



*Invest with Experience*

Quest Australian  
Equities  
Concentrated  
Portfolio

QUARTERLY REPORT  
DECEMBER 2022



## Australian Equities Concentrated Portfolio

Mr John Citizen  
123 ABC Street  
Sydney NSW 2000

ACCOUNT NAME: Mr John Citizen

### Portfolio Movement

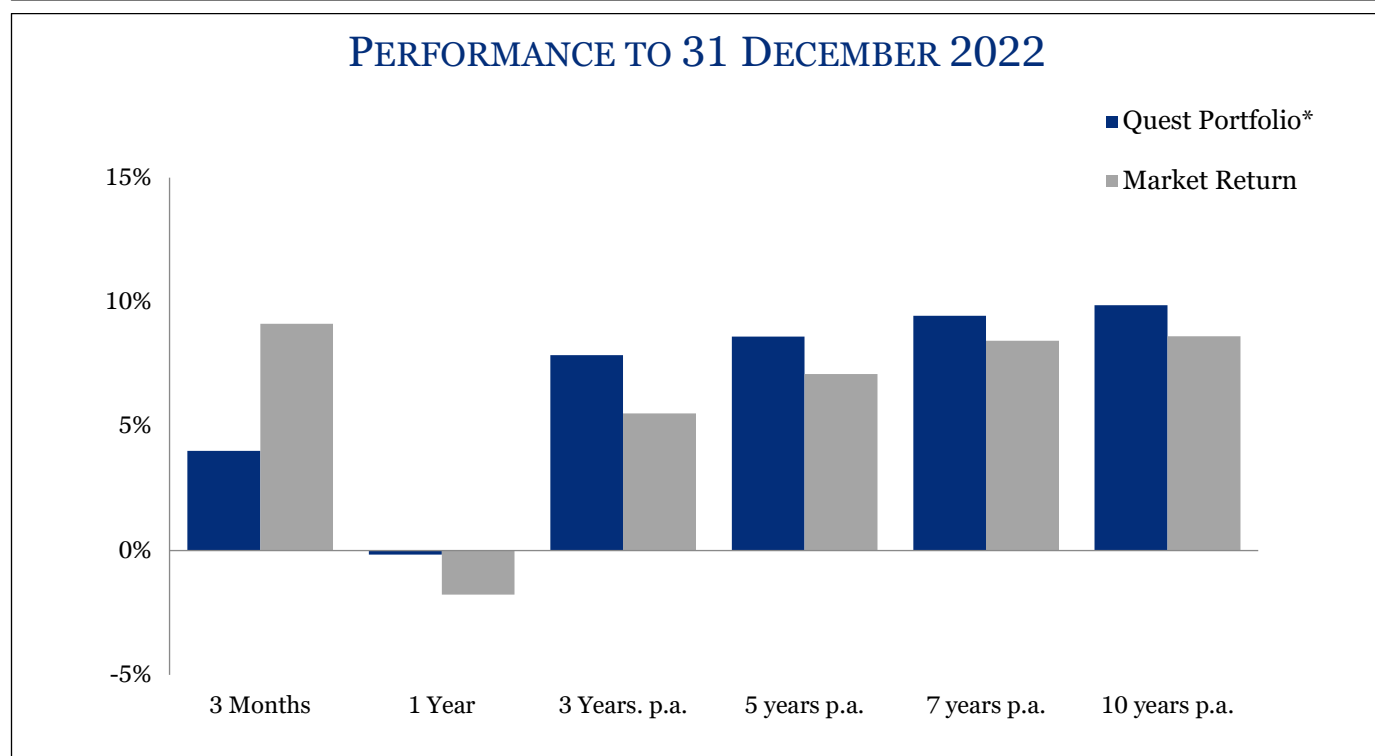
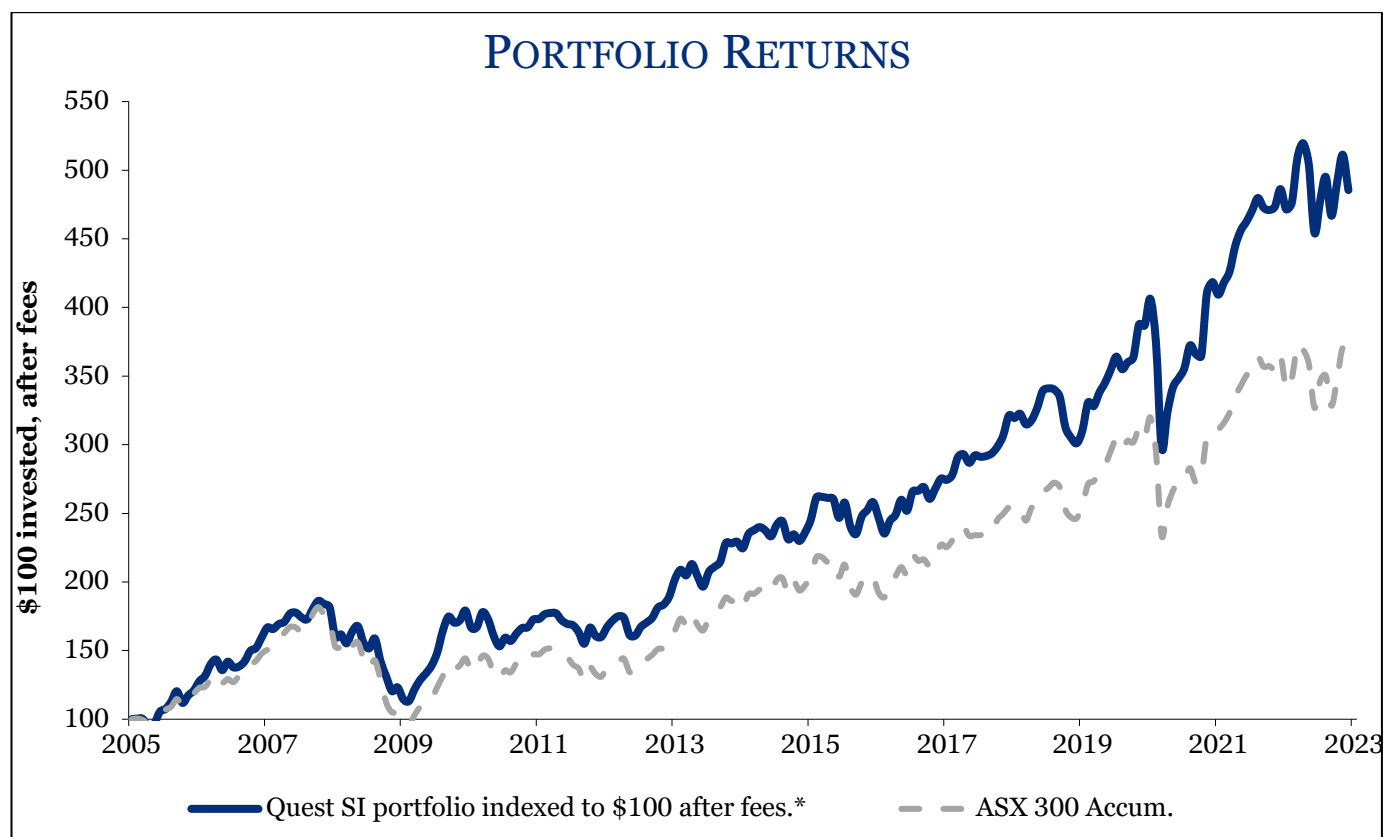
Previous market value 30-Sep-22	
Contributions during Quarter	
Portfolio movement*	
<b>Market Value 31-Dec-22</b>	

