CONCENTRATED LEADERS FUND

ASX LISTED INVESTMENT COMPANY (TICKER: CLF) | MONTHLY INVESTMENT REPORT: FEBRUARY 2019

Fund Description

Concentrated Leaders Fund Limited (CLF) is a concentrated portfolio of leading Australian companies. The CLF investment team uses a top-down macro thematic, quantitative filters and bottom-up fundamental research.

Fund Objective

CLF is a geared listed investment company, which invests primarily in companies within the S&P/ASX 200 Index. CLF is focused on providing investors with capital growth and a consistent yield.

Net Tangible Assets (NTA) as at 28 February

Total Investments	**$111,105,186**
NTA	**$83,031,881**
Shares on Issue	**59,401,545**
NTA per Share (pre-tax) *	**$1.40**
NTA per Share (post-tax)*	**$1.32**
Share Price	**$1.28**
(Discount)/Premium to NTA (pre-tax)	**(8.57)%**
(Discount)/Premium to NTA (post-tax)	**(3.03)%**
Fully Franked Dividend Yield	**6.70%**

* On realized and unrealised gains.

Fund Information

ASX Code	CLF
Date of launch	September 1987
Benchmark	S&P/ASX 200 TR Index

Service Providers

Custodian	National Australia Bank
Administrator	Fundhost Limited
Banker	National Australia Bank
Auditor	Deloitte Touche Tohmatsu
Legal Advisor	Watson Mangioni Lawyers

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Portfolio and Market Review

Investment Performance

Performance as at 28/02/2019 **	1 Month	3 Months	6 Months	12 Months	Financial YTD	Since Inception *
CLF	6.45%	9.57%	2.70%	9.44%	5.25%	10.35%
Benchmark	5.98%	9.95%	-0.26%	7.05%	2.56%	6.95%
Value Add	0.47%	-0.38%	2.96%	2.39%	2.69%	3.40%

* Inception date reflects when management of the fund was internalized as of 1 January 2018

** Gross performance excludes all expenses, fees and taxes. Net performance is reflected in the NTA calculations.

The portfolio returned +6.45% on a gross basis (pre-fees and taxes) in February versus the benchmark return of +5.98% This equates to a 8.53% increase in pre-tax NTA and a 6.45% increase in the post-tax NTA.

For the financial year to date, the portfolio delivered a return of +5.25% on a gross basis versus the benchmark's +2.56% This represents an outperformance of +2.69% in what has been a volatile environment for investors.

Market Review

The S&P/ASX 200 Total Return Index (including dividends) gained 5.98% during February. This brings the calendar year return to 10.08%, which seems extraordinary given the negative sentiment and heightened macro risk which dominated the market in the fourth quarter of last year. At the end of February, the S&P/ASX 200 Index was ~13% off its December 2018 lows.

The local market outperformed most of its global peers during the month with almost all sectors gaining:

- **Financials (+8.1%)** led the market with the big four banks benefitting from a Royal Commission outcome which was more favorable than most in the market expected. Fund managers also rallied strongly on the back of stronger global markets and ongoing 'dovish' US Federal Reserve rhetoric.
- **Materials (+6.1%)** benefitted from a 14.9% surge in the price of iron ore as the fallout from the Vale damn disaster in Brazil continued to flow through to stock prices. The share prices of the big miners (**BHP (+6.9%)**, **RIO (+10.5%)**, **FMG (7.3%)**) also benefitted from the declaration of large special dividends.
- **Healthcare (-2.2%)** was the only sector to finish the month in negative territory after weaker than expected earnings results from **COH (-11.8%)** and **MYX (-13.0%)** negatively impacted the sector. Industry heavyweight, **CSL (-0.5%)**, finished the month approximately flat after an in-line half-year earnings update.

The local half-year reporting season was marginally more negative in aggregate than expected, but certainly not as bad as some market pundits had warned. Aggregate measures however hide several divergences among sectors and amongst intra-sector companies. Resources and Technology companies generally reported stronger than expected earnings, although **WTC (-5.3%)** and **NXT (-8.9%)** where outliers for the latter. Financials and Consumer Discretionary generally underwhelmed in aggregate, although **IEL (+31.3%)**, **WEB (+30.6%)** and **BRG (43.4%)** were outliers in the discretionary sector.

Portfolio Review

The portfolio's outperformance last month was both pleasing and disappointing at the same time. Pleasing from the perspective that after a strong performance in January, we continued to exceed the benchmark return despite being 1) ~20% in cash when the market rallied so strongly; and 2) heavily underweight the three best performing sectors: Financials, Energy and Materials.

