



*Invest with Experience*

Quest Australian  
Equities  
Concentrated  
Portfolio

QUARTERLY REPORT  
JUNE 2022



## Australian Equities Concentrated Portfolio

Mr John Citizen  
123 ABC Street  
Sydney NSW 2000

ACCOUNT NAME: Mr John Citizen

### Portfolio Movement

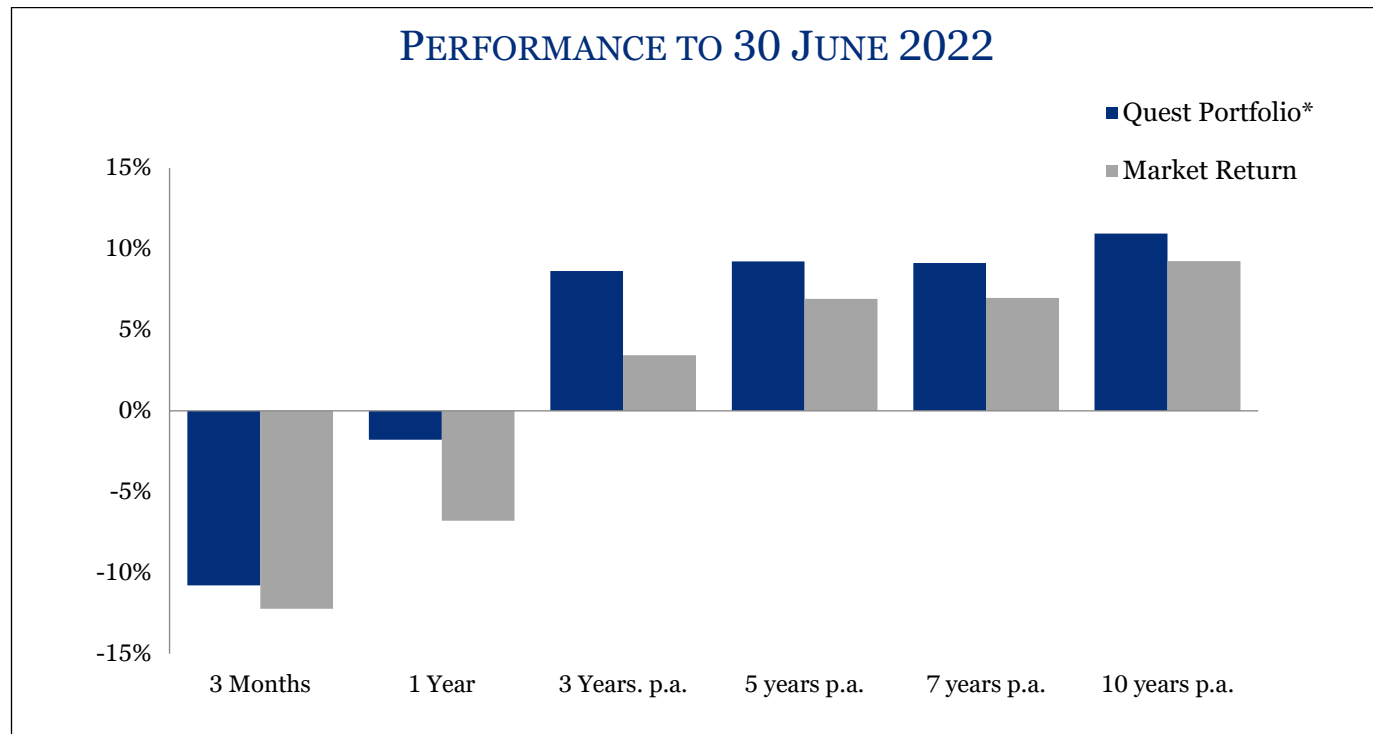
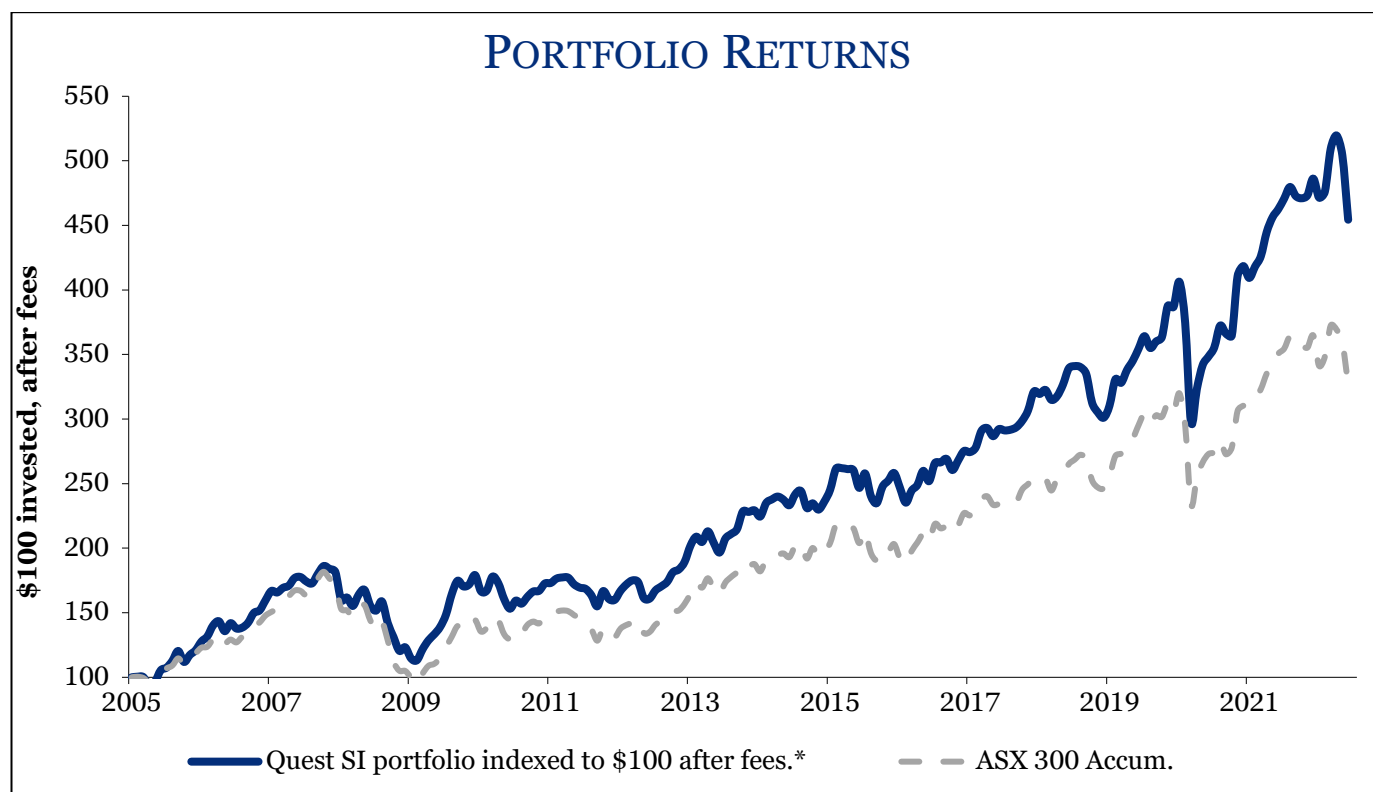
Previous market value 31 March 2022	
Contributions during Quarter	
Portfolio movement*	
<b>Market Value 30 June 2022</b>	

