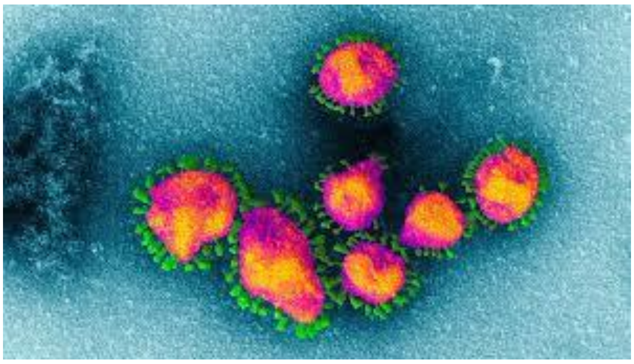
UNCONVENTIONAL WISDOM

Unique investor insights from Wattle Partners

January 2020

The month that was…



- Just when we thought the global economy couldn't get any more unpredictable, January brought the outbreak of the Coronavirus in China, a US-Iran tit-for-tat engagement, the worst Australian bushfires in recent history and the UK formally leaving the European Union. Yet as usual sharemarkets weren't overly worried, with the ASX adding 5% (the best start to a year in a decade), and the US falling by less than 1%. This time, it was a stronger than expected US economy, which grew 2.3% in 2019, supporting higher valuations.

- The outbreak of the Coronavirus, which by all reports has now killed over 300 people, couldn't come at a worse time for the Australian economy. The resulting shutdown of inbound flights from China is likely to have a substantial impact on tourism and when combined with the bushfires will have a negative impact on consumer spending. This comes after a retail spending rebound of 0.9% in November but subsequent slump in December as the Black Friday sales brought spending forward.

- The ASX All Ordinaries finally hit 7,000 points in January, this comes some 12 years after it was originally predicted by a number of 'experts' to occur in 2008. The key drivers behind the performance were the ever-growing CSL and BHP Group. Interestingly, Australian economic data remains strong, with unemployment falling to 5.1% and inflation holding at 1.8% even as the consensus turns negative towards growth. The S&P 500 and a number of key Asian indices also hit all-time highs during January, before giving back some gains as the month came to an end.

- It's been a busy few months for the profit-for-member of industry super funds, after the APRA Heatmap release in December which embarrassed a number of groups, economist Warren Hogan suggested the largest funds should be forced to hold additional capital not unlike a bank. He suggests the increasing allocations to illiquid assets and market power of the largest funds may represent a systemic risk and should be regulated accordingly. At present, management relies on incoming contributions to ensure liquidity.

- In a sign of the times, the huge venture capital fund run by Softbank, was identified as funding all three of the largest ride sharing competitors in Latin America, Didi, Uber and Rappi, as they attempt to destroy each other and win the important market. Such is the size of the fund that they can bet on all three players and still expect to make a profit.

- The Chinese economy benefitted from the actual signing of the Phase 1 Trade Deal with the US, however, many are questioning whether China can actually facilitate the purchase of an additional $200bn in US exports by 2021 as agreed. It is likely to have a negative impact on China's other trading partners, including Australia and the US, as commodities like LNG and motor vehicles are sourced from the US. Chinese growth hit 6.1% for 2019 but many now expect it to fall below the 6% mark for the first time. Positively, industrial production is improving once again, up 5.7%, and retail sales continuing to boom, up 8%. The result was an improvement in the IMF's global growth forecast, from 2.9% to 3.3% and Japan's as well, from 0.5% to 0.7%.

- It was the well-known technology stocks that lead the market higher as the decade turned into 2020, with Facebook, Apple and Google all hitting all-time highs during the month. Many are suggesting these valuations are reasonable given robust fundamentals and exceptional growth levels like Facebook's 24% year on year revenue growth and 56% earnings margin. Amazon initially underperformed but reached another high after hours following a 50% beat on its earnings per share estimate for the final quarter.

- President Trump appears to have beaten the self-titled impeachment 'witch-hunt' with the Democrat's unable to swing enough Senators to include additional witnesses in their high profile trial. The consensus appeared to be that there was little value in proceeding with the impeachment for the party given the President has just 10 months before another election.

