Australian Equities Update

February 2021

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 were up 1.5% over the month of February, with investors predominantly focused on reporting season in the first half of the month and the rising yield curve toward the end of the month.

Company results in February were strong across most sectors, with improving revenue growth and lower costs in many cases. The banks produced results that were better than expectations on a range of measures reflecting a much-improved economy and very cheap funding. Mining companies benefited from high commodity prices and retailers experienced a boom in consumer spending.

Travel-exposed stocks including QAN and SYD reported extreme declines in revenue as expected but demonstrated resilience to these conditions and are preparing for a rebound in activity during 2021. A highlight from our portfolio was IDP Education which reported a fall in revenue of just ~25% despite Australia not accepting any international students into the country during the period. Other sectors exposed to the pandemic generally reported substantial improvements in trading conditions, including SEK, REA and retail REITs.

In the latter part of the month, focus turned to rising bond yields and the reflation trade, which overshadowed the strong reporting season. The Australian 10 year bond yield rose to 1.88% during February despite the RBA's commitment to yield curve control and forecast of no cash rate hikes until 2024.

Covid related restrictions eased throughout Australia on the back of lower case numbers in February. Importantly, on 21st February Australia initiated its vaccine rollout program firstly to quarantine, border and frontline health care workers.

From a sector perspective, materials (7.1%) was the strongest performer supported by rising commodity prices over the month. Financials (5.1%) and energy (2.5%) also outperformed. As expected in a rising yield environment, the longer duration information technology sector (-8.9%) underperformed the most. Consumer staples (-4.5%) and health care (-2.8%) also underperformed the broader market.

Market Outlook

The attention of the market has shifted to the outlook for inflation and interest rates. These are hard variables topredict and we do not set our investment strategy according to macro forecasts. However, we can offer a few observations on current conditions.

Banks are beneficiaries of rising interest rates but their exposure is to short term rates, from the overnight cash rate out to about three years, and all of these rates have been pegged to 0.1% by the RBA. A bet on rising net interest margins therefore relies on a change of strategy by the RBA, not a continuation of current conditions.

Higher ten-year bond rates affect discount rates for equities, especially "structural growth" companies common in the tech and healthcare sectors. While bond rates have risen sharply, they remain very low in an absolute sense and well below the discount rates implied by share prices in these sectors.

Our focus is on the extent to which conditions will normalise over the next few years, both for beneficiaries of the current environment and for those companies still dealing with substantial disruption from covid such as the travel sector. In most cases we expect conditions to revert to something like they were pre-covid, including a reduction in retail spending, lower commodity prices, and a rapid recovery in travel.

In our view, the most likely scenario is a continuation of favourable conditions for asset prices generally with reasonable economic growth and low interest rates.

We currently see the best opportunities in high quality businesses with defensible earnings, which have been left behind by the recent rally in cyclical names.

Stocks in Focus

IDP Education was the standout contributor as its positive share price performance reflected another resilient result, with revenue only down ~25% vs pre-covid highs on a constant currency basis despite significant constraints to international mobility. Encouragingly, demand in areas where borders have remained open such as in the UK has remained strong with placements only down ~10% and IELTS testing volumes (a leading indicator for placements) already back at pre-covid levels. On an underlying basis, IDP is already free cash flow positive, with ample access to liquidity and are well positioned to continue to take market share as conditions rebound. We remain positive on their outlook.

Qantas's outperformance over the month was due to increased confidence in both the timing and speed of an expected recovery in aviation demand following the reopening of state borders. In addition to this, we believe Qantas is well placed to gain market share from its main rival Virgin, which we expect to focus heavily on improving returns for its private equity owners. **Macquarie** also outperformed, primarily due to upgrading its earnings outlook for 2021. This was a result of heightened demand for access to its energy transmission assets in the US during a recent freeze event in Texas. Whilst notionally a one off event, it highlights the range and depth of MQG's operations, which tend to be focused on profitable niches rather than hotly contested generic business lines.

On the negative side, overweight positions in **Fisher & Paykel** and **Transurban** both detracted from performance over the month. Whilst both businesses are demonstrating strong operating performance, investor sentiment has turned against them as investors preference more cyclical exposures. TCL and FPH both enjoy very strong economic moats around their core operations, which we expect to endure for many years. As a result, we remain comfortable that both exposures will reward patient investors over the medium to long term.

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