PM Capital

5 of our current investment themes. PM Capital, invest differently.

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Contents

PM Capital

Important information

This document is issued by PM Capital Limited (ABN 69 083 644 731, AFSL No. 230222) as responsible entity for the:

PM Capital Global Companies Fund	PM Capital Australian Companies Fund	PM Capital Enhanced Yield Fund
ARSN 092 434 618	ARSN 092 434 467	ARSN 099 581 558

the 'Fund', or collectively the 'Funds' as the context requires.

For Target Market Determinations for the Funds, please see our website: www.pmcapital.com.au/design-and-distributions-obligations

The document contains summary information only to provide an insight into how and why we make our investment decisions. This information is subject to change without notice, and does not constitute advice or a recommendation (including on any specific security or other investment position mentioned herein).

This report does not take into account the objectives, financial situation or needs of any investor which should be considered before investing. Investors should consider a copy of the current Product Disclosure Statement ('PDS') which is available from us, and seek their own financial advice prior to making a decision to invest. The PDS explains how the Funds' Net Asset Value is calculated. Returns are calculated from exit price to exit price (inclusive of the reinvestment of distributions) for the period from inception to 31 October 2021 and represent the combined income and capital return. The investment objective is expressed after the deduction of fees and before taxation. The objective is not a forecast, and is only an indication of what the investment strategy aims to achieve over the medium to long term. While we aim to achieve the objective, the objective and returns may not be achieved and are not guaranteed. Past performance is not a reliable guide to future performance and the capital and income of any investment may go down as well as up due to various factors, including market forces.

The Index for the PM Capital Global Companies Fund is the MSCI World Net Total Return Index in Australian dollars, net dividends reinvested. See www. msci.com for further information on the MSCI index. The Index for the PM Capital Australian Companies Fund is the S&P/ASX 200 Accumulation Index. See www.asx.com.au for further information. The Index for the PM Capital Enhanced Yield Fund is RBA Cash Rate. See www.rba.gov.au for further information.

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1. The PM Capital Enhanced Yield Fund was named Money Magazine's 2020 Winner for Best Income Fund – High Yield and Credit.

2. 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. These returns do not represent the actual net Fund performance and are included for illustrative purposes only.

Introduction from PM Capital's Co-Portfolio Managers

Last year, PM Capital argued that "groupthink" was as bad as we had seen in decades. Too many investors were buying a narrow group of overvalued – and overhyped – assets late in the cycle. They risked wealth destruction.

Some investors were seduced by social media. Others succumbed to a barrage of market "noise" about the latest hot stock or sector.

The boom in Exchange Traded Funds typified the folly of In-Crowd investing. Money poured into passive funds that replicate indices and contain many overvalued companies.

This year is the start of a reckoning for In-Crowd investing. The tech sector has had a significant correction since late 2021. Valuations of some buy-now, pay-later stocks, for example, have tumbled. Momentum-based growth stocks, generally, have lost favour amid expectations of rising inflation and interest rates.

PM Capital has argued that rising inflation would be more persistent than markets expected. We favoured sectors like banks and commodities that could outperform as rates rose. In fixed income, we had near-zero rate risk.

We believe markets are at a major turning point. The 40-year bull market in bonds has ended. Government bond yields are rising as markets expect some central banks to move sooner and more aggressively with rate rises to cool economic growth and dampen inflation.

The result: equity-market returns could be lower in the next few years. An emerging risk will be the loss of purchasing power as rising inflation eats into real returns.

This report provides a snapshot of how PM Capital is currently positioned in equities and fixed income. Our goal with the five highlighted themes is to explain how PM Capital invests away from the In-Crowd and the benefits of doing so.

We hope you find this report useful and would be delighted if you refer it to friends, family or colleagues who might benefit from this information.

We encourage you to follow PM Capital insights on our website (www.pmcapital.com.au) and our social-media channels in what could be a treacherous year for In-Crowd investing – and an opportunity for investors like PM Capital that think independently and have a disciplined, patient, value-focused approach.

Good investing,

Kevin Bertolo
Co-Portfolio Manager - Equities
PM Capital

John Whelan
Co-Portfolio Manager - Equities
PM Capital

The Investment In-Crowd V PM Capital's approach

European banks

The Investment In-Crowd	PM Capital's approach
The investment In-Crowd avoided European banks for more than a decade. Expectations of falling interest rates and tougher banking regulation in Europe weighed on the sector. After underperforming for so long, European bank valuations have badly lagged those in the US and Australia.	European bank valuations provided an attractive entry point into the sector. We expected inflation and interest rates to rise, which would support higher bank earnings. We also expected easing banking regulation in Europe, and for higher dividends and/or share buybacks to resume.

Irish home builders

The Investment In-Crowd	PM Capital's approach
The In-Crowd dumped European property companies after the 2008-09 Global Financial Crisis and then Brexit in 2016. Residential home builders in Ireland were particularly hard-hit. COVID-19 added further uncertainty into European property and diminished investor sentiment towards these companies.	PM Capital believed some European property stocks fell too far during the property crisis in the region in the previous decade. We expected the eurozone to recover, with strong growth in Ireland. A large gap between housing supply and demand in Ireland was an opportunity for residential builders in that market.

Copper, oil

The Investment In-Crowd	PM Capital's approach
Copper and some other commodities lost favour in the previous decade as the investing In-Crowd preferred tech or other momentum-based growth stocks. Expectations of slowing global economic growth weighed on copper. Oil was even more out of favour in the previous decade as the In-Crowd focussed on clean energy.	PM Capital thought copper had attractive fundamentals, based on supply constraints in the commodity. We believed a higher copper price was needed to incentivise new copper production. After our copper holdings rallied, we rotated to oil. Like copper, we believed oil faced greater supply constraints, which would support a higher oil price.

Macau casinos

The Investment In-Crowd	PM Capital's approach
The In-Crowd avoided casino stocks with operations in China, amid an anti-corruption crackdown, US/China trade dispute, COVID-19 and fears of greater Chinese regulation of the sector. At one point, the market ascribed almost no value to the Macau assets of some western companies that had Chinese government concessions to operate there. This valuation anomaly was despite Macau's position as the world's casino capital.	PM Capital took advantage of volatility in the Macau casino sector to lighten our positions (after share prices rallied) and re-established positions (after prices fell). We believed the market over-reacted to the risk of regulatory change in Macau. We were attracted to the Chinese casino industry's long-term growth prospects, favourable industry structures, relatively high return on capital invested, and low company valuations in the sector.

Fixed income

The Investment In-Crowd	PM Capital's approach
Last year, the investment In-Crowd believed higher inflation was a temporary response to supply-chain bottlenecks during COVID-19. They thought interest rates near zero were the norm, and that rate rises were a long way off and would be moderate. The In-Crowd seemingly thought the 40-year bull market in bonds would continue in perpetuity, aided by record low inflation and interest rates. They were positioned in fixed-rate bonds – a strategy that has so far underperformed in 2022.	PM Capital argued that inflation would be higher and more persistent than markets recognised. We expected some central banks to raise interest rates earlier and more aggressively than the market had priced in. We reduced exposure to fixed-rate bonds to almost zero in the PM Capital Enhanced Yield Fund. We preferred floating rates that benefit as rates rise. This strategy helped protect investor capital during volatile months for bond markets and supported the Fund's outperformance.