- After a multi-year boom in the share prices of the few Australian lithium miners, the sector has been hit with a reality check in recent months. Galaxy Resources (GXY) announced that production at their Mt Cattlin mine would be put on hold for the foreseeable future, blaming an oversupply and subsequent 50% drop in lithium prices for the closure. They joined the likes of Pilbara Minerals and Mineral Resources to reduce production.

- In a year when almost every asset class delivered strong returns, the renowned Ray Dalio and his Bridgewater Associations Pure Alpha Fund suffered its first annual loss, dropping 0.5% in the year, piling more pressure on the hedge fund sector as investors find more reasons to move towards passive strategies. Another hedge fund manager, AQR Capital, stressed that future returns remain lower than ever, indicating their internal models predict annualised returns of just 2.4% from a traditional 60/40 balanced portfolio.

- Engineering and construction specialist CIMIC Group, previously Leighton's, unexpectedly reported a $1.8bn writedown due to unpaid debts in Dubai, exacerbated by delays and additional costs on the West Gate Tunnel project. They weren't alone in confession season, with agricultural supplies outfit, Nufarm, forecasting a weaker second half, along with e-commerce retailer Kogan, and Treasury Wine Estates, which was once again hit by an oversupply of cheap wine in the key US market.

Model Portfolio Update

- Investment Committee -

Index	Index Points - December	Index Points - January	Performance	
			1 Month	1 Year
S&P/ASX 200	6684.07	7017.22	4.98%	19.65%
All Ordinaries	6802.4	7121.16	4.69%	19.94%
US Dow Jones	28538.44	28256.03	-0.99%	13.03%
US S&P 500	3230.78	3225.52	-0.16%	19.28%
Hang Seng (HK)	28189.75	26312.63	-6.66%	-5.83%
FTSE 100 (UK)	7542.40	7381.96	-2.13%	5.93%
Nikkei 225	23656.62	23205.18	-1.91%	11.71%

Top 5 Performers	1 Month	Bottom 5 Performers	1 Month
Link Administration Holdings Ltd	16.21%	AMP Ltd	-4.70%
Woolworths Ltd	15.71%	Platinum International Brands Fund	-1.01%
CSL Ltd	13.16%	NAB Preference Share 3	-0.68%
Boral Ltd	11.16%	Westpac Capital Note 3	-0.05%
Ramsay Healthcare Ltd	9.20%		

Sector	January
A-REIT	6.36%
Communications	8.10%
Cons. Discretionary	4.64%
Cons. Staples	8.20%
Energy	0.69%
Financials	4.69%
Healthcare	12.04%
Industrials	1.95%
IT	11.12%
Materials	1.75%
Utilities	0.59%

Ramsay Healthcare (RHC) +9%: Ramsay's strong recovery continued in January as growing public hospital waiting lists increase the likelihood of Government intervention likely to benefit Ramsay's market leading private hospitals. The strengthening Australian dollar is impacting Ramsay's competitors, however, it's more diverse European operations are providing some protection against this. The company remains well positioned to benefit from an ageing developed world population and the associated health issues and has recently benefitted from improving volumes and fee rebates in both France and the UK.

CSL (CSL) +14%: One of Australia's few global leaders, CSL continued from strength to strength reaching another all-time high of $319. The lack of growth opportunities on the ASX is attracting investors to CSL's growth and R&D profile but this is supported by further upgrades from brokers. For instance, Morgan Stanley are projecting 13% earnings growth for the next three years, well above the earnings contraction occurring in the majority of the ASX in 2019. They expect the immunoglobulin business to continue growing strongly, offsetting weaker flu vaccine sales, delivering a result ahead of guidance.

Link Administration (LNK) +7%: LNK performed strongly during the month as investors turned once again towards its defensive income stream, supported by the growing AUM of the industry super fund sector. It was on the final day of the month, however, that the largest positive move came, with LNK announcing the acquisition of Pepper Group's Loan Servicing, Advisory and Asset Management businesses in Europe. The company offers debt and credit management in many important European markets, including Greece, effectively buying and managing debt sold by the major banks. The purchase cost $165m Euro with an additional $35m payable should assets under management hit agreed targets in three years. The implied multiple for the purchase was 8 times earnings and is expected to deliver a 10% improvement to LNK's earnings per share.

