



*Invest with Experience*

Quest Australian  
Equities  
Concentrated  
Portfolio

QUARTERLY REPORT  
MARCH 2023



## Australian Equities Concentrated Portfolio

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ACCOUNT NAME: Mr John Citizen

### Portfolio Movement

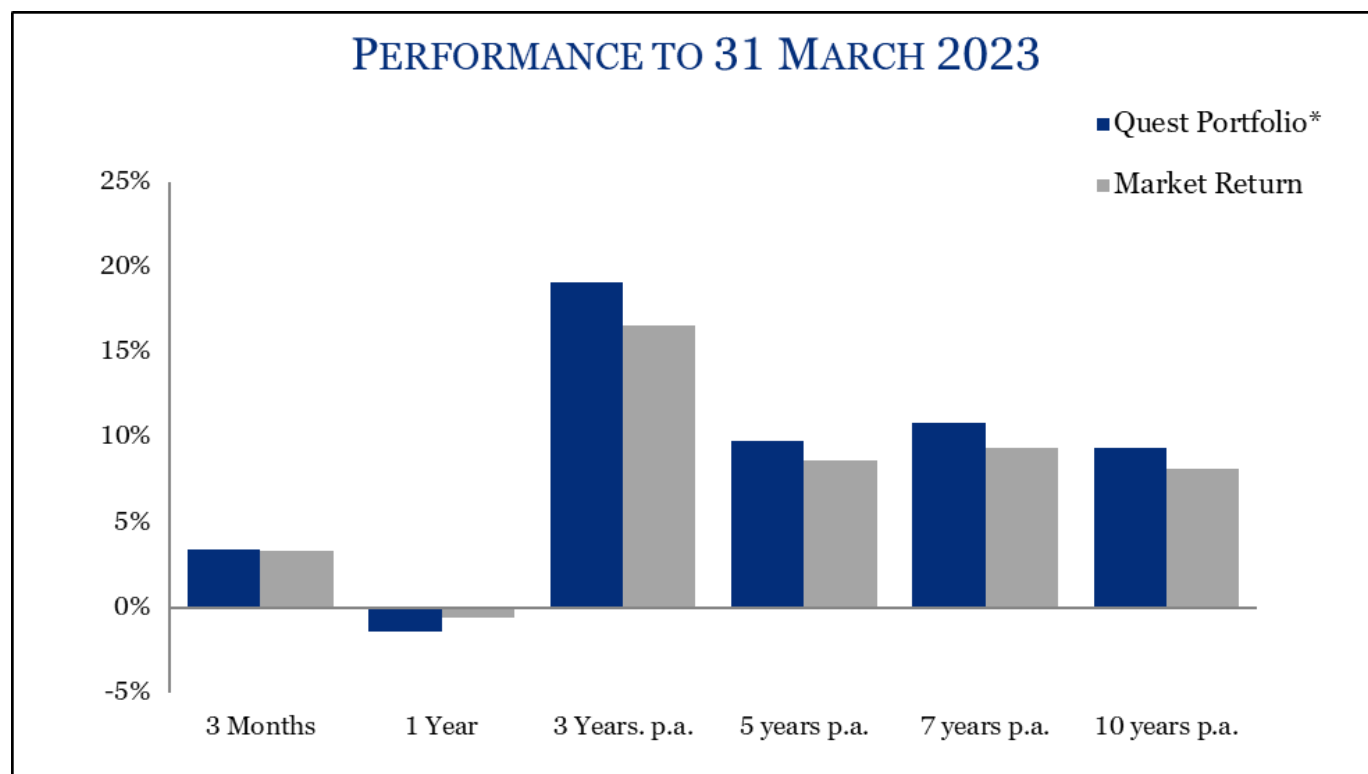
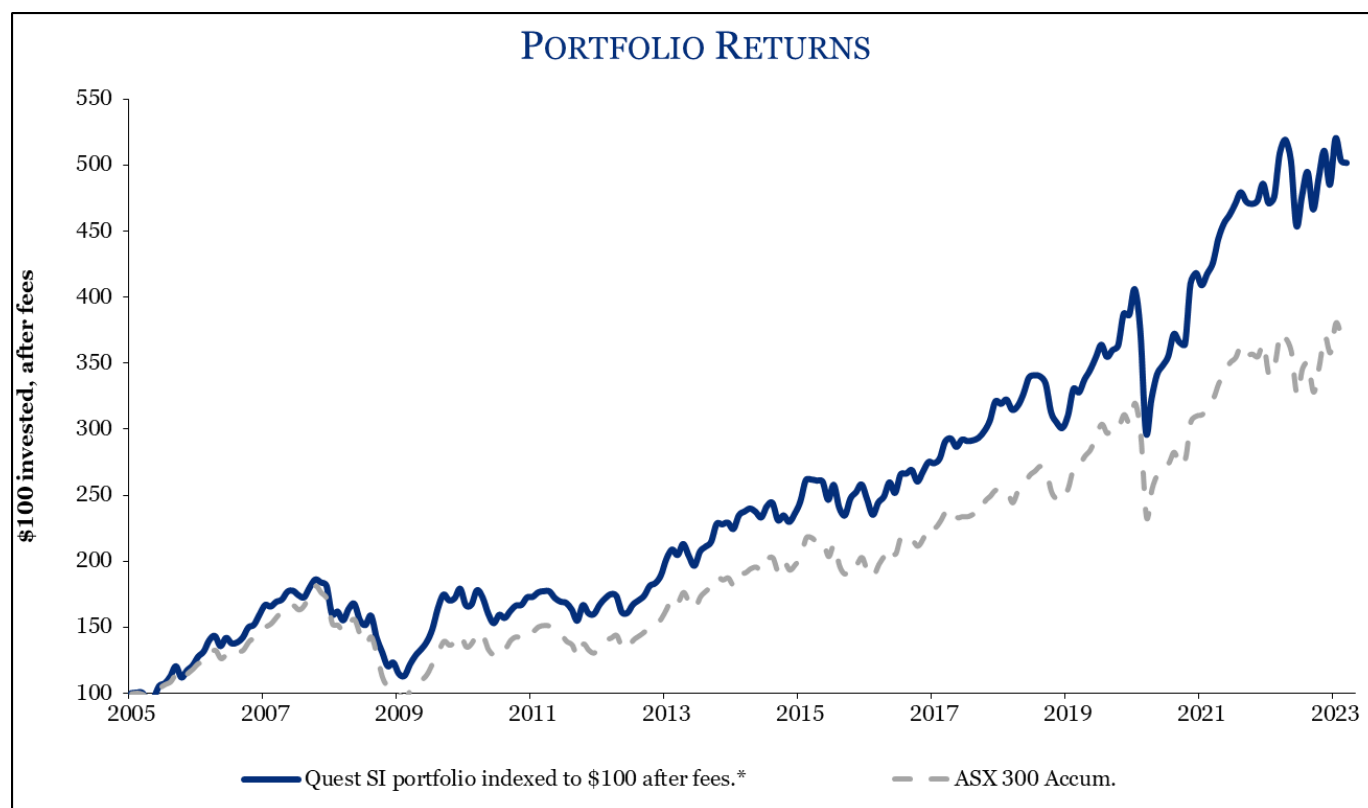
Previous market value 31 Dec 2022	
Contributions during Quarter	
Portfolio movement*	
<b>Market Value 31 March 2023</b>	