Your portfolio performance for the quarter*	-10.79%
Market return (S&P / ASX 300 Accumulation Index)	-12.22%
Your portfolio performance for the 12 months*	-1.58%
Market return (S&P / ASX 300 Accumulation Index)	-6.78%

\* Includes fees for the period.



## Portfolio Returns



\* The portfolio returns shown above are for an actual client portfolio on the JBWere Multi Asset Platform. They demonstrate the returns achieved if invested in the Quest portfolio since inception (February 2005). Individual returns will differ for investors that made an initial investment after this inception date or where additional investments, redemptions or any SPP investments have been made. Quest returns are net of fees. Past performance is not a reliable indicator of future performance.



## Market Review

The Australian equity market fell 12.2% in the June Quarter but again performed relatively well compared to other markets. The Dow Jones was also down 11% while the broader S&P 500 fell more than 16%. The Nasdaq lost another 22% after losing 9% in the March quarter. The worst sector was again technology, where the unravelling of the tech premium continues.

We warned of the hubris in tech prices last year but particularly in the September 2021 quarterly where the Outlook section stated:

*“We see the early signs that a 5-8% correction is possible. Regardless of the cause, the market needs to periodically correct to flush out hubris”.*

While our timing was somewhat early, the inflationary pressures from quantitative easing, labour shortages, logistics disruption and a European war have disrupted markets. Although it was widely expected that interest rates would rise, we are now seeing the price of central banks being slow to move: sharply higher rates. Australia raised rates by 0.5% on 7<sup>th</sup> June while the US Federal Reserve lifted rates in mid-June by 0.75%, the largest margin in 30 years.

Nothing stops the share market like an unexpected shock, particularly when that shock is a rate rise. Rates form the basis of stock valuation.

Expected and actual rate rises have scattered the pigeons in the tech sector. The big names have taken some huge hits this year with Alphabet down 23%, Apple down 21%, Atlassian down 50%, Meta down 51%, Microsoft down 22% and Netflix down 70%.

The carnage has been repeated in Australia where Altium is down 40%, Appen 49%, Xero 45%, and Wisetech down 34% year to date. The buy now pay later (BNPL) group have been led down by Square which, having risen all the way to the Top 20, has now shed 50% in only 3 months. Good luck to investors in index funds! Loss making growth companies and valuations based on sales multiples have lost their allure. Venture Capital is suddenly very selective.

Locally some sectors were resilient, with Energy (+1%) and Utilities (+0.6%) generating small gains and Healthcare down slightly (-2%). Large falls were seen in Info Tech (-27%), REITs (-19%), Banks (-17%) and many Small Caps (-13%).

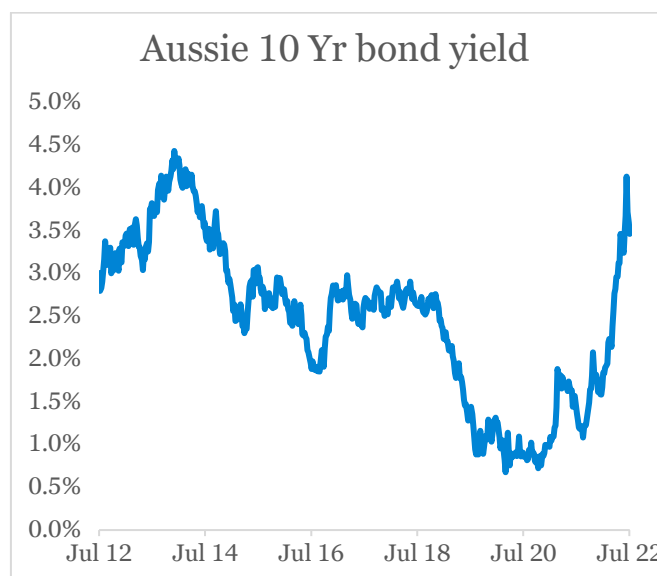
The good news is that Quest was very measured when it came to owning tech stocks during the euphoria of last year. We had no exposure to tech during this quarter until we bought selected stocks in May that were suddenly much cheaper. See details in the next section.

The Aussie dollar fell 8% in the June quarter from \$0.75 to \$0.69 as investors perceive growth is fading and a recession is likely. This would suggest less demand for resources. BHP and RIO both fell 10% in the quarter.