Gold Bullion +7%: Gold once again delivered due to a combination of factors, the first being the worst month for the AUD in several years, as the bushfires and recent cuts saw it sold off heavily. More recently, the twists and turns of the impeachment saga, strong retail and growth results in the US and a slight increase in inflation saw investors continue to flock towards gold as an alternative to negatively yielding government bonds.

Munro Global Growth Fund +6%: As highlighted earlier, it was technology driven rallies that supported the strength in global sharemarkets to begin 2020. Munro's focus on investing into the themes expected to deliver the greatest benefit over the next 10, 20 and 30 years, saw it post strong monthly returns. The holding in Alibaba specifically benefitted from further economic stimulus in China and the signing on the US-China trade deal, whilst Amazon stunning report provided an additional boost to end the month. ASML a supplier to the important semi-conductor industry, also performed strongly as signs of a global recession eased.

Nanuk New World Fund +6%: Once again, the sustainability focused fund was able to offset general weakness in its core renewable energy sector holdings with its diversified portfolio including the holding in Waste Management Inc. which is a Texas based recycling and environmental services provider. The French medical and chemical gas supplier who is focusing on biodiesel and similar technologies, Air Liquide, also delivered strong returns. The publishing and data company, RELX and rooftop solar installer Sunrun provided another tailwind during a volatile month.

The real costs of running an SMSF

- Jamie Nemtsas -

This article has been a few months in waiting as there were more pressing issues to cover, however, we thought it worth retouching on the issue raised by ASIC and numerous industry super funds throughout 2019. The issue was initially raised when ASIC published a fact sheet on the Self Managed Super Fund sector, asking readers to consider *are they for you?*

Of course, on its own this can only be a positive for the financial advice and superannuation sector, ensuring all investors really consider if they are willing and capable to control the investment of their own life savings. This is of course a unique structure compared to most parts of the developed world. The concern, however, came from reporting that the average cost to operate an SMSF is $13,900 per year! Not only this, they also suggested that trustees spend at least 100 hours per year running their fund. The ultimate conclusion, being that funds under $500,000 were unlikely to be cost effective, makes some sense for us, however, our experience is that the hurdle is substantially lower at closer to $250,000 following the introduction of a number of new service providers in the sector.

In light of these fact sheets and input from a number of SMSF specialists, we thought it worth putting forward our thoughts on the matter. Specifically, we are focusing on the fee question, as this seems to be driving the discussion. When it comes to SMSF's its important to note that there are many possible fees, but the majority of these are optional, depending on the investment strategy adopted. To summarise, they are as follows:

1. **Accounting and Administration Fee:** This is the only fee that must be paid by an SMSF each year, it represents the cost of meeting the funds taxation reporting and audit requirements. In our experience, the average cost of an SMSF tax return and audit is just $2,200 yet many accountants continue to charge amounts as high as $7,000 for what is today a commoditised service. The lowest fees for returns are around $1,650.
2. **SMSF Supervisory Levy:** This represents the 'registration' fee paid to the ATO each year which has increased from $191 a few years ago to $259 today and is now automatically deducted from your tax return.
3. **Platform Fees:** These are the first of many optional fees and represent the cost of employing groups like Hub 24, BT Wrap,

MLC or Netwealth to undertake all the paperwork for your investments on your behalf. The average cost of this fee is around 0.25% of the assets held in the SMSF. It means you are not required to complete any paperwork and will receive consolidated tax reporting each year.

4. **Management Fees:** These fees are charged by professional fund managers, exchange traded funds (ETF's) and listed investment companies. They are not an out of pocket expense, but rather deducted from your earnings within the structure. Importantly, they are optional and depend on your individual selection of investments.
5. **Adviser Fees:** Again, these fees relate to receiving professional advice to guide the investment of your portfolio and assist with meeting your reporting and other responsibilities. These are completely optional, SMSF's allow you to make all the decisions yourself, or to make none and outsource this task. Financial advice fees are not included in the cost structure of industry funds.