1 Banking on a recovery in Europe

Key points

- European bank stocks have underperformed for more than a decade. Low inflation, negative interest rates and tougher regulatory requirements during COVID-19 depressed bank earnings.
- However, the long term trajectory for European banks has improved, notwithstanding the near term disruptive impact of the Ukraine war. Inflation is rising, European rates will increase and regulatory pressures are easing.
- European bank valuations continue to lag those in the US and Australia. We believe a recovery in European bank stocks could just be starting.

By sector, banks are the largest allocation in the PM Capital Global Companies Fund, accounting for 32% of the portfolio.[1] Bank of America, Wells Fargo & Company and ING Groep are in the Fund's top-10 holdings.[2]

PM Capital has had a long-held position in US bank stocks. In 2020 and 2021, we increased our position in European bank stocks during market weakness. The Fund's overall weighting in European bank stocks is 18%.[3]

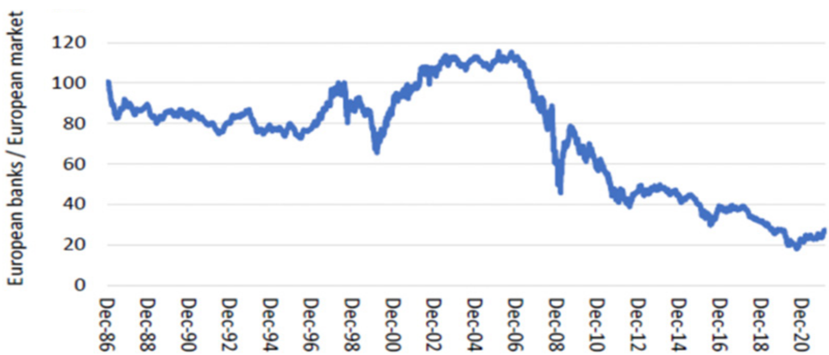
European and UK bank holdings in the Fund include ING (The Netherlands) Lloyds Banking Group plc (UK), Bank of Ireland and Caixabank (Spain)[4]. The latter three banks have negligible direct exposure to the Russian economy.

European banks still trade at bottom-quartile valuations. They have underperformed banks in the US and Australia partly because interest rates in Europe fell further, even turning negative in parts of Europe. German 10-year bonds, for example, were negative since early 2019 before turning positive in February 2022.

ING's direct exposure to Russia and Ukraine is less than 1% of its assets, but it has just over 10% in terms of its equity capital. Although this exposure is material, ING has excess capital on its balance sheet to cover a 100% write-down of these assets (a 100% write-down would be extreme, even in a worst-case scenario).

In our view, European bank stocks are the most undervalued sector in global equity markets today. Chart 1 highlights the relative underperformance of European banks.

Chart 1: Lessons of a lifetime: European banks have struggled relative to market



Source: Bloomberg, UBS

Inflation, rates and banks

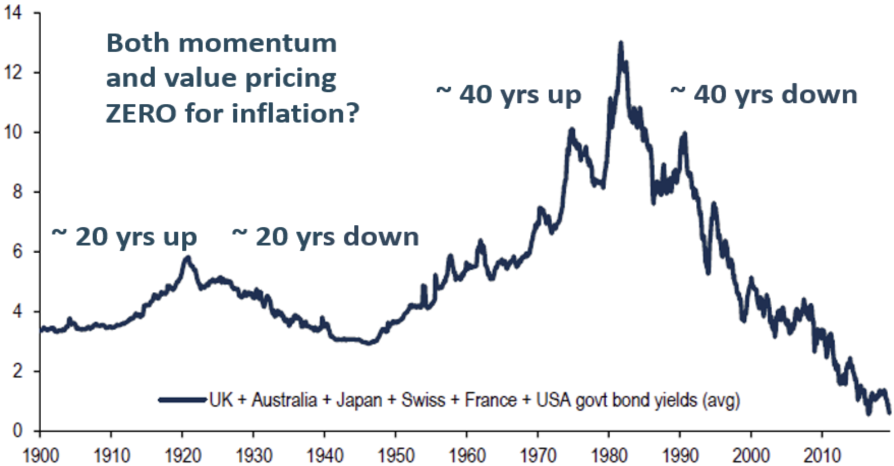
Russia's invasion of Ukraine in February 2022 has created uncertainty for the Eurozone economy. This could delay the timing of interest rate rises in Europe, but PM Capital retains its positive view on European banks. The sector's long-term growth drivers – economic growth, inflation and easing regulation – remain firmly in place.

Our conviction towards European banks – and global bank stocks generally – has been strengthened by changes this year in inflation and interest-rate expectations.

For the past 12 months, PM Capital has consistently argued that banks and commodity producers are the most attractive sectors as the world enters an inflexion point in inflation and interest rates.

After 40 years of falling government bond yields, the tide is turning, as Chart 2 below shows.

Chart 2: Global Government Bond Yields



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, Global Financial Data. Chart show simple average 10-year yield

PM Capital believed that inflation would be more persistent than the market realised and disputed the view that an inflation spike was solely a temporary result of COVID-19-induced supply-chain bottlenecks. Sharply higher inflation data this year confirms our view.

Rising inflation forces central banks to lift rates to slow demand. On balance, higher rates are good for banks. Rising rates point to a strengthening economy, which boosts credit demand. Also, as rates rise, bank net interest margins expand (the amount a bank earns on loans compared to the amount it pays on deposits). That aids bank earnings.

The US Federal Reserve and the European Central Bank this year acknowledged that rates would rise. Market forecasters like Goldman Sachs, a US investment bank, believe the US Fed will hike rates seven times in 2022 – for a combined 175 basis points.[5]

Clearly, the headwind for bank stocks over the past few years – record-low inflation and interest rates – is turning and becoming a tailwind. That could potentially underpin outperformance of global banks stocks this decade and a re-rating of European bank stocks.

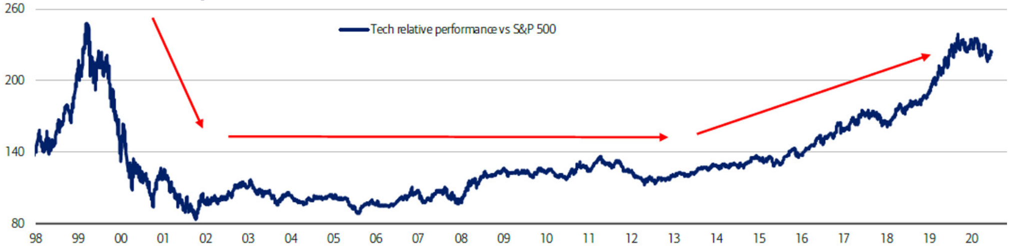
However, there are two caveats to that view. First, PM Capital believes global equity returns will be more constrained this decade. Large gains from 2020 and 2021, when equity markets recovered from the Covid shock, will not repeat anytime soon.

Second, sector recoveries take years to play out, as Chart 3 below shows. The top half of the chart shows how the rally in tech stocks took almost a decade to unfold. The bottom half shows the underperformance of financial stocks that lasted just over a decade.