Your portfolio performance for the quarter*	4.08%
Market return (S&P / ASX 300 Accumulation Index)	9.13%
Your portfolio performance for the 12 months*	-0.04%
Market return (S&P / ASX 300 Accumulation Index)	-1.77%

\* 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

This December quarter concluded an extraordinary year for global markets. Most markets delivered a positive return for the quarter despite the myriad of ongoing challenges: inflation, wage pressure, dramatically higher interest rates, supply chain disruptions and a European war.

The Australian market gained 9% for the quarter. The returns from other markets varied considerably. In the US the Dow Jones was up 15%, S&P 500 up 7% whilst the NASDAQ was down 1% (see chart below). Elsewhere, the Japanese Nikkei was flat, Shanghai was up 2% and the FTSE 100 in the UK rose 8%.

Australia's export markets have benefitted from strong resource and agricultural revenues which have delivered a bonus to the Federal budget. Iron ore rose 13% over the quarter while thermal coal moved down 7% (but has risen 138% this calendar year). Gold and silver were sought after, up 9% and 26% respectively for the quarter. Whilst oil was relatively flat, the price of European natural gas fell heavily, down 49%.

Utilities was the best performing sector on the Australian market for the quarter, buoyed significantly by the surprise takeover bid for Origin Energy. The \$9.00 offer from Brookfield Asset Management and EIG has the support of the Origin board and sent the stock up 45% in November. Origin closed out the year at \$7.72, suggesting the market is not convinced the deal will complete.

Resources were also strong during the quarter, along with the major banks and gold stocks. Market interest in future facing metals, copper, nickel, lithium and manganese continues. The sector rallied into November before a sharp correction prompted by COVID fears in China and suggestions of softer electric vehicle volumes. Lithium chemical prices remain close to record highs. We own **Mineral Resources**, **Allkem** and **IGO Limited** in this space.

Turning now to the action for the 2022 calendar year. There were some remarkable moves over the last 12 months and the combination of challenges thrown at the market are unlikely to be repeated. As the economic consequences of the COVID pandemic were continuing to unfold, we saw central banks dramatically lift interest rates to combat rampant inflation. This occurred whilst the world continued to battle the extensive impacts from the war in Ukraine, in addition to heightened geopolitical tensions with China.

It goes without saying that 2022 was a volatile year, with US equities delivering their worst performance since 2008.

The chart below highlights the dramatic fall in NASDAQ index, a bellwether for technology stocks in the US. The return for 2022 was -33%.

Over the page we list some of the key market shifts in the US that drove sentiment during 2022.



Source: IRESS

**Interest rates:**

- The US Fed Funds rose from 0.1% to 4.4%, the largest annual move since 1973
- US bond yields jumped from 1.5% to 3.9%, driving a heavy fall in earnings multiples

**Returns:**

- The S&P 500 returned -19%, troughing at -25% in October. Over the past 40+ years, only 2002 and 2008 were worse
- Energy stocks jumped 59%, whilst Tech stocks fell -34%

**Economy:**

- Forecasts for 2022 US GDP fell from 3.9% at the start of the year to 1.9%
- US\$ index (DXY) started at 95.7, peaked at 114 in October, and has fallen to 104

**Energy**

- Energy: WTI rose from \$75 to a peak of \$124 and has since declined to \$80
- Gasoline increased from \$3.30 to a peak of \$5.00 in June and is now at \$3.20

**Valuations**

- Growth PE multiples fell from 30.2x to 20.9x; Value from 15.1x to 13.6x

The following table highlights the extraordinary range of returns for the 10 largest stocks in the US.

Apple	-27%
Microsoft	-29%
Google	-40%
Amazon	-50%
Berkshire Hathaway	+3%
United Health	+5%
Johnson & Johnson	+3%
Exxon Mobil	+81%
JP Morgan Chase	-15%
NVIDIA	-51%

The returns for other global equity markets shows a similar picture, with most markets posting significant falls.

FTSE (UK)	+1%
DAX (Germany)	-12%
CAC (France)	-10%
Shanghai (China)	-9%
Hang Seng (Hong Kong)	-15%
Nikkei (Japan)	-15%

Against this backdrop the annual return for Australian market was more than respectable: down only -1.8%, after taking dividends into account (ASX/S&P 300 Accumulation Index).

Given this market turmoil, we are pleased with the performance of the Quest portfolio over this period, which delivered a small positive return.



## Portfolio Review & Outlook

The Quest portfolio delivered a positive return in the quarter but lagged the general market benchmark. Our portfolio, while having outperformed solidly for many years, has not kept pace with the strength of the market in the last three months.

The simplistic summary of the quarter is that few of our investments performed strongly whilst the market bounced. However, what is not obvious is that only a limited number of stocks in the market outperformed. Only one third of the companies in the ASX 300 actually beat the 9.1% return of the ASX 300.

During 2022 we have been more defensively positioned due to concerns that the impacts of inflation and central bank restrictive activities were yet to be seen. More on this below.

Materials had the largest impact on relative performance, due to weakness in lithium (**Allkem** AKE -19%), not enough iron ore exposure and production issues at **29Metals** (29M). There are further comments on lithium below.