Without becoming part of the industry vs. SMSF war it's important to ensure every option is compared on a equal footing. The structure of most large industry funds is highly opaque meaning it is difficult to understand the many layers of fees you may be charged. Consider for instance that most funds charge an administration fee of 0.60% but does this include payments made to their own associated investment entities? Most funds allocate returns based on a 'crediting rate' equal to a day's worth of estimated earnings, but the calculation of this rate is not transparent, does it include all relevant costs? Returns have no doubt been strong for both options, however, we believe investors will increasingly value the need for transparency.

Lennox Australian Smaller Companies Fund

- Drew Meredith -

This month we take a closer look at one of Australia's best performing smaller company managers, Lennox Capital. The company have partnered with Fidante Partners who look after administration and distribution of the fund. The founding principles James Dougherty and Liam Donohue own 60% of the company and have worked together since 2005. James and Liam were the portfolio managers of the Macquarie Australian Small Companies Fund and the Macquarie Emerging Companies Fund. Lennox has grown to $200m quickly since its establishment in 2017.

What's the fund?

The fund is a specialist smaller company exposure with seeking to outperform the ASX Small Ordinaries Accumulation Index through bottom up stock selection.

Why Lennox?

The managers of Lennox have quite a strong track record. At Macquarie they achieved a return of

19.70% per year over 3 years and over 5 years 13.88%. It is this time spent focusing on the Australian market and having the skill to generate alpha that we believe sets Lennox Capital apart, as we believe small Companies in Australia will continue to grow in the years ahead but are generally underrepresented in most portfolios.

Where does it fit in your portfolio?

We believe it fits the requirements of the Value Bucket as its underlying investment philosophy is to identify Australian companies' ex ASX 100 Index with a market capitalization of roughly $150m. The team focuses on purchasing an undervalued company that will benefit from substantial earnings growth.

Why Invest?

The Lennox Capital Australian Small Companies Fund uses both qualitative screening and in-depth fundamental research to identify investment opportunities. Combine this with a robust investment process which where key insights are gained through deep-dive research 'on the ground'. Lennox's research process is driven by fundamental, in-depth and comprehensive analysis of a business' operations. Lennox apply this practically in two ways – external research (site visits) and internal research (detailed financial modelling). The process culminates in the production of Lennox's forecasts for future earnings. These are ultimately used to assess the attractiveness of the business using a range of valuation metrics. The portfolio is a collection of the investment team's best bottom up ideas. It holds a concentrated number of securities that Lennox believes have medium term valuation upside as well as minimal near-term earnings risk. The portfolio is managed with strong adherence to Lennox's risk framework and investment objectives. The investment team ensure the portfolio is appropriately diversified.

Exposure to any one security and thematic are limited and liquidity within the portfolio is actively monitored. It holds between 20 and 40 individual companies. An investment is sold after it breaches any one of three reasons. It will be reduced as it approaches the team's investment target, there is a breakdown of investment thesis or the company becomes sub-investment grade. We think this sell discipline ensures maximum returns from stocks. We believe Lennox Capital Australian Small Companies Fund is best placed to provide outsized returns and exposure to stocks outside of the ASX 100 that otherwise is difficult to do. The manager charges a fee of 1.10% plus 15% of outperformance above the benchmark.

What does it invest in?

Every business that is considered an investment opportunity is assessed using Lennox's proprietary quality screening tool. Businesses are assessed on 4 key factors: the ability of management, sustainability, quality of earnings and industry dynamics. Only businesses that pass Lennox's quality screen and for which they believe they can confidently forecast future earnings are eligible for further research. Some of the best performing stocks have been A2 Milk, Wisetech Global, Altium and IDP Education. The current portfolio includes holdings in Adairs, Megaport, Austalian Finance and Collins Foods.

How has it performed?

Since inception the Lennox Australia Small Companies fund has returned 14.54%. The short-term performance has been below the benchmark adding 18.68% over the last 12 months as at 31 December 2019 compared to the index which added 21.36%. Since inception the fund has made 14.54% per annum beating the benchmark return of 10.76%. The fund's strong short-term performance has come from its approach to selecting investments.