Corporate action has faded in recent weeks but Blackstone Inc. have finally completed the takeover of Crown resorts Limited for \$8.9 billion. The Sydney casino has received permission to operate under the new licensee. The indicative bid for Ramsay Health Care is referred to in the next section. The prolonged takeover for Link Administration saw suitor Dye & Durham lower the initial bid by 22% in June. Charter Hall received unit holder approval to buy property manager Irongate Group via a scheme of arrangement.

The chart below highlights the abrupt lift in the Australian 10 year bond yield. US and Australian bond yields hit the low point nearly two years ago in July 2020 but the major surge started in late 2021 (before the Ukrainian war).

Interest rate movement is the primary cause of the current market correction.



Source Iress



## Portfolio Review

Recent quarterlies have highlighted our concerns regarding an imminent shift in market conditions given the emergence of inflation. The March quarterly stated:

***We are surprised at how relaxed and positive markets are given the magnitude of economic change that is now only weeks away.***

These concerns were well placed. Global markets are now tackling the destructive combination of rampant inflation and the reversal of a decade of central bank bond buying. Quantitative Easing (QE) has morphed into Quantitative Tightening (QT).

The Quest Investment Process seeks investments that satisfy both quality and valuation measures. This discipline has helped insulate the portfolio from sectors of the market that are priced to perfection, are vulnerable to rate rises and those that will struggle in an inflationary environment.

Major contributions for the June quarter are shown in the table below.

Whilst portfolio returns for the quarter are negative, our portfolio has again outperformed the overall market. For the 12 months to 30 June 2022, the portfolio return was slightly negative post fees, once again **decisively** better than the ASX 300 Accumulation Index return of -6.8%.

Several of our competitors, who have also performed well over the last few years, have seen a dramatic erosion in returns from these shifting sands. The momentum driven bull market is over.

Sticking to our Investment Process has again demonstrated the integrity of a process that has outperformed in four major corrections since our inception (2007, 2016, 2020 and now 2022).

Investments in **Transurban** (TCL) and **Ramsay Health Care** (RHC), 6.5% and 4.5% of our portfolio and both with defensive revenues, were solid contributors to performance.

Ramsay Healthcare continues to trade without any update on the KKR led consortium's indicative proposal of a cash offer at \$88. RHC is currently \$70. We believe higher debt cost and difficulty in conducting due diligence on the French assets have slowed progress. It is possible the consortium returns with a lower bid or even abandons this proposal. Ramsay shares are now trading at a large discount to the original

indicative bid price but have outperformed regardless in the recent market rout. At the current Ramsay share price, a lower bid would still likely result in a material premium for investors. Given the nature and quality of the Ramsay assets, we expect ongoing interest from investors with long-term investment horizons which mitigates downside risk at current prices.

Traffic volumes continue to rebound across Transurban's 21 east coast and North America roads. Volumes on most roads are above pre COVID levels. The desire to avoid public transport is more than offsetting any preference to work from home. Higher inflation rates are adding to toll revenues. An enquiry by the NSW Government into tolling is anticipated to shift tolls towards more standardised, distance base pricing. Transurban is participating in the review but is also contractually protected.

### June Quarter Portfolio Contributions

<u>Best</u>	<u>Worst</u>
Transurban	NAB
Ramsay	IGO
Stanmore Coal	BHP
Steadfast	Macquarie
Siteminder	29Metals
Woodside	Credit Corp