### Largest December Quarter Portfolio Movements

<u>Best</u>		<u>Worst</u>	
Bellevue Gold	+51%	Keypath	-33%
Stanmore Resources	+37%	Allkem	-19%
Dominos	+29%	29Metals	-17%
Qualitas	+20%	Maas	-16%
BHP	+19%	Catapult	-12%
Steadfast	+18%		
Mineral Resources	+17%		

In October major local banks bounced from what we believe will prove a temporary boost to net interest margins (NIM). A leading bank sector analyst recently published his sector NIM outlook with the heading 'From hero to zero'. Iron ore miners rallied in November despite Chinese COVID shutdowns on expectations the political leadership will do more to support their

property market. Quest is underweight both sectors and the market rally of over 12% in these two months did not suit our current portfolio stance.

Defensive sectors ie **Woolworths** (WOW), **Transurban** (TCL), **CSL & Ramsay** (RHC), where Quest has considerable exposure (collectively 23% of the portfolio) were muted. Any stock that fell in the quarter had an outsized impact on performance and a handful of Quest's smaller cap's were weak including **Boss Energy** (BOE), **Ventia** (VNT), **Corporate Travel** (CTD) and **Maas Group** (MGH). Small caps generally lagged the rally in the Top 50.

Quest portfolio returns remain well ahead of benchmark over longer periods. We have managed to position the portfolio to benefit from the huge economic and market gyrations of the COVID period from the start of 2020.

During the quarter the market adopted a view that the aggressive stance adopted by the US Federal Reserve would soften and that the series of rate rises in the US during 2022 was close to an end. The market adopted a quick fix attitude with a glass half full overlay. During December however, that confidence faded quickly as reality set in. After strong lifts in the S&P 500 in both October and November, the S&P slid 6% in December.

Market traders were too optimistic during most of the quarter, despite central bankers cautionary messaging and emphasizing the need to slow the economy.

As we look into 2023, there are headwinds and tailwinds. From a headwinds perspective, the major issue is the slowing European and US economies due to the weight of materially higher interest rates. Global equity strategists are highlighting that analyst forecasts have been slow to capture the impact of these slowing economies. For instance, recent US recessions have averaged a 23% drop in EPS. EPS reductions so far are 4%. Also, global inflation is expected to fall but is not yet tamed.

Locally, the effects on mortgagees after the fastest tightening cycle in Australian history will emerge in the next six months. Most economists expect at least one more rate rise of 0.25% (taking the rate to 3.35%). The banks know exactly where the loans are and peak rolling from previously fixed mortgage rates to variable rates will occur in the June quarter. This is when the pressure on the consumer will be seen. Thus, the Reserve Bank is walking a tight rope, trying to slow inflation with



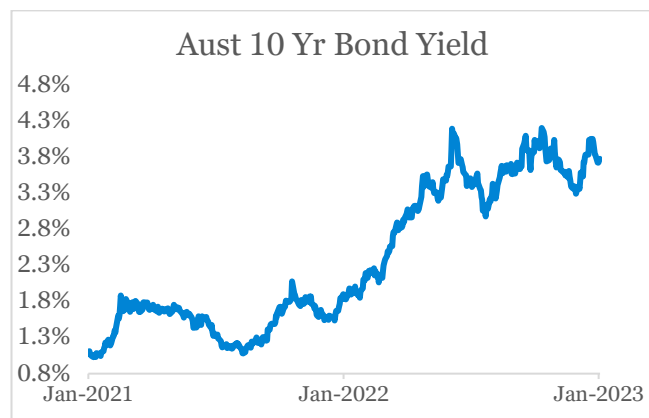
rate rises but without causing a recession. The RBA refer to this as a 'narrow path'.

One area of volatility is how higher mortgage costs impacts discretionary retail demand. Have the retailers repositioned? Do they hold too much stock? Have the analysts and share prices captured the likely changes in consumer behavior? Quest currently has no exposure to this sector.