What income does it provide?

There is a common misconception from investors that managed funds will provide regular income each year. However, the income is determined by the success of the underlying investments with only realised capital gains or dividends received being distributed at 30 June each year. Investors should not expect regular income and will see the unit price of the fund increase throughout the year, than fall when a distribution is paid in July.

Nvidia

- Rachana San -

This month we undertake a quick review of NVIDIA, a company we believe is one of the most important in the future of the global economy. Without getting too technical, NVIDIA is one of the world's largest producers of Graphic's Processing Units or GPU's.

What's a GPU? Some say GPU's are the soul of a computer, whereas the traditional CPU is the brains. Where CPU's work through a series of tasks by calling up information from a hard drive, GPU's break complex problems into millions of simple ones to work them out at once. What does this mean? It means they can drive substantially faster processing power as well as making them ideal for graphics which requiring rendering to occur immediately.

NVIDIA designs these GPU's with a particular focus on four key markets: gaming, professional visualisation, data centres and automotive uses. Their key competitors in the sector include the likes of Intel and Qualcomm among others. One of the more interesting uses is the parallel processing capabilities between computers that GPU's allow, which drives the processing capabilities of super computers used by researchers and scientists to solve complex problems.

The company was founded in 1993 but a couple of Sun Microsystems engineers, Chris Malachowsky, Curtis Priem and Jensen Huang, a Taiwanese American. It currently employs over 11,000 people and has a market capitalisation of over US$150bn. The company is seeing substantial growth from the increasing use of its chips in motor vehicle guidance as well as the automation of factors all around the world. This processing power is also key to powering the likes of internet of things, connecting your fridge to your WiFi for example, and the 5G networks expanding all over the world.

The company is by no means cheap, having returned 80% over the last 12 months and currently trading on a P/E multiple of 67 times. Yet their business remains inherently strong, as one of just a few players in the sector, seeing Q3 results 14% above consensus. The companies market position affords strong margins, 63.6% in Q3 up from 59.8% in the previous quarter and delivered a profit of $899m from $3.0bn in quarterly revenue. One of the great opportunities lies in the huge growth in the transport sector, a market expected to grow to $69bn by 2029.

NVIDIA truly is one of the standout companies of the future.

Wattle Watch

- Investment Committee -

In any given month, Wattle Partners meets with many different professionals offering a new investment product, idea or scheme. Most are a pass from us, but now and again some pique our interest.

We met with the team at Yarra Capital this month, who are in the process of marketing their Absolute Credit Strategy. The fixed income and credit sector has seen a great deal of change in recent months with many junk bond managers launching listed investment companies and paying the much discussed 'stamping fees'. Yarra Capital is the opposite, offering a traditional managed fund structure from an experienced credit manager.

You can be forgiven if you are finding it difficult to understand what is what in the new world of listed credit products, junk bonds, high yield and direct lending; we are finding it difficult ourselves. The most important factor to keep in mind is that every investment can be appropriate at a given level of return, however, it's important to have a real understanding of the risk involved.

The Absolute Credit Strategy has not yet been opened to investors, rather the manager, Phil Strano from VFMC, has been managing a pool of employee capital to gain a track record for over 12 months. On first blush, it appears to be a high-quality strategy, not unlike that implemented for solid results by the likes of Australian Super and the Future Fund. It is well researched and benefits from Yarra Capital's existing capabilities in both debt and equity markets. The group has around $2bn in fixed income assets under management and $6bn in equities, meaning they have strong fundamental understanding of the companies that are investing into.

The strategy is based around investing into high quality, albeit low rated, listed and unlisted bonds issued by corporates, not governments. The opportunity set is $1.5 trillion in Australia and it targets a return of cash plus 3% by investing into fixed bonds, floating bonds, hybrids, deriviatives and asset backed securities.

The opportunitiy lies in the fact that the spread on corporate debt particularly lower than BBB is around historical averages, compared to Government debt which is at multi decade highs. Yarra suggests that the threat of inflation is the biggest risk to bond yields and returns, whenever that may occur, but that credit is much better protected due to its wider spread in traditional comparisons. They also look to insure against spread widening by buying Credit Default Swaps of the businesses they own, as these move in the opposite direction.

