Global Equities Update

December 2020

Warakirri ASSET MANAGEMENT

This report has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Ethical Global Equiti es Fund.

Market Review

2020 was a continuous repeat of 'unprecedented' events, to use the most popular word of the year. This started with a global pandemic that has cost 1.8m lives so far globally and which had a severe impact on our economies as lockdowns closed down shops, restaurants, travel etc.

All countries around the world saw record GDP declines, with the US printing a -31% (Q/Q annualised) drop, which has never happened before, not even in the Depression of the 30's. This led to a joint global effort of monetary and fiscal stimulus by governments around the world.

In March in the US alone, Congress provided US$2tn in assistance to the unemployed and small businesses. The Fed lowered their rates quickly to zero and nearly doubled their balance sheet with quantitative easing, which was all significantly faster and more material than the previous action in the GFC. EPS expectations tanked and will likely decline by about 16% for the US in 2020.

Without further context, this would obviously not be good news for equity markets, especially given the very ritzy multiples that the market was still trading on in February. The S&P 500 did drop 34% in record time in late February and March from its February highs. The 68% recovery from those March S&P 500 lows that followed for the rest of the year will likely go in the history books as one of the fastest and biggest recoveries in the US share market. This price action resulted in a net 16% increase in the S&P 500 in 2020, a remarkable result given a) the state of the world and b) the relatively high starting point of 2020.

There is a lot more to be said about this return however as can be seen in the table below. First, whilst earnings growth drives share prices over the long term, that was certainly not the case in 2020 were EPS numbers went backwards and it was all about multiple expansion (from 18x to 22.5x now). Second, this was a year for 'Growth' stocks with the Russell 1000 Growth index outperforming the Value index by more than 35% (after a stellar run for Growth already since the GFC). This was best demonstrated by the 'FAANG' stocks. The top 5 names in the US (Apple, Microsoft, Amazon, Alphabet and Facebook) returned 65% last year, versus 10% for the other 495 stocks in the S&P 500.

Return Decomposition 2020 Summary

Benchmark	EPS*	+	P/E	=	Price Return	+	Dividends	=	Total Return
S&P 500	-4.3		21.5		16.3		1.8		18.4
Russell 1000 Growth	7.3		27.8		37.1		1.0		38.5
Russell 1000 Value	-13.2		15.4		0.1		2.6		2.8

Note: *Change in forward estimates
Source: Standard & Poor's, Russell, FactSet, Thomson Financial, Credit Suisse

The remarkable market recovery is mostly attributed to a better outlook for 2021 (certainly off a low base!) and low interest rates. The US 10-year dropped from 1.9% to 0.9% in 2020, mainly due to aggressive central bank activity and helped 'justify' significantly higher multiples around the world. Market sentiment changed in November however, as the news on the efficacy of vaccines was cheered by the market and resulted in a full-blown cyclical recovery rally. The other unique factor in 2020 was the comeback of the retail investor, at levels that we had not seen since the dotcom bubble. Robinhood and other low- cost platforms have opened up the market for newcomers that were eager to spend their stimulus cheques in what seemed a 'can't lose' game. While hard to prove, it seems likely that this played a role in new 'bubble' like share price movements seen in Tesla, Bitcoin and other Robinhood favourites.

The main positive contributor to performance in December was Electronic Arts, the biggest holding in the portfolio. While there was no specific news flow around the company, the stories coming out of the video gaming value chain is that we are looking at a potentially very strong gaming console cycle, with the new Xbox and PlayStation variants getting rave reviews.

We continue to believe that the market has very conservative estimates for the coming years and materially underestimates the strength of the various franchises, like FIFA. The return of live sporting events (hopefully this year) can also act as a catalyst for the sale of the electronic sporting version.

The other main contributor was similar to that in November, i.e. the fact that we do not own any of the 'FAANG' related stocks in our portfolio. The likes of Amazon, Microsoft and Facebook continue to underperform the market in recent months, which is likely a combination of high valuation multiples and increased regulatory scrutiny. The recent change in political direction in the US will in all likelihood not help, as the Democrats have an ambitious program to reign in the market power of these companies.

News Flow

December is traditionally a fairly slow month for corporate access and this time was no different. We did however have, amongst others, two update calls with Unicharm and Dollar General - both material holdings in the portfolio.

Unicharm Corporation (Japan)

Unicharm is a Japanese company that manufactures disposable hygiene products and household cleaning products. COVID has significantly increased demand for high margin masks and wipes in Japan and this is expected to be sustained for some time. Whilst nappies in Japan (more adult), India and Indonesia were most negatively impacted from COVID due to decreased usage frequency (not going out) and downtrading (more in EM), notably Unicharm has maintained market share.

In China, the company is restoring profitability in its baby nappy business and are bullish on the adult nappy and pet care opportunity. Raw materials are not a big issue next year but the impact in H2 will be bigger than in H1. We believe they can offset any negative impact as overall product demand remains strong and the India factory is back online after a fire last year.

Dollar General (United States)

Dollar General (DG) is the market leader of dollar stores in the US. This was a positive group call with the CFO reinforcing our positive view of DG's fundamentals with solid market share gains and plenty of growth drivers ahead, like the continued roll out of its various strategic initiatives.

The business is executing exceptionally well given it is able to accelerate its store roll-out and store refurbishment program whilst delivering on the increased demand seen currently due to Covid-19 and the recession. It remains one of the best defensive consumer staple retailers, outperforming peers this year. That said our near-term concern is around the rotation away from defensive and towards cyclical stocks which would impact DG's relative performance as we saw in November.

Notwithstanding, DG is on a very reasonable 21x forward PE and what could re-rate the stock is if it is able to demonstrate being able to grow earnings in FY21.

With COVID raging on in the US and a slower than expected employment recovery, this bodes well for continued sales tailwinds in FY21.

Below we summarise 3 key points from the update:

- Competitive landscape: Taking share from a variety of formats highlights the flexibility and convenience of their store format which also helps to build resilience. We should see more closures of less strong retailers and new real estate opportunities which should also help DG. They have seen opportunities to take over leases to move more quickly and cheaply into new space.
- Roll-out and refurbs: Very strong ROI metrics on new store openings and refurbishments: This has driven the increase in number of property projects ahead for FY21 given the very compelling returns being generated. We also think this is a very opportune time to do it while competitors are struggling. We don't know many retailers who have upped their store roll-out and refurbishment targets for the year ahead. In addition, the property landscape should be very conducive to gaining good sites at attractive financial terms.
- Metrics: Strategic initiatives are all delivering positively on ROI and Same Store Sales growth metrics as expected. There are multiple initiatives underway that should continue to drive sales and earnings growth beyond the COVID benefit we are seeing currently.

The Warakirri Global Equities Fund is long only, low turnover, concentrated and benchmark unaware. As such it will typically hold up to 40 stocks. These stocks will come from a concentrated Approved List based on Northcape's research of around 60-75 selected stocks from global developed markets which comprise of resilient companies with enduring quality characteristics that are typically within attractive industries.

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

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