Regarding tailwinds, last quarter we wrote:

*A study of the history of periods of RBA tightening reveals the market bottoming well before the earnings bottom. Historically, longer term bond yields peak as the RBA begins the tightening cycle. Central banks will lower the scourge of inflation and the cost of funds will settle. We therefore see this correction as well advanced with opportunities appearing.*

The chart below suggests we may have seen the worst from long term interest rates. Further, we are now seeing opportunities where companies that rate well on our qualitative assessment are trading at prices we can easily justify. However, the path from here remains difficult to predict. We therefore remain cautious and are mindful of portfolio risk when adjusting the portfolio.



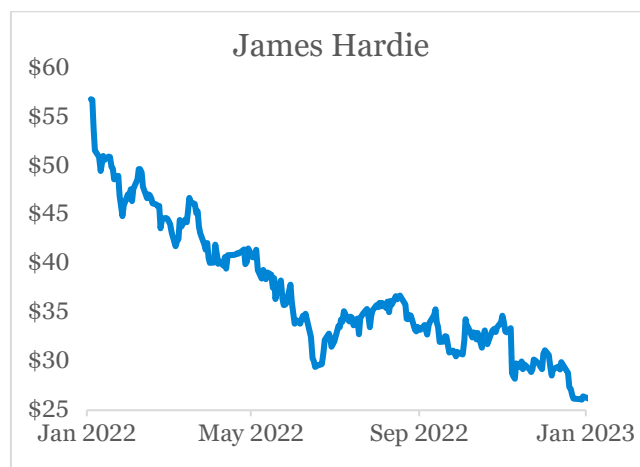
Source: Iress

In keeping with our long-established investment process we have a bias to quality. Our current portfolio comprises holdings trading below our target prices and it carefully balances risk and return. For this reason, we remain optimistic. This process has provided very competitive returns for clients over almost two decades.

In the past quarter we added **Charter Hall** (CHC) to the portfolio and in this quarter we added **James Hardie** (JHX).

The US is 80% of Hardie's business but it also has Australian, NZ, European and Philippine operations. The fundamentals for construction have changed considerably since we exited our position in 2021 around \$50.

Central banks had driven interest rates to three decade lows which boosted construction, employment and consumption. House prices and trading volumes boomed. Asset prices soared and share markets boomed.



Source: Iress

In 2022, the JHX share price slumped as interest rates moved higher. An unexpected change of CEO did not help. Housing demand is now in decline, house prices have peaked and Hardie is now \$20 lower than our exit price last year. Analysts have moved from an upgrade into a downgrade tilt on JHX.

Hardie rates highly in our process. Their construction product returns are very attractive. They continue to win share in the US market as well as locally. Steady investment in R & D has seen the company expand the product range and become the dominant provider of higher quality siding.

Whilst asbestos liability will be a drain for many years to come and lowers our overall Quest quality score to B, this liability is currently at its peak and will progressively fall away as forecast by KPMG back in 2007 when the Asbestos Injuries Compensation Fund was established.

We believe the drop below \$30 per share incorporates materially more conservative expectations than assumed by investors who paid more than \$50 last year.

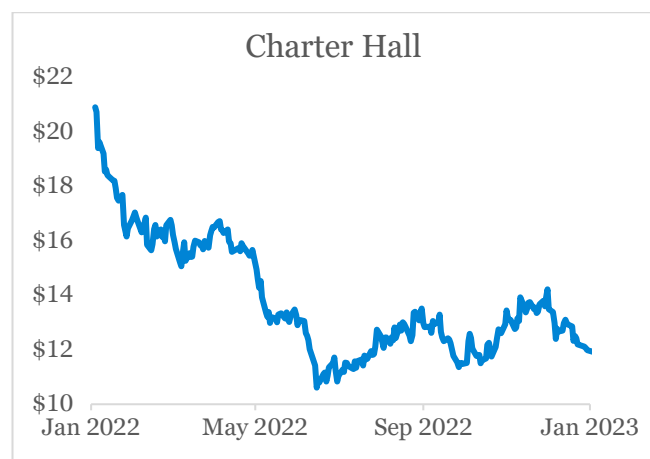


The position in **Charter Hall** has been increased in the December quarter after being initiated in the previous quarter. The business is a direct owner and manager of property assets including office, retail and industrial.

Charter Hall is the parent entity for three other listed vehicles; Charter Hall Retail REIT, Charter Hall Long Wale REIT and the Charter Hall Social Infrastructure REIT. The stock is capitalised at \$6 billion and sits just outside the Top 50 Australian companies. The position is now 3.5% of the Quest portfolio.

