Australian Equities Update

December 2020

This report has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Ethical Australian Equities and Warakirri Concentrated Australian Equities Funds.

Market Review

Australian shares surged 13% over the December quarter as the prospect of a vaccine rollout increased confidence in the sustainability of the current V- shaped economic recovery.

Changes in key variables over the quarter included:

- A sharp rise in commodity prices with oil (+23%) and iron ore (+32%) being the standouts.
- The Australian dollar strengthened against the US dollar from 0.716 to 0.772.
- 10-year bond yields edged higher from 79bp to 97bp, although are still very low relative to historical levels.

The impact of these key variables led to an extension of the market rotation towards value / cyclical stocks. From a sector perspective energy (26%), materials (16%) and banks (28%) were the strongest performers over the quarter while healthcare (-1%%) and industrials (6%) underperformed the broader market.

The recent AGM season pleasingly continued the pattern of growing engagement between Boards and shareholders. Increasingly Boards are reaching out to fund managers for opinions ahead of resolutions being finalised. This type of engagement is both constructive and appreciated on behalf of our clients. Similarly, where we do see contentious issues in AGM resolutions, companies are more willing to engage with us to discuss the issues we have and, in some cases, has led to changes prior to the meeting.

As a general theme our major point of contention with resolutions involves the setting of inadequate performance hurdles for executive remuneration schemes or a lack of disclosure surrounding performance hurdles. In these instances, we will most often vote against the resolutions if considered to be material to shareholder interests.

Market Outlook

The medium-term backdrop for equities appears supportive as macro policies are highly reflationary while the Reserve Bank's QE program continues to add liquidity to the system and has maintained low long term interest rates. Low interest rates are supportive of valuations, especially for companies with an outlook for long term growth. However, one consequence of this situation is that certain sectors are now very expensive on traditional valuation metrics, leaving less margin of safety in the event of a disappointment.

We are somewhat cautious on market outlook in the near term as equities have already advanced strongly in the last quarter while investor sentiment has turned universally bullish. This leaves no room for error if there are any unexpected adverse developments in managing the pandemic. While corporate performance has improved in recent months, as seen by a rising return on capital, it needs to accelerate further to warrant current valuation levels.

Earnings revisions have turned positive and broadened out across a majority of industry sectors, supporting the strong market rally over the December quarter. However, upgrades may begin to moderate or reverse over the next quarter in response to the significant strengthening of the Australian dollar relative to the USD which will have a negative translation impact on offshore earnings.

Health care and building materials sectors will be most exposed. Towards the end of the quarter, we saw a COVID outbreak in Sydney leading to state border closures which may impact on the pace of economic recovery and undermine business confidence if it continues. A worrying development was also the outbreak of a far more virulent strain of the virus overseas which raises the risk of transmission in Australia. The vaccine rollout is now scheduled to commence in early March but it will be many months before a significant proportion of the population is protected.

Stocks in Focus

Xero is a cloud-based accounting software platform for small and medium-sized businesses. The significant sector rotation away from defensive stocks towards banks and cyclicals opened up a number of trading opportunities and we used the strong rebound to trim our position in Xero.

Although Xero is a business that we like because it is growing rapidly into a large addressable market with sticky customers and high barriers to entry, we trimmed our holding during the quarter on valuation grounds. We are cautious of valuations in the tech sector, where share prices in some cases appear to have lost touch with reality. XRO's share price has roughly doubled in each of the last two years in spite of operating performance below expectations due to the effect of the pandemic. It is now on around 27x sales and in spite of the high-quality characteristics of the business, we find the valuation increasingly hard to justify.

Transurban: The stock underperformed by approximately 15% over the December quarter as investor attention shifted from defensive sectors to those which will benefit from global reflation.

We continue to hold a sizeable position in this stock as it offers a solid long-term return with a relatively low risk profile. Inflation protected tolls enhance the valuation appeal of Transurban and provide a considerable margin of safety in the event of a rise in long term interest rates.

In December Transurban sold down a 50% interest in its US (Greater Washington Area) assets to its long-term partners at a price well in excess of the valuation assumed by sell side analysts. This highlights the divergence in valuation of infrastructure assets between the public and private markets.

ASX significantly de-rated over the quarter following 24% underperformance relative to the benchmark. Contributing factors include yield curve suppression by the RBA which may have a negative impact on futures trading volumes, although the impact on Group profit is not expected to be material.

A market outage also added to negative sentiment but we believe the risk of a large fine from ASIC is low.

ASX offers a dividend yield of around 3.5% with moderate growth and low risk, which we think is an attractive combination in the current market.

The Warakirri Ethical Australian Equities and Warakirri Concentrated Australian Equities Funds are long only, low turnover, concentrated and benchmark unaware. As such they will typically hold no more than 40 stocks. These stocks will come from a concentrated Approved List of about 60 stocks based on Northcape's research of selected stocks comprising of resilient businesses with clear opportunities for growth.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au