- We have been underweight Financials for several months given the Hayne Royal Commission and thought that the recommendations would have been harsher on the major banks given the condemnation that had taken place following some damning testimonies and extraordinary findings. We favor **MQG (+10.4%)** over the other large Financials.
- We have moved to be underweight the large miners in recent months due primarily to the expectation that the Chinese economy would weaken and that demand for iron ore would in turn contract. While this has proven correct, the supply side of the equation changed dramatically with Vale's Brazilian dam disaster. Once the rally was underway, we did not want to chase the market, and as such missed almost all this rally. Our only exposure to the sector is **BHP (+6.9%)**.
- In terms of energy, the price of crude oil rallied ~23% between 24/12/18 and 9/1/19 (~ two weeks). We thought this was too much, too fast and as a result wanted to prudently wait for the market to normalize – unfortunately it kept rallying during February. Late last year however, we did decide to take an indirect exposure to energy via a position in **SVW (+22.6%)** which has a significant holding in **BPT (+15.6%)**. This has offset much of the overall sector underweight.

Our sector weightings ~~however~~ conceal what was an excellent month from an individual stock perspective with several holdings exceeding earnings expectations.

APX (+46.7%) – FY18 revenues increased by 119%, while earnings grew by 153% to $71.3 million (guidance was for $62-65 million). Management guidance to FY19 earnings to be in the range of $85-90 million. Underlying margins and cash conversions rates also improved.

BRG (+43.4%) – A solid result in terms of sales growth and business development despite a difficult consumer environment. Global sales were strong with Europe up 40%, including a significant beat in Germany/ Austria which is a large focus of the business. They expect FY19 earnings growth to be 'slightly higher' than consensus at +11% y/y.

WEB (+30.6%) – Underlying revenue increased 33% y/y, with earnings increasing 16% (21% with FX). The B2B in Europe was particularly strong with revenue increasing 72% and earnings up 136%. Management also delivered an ongoing upbeat outlook for its European business.

SVW (+22.6%) – 1H19 revenues increased 45%, while earnings increased 68% with WesTrac and Coates Hire both producing strong results. SVW also reiterated FY19 guidance of 25% earnings growth.

There were, however, also a couple of disappointments.

MYX (-13.0%) – Profits increased by 15% overall, but this was below consensus forecasts. Revenue from its Specialty Brands Division increased by 213% which was encouraging, but revenue in the larger Generic Products Division fell by 3% with increased competitor activity expected.

NXT (-8.9%) – Underlying earnings grew by 26% y/y, and the company demonstrated strong h/h growth trends. However, management downgraded its revenue guidance slightly to $180-184 million and delivered a statutory net loss after tax of $3.1 million – both of which disappointed the market.

Sector Exposure

Sector	Weight (%)
Consumer Discretionary	15.6%
Consumer Staples	5.9%
Energy	0.0%
Financials	21.1%
Health Care	8.5%
Industrials	12.2%
Information Technology	7.7%
Materials	8.0%
Real Estate	0.0%
Telecommunication Services	0.0%
Utilities	2.1%
CASH/LIQUIDITY	**18.8%**

Top 10 Holdings in alphabetical order

Company	Ticker
ARISTOCRAT LEISURE LTD	ALL
ATLAS ARTERIA LTD	ALX
AUSTRALIA AND NEW ZEALAND BANKING GROUP	ANZ
BHP BILLITON LIMITED (BHP)	BHP
COMMONWEALTH BANK OF AUSTRALIA	CBA
CSL LIMITED	CSL
MACQUARIE GROUP LTD	MQG
SEVEN GROUP HOLDINGS	SVW
TRANSURBAN GROUP	TCL
WEBJET LIMITED	WEB

Outlook

Markets have rallied strongly thus far this year and risk has increased

At the end of January, we wrote that we thought equity markets had moved up too quickly given the macro backdrop, however February proved to be an exceptionally strong month. We reiterate that view with the S&P/ASX 200 Index now trading even higher at an above-average of 15.5x earnings (14.8x at the end of January) and most of the major sectors looking fully valued – especially Financials, Technology, Materials/Miners and A-REITs.

Markets can continue rallying given the positive rebound in sentiment regarding central bank monetary policy and US/China trade negotiations. However, we don't view the risk trade-off as particularly attractive given the apparent weakness in the domestic economy, disappointing earnings updates from domestically focused businesses, ongoing housing weakness and increased political risk as a federal election quickly approaches. This cautious outlook and profit-taking during the month has seen our cash holding increase from 12.1% to 18.8% at month-end.

Conclusion

We continue to think that Australian equities represent an attractive investment opportunity over the medium term, but in the near term the risk/reward potential of the market has deteriorated. As such, we are reluctant side-liners waiting for a better opportunity to re-enter positions when we think that risk is being adequately priced into the market.

We continue to favor both offshore earners and quality yielders who can also deliver some enterprise and/or earnings growth. As such, we think the portfolio is well placed over the medium term for a depreciation of the Australian dollar, relative domestic economic weakness, a lower domestic interest rate and an environment with increased political/regulatory risk.

Important Information