Your portfolio performance for the quarter*	3.27%
Market return (S&P / ASX 300 Accumulation Index)	3.33%
Your portfolio performance for the 12 months*	-1.47%
Market return (S&P / ASX 300 Accumulation Index)	-0.57%

\* 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

Global equity market returns were positive for the quarter against the backdrop of a tumultuous 2022. Some of the largest global markets reported returns last year that were close to the worst in the last 40 years. Those markets, including the **Nasdaq**, the German **DAX** and the Paris **CAC** found their bases in the December quarter. The recovery in these markets continued in the March quarter, albeit on a bumpy and at times unnerving trajectory.

The recovery had a number of drivers. One was a drop in energy prices, especially as a result of a very mild European winter. Economic news generally was better than feared. US and Australian retail demand remained resilient despite tighter financial conditions. China's reversal of their COVID lockdown policy was also a plus. Equity returns were positive despite the collapse of three US banks and the required rescue of Credit Suisse.

Quest was in the US reviewing economic conditions just as **Silicon Valley Bank** (SVB) was placed into receivership. The failure of the US's 16<sup>th</sup> largest bank sent shockwaves around the world. A mis-match of borrowing and lending durations, a lack of deposit funding, losses on bond investments and insufficient liquidity buffers to offset the panicked withdrawals all contributed. By way of comparison, SVB was 1/4 the size of CBA in an economy 15x larger.