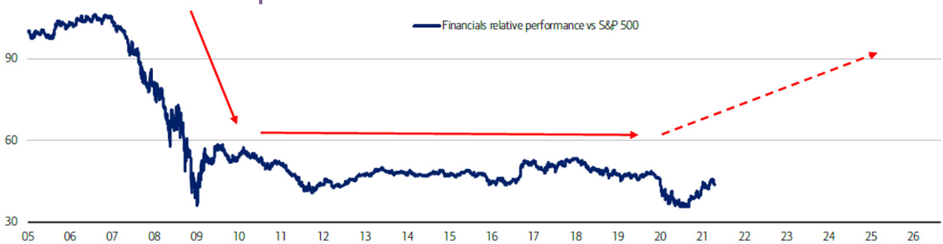
Investors who want to benefit from a potential recovery in European bank stocks will need patience. As PM Capital has said many times, investment cycles typically take 7-10 years to play out. A recurring trap is selling out of sector recoveries too early.

Chart 3: Sector performance

S&P Tech relative performance vs. S&P 500



S&P Financials relative performance vs. S&P 500



Source for charts: BofA US Equity & Quant Strategy, Bloomberg

4 reasons we own European banks

1. Earnings recovery

In June 2014, the European Central Bank (ECB) introduced its Negative Interest Rate Policy (NIRP) to boost the region's fragile economy. By September 2019, the deposit rate in Europe was -0.5%[6]. In March 2020, the German 10-year bond hit -0.91%.[7]

In June 2021, markets expected European interest rates to stay negative for at least five years.[8] Low rates depressed European bank earnings. Expectations that rates would stay negative for years weighed on sentiment and led to bank underperformance.

Simply, the market was too bearish on Europe's rate outlook and bank valuations. That created an opportunity for PM Capital to buy European banks at attractive prices.

European banks are strongly leveraged to rising interest rates. UBS, an investment bank, expects European interest rates to increase by 150 basis points by 2024.[9] UBS analysis shows a 100-basis points rise equates to a 20% increase in bank earnings.[10]

This could be even higher for some European banks. In a conference call with analysts, Caxibank said a 100 basis-points rise in European rates would expand its Net Interest

Margin by 20-25% (which flows straight through to the bank's earnings).[11]

In our view, Europe is on the cusp of rising bank earnings over the next few years. That could be a catalyst for a larger re-rating of the region's banking sector.

2. COVID-19 provisioning

European banks followed the global trend with heavy provisioning for bad and doubtful debts during COVID-19. Regulators require banks to make provisions for future non-performing loans. When banks expect such loans to increase, they set aside more funds, and vice versa.

The level of bank provisions affects their profits, balance sheet and capital position. New provisions are raised through a 'charge for bad and doubtful debts', which is recorded as an expense on the income statement. That reduces bank profits.

Actual loan losses during COVID-19 were less than feared. US banks started releasing their provisions and European banks began to do the same in 2021. Eight of the 25 largest European banks released provisions in the first quarter of 2021.[12] Lloyds Banking Group, in our portfolio, released the highest provisions of those banks.[13]

In its annual risk assessment of European banks, the European Banking Authority in December 2021 reported improvements in bank solvency, profitability and liquidity. It said fears about potential asset-quality deterioration had mostly not materialised.[14]

As European economies recover – and the risk of non-performing loans reduces – European banks will likely reverse more provisions. That could be another tailwind for European bank earnings growth and coincide with expanding net interest margins as rates in the region increase.

3. Excess Capital

As COVID-19 erupted in 2020, the European Central Bank sought to safeguard the banks' capacity to absorb loan losses and support the Eurozone economy.

In December 2020, the ECB called on banks to refrain from, or limit, dividends until September 2021.[15] The ECB also called on European banks not to conduct (or to limit) share buybacks. European banks faced tighter regulation than their US peers.

However, the requirement for European banks to hold more capital during the pandemic has paved the way for dividend increases and share buybacks to resume.

For example, ING announced a 0.62(€) total dividend in 2021, up from 0.39(€) in 2020.[16] In October 2021, ING announced a €1.7 billion share buyback program.[17] PM Capital believes ING's expected yield and its buyback program will result in a double-digit total yield.

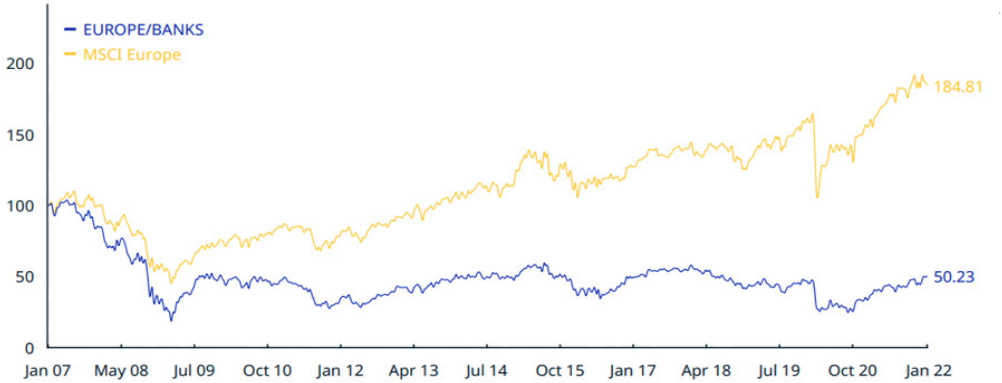
If our expectations of higher yield prove correct, some European banks could deliver an attractive total return (including capital growth) over coming years.

4. Valuations

The MSCI European Banks index, a barometer of 27 large- and mid-cap European banks, rose 38.7% in 2021. The index was down 2.87% year-to-date in a volatile period for European and global equities due to Russia's invasion of Ukraine (the MSCI Europe Index was down 6.11% year-to-date).[18]

Although recent European bank gains impress, they are off a low base. As Chart 4 shows, European banks (the blue line) have underperformed European equities (yellow line) since 2008. PM Capital expects this performance gap to close this decade.

Chart 4: Cumulative Index performance (net returns EUR)



Source: MSCI

At a stock level, adjusting for excess capital, ING trades on an adjusted forward Price Earnings ratio of 5 times according to our analysis. By comparison, Commonwealth Bank trades on a forward PE of almost 19 times. ING's price-to-book ratio is 0.6 times; CBA's is 2 times.[19]

European banks also look undervalued compared to US banks. In February 2022, European banks in aggregate traded on about 7 times forward earnings, according to our estimates. US banks had re-rated to 11 times earnings, our analysis shows. We expect that gap to contract in the next few years.

John Whelan
Co-Portfolio Manager - Equities

2 As copper climbs, oil appeals

Key points

- In 2018, PM capital bought copper producers at bottom-quartile valuations. In 2020, we added to our copper position during high market volatility. The pandemic created a once-in-a-generation opportunity to buy commodities.
- PM Capital remains positive on copper's long-term outlook but lightened that position last year after the re-rating in copper producers.
- We rotated into oil stocks in the second half of 2021.

"The easy copper deposits have been found over the years. Modern deposits at the surface are of much lower grade and require tremendous investment in infrastructure, mining and processing. Increasingly, mines are underground where costs are greater."

-Richard Adkerson, CEO Freeport-McMoRan[20]

"Investors should not fund new oil, gas and coal supply projects if the world wants to reach net-zero emissions by mid-century, the International Energy Agency said."

