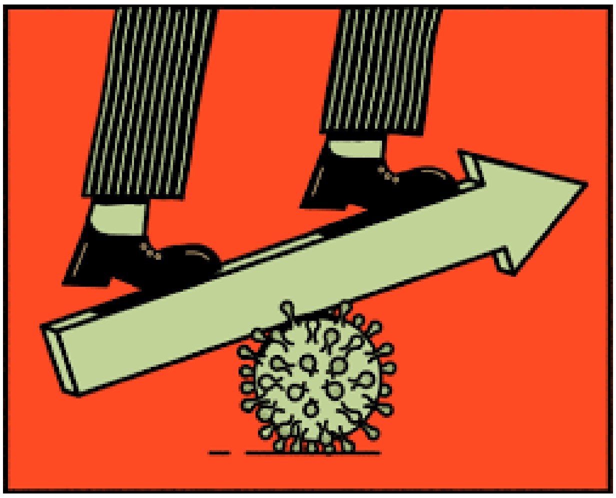
UNCONVENTIONAL WISDOM

Unique investor insights from Wattle Partners

June 2020

The month that was...



- What a month, markets rallying again capping off the strongest quarter for the ASX in over 20 years. The technology focused Nasdaq reached all-time highs and the S&P500 had the best quarter since 1938. The month continued the 'changing of the guard' trend, with the old-fashioned, capital intensive sectors, like property, energy and utilities, underperforming as e-commerce, consumer and IT focused companies came to the fore. The market has come a long way since the depths of the COVID-19 crisis, yet with escalating COVID-19 cases in the US and Victoria, there is a growing feeling that valuations may be overdone.

- There are two key takeaways from the June quarter; relying solely on the benchmark is high risk and timing the market is a dangerous game. Bloomberg reported this month that those who tried to time the market and sell out in March, would have suffered 30% falls if they missed just the five most positive days since. It's clear that the key to successful investing is to establish and maintain an appropriate asset allocation, but also have the flexibility to deploy capital when markets fall and not capitulate. There are a number of papers written about why un-advised investors underperform the very funds they invest in, as they tend to sell when markets are down and buy when markets are high.

- The worst kept secret in financial markets appears to have been exposed this month with Mayfair Platinum and IPO Wealth's flagship fund facing the Supreme Court and entering administration after it failed to make a loan repayment. Management continue to blame ASIC's targeting of their strategy and stress that it isn't a 'Ponzi' scheme; yet there are reports that new investors funds were being used to pay out existing investors and a series of unaccounted for transfers within the complex structure. We also saw the collapse and potential resurgence of Virgin Australia in a few short months, with unsecured bond holders, many of which were retail investors with bond specialist FIIG, likely to see nothing on their returns. Despite increasing regulation these and many other investments seem to be slip through to the detriment of un-advised investors, once again reiterating the value of financial advisers in their ability to be a 'bullshit' filter.

- June saw the release of a combination of outdated GDP results for the March quarter, and the all-important PMI's for most major economies. On the growth front, Australia lead the developed world shrinking just 0.3% in the March quarter, with exports supported by huge growth in iron ore and coal sent to China. The Chinese economy contracted 9.8% with the Communist Government conceding their growth target of 6.5% was no longer relevant. The US shrank 5%, France and Italy 9.2% and the UK 2.2%, with the latter's April figures showing a massive contraction of 20%. On the positive side On the positive side PMI's which are leading indicators of improving economic performance were universally improved; Australia almost doubling to 52.7, China back at recent highs of 55.7, Japan improving from 27.8 to 40.8 and the US 46.8 from 37. Anything over 50 signals a growing services and manufacturing sector.

- Looking forward, the IMF continues to adjust their expectations and forecasts for 2020, predicting a 4.5% contraction in Australia, 8% in the US and 10% in the UK. If we have learned anything from this incredible period in the history financial markets, it's that economic forecasts should never be relied upon. There is growing pressure on the sector in general to include more realistic and dynamic assumptions in light of glaring misses. One example was the US employment figures in May, where most predictions were for 7.5 million more job losses, but the actual result was 2.5 million new jobs being created.

- Continuing on the topic of unemployment, it's clear that global government policies, but particularly those in Australia, the UK and Europe, are having a huge impact on job losses. Australia's unemployment rate of just 7.1% is a testament to the Job Keeper package as is the UK, which is paying around 80% of workers' wages, with unemployment still just 3.9%. What happens when the tap is turned off by Government's must be the greatest concerns to all Australian's today, with many companies already cutting thousands of staff and many employers keeping employees solely for the government payments. This will be a real test of political leadership with politicians required to forget about the debt and focus on the welfare of their people.