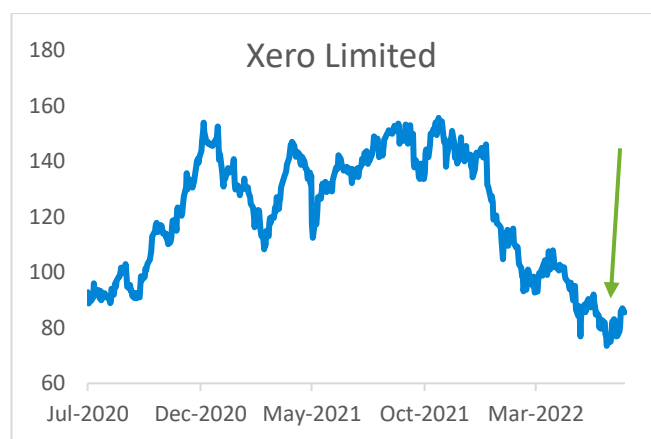
We have added **Domino's Pizza** (DMP) and **Xero** (XRO) to the portfolio. The team have followed Domino's for years and are impressed by the ability of the management team to utilise technology to drive efficiency and customer experience. The stock has however been too expensive until now.

Domino's has fallen over 50% from its ridiculous highs in late 2021. The stock has been a victim of rising bond yields along with concerns that it overly benefitted from COVID lockdowns. Taking a longer term view, we see a long runway for store growth across multiple international markets and a defensible market position as a fast and value focused food offering. We rate Domino's as a high B-grade and see sufficient valuation upside from the more sensible recent levels.





**Xero** returned to the portfolio in May after being sold back late in 2020 at over \$130. We have bought back at \$80. The business has continued to demonstrate strong growth but the share price is down more than 40% since our previous exit as rising bond rates pressure tech stock valuations. We rate Xero as an A-grade under our Q Stocks process and the selloff has provided us with the opportunity to re-establish a position at a reasonable valuation. Xero's SME accounting product is well regarded by its customers, it has a large addressable global market and limited competitors with the same global scale. Importantly, it is also free cash flow positive despite consistently reinvesting for growth.



Source: Iress

Holdings in **Macquarie** (MQG) and **Aristocrat** (ALL) were increased at attractive prices.

The **Woodside** (WDS) shares received from **BHP** were sold in preference to our **Santos** (STO) holding. We believe Santos's longer-term upside, ESG commitment and valuation are more attractive than the Woodside alternative. The unwinding of the Dual Listed Company (DLC) resulted in BHP again becoming ASX's largest stock at an index weight of over 10%. This resulted in a scramble for BHP stock early in the quarter lead by the indiscriminate Index funds. Our holding in BHP was reduced into the flurry at prices well above \$45.

Smaller company industrial investments have not fared well recently. Quest hold three: **Ai Media** (AIM), **Catapult** (CAT) and **Keypath Education** (KED) which fell 53%, 43% and 52% respectively in the quarter. In our view they are well over sold. There are now many cheap small industrial stocks that have been hammered which suggests corporate actions are likely.

In fact, some corporate activity has already commenced. This includes a bid for salmon farmer **Tassal** (TGR), **Infomedia** (IFM) which has now received three takeover offers while **Pushpay** (PPH) is also considering an offer. Overall however, there continues to be scant interest in smaller stocks at the moment for the following reasons.

Firstly, the popularity of index funds generally means that stocks outside of the ASX300 are excluded from these index tracking portfolios. Secondly, large market falls generate fund redemptions forcing managers to sell stocks into thin markets. It is hard to sell small stocks when the market fears recession; the buyers vanish and prices tumble. Thirdly, many small stocks become irrelevant in larger portfolios and are often sold as they cease to be material. Tax selling in June is another pressure borne by the smaller stocks.

Quest portfolios hold no investments in the discretionary retail sector as we see the consumer to be under some pressure from a rising cost of living. The absence of holdings in stocks such as **Wesfarmers** (WES), **Harvey Norman** (HVN) and **JB Hi-Fi** (JBH) has been good for the portfolio performance.

Defensive holdings have served the portfolio well in recent months but with significant falls in other areas of the market, we are seeing valuations of quality businesses returning to investible levels. **Dominos** and **Xero** are examples.

**Bank of Queensland** (BOQ) was sold when actual results delivered were below our expectations. Some profits have been taken in the long standing **SSR/Alacer Gold** (SSR) investment. SSR Mining has outperformed gold producing peers this year. **Carbon Revolution** (CRB) was sold after a tough year where covid disrupted production in Australia and customers in Europe. The sale crystallised a significant tax loss in June.