Over the quarter the Nasdaq index rose 17%, the CAC lifted 13% and the DAX 12%. The Gold price rose 9%, Oil fell 7% and longer term bond yields dropped. The Australian 10 year Bond yield dropped from 4.0% at the end of 2022 to 3.3% at the end of March. We consider this drop in long term interest rates to be significant, partly

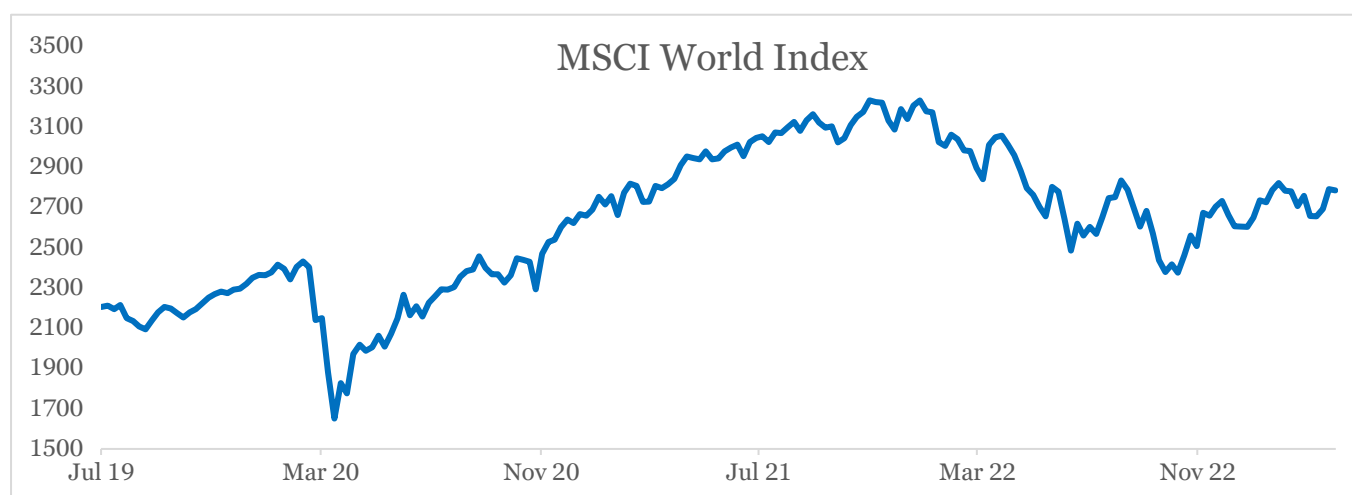
explaining the positive market returns during the quarter. This quote by Morgan Stanley CEO James Gorman sums up the current mood:

*"If I'd said two, three or four years ago that we're going to have the first land war that we've had in Europe in 7 decades, the biggest pandemic we've had in 100 years, the highest inflation in 40 years and the highest interest rate response to that in 40 years, and asked how do you think the world would look then most people would say it would look terrible. But it actually doesn't".*

Central Banks remain very active as they attempt to slow demand and therefore inflation without causing significant panic. This has included both restrictive and supportive activities during the quarter. The RBA raised the cash rate at both February and March Board meetings. The March statement stated further tightening of monetary policy 'will be needed to ensure that inflation returns to target'. Subsequent to the failure of SVB, RBA softened the cash rate outlook.

Overseas corporate interest in Australian companies continues with **Newmont** proposing a non-binding scrip bid for **Newcrest** (NCM) valued at \$24bn. American lithium producer **Albermarle** bid \$6bn for WA lithium developer **Liontown Resources** (LTR). Quest forecast in our December quarterly that 2023 'would be a year of consolidation' for lithium. The first consolidation step has been taken. **Invocare** (IVC) and **United Malt** (UMG) also received bids.

Reporting season in February had the usual volatility. Aggregate earnings forecasts dropped due to cost pressures, lower oil & gas revenues and revisions in the utility sector.



Source: Iress



## Portfolio Review & Outlook

The Quest portfolio delivered a similar return to the benchmark for the quarter. The following table details the major contributors.

Stock Contribution to Total Return March Quarter 2023			
<u>Best</u>		<u>Worst</u>	
Aristocrat	+0.64%	29Metals	-0.66%
Woolworths	+0.63%	Dominos	-0.65%
Zero	+0.55%	NAB	-0.54%
Ventia	+0.55%	Charter Hall	-0.31%
BHP	+0.52%		
Transurban	+0.52%		
Stanmore	+0.51%		
Corporate Travel	+0.42%		
James Hardie	+0.42%		

Only owning one of the big four banks was a major contributor to relative returns. The mortgage banking net interest margin (NIM) expansion proved temporary and the sector was the worst performer in the quarter. Bank funding costs are escalating as clients switch cash from transaction accounts into higher returning term deposits. At the same time mortgage competition has stepped up to a new level of intensity. This is a Catch 22 for the banks. They need to grow mortgage books to offset rising costs but there is intense competition for new customers. **Macquarie Bank**, a smaller part of **Macquarie Group** (MQG), has newer mortgage origination technology and a much lower cost to service. This operation is well placed to continue disrupting the major banks' oligopoly.

