# Chief Investment Officer Letter - Equity Strategies

Paul Moore
Global Portfolio Manager

Dear Investor,

Financial Year 2021 was another extraordinary year. COVID-19 and China dominated headlines and stockmarket indices finished FY21 at record highs. I am pleased to report that each of our equity strategies have comfortably exceeded their benchmarks for the year;

| Performance as at 30 June 2021[1] | 1 Year |
|---|---|
| **Global Companies Fund** | **52.1%** |
| **Australian Companies Fund** | **33.9%** |
| **Asian Companies Fund** | **33.1%** |

1. Past performance is not a reliable indicator of future performance. Please refer to our monthly and quarterly report for standard reporting periods.

Short-term investment discussions are all about interest rates, the "growth" and "value" debate, and if higher inflation will be transitory. When there is nervousness over COVID-19 and the economy, growth stocks are favoured. When markets are comfortable that growth is strong and sustained, bond yields rise and value stocks are favoured.

It is likely that everything we have known in our investment lifetime is changing. Forty years ago, the yield on a US government 10-year bond was 14%. Today, it is 1.4%. In Germany, government bond yields are negative.

This "Great Race" to zero rates has been a driving force behind all asset classes, and produced above-normal returns. It has also created record crowding and record valuations in specific assets and sectors of the equity market. Investors have never been "longer duration" (at risk from a secular change in long-term interest rates). If inflation and interest rates have troughed, combined with dramatic change in geopolitics and accelerating technological change, it will never be more important to think carefully about, and be disciplined in, your long-term investing framework.

We all like to consider ourselves independent thinkers, but "groupthink" is becoming more pervasive, reinforced by "process" and social media. Witness the similarity in how central bankers behaved over the past decade and particularly after COVID-19. The same is true for the fiscal discipline of our politicians.

An example of where thinking might need to change is portfolio diversification: cash, bonds, property, equities and, now, alternative investments. Consistently declining interest rates have supported diversification. However, with cash now providing no return, bonds returning 1.5% and property delivering 3%, (after costs in the system), a large part of a diversified portfolio will provide zero return with increased mark-to-market risk (from rate volatility).

A passive equity portfolio will not help much either as parts of the stockmarket are fully valued at best. Some parts are fairly valued, and some, we believe, are at a decent discount to fair value. But it is likely that the fully valued, and more likely overvalued companies, will offset those selling at a discount. That will lead to a stalemate for the generic index. So, how will advisers provide a return for their clients?

If I am correct, a rethink of the go-to strategy of the last decade - passive index tracking funds – is needed.

> **"Cheap, index-tracking share funds are on the cusp of eclipsing actively managed portfolios after a run of inflows over the past year as equity markets around the world trade at record high levels."**
>
> AFR, 16 June 2021

An attraction of passive equity funds is that in an above-normal return environment, difficult conversations with clients are not required. One never has to explain short-term variances in manager performance to their clients. Now, the issue may be: how do you explain the lack of return?

As to the investment industry's fixation with short-term volatility, this summation in a Bernstein research report is worth considering:

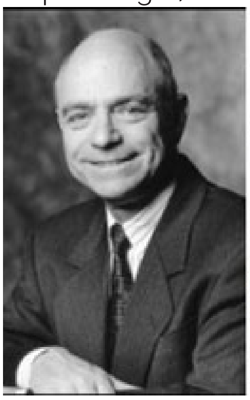
> **"A financial legacy of the pandemic will be a significant reallocation of assets that has barely begun. But we also think it leads to a more fundamental shift, in a questioning of the underlying assumptions used to form investment decisions.**
>
> **We suggest the way goals are set and how they inform the interaction of asset managers and asset owners needs to shift. This includes an evolution of the proper measure of risk in a world where risk-as-volatility may clash with the risk of loss of purchasing power."**

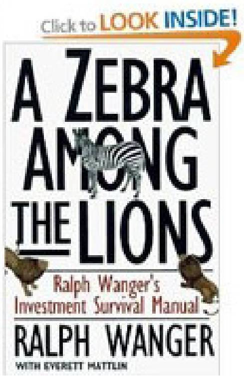
Bernstein, July 2021

I doubt PM Capital could ever be accused of groupthink. In trying to highlight the characteristics of our approach, I reflected on an excerpt from a book, "The Story of the Zebra Among the Lions", that I included in our first Product Disclosure Statement, more than 20 years ago. I first read this excerpt when researching the US equity market, early in my career. It still resonates today.