We continue to hold our three lithium holdings, **Allkem** (AKE), **IGO Limited** and **Mineral Resources** (MIN). The three add to 8% of the portfolio. Lithium pricing has held record levels despite recent commodity price weakness.

In terms of activity levels, we have been quietly waiting for markets to respond to the changed circumstances. The mood finally shifted to pessimistic in late April when we targeted **Domino's** and **Xero**. There will be more opportunities given the extent of falls in higher quality stocks.

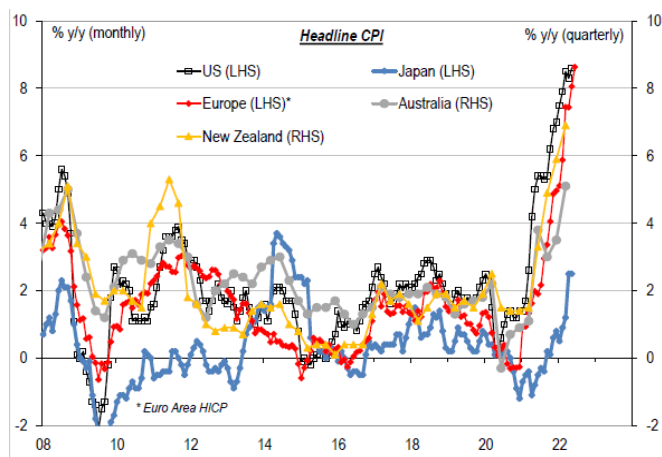
## Outlook

The statements from the March Quest quarterly remain relevant:

*The macro picture remains complex with concerns over interest rates, inflation, wage rises, logistical delays, conflict in Europe (and an upcoming election).*

*It is nearly 2 years since the US 10 year bond reached a nadir after a thirty year slide in July 2020. The medium term will see higher rates as forecast clearly by the US Federal Reserve. Quantitative Easing (QE) is now morphing to Quantitative Tightening (QT).*

The economic outlook for much of the global economy has worsened. Consumer and corporate confidence have fallen to low levels in major markets even before the central banks responded. Most importantly, central banks have finally committed to reining in rampant inflation, the extent of which can be seen in the following chart.



Source: UBS

The RBA have recently stated:

*'The Bank is committed to doing what is necessary to ensure that inflation in Australia returns to target over time.'*

A number of international markets appear ahead of Australia on this journey. As central banks lift rates to lower demand, the headwinds will not be evenly distributed. This is already showing up in the share prices of some exposed businesses. Discretionary retail spending, consumption vulnerable to falling house prices as well as sectors unable to pass on higher wages, energy and other costs will all see lower earnings. The magnitude of these falls is still unclear, with a wide possible range, depending most crucially on whether a recession can be avoided, both here, in Europe

and in the US. One experienced observer has noted that the US has never avoided a recession when the starting point for inflation sits above 5%. It is currently over 8%.

The situation is further complicated by ongoing supply chain issues arising from the war in Ukraine coupled with COVID impacts in China. In addition, many governments are saddled with high debt levels following actions taken to offset the GFC and more recently COVID. Budgets have assumed cheap funding costs but interest rates are now higher. Central banks are not finished yet. US Government debt is \$US24 tn. That's 12 zeros! The recent change in interest rates in the US means the \$US7 tn needed to be refinanced in the next 12 months will cost an extra \$US280bn, a 10% lift in the US deficit. The path for fiscal spending remains in question.

Given this backdrop, markets are struggling to price risk with any confidence. This uncertainty drives the wild swings seen in global markets over recent months.

**Historically, markets struggle to rebound until the earnings reductions are well progressed.** Whilst we wait for earning expectations to reset lower, significant PE compression has already occurred in sectors where valuations were at their most extreme ie technology stocks and in stocks most exposed to the factors noted above.