- With deficits in mind, the new economic concept of Modern Monetary Theory has been a major talking point with Alan Kohler the latest proponent of its potential benefits. He was immediately attacked by many other finance journalists, who seem to have limited knowledge of the underlying workings of the economy or the monetary system in general. The concept that money printing creates inflation has cleared been debunked after seeing the Japanese, European's and US extend monetary policy with no such results. Nathan Tankus, an unknown US student, has grown a substantial following via his simple explanation of this and many other concepts. If there is only one takeaway from the discussion it is that austerity economics simply does not work and the repayment of Government debt should not be a priority, particularly in the current 'wartime' footing. With interest rates so low, debt can be utilized and doesn't require higher tax rates to repay it more quickly.

- *How did your portfolio perform this year?* If you are sitting on a large negative return for the financial year, then you clearly didn't have enough exposure to the companies of the future or were among the many relying on dividends for the bulk of their returns. With the likes of ANZ and Westpac deferring but really cutting dividends, they lead the worst performance for the financial year, down 34% and 26% respectively. This compares to the 'overvalued' CSL which delivered a 33% return in the worst market in history. The dispersion occurring in share prices has been substantial with a laundry list of technology companies leading the way: Afterpay (ASX:APT) +143%, Fisher and Paykel (ASX:FPH) +123%, Megaport (ASX:MP1) +85%, and gold miner Silverlake (ASX:SLR) +69% up strongly. Global performances were even more stark, Tesla (NYSE:TSLA) leading the way up 106%, Apple, 43%, Microsoft 29% and [Nvidia]() 44% as the world goes digital at a breakneck pace. Unfortunately, for those with a preference for domestic shares or who are not comfortable with investing in managed funds, these incredible returns would have been sorely missed.

➢ *__What to expect from here?__* We expect a great deal of volatility ahead and huge dispersion in those companies that are able to weather both the second wave of infections and the huge changes to the economy as we know it. We expect a lot more retail pain, substantial write-downs across the oil and gas sector and the potential for devaluations in both commercial property and residential investment property values. Many of these trends are already underway, with tenants exiting retail leases, spiking vacancies in offices and apartments, and a substantial rise in off the plan purchase cancellations.

Model Portfolio Update

- Investment Committee -

Index	Index Points - May	Index Points - June	Performance 1 Month	Performance 1 Year
S&P/ASX 200	5755.69	5897.88	2.47%	-10.89%
All Ordinaries	5872.2	6001.35	2.20%	-10.42%
US Dow Jones	25383.11	25812.88	1.69%	-2.96%
US S&P 500	3044.31	3100.29	1.84%	5.39%
Hang Seng (HK)	22961.47	24427.19	6.38%	-11.39%
FTSE 100 (UK)	6076.60	6169.74	1.53%	-18.32%
Nikkei 225	21877.89	22288.14	1.88%	2.49%

Top 5 Performers	1 Month	Bottom 5 Performers	1 Month
Boral Ltd	21.86%	Ramsay Healthcare Ltd	-5.04%
AMP Ltd	13.80%	Telstra Corporation Ltd	-3.40%
Orora Ltd	13.01%	Nanuk New World Fund	-3.06%
National Australia Bank	11.44%	Magellan Infrastructure Fund	-1.99%
Commonwealth Bank of Australia Ltd	8.89%	Invesco Global Targeted Returns Fund	-1.99%

Sector	June	Quarter
A-REIT	-2.74%	19.92%
Communications	0.09%	13.47%
Cons. Discretionary	5.37%	30.08%
Cons. Staples	5.09%	7.19%
Energy	-2.01%	28.17%
Financials	4.42%	12.90%
Healthcare	3.52%	2.31%
Industrials	-1.73%	15.30%
IT	5.96%	48.69%
Materials	2.25%	26.23%
Utilities	-1.41%	5.49%

The end of June saw most global sharemarkets, including Australia, deliver the best quarterly returns in over two decades. Yet it also saw the worst financial year return, -11%, since the GFC with a long way to go before February highs are eclipsed. These highs are looking increasingly unattainable as Australia's lack of true global leaders becomes increasingly evident. It was a strong month, quarter and financial year for the Model Portfolio, with three key drivers: gold bullion, global share exposure and opportunistic buying in March paying off for investors.