Quest have owned this stock twice before. It is familiar territory for our team. The opportunity to reinvest arose when persistent rises in interest rates saw the share price tumble from \$22 in December last year to sub \$12 in September this year.

The business has a long-standing CEO who has aggressively built the business since establishment back in the 1991. CHC is rated a high B in our Q Stocks process. In 2021 we sold our holding between \$18 and \$20 as part of a shift in our portfolio away interest rate sensitive businesses.



Source: Iress

Our stock valuation includes a discount to the carrying values of assets of 20% to allow for a fall in property valuations and valued the funds management business on a conservative multiple. The sum of these parts gave us confidence to buy Charter Hall below \$12.

We have added to the holding in **Santos** (STO) during the quarter. Since being added to the portfolio in late 2021 the holding has been a reasonable contributor but remains well short of its full potential. Buying **Woodside** would have been better in the short term, but we continue to

see significant upside in Santos as a well managed, low cost, diversified gas producer. Santos sells no east coast gas above \$12 so is not financially impacted by the Federal government move to cap gas prices. The risk with this policy is it's yet another shift in Australian Energy Policy. Also it undermines rather than promotes supply. Lack of gas supply is anticipated to be a serious issue within 18 months. Santos' largest asset is actually the major PNG LNG operations, outside the jurisdiction of our government policy recklessness. Santos have recently increased their buyback.

The only stock to be sold in the quarter was insurer **IAG**. This stock took a drubbing in 2021 which gave us the opportunity to buy a company that had halved in the previous two years. The tally of storms, floods and fires combined with the pandemic was taking a toll. The provision for business interruption of over \$1 billion looked too conservative. IAG performed relatively well in a tough year but we see better opportunities elsewhere now. The business interruption provision was too conservative and an unwind has started which allowed a share buyback to commence in October.



## Lithium Market Update

Early this year, in our December 2021 Quarterly, we summarized our bullish stance on the lithium market and the stocks held in the Quest portfolio. We outlined the development pipeline for the industry, the response of auto makers, the thirst for battery materials and a summary of our various lithium stock holdings at the end of 2021.

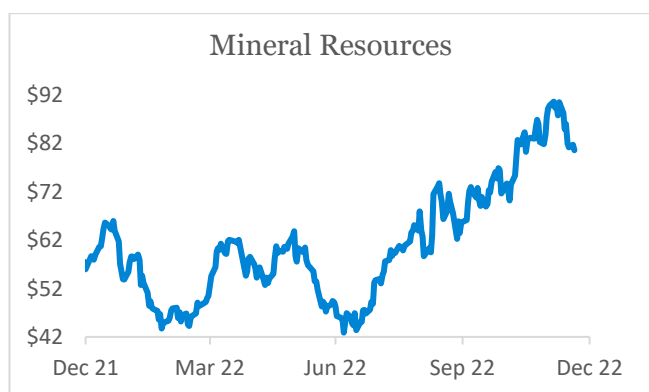
History has shown that the Quest bullish predictions were not bullish enough! In 2022, 6% spodumene (host rock of lithium salt) prices have moved from US\$2,360 per T to over US\$6,000 at end Dec 2022, a rise of 150%.

The Dec 2021 Quarterly stated:

*“We expect any stock associated with lithium to get caught up in the excitement during 2022. New hopefuls with early stage prospects, a drilling program and some handy grades will be raising funds from a willing marketplace.”*

That prediction was accurate. The larger producing companies reveled in the booming market with peaks reached in late 2022.

**Mineral Resources** has moved up 38% from \$56 to \$77 but peaked at \$92 in November, **Allkem** rose from \$10.60 to \$11.24 with a \$16.75 peak in November while **IGO Limited** has risen 17% from \$11.50 to \$13.50. During the year we also closed profitable trades in **Pilbara Resources** and **Core Lithium**.



Source: Iress

The lithium developers were mixed with **Core Lithium** up 122%, **Anson Resources** up 60%, **Liontown** up 16%, **Piedmont** up 12% and **Lake Resources** flat after a turbulent year. The European green wrapped candidate, **Vulcan Resources**, fell 32% while **Ioneer** gave up 33%.