-Reuters report (May 2021)[21]

Introduction

As a leading long-term value investor, PM Capital is known for investing significant capital in sectors of the market that are often deeply out-of-favour with investors.

Over the last 25 years, we have observed that opportunities emerge when an impatient and often short-sighted equities market misreads an industry's longer-term outlook when investors extrapolate the recent past.

One such opportunity emerged in late 2018 when commodity companies traded in the bottom quartile of their long-term valuation range and were shunned for more popular growth stocks.

PM Capital identified copper as a particularly attractive segment of the commodities industry and initiated a position in several tier-one global producers.

In 2020, we added to our copper position during heightened market volatility caused by the COVID-19 pandemic, which had created a once-in-a-generation opportunity to buy commodities.

Our core copper investments – Freeport-McMoRan, First Quantum Minerals and OZ Minerals – have outperformed meaningfully over the past three years. Freeport-McMoan has rallied almost eightfold since the March 2020 low in global equities.[22]

Chart 1: Freeport-McMoRan

Source: Bloomberg

Although PM Capital remains constructive on copper's long-term fundamentals and retains a position in its core holdings, we began reducing our exposure last year after the significant share price re-rating witnessed across the sector. Put frankly, valuations in the sector are no longer the extreme anomalies they once were.

Having realised gains in copper, we rotated our commodities exposure into energy stocks. Our core positions include Shell plc (previously known as Royal Dutch Shell) which was first purchased in 2020 as well as Chinese National Offshore Oil Corporation (CNOOC) and Woodside Petroleum.

Our copper and oil positions have several interesting parallels. Firstly, the initial observation that both sectors traded at bottom-quartile valuations drove the decision to investigate each sector in greater depth.[23]

Secondly, our investment thesis for each commodity was supported by a positive view of long-term supply dynamics. We believed the market underestimated long-term supply constraints in copper and oil and the impact this would have on their price (our views on copper and oil supply are outlined in more detail below).

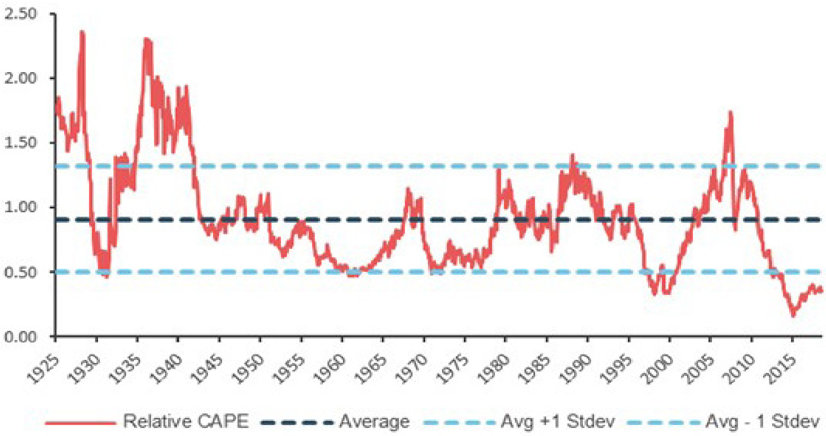
While it's too soon to know if our energy holdings will deliver similar returns to those in copper, early returns have been positive with geopolitical concerns pulling forward supply risks and refocusing investors' attention on the issue. Energy has been among the best-performing sectors year to date. Through February 2022, the S&P 500 energy sector returned 23% compared to the wider market declining -8%.[24] Over 12 months to end-February 2022, their return was 46.5%.[25] While energy has outperformed with a backdrop of structurally higher oil and gas price we believe the sector rotation is still in the very early stages. Energy accounts for a small percentage of investor portfolios, at the end of December 2021, the energy component of the S&P 500 was at a record low of only 2.67%.[26]

Positive view on copper

In 2018, fears of slowing Chinese economic growth and an intensifying trade war between China and the United States (under the Trump Presidency) weighed on commodity prices. China is the largest consumer of most industrial metals.

Also, as capital flowed into new-economy stocks, such as the FAANG companies, commodity stocks underperformed. The result: commodity producers had never been cheaper relative to the market in almost 100 years, as Chart 2 shows.

Chart 2: CAPE Multiple - Mining Relative to Market (S&P 500) Since 1925



Source: Bernstein. CAPE stands for Cyclically Adjusted Price Earnings ratio

Market sentiment towards copper was especially bearish, in large part because China accounts for about 50% of the metal's demand. There were record short positions against copper (investors betting on the price to fall) and the copper price was nearing its marginal cost of production.

Investor perception, however, was in stark contrast to the commentary from commodity producers. They were openly bullish about copper's long-term fundamentals with the emergence of new demand drivers (renewables and electric vehicles) central to their bullish thesis.

PM Capital spent the better part of six months looking closely at the copper market and concluded while renewable energy and electric vehicles were attractive new markets, challenges on the supply side were poised to be an even greater threat.

Our research indicated that the likelihood supply lagged demand over the next decade was high. Firstly, grades at existing copper mines were falling fast. According to Wood McKenzie, grades across the industry had fallen 25% over the past two decades, which meant it was costing more money to pull the same amount of copper out the ground.

Secondly, there had been no new discoveries of large copper deposits (so-called mega deposits) in decades. These were required to offset the natural decline in existing supply.

Thirdly, it was taking more time and money to bring new supply to market as geology became more difficult and environment permitting more rigorous.

When we began our analysis, the spot price (for immediate settlement) of copper was US$2.50 per pound. We believed the long-term copper price needed to be more than US$3.50 per pound to incentivise new production and increase copper supply. Based on this incentive price, copper stocks in 2018 were extremely undervalued in our view.

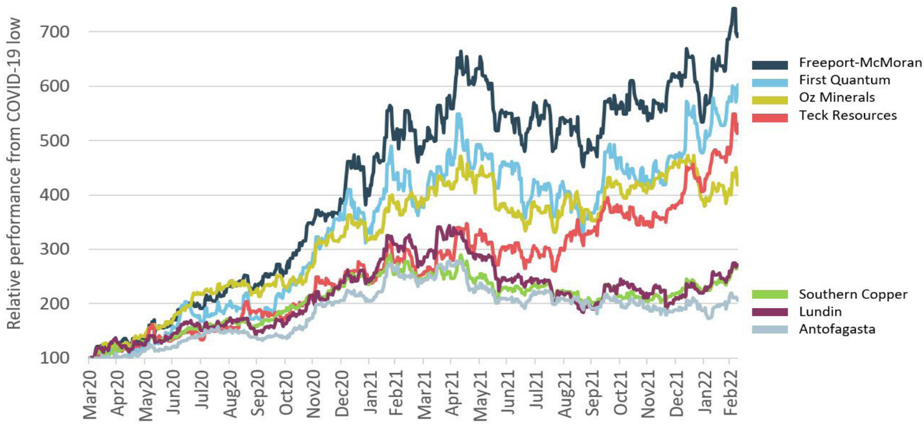
The pandemic has further exacerbated supply challenges in copper. Peru, the world's second-largest copper producer, had the largest fall in copper production in its history in 2020.[27]

As copper supply became more challenged, demand for the metal had improving prospects as governments worldwide looked to revive economic conditions. This has driven copper inventories to near record lows.

