market indices will generate a return in excess of 4-6% going forward. Throw in cash, bonds and property that will unlikely do better than their underlying yields of approximately 1% to 4% and the typical blended portfolio is unlikely to meet the investment objectives of most investors. Combine that with the recent research findings of the BAML Equity and Quant strategy group who highlighted that "Valuations explain almost 90% of the S&P 500's returns variability over a 10-year time horizon and that ironically, what should be an increasingly efficient market has shown signs of becoming less efficient over the long term — alpha opportunities, measured by the range of market prices, have shrunk on a short-term basis, but have demonstrably risen on a long-term basis.

"And that is the reason that we believe. More than ever, investors need the help of genuine high conviction managers."