Boral Ltd (ASX:BLD): Was by far the standout for the month, adding over 21% as it benefitted from a flurry of positive news. The first was the successful refinancing of $1.2 billion in debt, staving off the need for additional capital for at least 12 months. The second was the long awaited announcement of a new CEO to replace Mike Kane, Zlatko Todorsevski, who has extensive experience at both Brambles Ltd (ASX:BXB) and Oil Search Ltd (ASX:OSH). There is a growing expectation that he will announce a demerger or sale of the weaker US business in before 2020 is out. Finally, it was the announcement by Seven Group Holdings Ltd (ASX:SVW) that they had acquired a 10%+ friendly stake in the business that triggered hopes of a takeover bid.

Orora Ltd (ASX:ORA): June saw the finalisation of the sale of ORA's Fibre business to Japan's Nippon Paper, with $600 million of the $1.7 billion sale price paid to investors in the form of a special dividend and substantial return of capital. The remainder was retained to repay debt but also ramp up acquisitions and fund the struggling US consolidation strategy in the retail sector. Whilst a positive outcome for investors, particularly at that sale price, the outlook is increasingly difficult for the energy intensive company.

AMP Ltd (ASX:AMP): The long-awaited turnaround of AMP ramped up during June with the regulatory approval of the sale of their Life insurance business meaning the company has now exited the sector for the first time in 170 years of history. Analysts are now expecting the return of a dividend before the year is out. Management are making great strides in simplifying the company's business model, improving the quality of their products and identifying those areas that are best outsourced; for instance, the new CEO highlighted the importance of AMP advisers providing advice on insurance, just not doing so with their own in-house products. With the well-publicised issues with industry funds AMP stands out as a potential long-term beneficiary.

Platinum Asia Fund (PLA0004AU): This Asia-focused fund had a strong recovery in June, adding 6.5%, following the switch from the consumer focused Platinum International Brands Fund in March. The changing nature of global trade and reimagining of supply chains as companies seek to diversify away from China has and will continue to benefit the region. The biggest highlights in the fund were holdings in Tencent (HKG:0700), whose online gaming and cloud computing divisions have been key beneficiaries of global lockdowns, and Reliance Industries, the Indian energy, e-commerce and telecommunications conglomerate, after signing a deal with Facebook. The fund offers a unique exposure to fast growing Asian markets that we expect to deliver solid long-term returns and diversification benefits.

MACQUARIE

Macquarie Group Ltd (ASX:MQG): Finally, Macquarie Group has once again topped the capital raising tables, signing 28 of the biggest deals throughout the post-COVID 19 flurry of corporate activity, represent $4.0 billion in value and 21% of the market. MQG was added in April as a high quality business, with a diverse business model spanning infrastructure, traditional banking and corporate market transactions and has rewarded investors in just a few short months, adding close to 30% returns from the bottom.

Alternative Assets

- Jamie Nemtsas -

Wattle Partners has adopted the philosophy to 'challenge everything' as we move into the post COVID-19 world. There seems to be some level of complacency creeping into markets, investment advice and all matters of economics in recent months meaning it is becoming increasingly importance to question the conventional wisdom. It is now abundantly clear that the traditional approach of holding long-term bonds and 'blue-chip' shares will find it difficult to deliver the required returns in the years to come, for differing reasons, and that one of the most important strategies will be extracting every dollar of returns from low risk allocations as possible and also protecting downside in the equity components of portfolios. The only way this is likely to be possible, is to increase the use of non-traditional, alternative assets.

The asset class is much broader and deeper than many understand, hence we provide a short summary this month and will embark on more detailed analysis in future issues. Essentially, alternative assets are anything that isn't a stock, bond or bank account, which by their definition suggests they have less correlation with these asset classes and therefore offer diversification benefits to portfolios.

- **Land –** The name speaks for itself, owning land directly to benefit from its scarcity over time;
- **Timber:** Timber tends to grow consistently year after year and remains a key input into many products starting with paper;
- **Precious Metals:** Gold bullion, silver, platinum, palladium, the list extends with some offering both industrial uses and currency alternatives;