**The story of A Zebra Among The Lions**

Ralph Wanger, USA






By the time he retired in 2003, Ralph Wanger was widely acknowledged as the guru of small-cap investing. In his career from 1977 to 2003 managing the iconic Acorn Fund, Wanger delivered an astounding 16.3% annualized return - more than 400 basis points alpha over benchmark across a 25-year period - in a market where most fund managers struggle to eke out any alpha. Wanger discussed his winning investment strategy in his book, "A Zebra Among the Lions". Wanger's approach was starkly different from most institutional fund managers.

**"Zebras have the same problems as institutional portfolio managers like myself. First, both have quite specific, often difficult-to-obtain goals. For portfolio managers, above-average performance; for zebras, fresh grass. Second, both dislike risk. Portfolio managers can get fired; zebras can get eaten by lions. Third, both move in herds. They look alike and stick close together.**

**If you are a zebra, and live in a herd, the key decision you have to make is where to stand in relation to the rest of the herd. When you think that conditions are safe, the outside of the herd is best; for there the grass is fresh, while those in the middle see only grass that is half-eaten or trampled down.**

**The aggressive zebras, on the outside of the herd, eat much better. On the other hand - or hoof - there comes a time when lions approach. The Outside zebras end up as lion lunch. The skinny zebras in the middle of the herd may eat less well but they are alive.**

**A portfolio manager for an institution such as a bank trust department, insurance company or mutual fund cannot afford to be an Outside Zebra. For him, the optimal strategy is simple: stay in the center of the herd at all times. As long he continues to buy the popular stocks, he cannot be faulted.**

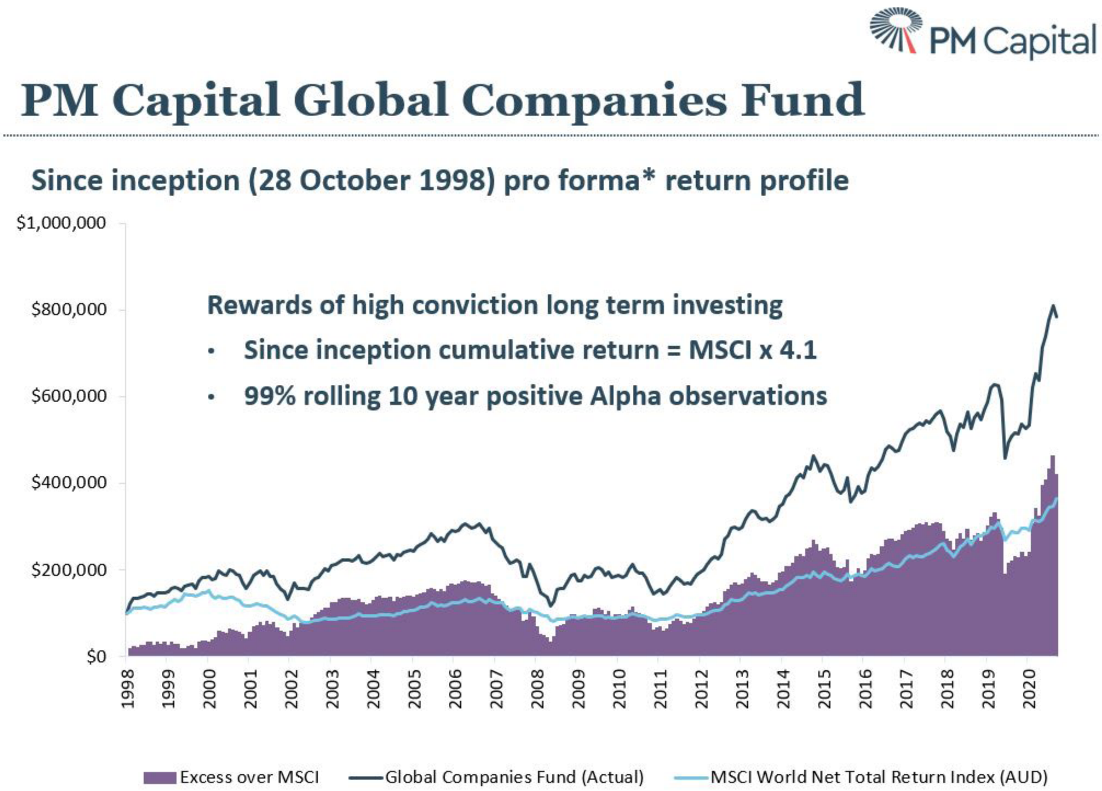
**On the other hand, he cannot afford to try for large gains or unfamiliar stocks that would leave him open to criticism if the idea failed. Needless to say, the Inside Zebra philosophy doesn't appeal to me as a long-term investor."**