Lithium carbonate ( $\text{Li}_2\text{CO}_3$ ) prices have moved from US\$40,000 per T to US\$74,000 per T. Lithium Hydroxide prices have moved from US\$31,000 per T to over US\$70,000 per T.

So what happens next?

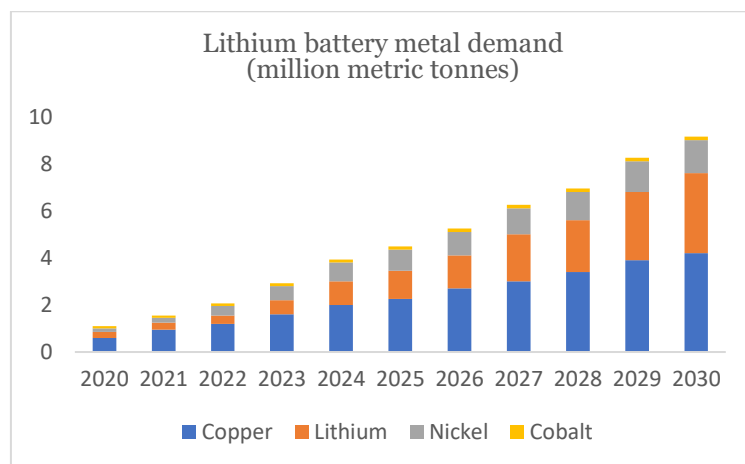
There is little sign of a reduction in demand for battery materials medium term. During our Perth visits this year, all investee companies reported strong demand with buyers looking to secure increased volumes and term contracts. There may be some softness in Chinese demand in the March quarter due to disruption from lock downs, rising COVID cases on reopening and Chinese New Year holidays. We anticipate restocking will commence post Chinese New Year.

### Auto Makers

The major auto makers, **Volkswagen**, **Toyota**, **Stellantis**, **GM**, **Hyundai** and **Ford** are committed to expanding EV ranges. This underwrites a dramatic increase in battery demand.

The best indicator of future demand is the number of battery factories operating or in planning. In our December 2021 Quarterly, we noted more than 200 gigafactories were to be operating by 2030. This number is now above 350 globally with 150 producing now.

The dominant battery manufacturer is China by a huge margin. China plans to have 226 gigafactories by 2030 and will control 70% of the battery market. The United States currently has 12 and will have 23 by 2030. Europe has a few sites operational now and should have at least 30 by 2030. Battery manufacturers, including the Chinese, are looking to position into Europe and North America; closer to growing markets.



Source: Bloomberg NEF July 2022

Automotive companies also have existing direct relationships with lithium miners but these are not as extensive. **Great Wall** own **Pilbara Minerals** shares, **Toyota** have an indirect stake in **Allkem** while **Stellantis** owns **Vulcan Resources** shares. **Ford** has provided debt to Australian prospective miner **Liontown**.

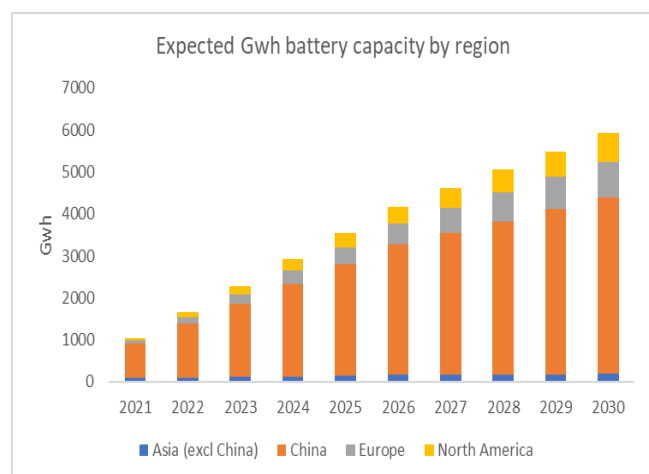
## Battery Production

Lithium continues to be the building block for the industry despite the intense search for alternatives. The globe is now so committed to this technology that the automotive industry has now locked in for at least the next decade.

China controls 80% of cathode (includes the lithium content) manufacturing capacity, 90% of global anode capacity and 79% of lithium battery capacity. It will take a long time to shift this balance!