Non-bank mortgage providers like **Athena**, **AFG** and **Pepper** (PPM) have seen their funding costs rise and have chosen to step back from the intense competition, but that hasn't stopped Macquarie. They consider that the returns in the sector remain sufficient for them. An attractive solution for the big four isn't readily

apparent. **NAB** was our only bank holding during the period and the position was reduced early in the quarter. Significant profits were booked from the **NAB** sales.

Globally the **Information Technology** sector bounced strongly during the quarter. Lower longer term interest rates improved valuations for businesses with structural growth potential. **Aristocrat** (ALL), **Xero** (XRO) and **Corporate Travel** (CTD) all benefitted from this recovery. Xero's new CEO Sukhinder Singh Cassidy announced a significant refocus on more profitable growth and cut 15% of roles. The market embraced the improved guidance with the stock up 27% for the quarter.

**Domino's Pizza** (DMP, -24%) reported disappointing earnings results and the share price was subsequently punished. Domino's attempted to increase delivery prices to make up for higher costs, but this resulted in an unexpectedly large fall in order volumes. The company has since adjusted prices through its new flex voucher with some encouraging early results. This was a rare mistake from a well-regarded management team. We have maintained our holding but continue to monitor the situation. We see upside if Domino's can deliver on its store growth targets, which requires improved franchisee profitability and confidence. This is a key management focus and is supported by Domino's scale advantages and signs that peak cost inflation could be behind us.

**29Metals** (29M, -38%) performed poorly with weather damage and approval delays at their North Queensland mine impacting mine production. We continue to believe that the global energy transition will result in shortages of key metals including lithium, copper and nickel but the performance of 29Metals is proving unreliable. The holding has been exited. We also reduced holdings in **Mineral Resources** (MIN), **Steadfast** (SDF) and **Macquarie Group** banking good profits at attractive prices.

Quest has recently been in the US and in Europe to visit companies and to review the major local economic drivers. In summary, the message heard overseas was one of *cautious optimism*.

The trip to the US included three days with Macquarie Group. We heard in detail from the three US centric businesses and how in aggregate they are now the largest geography for Macquarie. Macquarie has shown remarkable agility over five decades to reinvent itself. They





successfully combine entrepreneurial investment and dexterity with deep risk awareness and control. Even small businesses struggle to transform when market conditions change. Macquarie has been able to repeatedly transform and grow at scale. We consider it as close to a core holding as our investment process enables.

We also met with **Home Depot**, the massive US hardware business **Bunnings** (now the largest part of **Wesfarmers**, WES) has copied with great success. Depot expect that in the first half of 2023 volumes will slow maybe 3% from the record home renovation activity seen during Covid but then recover modestly in the second half. US centric transport company **UPS** painted a similar picture.

Quest found surprising optimism in the UK. There is light at the end of the tunnel. The European trip was focused on Quest's large healthcare holdings: **CSL** and **Ramsay Health Care** (RHC). Our assessment was the news for both was marginally better than current expectations, with Covid issues gradually receding. Details were provided about CSL's newly acquired Vifor business. We expect opinion regarding Vifor to improve. Stresses on French and UK government budgets again raises the possibility of increased private hospital utilisation. Ramsay is considerably more efficient than the public system.

At the global level, tight fiscal policy is finally starting to influence consumer behaviors although cash buffers continue to protect significant cohorts. Employment locally and in the US has remained strong and shortages continue to be reported in some professions and geographies. Wages growth is also sustaining consumption. A shortage of WA truck drivers for instance has resulted in very handsome salaries.

Migration is also boosting local demand. Australian inbound migration is expected to boom in 2023. Federal Treasury is forecasting 235,000 net arrivals in both 2022/23 and 2023/24 but some are expecting a lot more. The net figure for October 2022 was +200,000.

Given the cautious optimism in the paragraphs above, it's worth considering what could disrupt the narrative. Could the failure of SVB cause a chain reaction?

One important lesson from the GFC was to adequately recapitalise globally *systemically important* banks (G-SIB), as well as major

regional banks and other financial institutions (SIFI). There are higher prudential requirements for the largest. SVB wasn't on this list. Australian banks are well placed with some of the highest capital buffers globally. Panic can be hysterical and irrational but extrapolation of the SVB issues to G-SIB & SIFI categories appears unreasonable.