PM Capital's approach has always been to focus our portfolio on stocks we genuinely believe to be at a discount to their intrinsic worth. Our philosophy is that valuation will dictate long-term returns and patience will ensure those returns are delivered. It takes genuine conviction (and stress) at different times. But the reward from doing

A note from the CIO

so is hopefully reflected in our long-term results.

Chart 1:




* Pro forma Fund performance has been calculated based on the new fee structure (implemented 1 December 2018), assuming it had applied from the Fund's inception. As at 30 June 2021. These returns do not represent the actual net Fund performance. Fund's inception date 28 October 1998. Past performance is not indicative of future performance.

Now, the only problem with historic results is: they are historical. Yes, they give valuable information about a manager's skill set and the characteristics one should expect from their fund. Unfortunately, historical results give no insight into the risk-reward equation for the capital we have invested today.

As I alluded to, future return expectations for markets should be much lower than what has been achieved historically. Markets, now at their highs, have benefited from record monetary and fiscal stimulus. A key debate is if we have seen peak liquidity and stimulus, given the market is a forward discounting mechanism. Also, have we seen the end of cycle markets?

Red flags abound. Every day there is a financial scandal reported in the media, and ludicrous valuations on Initial Public Offerings. It has been a commission-generating paradise.

We have seen the collapse of Australia's own supply-chain finance phenomena, Greensill Capital. We have seen the overnight implosion of Bill Hwang's supposed US$25-billion hedge-fund fortune with steep losses for several investment banks. My favourite was the Hollywood actor, Zachary Horwitz, who allegedly managed to lighten investors of nearly a billion dollars on the promise of 35%+ returns from financing distribution rights for movies that would run on HBO and Netflix. Only one problem: I don't think HBO or Netflix had ever heard of Mr Horwitz!

PM Capital's view is that given current dynamics, whatever one's risk profile, dial down risk a notch or two. That means holding more cash and only own investments you genuinely believe will offer a satisfactory return.

So, where do we see those opportunities?

Our portfolio is currently dominated by businesses that fall into the so-called "Value" sectors of the market – sectors that over time were pushed to record-low relative valuations by the "Great Race" to zero rates and COVID-19.

*[As an aside, for us value does not simply mean low Price Earnings (PE) multiples. Not all so-called "Value" is value. For some stocks, there is a good reason why they look cheap using simple metrics and investing in these will not derive a good outcome. For us, Value is when you find a business selling below the value it should sell for under normal industry conditions, and that will give you a satisfactory return over a defined period. For example, Visa, a great company, would be considered by most as a "growth" company and sells at more than 30 times forward*

## A note from the CIO

*earnings. At 20 times forward earnings, we'd consider Visa to be "Value".]*

COVID-19 created one of those rare investment opportunities that seems to play out about every 10 years. After the 1987 sharemarket crash, it was quality brand names, such as Coca Cola, selling at 10 times earnings. After the "TMT" (technology, media and telecommunications) internet mania of 2000, it was old economy stocks, such as BHP. After the Global Financial Crisis in 2009, it was the global oligopolies, such as Visa. Interestingly, these stocks went from deeply discounted valuations to over-valuation over a similar 10-year period. Then in 2020, it was "Cyclical Value".