Our copper thesis – a higher copper price due to supply constraints and firming short-term demand – proved correct. The copper spot price is now US$4.42 a pound[28] – or double the price during our initial analysis in 2018.

The rising copper price sparked a rally in copper producers, as Chart 3 below shows. Freeport-McMoRan, First Quantum Minerals and Oz Minerals have been the best performers among the largest copper producers.

Chart 3: Copper producers (Q220 - Today,USD)



Source: Bloomberg

Foundations for higher oil prices

Like copper, the oil market was hard hit during the pandemic. Oil demand plunged as governments worldwide shuttered their economies to prevent the spread of COVID-19. In April 2020, the International Energy Agency estimated oil demand fell 30% year-on-year – to the lowest level since 1995.[29]

At the same time, an oil-price war erupted between Russia and Saudi Arabia, the two largest OPEC producers, when they could not reach consensus on oil production. An ensuing oversupply of oil sparked a price collapse: the contract futures price for West Texas Intermediate briefly plummeted from US$18 a barrel to negative US$37 a barrel in April 2020.

The structure of oil contracts exacerbated the sell-off. The contracts are settled in physical oil, meaning investors needed somewhere to store a glut of oil supply.

At the time, there was talk that the oil sector might never recover fully, given the long-term move towards clean energy. Long-term capital allocation to the sector had fallen. As with copper, PM Capital believed unrelenting negativity surrounding the oil and gas industry had created extreme valuations in the sector.

Even more extreme than copper, oil (in 2020) traded below its marginal cost of production. Oil, too, faced significant medium-term supply challenges, but for different reasons to copper.

Although a focus on emissions targets and the subsequent transition to renewable energy and electric vehicles is a favourable tailwind for long-term copper demand, it's negative for oil, coal, and other fossil fuels.

Also, growing opposition to fossil fuels, one which is coming from multiple fronts, has the potential to exacerbate underinvestment in the oil industry.

Although oil and gas may see reduced demand in the long run, the energy transition story is one which will take decades to unfold, and we risk seeing an undersupplied market in the short to medium term.

In its landmark 2021 report,[30] the International Energy Agency (IEA) set out more than 400 milestones to guide the global journey to net-zero carbon emission by 2050. Chief among them was no new investment in fossil-fuel supply projects, and no further final investment decisions for new unabated coal plants.

The IEA's recommendation that the global oil and gas industry stop investing in their traditional upstream businesses – and relocate capital to renewable energy projects – could have profound implications for future oil supply.

The IEA said oil supplies will become increasingly concentrated in a small number of low-cost producers. OPEC's share of global oil supply will grow from around 37% in recent years to 52% in 2050[31] – a level above any point in the history of the oil market.

Goehring & Rozencwajg, a firm that invests in natural resources, argues that non-OPEC oil supply will fall further as Western companies curtail investment in new oil projects. A structural gap between oil supply and demand will emerge as early as the fourth quarter of 2022 and non-OPEC oil supply growth will turn negative this decade.

Institutional investors that incorporate Environmental, Social and Governance (ESG) filters in their decisions are also allocating less capital to traditional oil and gas equities, and more to those in renewable energy.

The sector has also attracted the attention of activist investors looking to accelerate the transition away from fossil fuels. In June 2021, Engine No. 1, a small US hedge fund that was supported by giant index funds, successfully waged a battle to install three directors on ExxonMobil's board. The activist's goal: to push the energy giant – and ultimately others like it – to reduce its carbon footprint.

Governments, too, are increasing pressure on energy companies. In May 2021, the Hague District Court in The Netherlands ordered Shell to reduce its worldwide carbon-dioxide emissions by 45% to 2030 (compared to 2019 levels).[32]

Government and investor pressure on oil 'supermajors' will exacerbate challenges to maintain their reserve base and production level. Although capital investment from oil supermajors on new projects has surged over the past 20 years, production and reserves have consistently declined, notes Goehring & Rozencwajg.

Taken together, there could be lower oil supply for non-OPEC countries at a time of continued growth in energy demand. In theory, that means a higher oil price, rising oil-company earnings and continued energy-sector outperformance.

While not factored into our thesis, the recent Russia-Ukraine conflict has reinforced the risk of structural supply shortages in the energy markets pulling forward deficits.

Oil prices soared to a 13-year high on fears over Russia's possible invasion of Ukraine and tightening oil supplies. Brent Crude oil futures traded above US$130 a barrel in early March[33], its price up 67% since the start of 2022 (it was about $US78 a barrel then).

Consequently, PM Capital's energy sector holdings- Shell, CNOOC and Woodside Petroleum have all rallied - as Chart 4 shows. Despite the year-to-date move, we continue to hold these positions with valuations yet to fully factor in the increasingly favourable demand supply dynamic, in our view.

Chart 4: Energy sector holdings

Source: Bloomberg

Conclusion

PM Capital's rotation from copper to energy stocks reinforces three factors that underpin our investment philosophy:

1. The conviction to buy assets when sentiment is strongly against them and ignore market noise. That is, to go against the investing 'in-crowd'.

2. The importance of long-term investing and holding stocks through investment cycles that typically take 7 to 10 years to play out. We believe gains in copper and oil could have further to run over the course of this decade.

3. The benefits of buying companies at bottom-quartile valuations and rotating out of them as they approach top-quartile valuations. The ability to realise profits and rotate into undervalued assets is the key to sustained market outperformance over long periods.

Kevin Bertoli
Co-Portfolio Manager - Equities

3 Greenshoots for Irish home builders

Key points

- Parts of the European property market collapsed after the Global Financial Crisis. The sector remained out of favour for years after the GFC.
- PM Capital identified an opportunity to buy European property companies, first in commercial property, then residential, at the bottom of the cycle.
- We favoured Ireland, which is now one of the world's fastest-growing economies but still has a large supply/demand imbalance in its housing stock.

Introduction

PM Capital has a history of investing in the epicentre of crises. Our search for value sometimes takes us to the most-affected companies in the worst-hit sectors.

That was true of our initial investment in European commercial real estate companies in 2014 and our rotation to European residential builders over 2015 to 2018.

Parts of the European property market collapsed after the 2008-09 Global Financial Crisis. Several European countries entered recession; demand for office, industrial and retail property stalled; and banks curtailed lending to property companies and individuals.

PM Capital took advantage of sharply lower valuations in European commercial property companies through an initial investment in Hibernia REIT, an Irish Real Estate Investment Trust that invests in offices. We also initiated a position in Hispania, a Spanish REIT that invested in hotels (Blackstone acquired Hispania in 2018).

Both stocks performed well following the recovery in the underlying market, prompting PM Capital to realise gains and move into European residential builders a few years later. We expected the European property recovery to begin with commercial property then work its way to the residential market, in a cycle that would take up to a decade to play out.

In 2016, the United Kingdom's decision via a referendum to withdraw from the European Union injected further uncertainty into European property markets.

At the time, land and property prices in Ireland had collapsed. Residential property transactions were sharply lower. A speculative property bubble in Ireland that began in the early 2000s had burst. Residential property stocks were badly out of favour.