The **US Inflation Reduction Act** is intended to encourage clean energy in the USA and reduce the dependence of the USA on Chinese materials. The budget is an impressive US\$369 billion and is driven by tax breaks based on encouraging the use of home grown materials or those materials from a country with a Free Trade Agreement (which includes Australia, Europe and Canada). The IRA has seen a rush of early stage hard rock candidates raise money for initial and advanced exploration drilling.

When it comes to cost per gigawatt hour, the Chinese have a huge advantage. Estimates are that gigafactory construction costs are one third of western countries with low wage rates and a faster approval process.



Source: Benchmark Intelligence

Approvals and cost did not stop **Tesla** opening a factory south of Berlin in March 2022. In fact, Angela Merkel pushed the bureaucracy hard to get this facility approved in a short time. The site is huge, boasting 8,000 employees and covering three square kilometres. Capacity is scheduled to be an immense 150 GW by 2030 at a cost of at least US\$5 billion. This is one of 6 factories in Germany which is committed to Merkel's ambition to be the European centre of excellence. Tesla has three other factories, one in China and two in the USA.

The leading battery producers are **CATL** and **BYD**, both Chinese. These companies are under pressure from rising feedstock prices as lithium prices surge. Battery prices have moved higher in 2022. This raises the question as to whether these companies may look to buy or joint venture into actual mining operations to reduce the burden of being a price taker.

The downstream investment by automotive manufacturers into batteries has continued in 2022. Tesla has a factory in JV with **Panasonic**, **Stellantis** has a JV with **LG Energy Solutions** in Canada and another with **Samsung** in the USA, **Ford** with **SK Innovation** in Tennessee and **GM** with **LG Energy Solutions** across 4 sites in the USA. There are many others.

**The growth in EV demand leads to growth in battery demand which means more lithium, nickel, copper, manganese, graphite and cobalt are needed to supply battery factories.**

## The Year Ahead

Share prices of lithium producers have more than doubled in the last two years. The Allkem price is more than 5 times our initial purchase price back in 2012. The dramatic gains have now been achieved.

The future direction of stock share prices will always hinge on the lithium price but expansion downstream and delivery of higher volumes to reduce unit cost will be critical in 2023. The miners need to be able to deliver to an expanding market.

Our three stocks, **Mineral Resources**, **Allkem** and **IGO Limited**, all have expansion plans underway both in mining/brine operations and in downstream production of lithium carbonate or hydroxide. The next phase is value add, an opportunity missed in other Australian commodities. Australian based producers need to



do more than dig up rocks, crush them and put ore on boats!

There has been a major surge in lithium stock pricing. Margins at the operating level are very high at current price levels but investors should remember that prices could halve and can still generate a healthy long term margin. Whilst the spodumene price is currently over US\$6,000, the long term analyst consensus is below US\$2,000. The market is susceptible to a correction in the short term but we are not concerned about the long term future of this industry. The strategic positioning is yet to start.

The only stock that has exceeded our price target is **Pilbara Minerals** which we sold as our price target was achieved.

A critical issue for Quest is that the lithium market, in terms of the stock market, is now far more mature. The spectacular gains of the last two years are less likely in 2023. Five years ago there were almost no lithium analysts and Quest were often one of only a few attendees at company presentations.

**These stocks are now well researched and widely owned. The stocks are now more subject to daily news events, the latest analyst update and press reporting than in prior years. This will result in continued volatility in 2023.**

## Consolidation

While the quick gains may be made, we see the potential for a new phase in the lithium market in 2023.

The strategic control of source material is critically important. Automotive manufacturers may buy equity positions in lithium producers (and other commodities such as nickel and graphite). Battery manufacturers may buy equity stakes in producers to ensure long term supply. Lithium companies may bulk up and bid for each other.

Large corporates (such as RIO or Wesfarmers) could bid for lithium producers and other large players, such as BHP and Glencore, have no lithium exposure and may choose to get involved.

There are also a long list of oil and gas stocks that may look to diversify from oil exploration to future facing metals. Also large, diversified resource investors may look to consolidate global assets. The early movers will control the rock and brine

supply chain at the end of this decade. Those that wait will miss out.

**The upcoming year could be the year for consolidation. If any takeover bids do occur, the entire sector will rerate higher as a result.**

## Performance Fees

No performance fee is payable for the December 2022 quarter.