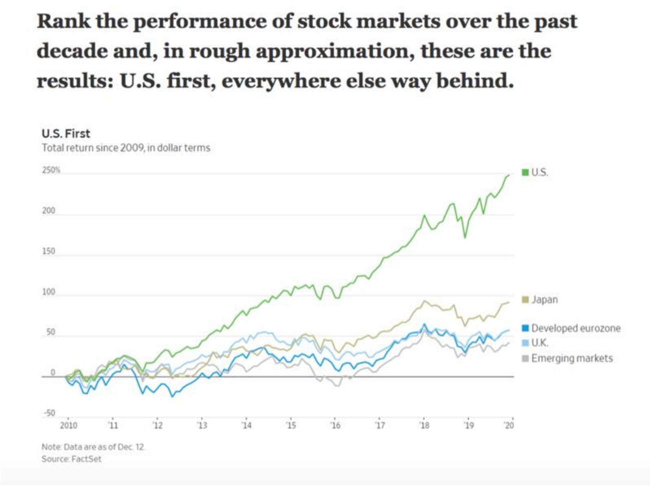
The fund carries an average rating of BB+, offers a 4.85% yield, -0.13 year durartion and its current top holdings include preference shares CBAPD, NABHA and most importantly MBLHB which was redeemed at a substantial profit unexpectedly during January. They have an internal credit rating and legal team to understand the terms of each bond, which is incredibly important, comparing their ratings to S&P. The 1 year return of 7.96% and 7.15% since inception has been unexpected by exceptional.

The fund will be opening to investors in the coming months.

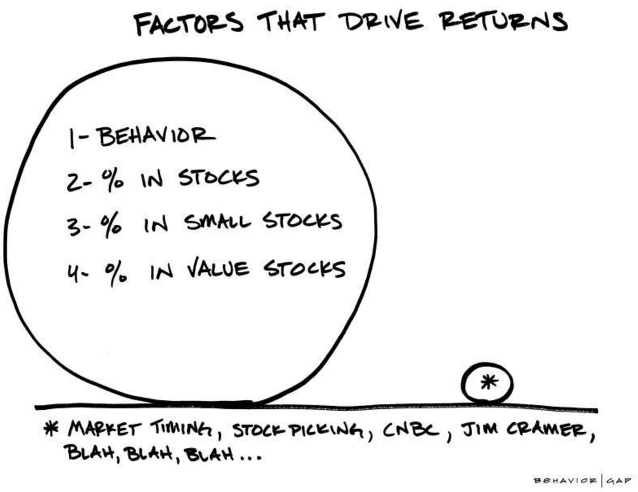
Interesting Charts

As we enter a new decade, it's always worth understanding where we are in a global context. We start 2020 with bonds rates at the lowest level in over one thousand years. The chart below shows the recent movement by central banks across the world, as you can see by the pink sections, the majority of the world continues to cut cash rates as they attempt to stimulate their economy or devalue their currencies.

The second chart is another interesting one, plotting the performance of the world's major sharemarkets over the 2010's. As you can see the result has been simple, the US first, then daylight.....



And another one of Carl Richard's infamous sketches, this one depicting the real driver of investment performance over the long-term:



What are we reading this month?

In terms of our reading this month, it was incredibly diverse as usual, as we seek to understand what is happening around the world.

The first article we enjoyed was a piece on the growing influence of index funds and weighing up both the benefits for investors and the long-term costs for capital markets. Interestingly, the likes of Blackrock, State Street and Vanguard now own on average 22% of each S&P 500 companies, meaning if they decide to become more active with proxy voting or have concerns about management direction they can exert substantial influence.

In this piece from the Wall Street Journal one of their journalists provides an insight into his recent discussion with a 22 year old on the outlook for capitalism in light of growing inequality and the impacts of climate change. Finally, on the lighter side was Bloomberg's piece on why the onion shortage in India, which has caused social unrest and a spike in inflation, may be coming to an end.