PM Capital visited Ireland to understand why property prices had fallen 60% or more in some areas, in addition to homes sales falling over 80%. We wanted to know why more people were not buying Irish residential property at much lower prices, and to gauge the sector's recovery prospects. We asked ourselves: "What would happen if Sydney home prices fell 60% peak-to-trough?"

In 2015, PM Capital invested in Cairn Homes, a designer and builder of new homes in Ireland and owner of a large land bank. Later, we invested in Glenveagh Properties, another Irish home builder that has similar investment characteristics to Cairn.

Beneath the short-term gloom, PM Capital had a positive view on Europe's long-term recovery prospects and particularly those of Ireland, a growth engine in the region. Our investment thesis was that economic recovery in Ireland would drive jobs growth, which in turn would bolster demand for new home-and-land packages.

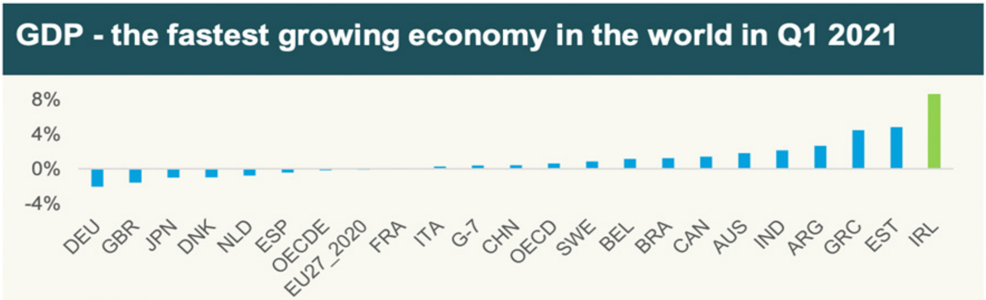
That view proved correct. In 2021, Ireland had the fastest-growing economy in the eurozone.[34] In January 2022, the Central Bank of Ireland said it expected the Irish economy to grow by 8.7% this year and 5% next year on the back of strong domestic demand and a COVID-19 recovery.[35]

Ireland's strong macro-economic backdrop is translating into rising housing construction. New housing starts exceeded 30,000 last year – the highest since 2008.[36] That is a big tailwind for Cairn Homes and Glenveagh Properties.

Although new housing starts are increasing, we expect housing supply in Ireland will lag demand for several years. COVID-19 caused construction delays, exacerbating the housing supply/demand gap. At the same time, a sharply higher savings rate in Ireland during the pandemic has contributed to rising property demand.

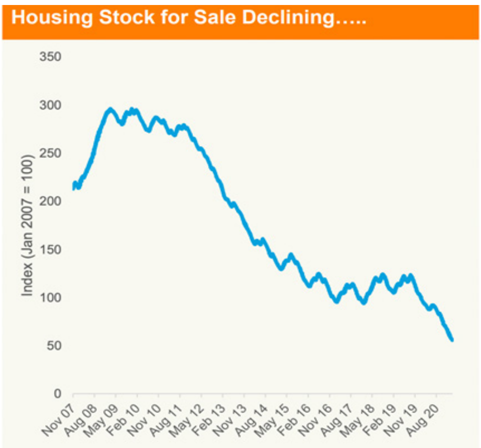
Glenveagh believes Ireland will need upwards of 35,000 new homes built each year, or 400,000 in the next decade, to meet demand. The Irish Government's new 'Housing for All' strategy to 2030 should further support housing demand.[37]

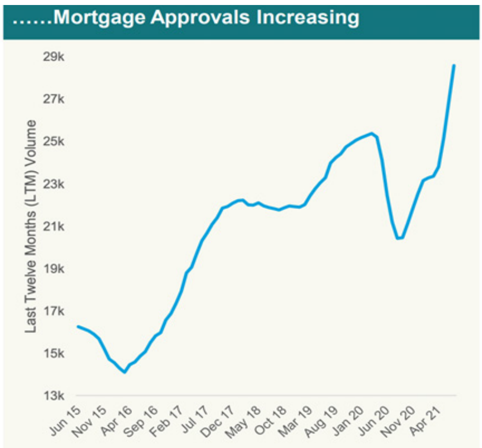
Chart 1: Irish economy booms



Source: OECD, via Gleveagh Properties' H1 FY21 results presentation.

Chart 2: Mismatch between Irish home supply and demand





Source: Daft.ie and BPFI via Gleveagh Properties' H1 FY21 results presentation.

Attractive fundamentals

Cairn Homes is well positioned. In 2015, Cairn invested in a large land bank. Unlike most property developers, Cairn bought the majority of its land bank early at a lower price, rather than buy land in parcels and pay higher prices as the recovery unfolds.

The result: Cairn has a 10-12-year land bank in an undersupplied Irish housing market where property prices are growing 5-10% annually. With no need to replenish its land bank, Cairn should generate 18-20% free cash flow margins, which we expect will be returned to shareholders through dividends and share buybacks. These higher margins should persist until Cairn's land bank normalises in 2025.

Early signs are promising. Cairn shares have more than doubled from the March 2020 low but remain below 2018 levels. Some investment banks have upgraded their earnings forecasts and price targets for Cairn.

In March 2022, Cairn said it had its "strongest-ever performance" in terms of new home sales in 2021. Cairn upgraded its earnings guidance and said it will return capital to shareholders through special dividends and/or share buybacks.[38]

Like Cairn, Glenveagh Properties is performing strongly as residential property demand in Ireland outstrips supply.

Launched in 2017, Glenveagh Properties targets three key property segments: suburban, urban and partnerships (through joint ventures with local authorities that provide the land). The partnership model provides a higher return on equity for Glenveagh and enables it to use its building expertise without allocating large amounts of capital to buy land.

Also like Cairn, Glenveagh has strong free cashflow generation and is returning capital to shareholders through an aggressive buyback program. Glenveagh has delivered positive recent trading updates amid rising construction volumes of new homes in Ireland and higher sales prices. Glenveagh's share price also rallied last year.

Conclusion

PM Capital's investment in European property companies shows the benefits of buying assets at bottom-quartile valuations when there is excessive negative sentiment.

Through a long-term, disciplined approach, we were prepared to wait for a recovery in European property, believing it would be strong when it arrived. Irish property, among the worst-affected markets, had some of the best recovery prospects.

Our rotation from commercial to residential property capitalised on cycles within a broader European property cycle. In hindsight, we invested in Irish residential builders slightly too early, but their results in the past two years vindicate our strategy.

John Whelan
Co-Portfolio Manager - Equities

4 Betting on a recovery in Macau casinos

Key points

- Casino companies with operations in Macau have been volatile due to the risk of government regulation, geopolitical tensions and COVID-19.
- PM Capital took advantage of this volatility to lighten positions in Macau casino stocks after share-price rallies – and re-establish positions after price weakness.
- We are attracted to Macau's long-term growth prospects, favourable industry structure and the relatively high return on capital investment from casino companies that have concessions to operate in Macau.

Introduction

PM Capital's investment in casino companies with Macau operations shows the benefits of capitalising on valuation anomalies that can emerge within cyclical industries.

Since 2009, we have invested in the Macau casino sector on several occasions, primarily through the ownership of US-operated companies with concessions to operate in the Macau market.

PM Capital's largest casino position is in Wynn Resorts, a US-listed operator that owns and operates casinos in Las Vegas, Boston and Macau.