- **Cryptocurrency:** Becoming more widely accepted by the day, offers unique exposure to the future of global currency;
- **Infrastructure:** Anything from power plants, solar farms, airports, electricity grids to roll roads and rail roads.
- **Long-short:** Equity or bond strategies that bet on shares going both up and down, offering downside protection;
- **Event driven:** Primarily equity strategy that seek to invest where companies are subject to takeover offers, mergers, asset sales etc.
- **Activist:** Similar to event-driven but with the manager themselves advocating for change;
- **Market neutral:** Similar to long-short but where the long positions equal the short positions in size;
- **Global macro:** Traditional hedge fund strategy investing based on major macroeconomic events like inflation or GDP growth;
- **Artbitrage:** Exploiting mis-pricings, whether between markets (small vs. large) or where a takeover offer is in play;
- **Distressed:** Opportunistic strategy that seeks to buy bonds of struggling companies and help them recover;
- **Quantitative**: Investment decisions based solely on computer driven 'screens' of an asset class;
- **Private equity:** Ownership of non-listed companies;
- **Private credit:** Direct loans, traditional to small and medium sized businesses;
- **Venture capital:** High growth, technology driven investments into loss making companies.

Never Sell Stocks Wesfarmers

- Drew Meredith -

Wesfarmers Ltd: WES is a diversified conglomerate with operations across retail department stores, home improvement, office supplies, resources, chemicals, energy and industrial products. Primarily though, the company is a consumer-facing business due to its ownership of the dominant Bunnings and Officeworks chains.

Why Wesfarmers? We consider WES as being one of Australia's modern-day success stories, having acquired, built and sold a diverse array of businesses since its foundation in 1914. That said, the companies earnings are currently concentrated in its market leading, monopolistic Bunning's franchise, which contributed $938 million of the $1.54 billion in earnings in 2019, or 60% of the total, following by discount department store Kmart, $343 million and WesCEF or Chemicals, Energy and Fertilisers at $422 million. The company is an aggressive acquirer and it is this forward-looking nature that means WES warrants a position within portfolios. The company deployed some $1 billion in 2019-20 through acquisitions of Kidman Resources, a lithium producer and Catch Group, an online, discount coupon retailer. This follows WES' sale of its thermal coal assets in 2019.

Why Income Bucket? WES meets the requirements of the Income Bucket due to its fully franked dividend yield of 5.4% and the relative consistency of both its dividends and free cash flow generation over the last decade. The dividend was cut in 2019 following the successful demerger and sale of its investment in Coles Group (COL) which will benefit the company in the longer term by reducing the substantial working capital requirements in what is an ultra-competitive sector.

Financials: WES' key business lines continued to delight shareholders in 2019 with strong sales growth across all, however, like-for-like EBIT margins contracted in all five segments due to a combination of reasons. These included wage inflation, payroll errors, digital investment, and product mix changes. As is the case with most consumer companies post COVID-19 comparable figures offer little insight into the future. Management did however provide an update on its retail performance up to the end of May, reporting Bunnings had increased sales 19.2% and Officeworks 27.8% as investors flocked to both businesses as they prepared to work from home. Target remains the only concern to shareholders, with management announcing a wide ranging consolidation of their store network and a cost cutting exercise in a bid stifle its poor performance. They expect close to half of Target stores to be closed or converted into the more successful Kmart model and are using the COVID-19 opportunity to renegotiate lease terms around Australia.

Reasoning: WES provides investors with an excellent combination of monopolistic assets and growth opportunities. The market leading return on capital delivered by Bunnings (52%) and Kmart (25%) affords management the flexibility to purse long-term acquisitions across any and all sectors of the market. It is this ability to be patient and extensive experience in both the mining and retailing sector that saw the company generate such strong returns from its significant bet on the turnaround of Coles Group. We view the demerged of Coles as a positive for shareholders, as it frees up flexibility for less capital intensive business opportunities in the faster growing e-commerce and technology sectors. It is becoming clear that the retail sector will look very different following the impending recession with WES conservative balance sheet offering the potential for a number of purchases. Additional upside will come in the form of continued improvement of their existing businesses, with Bunnings only launching a full digital ordering offering in 2020, which we expect to add significantly to margins and sales. The company is by no means cheap, trading at around 27x earnings, however, the business model is sound, gearing is conservative, and the company is well led.

Six changes for 2021 and beyond

- Jamie Nemtsas -

As the financial year comes to a close, it's worth reflecting on what we have just experienced; not just in investment terms, but our health and community. COVID-19 will have long lasting impacts on our lives and has resulted in one of the most unique investment environments in history. Markets experienced one of the fastest collapses in history only be followed by the fastest recovery in history; this velocity of change seems to be a fact of life in the information age. In addition, bond markets experienced one of the most volatile periods ever seen, requiring the intervention by nearly every major central bank to the tune of trillions of dollars. Let's take a breath….