Chart 2:

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### Ten year cycles

**Top- ten market by market cap: how often do winners stay on top?**

| 1980 | 1990 | 2000* | 2010 | 2020 |
|---|---|---|---|---|
| IBM | NTT | Microsoft (-74%) | Exxon Mobil | Apple Inc. |
| AT&T | Bank of Tokyo-Mitsubishi | General Electric (-87%) | Petro China | Microsoft |
| Exxon | Industrial Bank of Japan | NTT DoCoMo (-85%) | Apple Inc. | Amazon Inc. |
| Standard Oil | Sumitomo Mitsui Banking | Cisco Systems (-88%) | BHP Billiton | Facebook Inc. |
| Schlumberger | Toyota Motors | Wal-Mart (-39%) | Microsoft | Alphabet Inc. (C) |
| Shell | Fuji Bank | Intel (-71%) | ICBC | Alphabet Inc. (A) |
| Mobil | Dai ilichi Kangyo Bank | NTT (-85%) | Petrobras | Johnson & Johnson |
| Atlantic Richfield | IBM | Exxon Mobil (-25%) | China Construction Bank | Visa A |
| General Electric | UFJ Bank | Lucent Technologies (-87%) | Royal Dutch Shell | Nestle |
| Eastman Kodak | Exxon | Deutsche Telekom (-89%) | Nestle | Procter & Gamble |
| **Survivors** | | | | |
| 2/10 | 2/10 | 2/10 | 3/10 | ??? |

**Who will be the survivors in 2030?**
**More importantly, who will be the new entrants?**

Source: Evergeen Gavekal and MSCI World Index. * Returns shows are 2000 peak to decade trough

Chart 3:

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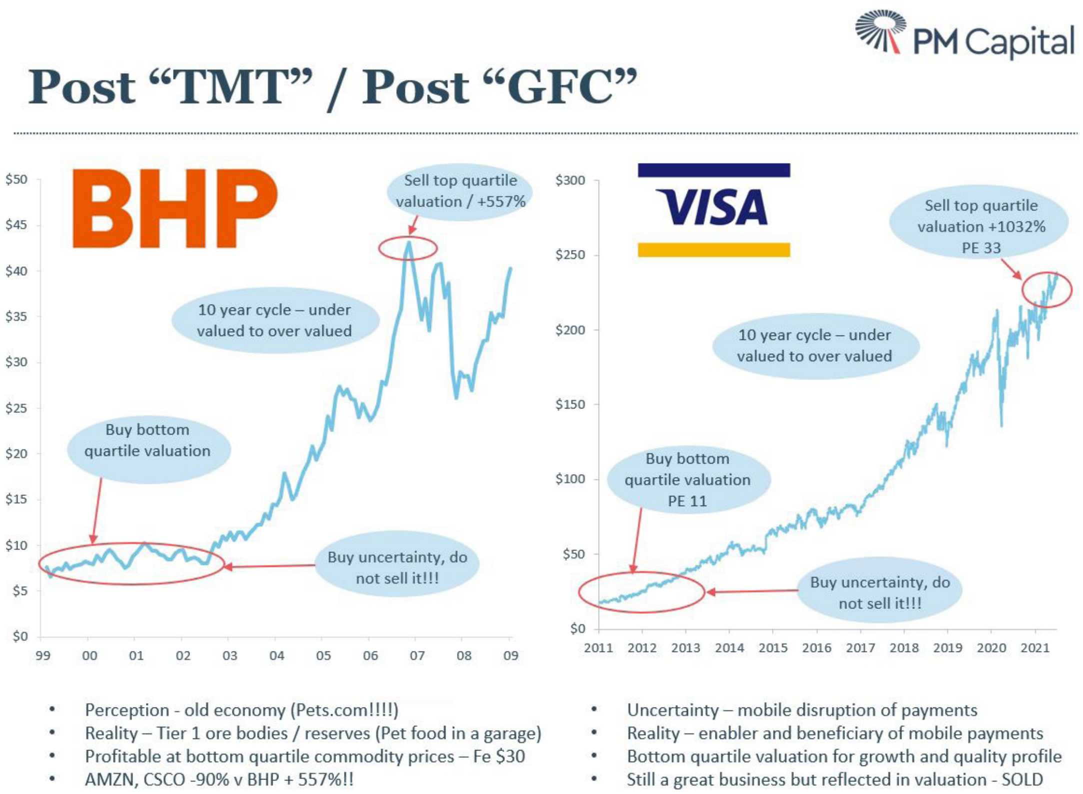
### Post '87 crash - Coca-Cola

