CONCENTRATED LEADERS FUND

ASX LISTED INVESTMENT COMPANY (TICKER: CLF) | MONTHLY INVESTMENT REPORT: MAY 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 Accumulation index. CLF is focused on providing investors with capital growth and a consistent yield.

Net Tangible Assets (NTA) as at 31 May

Total Investments	**$109,110,959**
NTA	**$77,270,606**
Shares on Issue	**59,401,514**
NTA per Share (pre-tax) *	**$1.30**
NTA per Share (post-tax)*	**$1.26**
Share Price	**$1.27**
(Discount)/Premium to NTA (pre-tax)	**(2.31)%**
(Discount)/Premium to NTA (post-tax)	**0.79%**
Fully Franked Dividend Yield	**12.65%**

* 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 31/05/2019 **	1 Month	3 Months	6 Months	12 Months	Financial YTD	Since Inception *
CLF	-2.22%	0.27%	9.87%	6.89%	5.53%	10.65%
Benchmark	1.71%	4.88%	15.32%	11.08%	7.57%	12.18%
Value Add	-3.93%	-4.61%	-5.45%	-4.19%	-2.04%	-1.53%

* 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 -2.22% on a gross basis (pre-fees and taxes) in May versus the benchmark return of +1.71%. This equates to a 7.14% decrease in pre-tax NTA and a 5.97% decrease in the post-tax NTA. The large divergence between the gross portfolio performance and the change in the NTA can be explained by a special dividend of 4 cents per share in addition to the regular quarterly dividend of 1.25 cents per share (total 5.25 cents or 4.92%) being recorded during the month.

For the financial year to date, the portfolio has delivered a return of +5.53% on a gross basis versus the benchmark's +7.57%. This represents an underperformance of 2.04%

Market Review

The S&P/ASX 200 Total Return Index gained 1.71% during the month, which was a significant outperformance of global equities with the MSCI All Country World Index falling 6.1%. The S&P/ASX 200 Total Return Index has now delivered a return of 15.5% for the calendar year-to-date and 7.6% for the financial year-to-date.

The strong performance recorded by the domestic equity market was primarily driven by:

- The surprise Coalition victory in the Federal election,
- Australian Prudential Regulation Authority (APRA) easing lending standards, and
- The Reserve Bank of Australia (RBA) hinting of a June rate cut.

While the June rate cut was generally expected, the other two developments were not and provided a positive shock for the market. Interestingly though, the market had already rallied 13.5% in the first four months of the year, so it is hard to argue that the market was defensively positioned going into the election. Either way, the positive domestic news easily outweighed increased global concerns about trade and the fragility of the global economy.

- **Communications (+7.1%)** was the best performing domestic sector with several participants including **DHG (+21.9%)** and **NEC (+18.9%)** benefitting from the improved outlook for housing related advertising given the positive APRA and RBA policy announcements.
- **Healthcare (+3.5%)** was the next best performing sector with **NHF (+19.1%)** and **MPL (+15.7%)** both benefitting from the Coalition victory. The Labor Party had proposed capping the annual increases in the price of private health insurance at 2% for two years.
- **Consumer Staples (-4.2%)** was the worst performing sector. **CGC (-30.3%), TWE (-12.5%)** and **A2M (-8.0%)** were the major laggards. The latter two were dragged down primarily by their exposure to the Chinese economy and growing concerns about the impact of Chinese consumption if the US-China trade wars escalate.

Portfolio Review

The portfolio experienced its worst monthly performance relative to the benchmark since new management took over responsibility for the portfolio in January 2018. The underperformance was multi-faceted, but the surprise Coalition election victory and the rally in 'election-sensitive' stocks post the result caught us ill-positioned. CLF held none of these companies given the expected Labor victory and our assessment that most of these stocks were low-quality with too much policy risk.

In terms of portfolio positioning and macro factors, some of the key reasons for the underperformance during May include:

- **Overweight cash** – Positioning rationale: Election risk, high valuations, a slowing domestic economy and increased global trade concerns. The *election result and RBA/APRA policy easing outweighed global concerns and saw domestically orientated companies outperform*.
- **Underweight the major banks** - Positioning rationale: Elevated housing risks, increased remediation costs, poor earnings outlook, shrinking interest margins and higher offshore funding costs. The *election result and the RBA/APRA policy easing changed the market's sentiment towards the major banks. This led to major short-covering and momentum buying which overshadowed their ongoing poor fundamentals.*
- **Overweight global growth** – Positioning rationale: Sustainable above-market earnings growth, a depreciating Australian dollar, larger addressable markets and relatively stronger consumers. *Companies with a global focus were more sensitive to trade concerns than domestically orientated companies and hence were more collated with underperforming global markets.*

In addition to these macro and positioning factors, several individual stock holdings also performed poorly. These include:

CGC (-30.3%) – Costa Group lowered its earnings guidance for the second time this year with FY19 net profits now expected to be $57-$66 million from an expected $73 million. The company cited lower prices for mushrooms, 'crumbly fruit' in raspberries, and a fruit fly at its Stuart's Point citrus farm as reasons for its downgrade. This new guidance equates to an earnings growth in the range of 1-16% FY19, which is a dramatic change from 30% projection the company gave only two months earlier.