With everything moving so quickly, its often difficult to step back and take a macro view of portfolios. There are so many spot fires, opportunities, capital raisings or threats that the idea of adjusting currency or duration in bond allocations moves further down the priority list. Yet history has shown it is these major asset allocation decisions that can drive substantial outperformance over the long-term. On this basis, there are six major changes everyone should consider as the end of financial year approaches, in no particular order.

- **Hedge currency exposure back to AUD –** Every market participant has a view on the movements of the AUD, but as Buffet suggests 'forecasts may tell you a great deal about the forecaster; they tell you nothing about the future'. As many 'experts' are predicting a stronger AUD as there are predicting a weaker AUD. On the positive, there is Australia's (excluding Victoria's) strong recovery from COVID-19, on the other is our worsening relationship with China. Here is a simple solution to help clients sleep at night: **remove one risk from your portfolio that can be efficiently hedged, currency.**

- **Sell retail exposures –** Despite the prospect of incredible returns should consumers flock back to retailer's post lockdowns, the sector simply carries too much risk to warrant a position in the short-term. The list of reasons is extensive, starting with news that some 50% of retail tenants simply aren't paying their bills during the lockdown and extending to the many 'renegotiations' occurring where stores refuse to open, negotiate discounts or just back out of leases altogether. This has a long time to play out and the downside risk still outweighs the upside in my view.

- **Active over passive –** Now is not the time to be adding passive, index exposures to portfolios. By all historic measures both the ASX and S&P500 are overvalued. The issue, in my view, is the look through on earnings. How many companies in the S&P500 or ASX200 can you confidently say will meet, let alone beat, consensus earnings estimates for FY20? Very few given many of the companies themselves have removed their outlook guidance. There are, however, many individual companies that are still growing, think Amazon, Apple, Microsoft, Afterpay; they appear much better bets than buying the whole basket.

- **Reduce duration –** The duration tailwind is dead. After several decades of falling interest rates spanning my entire 15-year career, it appears we are finally near the bottom. 10-year bonds now offer interest of just 0.6% and many corporates, like Woolworths or Amazon are issuing similar debt at record low levels. Despite the implications for sharemarkets, interest rates can and will increase in the coming decades and duration will lead to capital losses. Most bond indices have duration of around 6.5 years, meaning a 0.25% increase in rates will lead to a 1.6% capital loss.

- **Go global –** The global lockdown has exposed the Australian economy for its lack of diversity and reliance on China, for both travel, commodities and educational exports. Equity portfolios must reflect the changing nature of global trade and Australia's position within this. My view is that global equities should be at least equal to if not exceed Australian exposures. Moreso, the focus needs to be buying companies that have large addressable audiences, are growing cash flow, have scaleable business models and are capital lite.

- **Focus on total returns -** What does a dividend deferral really mean? It seems that most of those companies, including our major banks that form the majority of many portfolios, have actually cut rather than 'deferred' their payments. This will have huge impacts on retirees that rely on their dividends to fund their lifestyle. It's time to make a change, we need to start focusing on long-term returns and actively managing cash flow in portfolios, not dividend flow. When sharemarkets are high, sell shares to pay pensions, when markets are low, sell bonds to pay pensions. The super system forces ever higher pension withdrawals that are simply unattainable when the focus is solely on income.

Artesian Corporate Bond Fund

- Drew Meredith -

Who is Artesian? Artesian are a global, absolute return fixed income manager with around $400 million in assets under management. The company was founded in 2004, has offices in the US, UK, China, Singapore and Australia and employs 36 staff across its venture capital, fixed income and credit capacities.

Why Artesian Corporate Bond Fund? The fund offers a unique exposure to Australian dollar bonds issued by both Australian and International investment grade companies; investment grade referring to those with credit ratings of BBB or higher. Artesian seeks to construct a portfolio of highly liquid, fixed and floating rate bonds, but with a preference for floating rate (50-60% of the portfolio) in light of interest rates sitting at all-time lows. The fund is actively managed, solely invested in AUD-denominated bonds, does not track an index, and seeks to generate outperformance through identifying relative value opportunities. These come in the form of the perceived mispricing of credit risk or yield premiums over Government bonds.

Why Capital Stable Bucket? The fund meets the requirements of the Capital Stable Bucket as it invests primarily into high quality, senior, investment grade bonds, primarily A-rated or higher. The fund targets a return of at least the RBA Cash Rate, currently 0.25% plus 2.75% after fees, will distribute all income on a monthly basis and offers daily liquidity. The fund has maximum allocation limits on foreign bond issuers, being 50% of the portfolio, fixed rate bonds at 70%, subordinated debt of 25% and ASX-listed hybrids at 10% further ensuring the quality of the underlying portfolio.