Other gaming positions in our portfolios include US-listed Las Vegas Sands, Sands China (70% owned by Las Vegas Sands) and Crown Resorts, which is currently the subject of a takeover by Blackstone, a US private equity firm.

Our positive view on Macau is based on five main factors. The first is a clearly defined industry landscape. The Macau Government has granted six casino operating concessions and provided set land allocations for casinos. That has strengthened the competitive position of a small group of operators there.

The second factor is China's large addressable market. More than half of China's population has entered the middle class, from an estimated 3% in 2000.[39] China knows there is strong local demand for casinos and that Macau is the best place to contain and regulate it.

Improving accessibility to Macau is the third factor. Macau is 60 kilometres west of Hong Kong on China's southwestern coast. An increase in hotel rooms and flights, and favourable visa policies to encourage tourism, will help Macau accommodate more tourists. In 2018, Macau had just under 40,000 hotel rooms; Las Vegas had almost 150,000 rooms.

The fourth factor is the presence of world-class casino operators in Macau. Wynn Resorts, Las Vegas Sands and MGM have long experience in the sector. Operators with Macau concessions are listed on US or Hong Kong exchanges.

The fifth is an attractive return on capital invested. Since the breaking of Macau's 40-year gaming monopoly in 2006 with the opening of Las Vegas Sands' Sands Macao property, there have been 18 integrated resorts built by the six concession holders.

Our analysis has found that while returns have come down from the stratospheric 75%+ achieved by the Sands Macao property in the initial years after its completion, most properties have a return on investment (ROI) of 15-20%, compared to a single-digit return for most Las

Vegas casino operators. Wynn Resorts' two properties, Wynn Macau and Wynn Palace, for example, have an ROI of over 20% per annum.

High volatility

Although Macau casinos have favourable growth characteristics, industry volatility has been high. That is to be expected of an emerging industry in a developing nation – and is a reason why PM Capital has taken a long-term view of Macau's casino sector.

To recap, Macau was transferred from Portugal to the People's Republic of China in 1999 and became a special administrative region. In 2002, the Macau Government ended the monopoly rights to all forms of gambling there and granted three (later to become six) licences to foreign and local companies.

Today, Macau is one of the world's wealthiest places due largely to its casino industry. Covering 32 square kilometres, Macau has 41 casinos. It attracted almost 40 million visitors in 2019[40], many of whom came to gamble. Despite having fewer casinos than Las Vegas, Macau generates far more gaming revenue than the US casino city.[41]

However, as Chart 1 below shows, the performance of Wynn Resorts (and other Macau operators) has been volatile over the past decade due to regulatory uncertainty, geopolitical risk and COVID-19.

Chart 1: Wynn Resorts

Source: Factset, PM Capital

This chart also shows how cycles have formed within Macau's long-term structural growth cycle – and the market's intense reaction to bad news. By 2016, Wynn Resorts shares had fallen 80% peak-to-trough as the Chinese Government initiated an anti-corruption crackdown across China.

Casino operators linked to Macau recovered, only to be affected by negative sentiment from the US-China trade dispute. Wynn fell 50% from peak-to-trough in 2019.

When COVID-19 erupted in 2020, Wynn Resorts fell 75% from peak-to-trough as casinos worldwide were shuttered because of lockdowns, and as arrivals to Macau stalled.

At its COIVD-19 low, Wynn Resorts traded on a Price Earnings (PE) multiple of less than 5 times its normalised earnings, according to our analysis. Its valuation was bottom quartile.

Having meaningfully reduced our holdings, including the sale of our Wynn Macau and Las Vegas Sands positions in early 2018 after a 2-year rally, we took advantage of price weakness to re-establish positions in 2019 and 2020. We believed the market had overreacted to geopolitical risks stemming from the US-China trade dispute and the COVID-19 and regulatory uncertainty.

New risks emerge

The latest risk has been regulatory. In September 2021, the Chinese Government commenced a Gaming Law Review and licence-renewal process. The public-consultation process raised fears of increased government oversight of the Macau casino sector, dividend controls, a required increase in local ownership, and the appointment of Chinese government representatives to the boards of Macau casinos.

Having watched a regulatory crackdown in Chinese education and technology sectors, the market feared the worst for Macau casinos. Valuations tumbled. At one point, the market ascribed almost no value to the Macau operations of Wynn Resorts and Las Vegas Sands, even though they were prized assets in the world's casino capital.

PM Capital has invested in casino companies for many years. We know the market has a history of overreacting to bad news in casino stocks overseas and in Australia.

We have also owned casino stocks closer to home. In 2020, PM Capital initiated a position in Crown Resorts, an Australian casino operator with world-class assets in Melbourne, Perth and Sydney. In our view, Crown shares had fallen too far amid the dual concerns of COVID-19 closures and fears it could lose its licences after money-laundering allegations, which were first examined by the Bergin Inquiry in New South Wales.

PM Capital initiated a position in Crown at under $9 a share. In January 2022, Blackstone proposed a scheme of arrangement for Crown at $13.10 per share, which Crown's board recommended. At these levels, we viewed the valuation as being backed by Crown's underlying property assets, with no value being ascribed to the operating licences. With very little debt on its balance sheet after the sale of apartments at Crown Sydney, we view the downside in Crown Resorts as well protected.

It did not surprise PM Capital that private equity pounced on Crown. Having invested in alternative asset managers for years, PM Capital knows that private equity firms look to acquire quality assets, such as casinos, when they are oversold. In Crown's case, the quality of its property portfolio supported its valuation.

Ironically Blackstone's proposal signals the end of PM Capital's long association with the Crown assets. In 2004, we were a substantial shareholder in the listed Burswood Casino Trust (owner of the Burswood Casino in Perth) which was acquired by Crown.[42]

Outlook

PM Capital retains a positive view on Macau casino operators. The Chinese Government's Gaming and Licence Renewal Update has confirmed our view that the market was too bearish on the potential for regulatory change in the sector.

In January 2022, the review said there would continue to be a maximum of six licences of up to 10 years each, with no increase in tax rates. There would be no dividend restrictions or requirements for government representatives to be appointed to boards. Local ownership (voting, not economic) will increase from 10% to 15% and be applied after licence tendering. The market reacted positively to this news.

This outcome aligned with our views of the Macau casino sector. PM Capital believes the sector is well regulated and that gaming has been critical to Macau's growth over the past decade. We thought it was not in China's interests to disrupt the status quo in Macau and that changing the licence structure would have been hard to implement.

Longer-term, Macau is vital in the development of a larger Chinese tourism industry, particularly in the Greater Bay tourism zone, which includes Macau and Hong Kong.

Another potential tailwind for Macau is the world's emergence from the pandemic. China's zero COVID-19 strategy means it has tougher restrictions than most nations, which disproportionately affects its casino operators (compared to those in the US). But as COVID-19 becomes endemic rather than pandemic, Macau's recent increase in gaming tourism should gain momentum this year and next.

When COVID-19 struck, PM Capital believed the pandemic would not change the positive long-term outlook for Macau casino operators. Our casino holdings had the balance-sheet capacity to handle a prolonged industry shutdown due to COVID-19 (18 months or more). We expect Macau casino operators will emerge from COVID-19 with higher profit margins, having cut costs during the pandemic.