RWC (-24.8%) – Reliance Worldwide downgraded its FY19 profit guidance to be in the range of $260-$270 million (from $280-$290 million). The company cited 1) a lack of freeze in the US, 2) US retailer destocking and 3) weaker conditions in both Australia and Spain as reasons for the change in guidance.

MYX (-20.7%) – Mayne Pharma gave a trading update which showed that in the four months to April 2019 its reported revenue had fallen by 15% and its reported gross profit had fallen by 20%. This was a surprise given that the company revealed revenue growth of 13% and gross profit growth of 67% at its half yearly results earlier this year.

MQG (-10.7%) – Macquarie Group also weighed on the portfolio as it is one of our largest positions. Macquarie announced a strong FY19 result with profits up 17% to $2.98 billion for the full year, however the outlook for FY20 was more measured with profits forecast to be 'slightly down' relative to FY19.

The portfolio had several decent contributors during the month; however, they were not sufficient to counter the above-mentioned detractors. Yield orientated companies **TCL (3.7%), ALX (1.1%), CHC (5.4%)** and **APA (5.4%)** all performed well. As did **NST (+18.6%)**, which was recently added to the portfolio. Northern Star Resources benefitted from higher gold prices as well as an update stating that the company was focused on growing reserves and lifting production.

Sector Exposure

Sector	Weight (%)
Consumer Discretionary	7.7%
Consumer Staples	4.9%
Energy	0.2%
Financials	18.6%
Health Care	6.5%
Industrials	14.2%
Information Technology	4.4%
Materials	11.4%
Real Estate	2.6%
Telecommunication Services	0.0%
Utilities	3.0%
CASH/LIQUIDITY	**26.5%**

Top 10 Holdings in alphabetical order

Company	Ticker
AMCOR LIMITED	AMC
APA GROUP	APA
ARISTOCRAT LEISURE LTD	ALL
ATLAS ARTERIA LTD	ALX
BHP BILLITON LIMITED	BHP
COMMONWEALTH BANK OF AUSTRALIA	CBA
CSL LIMITED	CSL
MACQUARIE GROUP LTD	MQG
NATIONAL AUSTRALIA BANK	NAB
TRANSURBAN GROUP	TCL

Outlook

We think the domestic economy is weak and will continue to weaken despite the recent interest rate cut by the RBA and the policy easing by APRA. The market has rejoiced the rate cut and the election result, however we do not think either will positively impact the economy in any meaningful way.

1. The Coalition victory simply keeps the status quo, although it does reduce the housing market tail risk, and
2. Cutting rates to ultra-low levels did not work in Japan, US or Europe and we see no reason why Australia should be any different. This is primarily driven by lower cashflows to savers and bond holdings who either must save more to make up the difference and/or operate on lower incomes – both of which are negative for the economy.

The market has rallied strong on the hope (and now delivery) of interest rate cuts and despite the above, rate cuts are generally thought to be positive for asset markets as savers are forced into more riskier assets such as equites. However, on the flipside, people tend to forget that central banks cut interest rates due to economic weakness and this negatively impacts company earnings. As demonstrated by the US equity market which fell by ~-15% and ~-45% respectively during the US Federal Reserve's (Fed) last two rate cut cycles.

Despite the election passing, we still do not think the macro risk, both domestically and globally, is being adequately priced into markets. Additionally, the markets belief that the Fed can rescue any market decline with interest cuts is fundamentally flawed (see the evidence above). As such, we view the current buoyancy in markets with some skepticism, but it is hard to fight momentum in markets like this.

As such, we would like to be more fully invested post the recent policy changes, but the domestic market seems to have priced in the upside with the S&P/ASX 200 Index trading at an earnings multiple of 16x despite these apparent economic and earnings risks. Additionally, the index's dividend yield has fallen to 4.45%, which is close to its lowest level since 2011 – albeit this is still at a significant premium to bond yields.

We have maintained our portfolio positioning such that we are overweight what we call quality yielders which can a) produce some enterprise and/or earnings growth over the medium term, b) deliver stable and growing cashflows, and c) potentially benefit from a low interest rate environment. These companies have benefitted and should continue to benefit from a lower interest rate environment. However, most have already rallied strongly with many being at all-time highs, so we are wary of their current valuations.

We have also maintained our overweight to offshore earners despite their underperformance in May. We think they can deliver superior earnings growth compared to domestically orientated companies, in addition to benefitting from a weaker Australian dollar as the RBA ill-fatedly continues to cut interest rates. This group of companies has performed well for us prior to May and we think that they will add considerable value to the portfolio over the medium term.

We continue to have excess cash which has been a drag on the performance of the portfolio year-to-date given the strength of the rally. We are actively looking to deploy this capital but will not be lured into chasing the market and buying over-priced companies as many other managers have done in recent times. As we did in Q4 last year, at an appropriate time, we will prudently deploy this capital into companies that we think will offer our shareholders sustainable capital growth and/or cashflows over the medium-term.