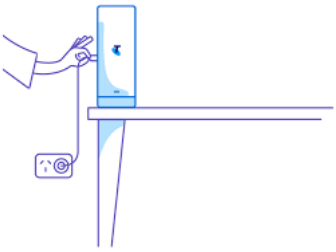
Performance & Top Holdings: Further to the maximum allocation limits the fund is required to invest at least 90% of funds not held in cash in investment grade debt, and a maximum of 55% into the financial sector which dominates the AUD bond market. The result is a highly diversified portfolio with around 49% currently allocated to financials, 12% to transportation, 8% to utilities and 7% in cash. At present, 57% of the portfolio is invested in floating rate securities, 71% of which are rated A or above. The portfolio has interest rate duration of just 0.57 which means a 1% increase in interest rates would result in a capital loss of just 0.57%. The fund has performed well since inception, delivering a return of 3.73% per annum after fees but was not immune from the March selldown, falling 3% in March but recovering quickly as it became apparent the market was reacting to short term concerns.

Reasoning: Interest rates around the world have gravitated towards zero as Central Bank resorted to quantitative easing and direct market intervention policies to minimise the impacts of the worst recession since the Great Depression. With most highly rated Government bonds now offering yields below 1% for maturities as long as 10 years, it is becoming evident that a traditional approach to investing in bonds, which relied on interest payments as the key source of income and ever lower rates to generate capital gains has gone. The issue is that the majority of traditional bond managers follow passive indices or benchmarks which now carry duration of up to 7 to 10 years. Why is this important? Duration of 7 years means that today's bond investor will experience a capital loss of 7% for any 1% increase in global bond rates (not central bank cash rates). This is clearly not a preferred outcome. There are very few short duration bond strategies available in Australia, with Artesian one of the few focused solely on investment grade corporates and offering exposure to global companies issuing bonds in Australia; hence why it has been recommended within your portfolio. The team targe duration at a maximum of 3.5 years.

Artesian's 15-year experience and established network mean they have access to both new issues of bonds as well as the secondary market. Finally, Artesian are signatories to the UN PRI and apply strict negative screens on their portfolio excluding fossil fuels, tobacco, gaming and munitions producers.

Six reasons I'm backing Telstra in 2021

- Drew Meredith -



As a change of pace, I've taken a look at the outlook for Telstra both during and post COVID-19. The share price fell from a high of around $4 in February to around $3.04 in mid-March and still sits around $3.15. That's a 20% fall despite the company being significantly sheltered from the events occurring around the globe. Whilst I am prone to buying a value trap, attracted to those stocks that are unfavoured by the market, I believe the experts may be missing something on Telstra. In my view, there are multiple reasons to be positive about the outlook for the business and very few to be concerned about.

Microsoft partnership

Many shareholders are unaware, but Telstra is one of Microsoft's major partners in Australia for the delivery and rollout of their world-leading Azure platform, including the now widely used Sharepoint and OneDrive cloud storage platforms. This forms part of Telstra's enterprise of Network Applications and Services division, which also includes commercial installations of the NBN. Telstra has an extremely skilled enterprise team that assist companies in gaining the efficiencies associated with digitising their business process and offers an incredible growth opportunity. This was best highlighted by the CEO of Microsoft Satya Nadella recently stating that some "2 years of digital transformation has occurred in just 2 weeks". A powerful them if I've ever seen one.

Dividend sustainability

Management did the unthinkable a few short years ago, cutting the dividend which had neared a payout ratio of 100% of earnings. Not only was this an important decision for the company, allowing greater investment back into its growth opportunities, but was a precursor to what we are seeing today. Two of the four major banks, ANZ and Westpac, didn't reduce but entirely deferred and potentially cancelled their dividends for the first half of 2020. The COVID-19 crisis has seen the transition to a near cashless society occur in just a few weeks and exposed some old-fashioned businesses for the lack of investment in themselves. Whilst Telstra's dividend may be lower, it is more sustainable and has allowed the company to focus on reinvention.

Telstra Ventures

This leads us to the underappreciated Telstra Ventures division, it's high growth venture capital portfolio of investments. Where a company like Facebook or Google attracts plaudits for the many acquisitions it makes, income starved investors tend to view growth as a bad thing for Telstra. Yet the company has been actively investing in a broad range of leading technology businesses which can benefit itself and many of its customers. Recent examples including investments in Docu Sign and Box App, digital storage options, a holding in Snapchat and a particular focus on Cyber Security via AttackIQ.