Tighter financial conditions from higher wholesale funding costs as well as tighter bank regulatory oversight are likely. This will allow Central banks to ease back on the magnitude of rate rises. This transfers some of the stress from mortgage holders to indebted corporates who borrow in the wholesale market. In summary, the collapse of SVB is expected to slow global activity but only at the margin at this stage.

The elephant in the room is government debt. Since the GFC, fiscal and monetary support has been central to a more optimistic economic mood. Politicians promise spending and voters demand it. Sir Humphrey from the political satire *Yes Minister* would call any significant move towards a more fiscally responsible approach "courageous".

The US debt ceiling is once again only weeks away. The expectation is yet another alteration to the ceiling height. There are multiple pressures on major economy budgets. Higher interest costs have added to annual deficits. Another budgetary burden is energy transition. BloombergNEF forecast that global investment in the energy transition will lift to \$4tn pa by 2030.

The Australian Federal budget is now less than four weeks away and Treasurer Chalmers appears likely to lift taxes in several areas of the economy. The affluent are one target. He has raised superannuation taxes and now banks and energy companies are nervously awaiting the budget. His manifesto released in late January stated: *"It's not just our economic institutions that need renewing and restructuring, but the way our markets allocate and arrange capital as well"*. We remember Kevin Rudd's first term as PM when a considerable portion of the ASX was under attack.

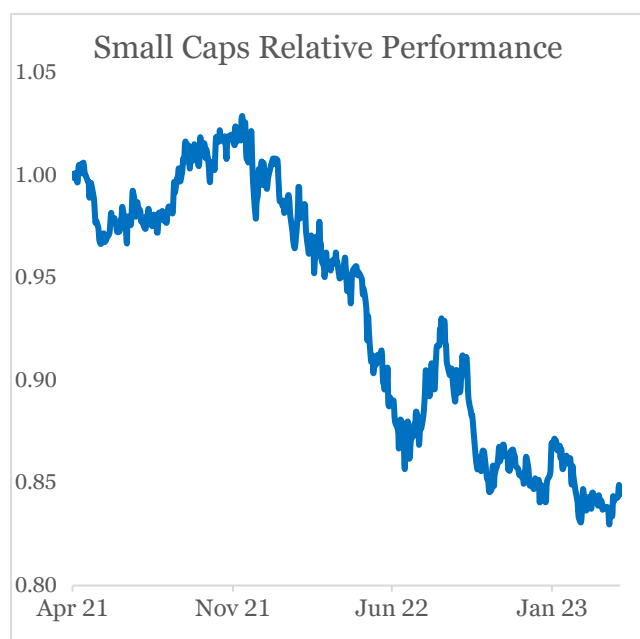
Inversion in the bond yield curve is indicating that the economic news will continue to deteriorate. Inflation won't easily fall without at least a meaningful slowdown. Earnings forecasts have dropped and more is expected, but we believe there are reasons to be more optimistic.



Quest's June and September 2022 quarterlies provided the historical perspective of earnings, bonds and equity market returns during a tightening cycle. They referred to longer term bond yields peaking as the RBA started tightening, of earnings reductions and markets bottoming well before the earnings do. The first of the ten RBA rate rises so far were almost 12 months ago. The Australian 10 year bond peaked in June 2022 at 4.2% and was down to 3.3% at the end of March.

At the same time some of our larger, more defensive holdings such as **Transurban** (TCL), **Woolworths** (WOW) and **Steadfast** have performed well for clients but are trading at or close to target whilst opportunities to switch into cheaper, more dynamic parts of the market are emerging.

Historically, as economies slow small cap's struggle to perform. This is primarily due to a lower earnings diversity relative to larger companies. They are typically viewed as riskier. The following chart shows the underperformance of ASX listed smaller companies over the last 12 months. As inflation slows, the market will start looking for an easing in financial conditions and improving outlooks. Valuations have also become more palatable. Small cap investing has historically provided our clients some very attractive returns.



Source: Iress

One example is **Catapult Group** (CAT). Quest recently visited Catapult in the US and in the UK and continue to believe the current valuation does not reflect the position and potential of the business.

During the quarter we added to the holding in **BHP** to capture an attractive, fully franked dividend. We increased the **Macquarie Group** holding late in the quarter as the SVB news rattled markets. Holdings in **Charter Hall** (CHC) and **Ventia** (VNT) were also increased.

## Performance Fees

No performance fee is payable for the March 2023 quarter.