We believe the completion of the licence-renewal process could potentially act as another positive catalyst helping to re-rate Macau casino stocks, as it allows investors to refocus on the longer-term earnings power of these businesses.

Under the right conditions, our expectation is that Wynn Resorts will trade closer to its long term valuation - a PE closer to 20 times normalised earnings - suggesting potential upside remains.

Kevin Bertoli
Co-Portfolio Manager - Equities

PM Capital

5 Near-zero exposure to interest-rate risk

Key points

- PM Capital has consistently argued that inflation would be higher and more persistent than markets recognised.
- The PM Capital Enhanced Yield Fund positioned for the prospect of higher interest rates by cutting exposure to fixed-rate bonds and increasing exposure to floating-rate bonds that benefit as bond yields rise.
- This strategy helped the Fund protect investor capital during heightened bond-market volatility.

Introduction

When assessing fund performance, it's not enough to analyse a fund's positive returns during good months for markets – after all, a rising tide lifts all ships. As important is understanding how the fund performed during bad months and its ability to preserve investor capital.

Consider the PM Capital Enhanced Yield Fund, an award-winning[43] fixed income fund that invests in local and global bond-market opportunities. The Fund aims to provide an attractive return above the Reserve Bank of Australia (RBA) cash rate, with low volatility and minimal risk of capital loss.

In February 2021, volatility in fixed-income markets spiked. Signs of global economic recovery fuelled fears of higher inflation and interest rates. The Australia 10-year Government Bond yield leapt around 0.75% that month.

Many income funds with high fixed-rate exposure underperformed significantly that month. In contrast, the PM Capital Enhanced Yield Fund returned 0.11% in February 2021, or 0.10% above the RBA cash rate.[44] The Fund's low exposure to interest-rate risk preserved capital.

October 2021 was another bad month for fixed-income markets. As market expectations for higher inflation grew, the Australia 10-year Government Bond yield rose 0.5% that month. That equated to a fall of around 5% in the 10-year bond's value.

The PM Capital Enhanced Yield Fund returned -0.28% in October 2021. Again, the Fund's near-zero interest-rate risk minimised losses and preserved capital.

Interest-rate market volatility has continued this year. In January 2022, fears that central banks had underestimated inflation strengthened expectations of faster rate rises. The Australia 10-year Government Bond yield rose around 0.25% that month.

As bond yields in Australia and the US spiked, the PM Capital Enhanced Yield Fund returned -0.02% in January 2022 due to its near-zero interest-rate exposure.

We highlight these returns for two reasons. First, to demonstrate the PM Capital Enhanced Yield Fund's ability to outperform in different market conditions. Over one year[45], the Fund outperformed the RBA cash rate by 1.2%. Over three and five years, the Fund outperformed its benchmark by 1.5% and 1.7% respectively.[46]

Second, the Fund's performance during February 2021, October 2021 and January 2022 demonstrates how it continues to derive its returns with minimal volatility and low risk of capital loss.

Inflation view underpins Fund strategy

For the past year, PM Capital has argued that inflation would be more persistent than realised and disputed the view that an inflation spike was solely a temporary result of COVID-19-induced supply-chain bottlenecks. This view is reflected in PM Capital's equities funds and in the PM Capital Enhanced Yield Fund.

Sharply higher inflation data this year confirms our view. In January 2022, the US inflation rate accelerated to 7.5%, the highest in 40 years. Australia's Consumer Price Index rose 1.3% in the December 2021 quarter, bringing annual inflation to 3.5%.

Markets expect central banks will have to lift rates sooner and more aggressively than previously communicated, to cool contain inflation.

Goldman Sachs, a US investment bank, believes the US Fed will hike rates seven times in 2022 – for a combined 1.75%.[47] UBS expects European interest rates to increase by 1.5% by 2024.[48]

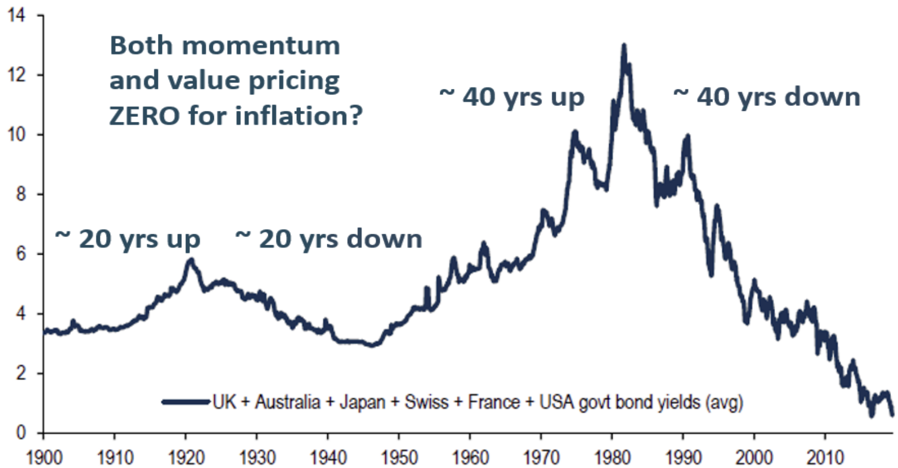
In Australia, Westpac expects the RBA to start raising interest rates as early as August this year – and for the cash rate to reach 1.75% by March 2024 (from 0.1% now).[49] Like other developed nations, Australia is on the cusp of a rate-raising cycle.

The Bank of England (BOE) has already begun raising rates to combat soaring inflation. In February 2022, the BOE raised rates for the second time in three months.

Higher interest rates do not surprise PM Capital. Our investment approach is based on understanding where assets are in a cycle. We seek to buy assets at bottom-quartile valuations and sell at top-quartile valuations. We also look for signs of irrational market sentiment.

That was true of global bond yields last year. In our view, too many investors had forgotten what a normalised rate should look like. After 40 years of falling government bond yields (see chart below), some investors assumed near-zero rates were the norm. They did not realise that negative rates in some European countries signalled the end of a 40-year bull run for the bond market.

Chart 1: Gloal Government Bond Yields



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, Global Financial Data. Chart show simple average 10-year yield

Our long experience from investing through several bond market cycles reminded us that government bond yields were abnormally low. We positioned the Fund for the prospect of high rates by cutting exposure to fixed-rate bonds and increasing exposure to floating-rate bonds that benefit as yields rise.

Current Fund positioning

The PM Capital Enhanced Yield Fund retains a highly defensive position. About half of the Fund is invested in cash and short-dated yield investments.

We believe this strategy will help protect investor capital if volatility in bond markets increases over the next six to 12 months. The strategy also provides Fund liquidity to capitalise on mispriced corporate bonds during a period of high volatility.

We continue to believe some central banks worldwide are 'behind the curve'. That is, they are not raising interest rates fast enough to keep up with inflation and growth. If inflation rises too far, central banks will have to raise rates sooner and in larger increments. If this happens, volatility in equities, corporate bonds, real estate and other risk assets will increase.

The ability to preserve capital – a central tenet of successful long-term investing – could come to the fore in 2022. That is a key focus of the PM Capital Enhanced Yield Fund and our performance during volatile months for bond markets reinforces our strategy.

Jarod Dawson
Portfolio Manager - Enhanced Yield Fund

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