Mobile Network

Despite the merger of TPG Telecom and Vodafone finally receiving approval, it may be too little too late in the battle for supremacy in Australia. Where Telstra's used to be the uncompetitive, expensive provider with poor systems but the best network, its Telstra 2022 strategy has seen the business turn the corner. I learned this first hand recently when negotiating a new business contract for my handset, and being told there was now only 3 options to choose from, not the 10 – 12 legacy plans that existed previously. Telstra is already well ahead and established as the leader in the 5G space, and is one of the few providers committing enough capital on a regular basis to ensure the highest quality network remains around the country.

Traditional Sales

The majority of analyst attention on Telstra is focused on replacing the income lost to the NBN, yet this information is irrelevant for those investing in the future. The company will not be what it was prior to the NBN being completed, nor should shareholders want it to be. It was bloated, inefficient and unable to evolve its business due to the anchor of an inflated dividend. Telstra continues to receive the lion's share of NBN installations along with mobile handset plans, ensuring its profitability for years to come. Interesting, after an unfortunate accident with my own smartphone in the middle of the COVID-19 shutdown I was informed that the demand for networking products had grown exponentially in just a few weeks as work from home only began to take off.

Behavioural Bias

The greatest opportunity in Telstra lies in its weakest selling point; underperformance for many years. Behavioural biases mean that Telstra remains an income payer in the minds of retired investors around Australia and many analysts refuse to see the growth opportunities that are beginning to arise. In my view, these biases are what is keeping Telstra from a valuation similar to Charter Communications in the US (NASDAQ:CHTR), which trades on a P/E of 60 times. Maybe management should consider a Nasdaq listing?

Rightsizing, short for 'we were wrong?'

- Annabelle Dickson -

Investors relying on dividends for income have had a rude awakening over the last few months, with many ASX-listed companies cutting or deferring dividends. But there are certain management terms to spot in company reports to analyse the strength of the business.

Angela Ashton, founder and director at Evergreen Consultants, thinks dividends will be impaired for a while. "Banks have to keep lower dividends for a while at least for a year. I think it will be tough," she says. Ashton says there are a few terms in ASX announcements that investors can look out for, including "right-sizing," "normalisation" and "one-off adjustments."

ASX-listed companies are required to disclose immediately any information concerning them that a reasonable person would expect to have a material effect on the price or value of the entity's securities. This type of information covered by the rule is usually referred to as "market-sensitive information". An ASX guidance note provides some examples, including "a transaction that will lead to a significant change in the nature or scale of the entity's activities."

Here is what to look for in ASX reporting:

Dividend deferrals and cuts

The impact of COVID-19 has led to many ASX-listed companies to cut, or defer, interim dividends. Quan Nguyen, head of equities at Zenith Partners, says: "A flow-on effect of an earnings downturn is the subsequent impact on dividends, as companies retain earnings, reduce payout ratios and raise capital to shore-up balance sheets." However, it is unclear as to whether a company's dividend "deferral" is a euphemism for cancelling the dividend altogether.

Companies such as Westpac, ANZ, Bank of Queensland, Qantas, Northern Star Resources, Downer and James Hardie are among many that have deferred paying interim dividends this year. Flight Centre and Super Retail Group have cancelled their interim dividend payments.

Ashton says if a company has announced a deferral it will do its best to pay the dividend, but it will completely depend on the individual circumstances. "The future is very unclear, but it depends on the business itself. In some cases, a deferred dividend will be paid but investors can't count on it. It is better for the company to have the money on its balance sheet."

Rightsizing

Ashton says this is a nice way for a company to say that it is downsizing. This is likely to appear more in announcements due to the impact of COVID-19. A company might say something along the lines of "we are looking to right-size the organisation due to challenges facing us ahead." As a result of the pandemic, employees are happier to work at home and offices may look to reduce office space.

Ashton says: "Companies likely won't get rid of their offices but there will be a lot more flexibility. This could have a potential effect on real estate investment trusts (REITs) as there have already been cuts in valuations to some commercial properties. "Companies are locked into leases, so this can't happen straight away, but over time there will likely be less demand for office space," she says.

EBITDA

EBITDA is earnings before interest, taxes, depreciation and amortisation. This is simply giving investors an idea of the profit prior to paying debts, tax and taking into account depreciation. Owen Raszkiewicz, founder of Rask Group, says EBITDA is "just a fancy way of saying profit, excluding a lot of expenses." The higher EBITDA figure, the better, he says – because the company is making more money.