However, we need to be aware that long term bond yields, especially for the all-important US 10yr Government Bond, have already spiked to levels that would have seemed unlikely only months ago. In fact, the most recent moves in yields have been down, with a peak being reached mid-June. In addition, recent economic data is showing that some areas of activity appear to be slowing, suggesting the markets are starting to believe that the tightening will be effective. This has important implications for stock markets, as relief from the relentless pressure of upward interest rates can provide the impetus for a strong market rally.

As long-term investors will know, Quest's highest ranked quality businesses are normally expensive. As investor expectations reset, good businesses are available at much lower prices. Our Quest process favours quality businesses and we are now finding a number of what we consider A and B grade stocks at investible prices.



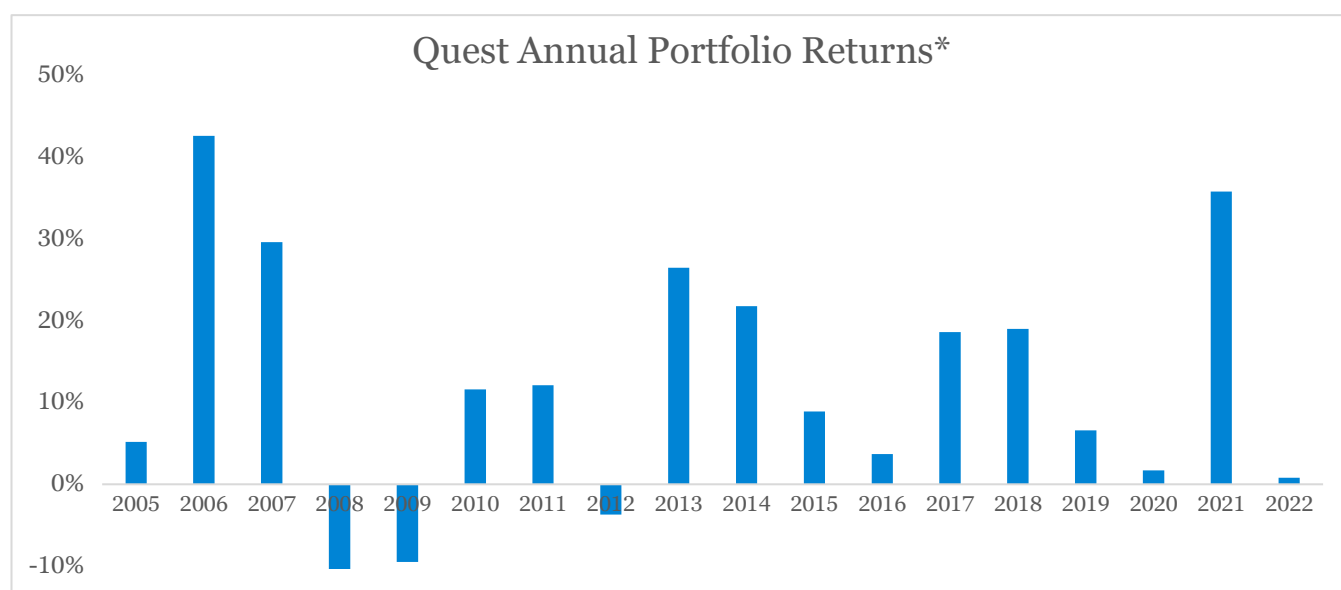
Whilst the outlook remains challenging, investors should expect ongoing changes to the portfolio to take advantage of the opportunities being presented.

We remain diligent in the assessment of risk. Given the level of change being digested by the market, we expect there will be significant shifts in leadership amongst stocks in the market over the next 12 months. Stock selection and stock weight will be the key to delivering returns ahead of the benchmark while avoiding unnecessary risk.

The charts below highlight historic total returns and relative performance against the S&P/ASX300 benchmark over the 18 years since inception.

## Performance Fees

No performance fee is payable for the June 2022 quarter.



\* Pre fees, 2005 is part year