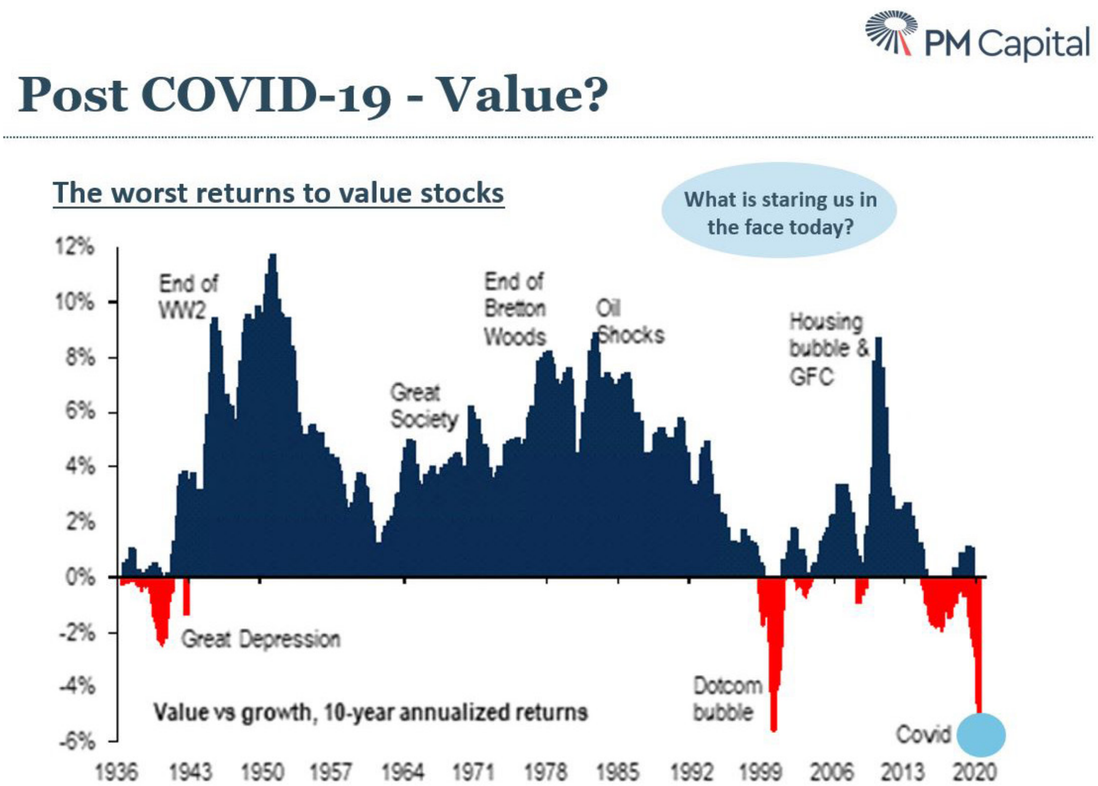

Source: Bloomberg

Chart 4:




Source: BHP: Bloomberg. 10 year cumulative return from 1999 to 2009. Visa: Bloomberg. 10 year cumulative return from 2010 to 2020.

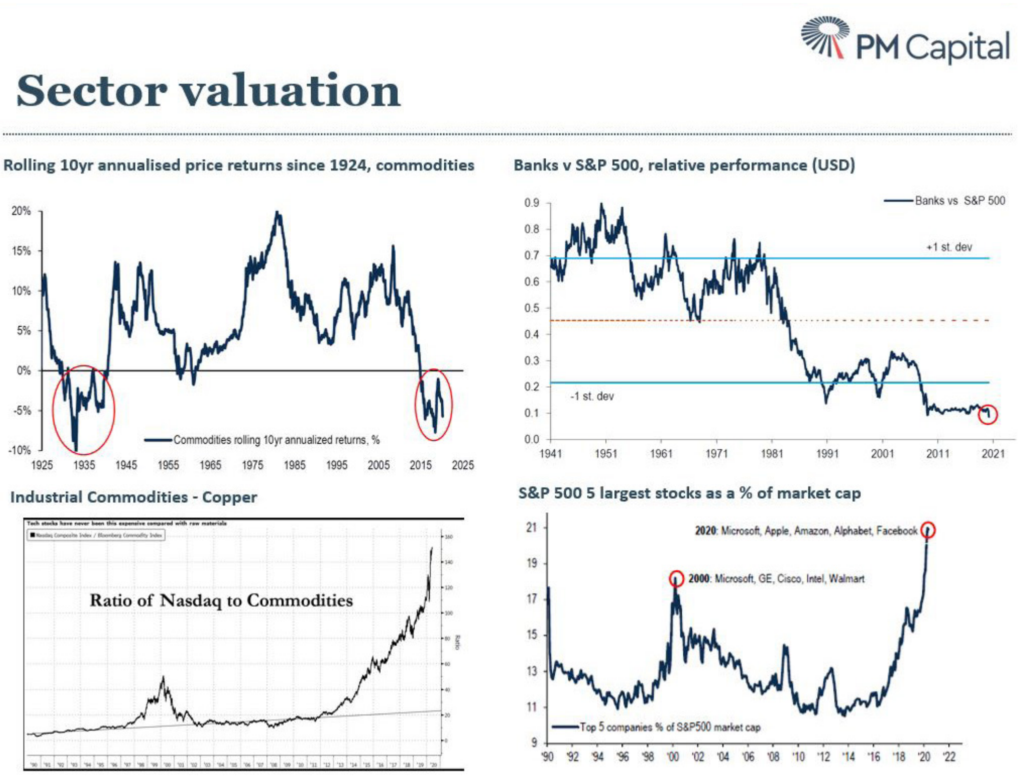
Chart 5:




Source: BofA Research Investment Committee, Fama & French

## A note from the CIO

Chart 6:




Source: BofA Merill Lynch Global Investment Strategy, Bloomberg, Datastream, Ibbotson, Global Financial Data Chart shows market cap of MSCI equity indices vs. US stocks in US $ (as of 4/4/2019).

Our core investments and their origins have been well highlighted in our video insights that can be viewed on PM Capital's website. So, I will give a quick update on current dynamics.

Freeport Copper, Teck Resources and Royal Dutch Shell are our core commodity investments, mostly initiated after COVID-19. Given the significant commodity price moves over the last 12 months, and likewise with Freeport and Teck, it was no surprise to see them pull back from short-term highs and consolidate over the June quarter.

On spot commodity prices, Freeport still looks cheap at 12 times earnings. Teck looks ridiculous at potentially three times 2023 earnings. Can spot prices hold; who knows? But even on trend commodity prices, the stocks still look reasonable, especially given our expectation that commodities, such as copper, will stay at sustainably higher prices than most expect, supported by above-normal demand due to the renewables driven re-engineering of the world's electricity grids. We expect to maintain a core position in Freeport Copper and Teck Resources for some time.

Royal Dutch Shell is a little different in that we typically don't like to buy a commodity with structural oversupply; OPEC having excess capacity. But with the drive to net zero emissions and Environmental, Social and Governance (ESG) activists on the war path, the oil industry is spending well below what is needed to expand oil production. There is a chance of an oil squeeze at some point, and control of oil markets is returning to OPEC.

Royal Dutch Shell is selling at 8 times current forward oil prices and half what its peers in the US sell for. We find that interesting and expect the stock to re-rate closer to its peers as increased dividends and buybacks return booming cash flow back to shareholders, starting in the second half of this year.

Siemens, a quality industrial with market leadership in intelligent factory automation and healthcare, still sells at a discount to its global pure-play peers. With further re-rating ahead of it, plus earnings growth, Siemens will most likely provide a satisfactory return.

The cheapest sector of the market (and now PM Capital's biggest position), is European banks. They sell at 6.5 times 2023 excess capital-adjusted earnings. To put the potential upside of European banks in perspective, compare their valuations to the likes of ANZ and Westpac that sell on 14 times earnings. We expect the removal of post COVID-19 restrictions on dividends and buybacks to start a slow process of re-rating in European banks, noting Chart 7 as a precursor to what may transpire. While we wait, we will pick up a high single-digit dividend yield.