Underlying EBITDA

This is almost the same as EBITDA except it reflects any changes to normalise the income and expenses of the business. It strips out one-off costs such as legal matters

Ashton says underlying EBITDA is the current EBIDTA from the business itself, not considering things like the sale of something that might impact gross profit. It is specific to a point in time. "Companies sometimes take items out and call them one-off when they may happen every second year. Investors have to be careful when they look at it and think about whether it's recurring or not," she says.

Raszkiewicz says: "Sometimes these terms are OK, but often they are used to avoid presenting bad news to shareholders. Compare the 'adjusted' figure to what is written in official audited financial statements and make up your own mind."

Normalisation

"Normalisation" is similar to underlying EBITDA, but is longer-term. It means presenting the earnings of a company without the impact of unusual or one-off situations. Ashton says the company adjusts one-off expenses to show the true earnings of the business and refers to idea looking at earnings through a business cycle. This is generally reflected in the profit and loss statement. "Normalisation is the average earnings through a business cycle, so it is a slightly longer time idea. It helps investors to understand the earnings from a business' normal operations," she says.

One-off adjustments

Compared to underlying EBITDA, which is more at the earnings line, one-off adjustments can be presented anywhere, such as the balance sheet: a one-off adjustment can involve writing-down the value of assets. Ashton says: "An example could be buying a company and revaluing the assets. It could also be on the earnings side or anywhere on either statement that doesn't tend to be related to earnings."

Dividend payout ratio

This is the ratio of the total amount of dividends paid out to shareholders relative to the net income of the company. It is the percentage of earnings paid to shareholders in dividends. This can be calculated by dividing total dividend payments by net profit, and multiplying by 100.

Wattle Watch - Prime West Agricultural Fund -

- Jamie Nemtsas -

One Amazing Property

Our family often takes day trips down to the Mornington Peninsula. We normally take the back way, down 'Browns Road'. As you drive down from Red Hill towards Sorrento you can see perfect hedged pine tree paddocks. Sometimes we stop and peak through the thick hedge, where we find the most amazing lush dark sandy soil growing some spectacular vegetables.

These farms are owned by the Lamattina family. They were purchased over 75 years ago; about the same time it takes to grow a thick pine hedge. The Lamattina's are responsible for half of all the celery sold in Australia. It isn't just the picturesque views and the amazing soils, it is also that it is located where the Pennsulia starts to narrow, only 10 kilometres between two large stretches of water. This give this already amazing property a very unique microclimate. Some of the most fertile growing areas in the world share similar characteristics.

The Opportunity - PrimeWest Agricultural Trust No.1

The Lamattina's have recently done a deal to sell the property and lease it back for 10 plus 5 plus 5 years with ASX listed Primewest (ASX:PWF) – An ASX listed Western Australian property company. Primewest have had a long history of managing quality real estate on behalf of third party investors. This is their first foray into agriculture, and they are doing it in a very similar manner as they would invest in real estate. A sale and leaseback. Meaning the Primewest won't manage the property, do real farming and operation experience is not need, the Lamattina's will look after that. Primewest has set up a new trust, aptly named the PrimeWest Agricultural Trust No.1, and have agreed to purchase 385 acres of land. Lamattina's will have the first right and last right to buy the property back, if Primewest sells the property. The trust will run for a period of 8 years, at the time Primewest will decide what to do with each the properties, but essentially they will be sold and proceeds distributed to all the unit holders. This isn't the only property for the new Primewest trust it has also purchased another property owned and leased called Pinegatta; carrots and potatoes in country NSW. That property isn't that substantial and is far less exciting then the Mornington Peninsula property. The trust is open to any wholesale investors, will be about 40% geared. It promises to pay investors a 7.5% yield monthly. It will run for a period of 8 years, with further assets will be added to the trust until the value is circa $100million.

Our View

Even though we love this property we think the price being paid values everything at top dollar including the pine hedges. It has only one tenant really doing one thing, also 8 years isn't a long time to get stamp duty, and establishment costs back, NTA will be down from $1.00 to 88 cents soon after purchase. The costs that Primewest are charging seem fair, but we do think the fee structure could have been more aligned with investors outcome. We also worry that other properties added to the trust over time will not have the same quality.

So we applaud Primewest, they have got their hands on one of the best pieces of real-estate on the Peninsula but this one we would recommend you watch from the sidelines. Our preference in this sector still remains to be Arrow Funds Management with a very diversified portfolio of leased assets across location, industry and an average lease maturity of over 23 years.