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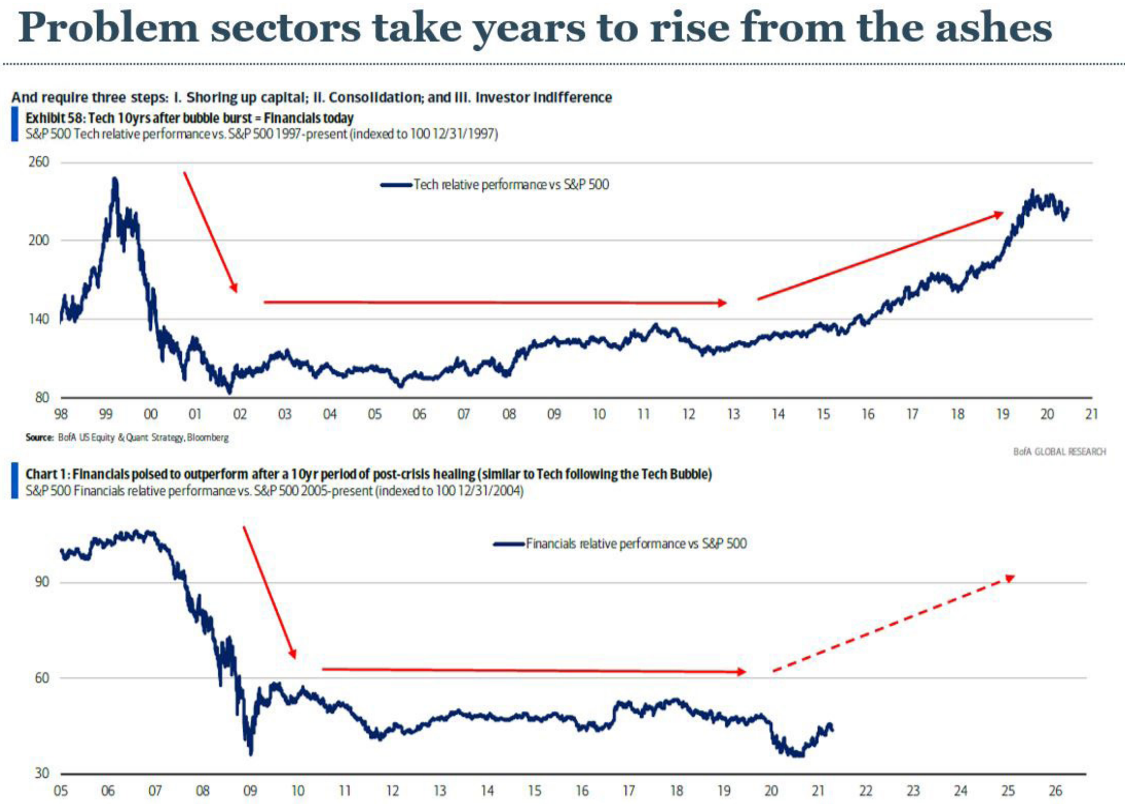
**Chart 7:**




Source: BofA US Equity & Quant Strategy, Bloomberg

One investment that has seen its thesis delayed by the effect of COVID-19 is our European homebuilders. The severity of the Europe's lockdown led to closed building sites and deferred the release of pent-up demand for new homes, such as that seen in the US and Australia. Europe is opening, pent-up demand is being released, house prices are increasing. With both the Irish and Spanish homebuilders selling at book value, we recently added to our positions.

Likewise, our Macau casino investments have seen their recovery pushed out by the conservative post COVID-19 approach to re-opening the border between Macau and mainland China. We expect that 2023 is when gaming trends normalise. That said, it is interesting to note recent gaming statistics out of Las Vegas as its market opens up. Despite visitation levels at 75% of pre-COVID-19 levels, Nevada hold (casino winnings) is 25% higher. We could be surprised at the level of pent-up demand waiting to be released. Wynn Resorts, our largest gaming investment, has exposure to casinos in Boston, Las Vegas and Macau.

On the sale side, we finally exited the last of our global oligopoly investments: Visa. In 2011, Visa sold at 11.4 times forward earnings and now sells at 33.4 times forward earnings. Visa is still a great business, but its valuation is at record levels, so we move on.

To conclude, market dynamics warrant caution and careful thought about one's investment decisions. COVID-19 provided one of the great buying opportunities, this time in quality cyclical and industrial businesses (generically "Value"). This movie has played before and the trick, as always, is to be proactive and not anchored by the past.

Significant valuation anomalies typically take three to five years to return to fair value. Over seven to 10 years, they usually become overvalued. We do not expect the "Value" play to be any different. It is likely that we have only seen the first quarter of the rotation into "Value" sectors of the market.

Yours sincerely,

**Paul Moore**

Chief Investment Officer and Global Portfolio Manager