CONCENTRATED
LEADERS FUND

ASX LISTED INVESTMENT COMPANY (TICKER: CLF) | MONTHLY INVESTMENT REPORT: AUGUST 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 30 August

Total Investments	**$111,066,366**
NTA	**$79,334,177**
Shares on Issue	**59,401,514**
NTA per Share (pre-tax) *	**$1.34**
NTA per Share (post-tax) *	**$1.29**
Share Price	**$1.24**
(Discount)/Premium to NTA (pre-tax)	**(7.46)%**
(Discount)/Premium to NTA (post-tax)	**(3.88)%**
Fully Franked Dividend Yield	**10.37%**

* On realised 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 30/08/2019 **	1 Month	3 Months	6 Months	12 Months	Financial YTD	Since Inception *
CLF	-2.53%	3.05%	3.33%	6.11%	0.46%	14.03%
Benchmark	-2.36%	4.23%	9.33%	9.04%	0.52%	16.93%
Value Add	-0.17%	-1.18%	-6.00%	-2.93%	-0.06%	-2.90%

* 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 -2.53% on a gross basis (pre-fees and taxes) in August versus the benchmark return of -2.36%. This equates to a 3.60% decrease in pre-tax NTA and a 3.01% decrease in the post-tax NTA.

For the financial year to date, the portfolio has delivered a return of +0.46% on a gross basis versus the benchmark's +0.52%. This represents a relative performance of -0.06%.

Market Review

The S&P/ASX 200 Total Return Index lost 2.36% during the month, which was marginally more than global equities, with the MSCI All Country World Index falling 2.2%.

August was a month of two halves with the Australian market falling ~5.5% in the first two weeks of the month before staging a recovery in the second half. This dynamic was witnessed across most global markets with investors growing increasingly concerned about the US-China trade war and the increasing risk of a global recession.

The month of August saw:

1. China announce increased tariffs on $75 billion of US imports, to which the US immediately responded with its own tariff increases on Chinese imports,
2. An escalation of the protests in Hong Kong which has subsequently seen the controversial China extradition bill cancelled,
3. A collapse in bond yields and an inversion of the US 2-10 year interest rate curve, historically a good signal for a future recession,
4. A domestic reporting season which finished marginally worse than expected,
5. Iron ore prices falling 24% over the month on increased Brazilian supply and Chinese steel mills reducing the usage of lump in response to thin steel margins, and
6. Higher domestic house prices suggesting that the market has troughed and the recovery is gaining momentum.

The recovery in the second half of the month was primarily due to hopes that the US and China would re-engage in trade discussions after comments at the G-7 leaders meeting suggested that both countries were willing to negotiate. In addition, the domestic market rallied ~1.7% in the last two days of the month despite any discernable news.

In terms of domestic sectors, Healthcare (+3.4%) and Real Estate (+1.8%) were the best performers in August as investors sought defensive exposure. Materials (-7.8%) and Energy (-6.4%) underperformed in line with underlying commodity prices.

Portfolio Review

The portfolio was outperforming the market by a considerable margin until the final days of the month with the sharp snapback in the domestic market, and the bank stocks in particular, extinguishing our relative performance.

The portfolio's underweight position in underperforming sectors including Materials, Energy, Communication Services and Financials was a contributor to performance. As was our cash holding which should have been of great benefit in a declining market.

However, the reporting season was not kind to us, and the portfolio was impacted by several stocks falling despite delivering reasonable earnings results. In addition, despite reducing some exposure to offshore growth considering the increased trade tensions and the slowing global economy, these allocations have also been a detractor from performance recently.

Major Contributors:

DOW (+6.8%) – Performed well after announcing a 14.7% increase in underlying net profit (NPATA) to $340.1 million in addition to potentially selling its mining business to reduce its capital spending, pay down debt and focus on the infrastructure market. Downer has also now reached an agreement with the South Australian government over the new Royal Adelaide Hospital after two years of negotiations.

TWE (+5.9%) – Rallied after a strong earnings result which showed earnings increased by 19.9% y/y in FY19. It also gave guidance of ~25% growth implying EBITS of ~$663 million.

Major Detractor:

A2M (-20.9%) – Declined sharply despite delivering an exceptionally strong 41% y/y revenue growth and 46% y/y earnings growth which was in line with guidance. Unfortunately, market expectations were too high and there were also concerns about the lack of transparency regarding their marketing spend. Forward margin guidance was lowered.

NXT (-12.8%) – Fell sharply along with most technology stocks early in the month but got hit a second time after reporting a statutory net loss after tax of $9.8 million, compared to a profit of $6.6m in financial year 2018. Revenue and underlying earnings both increased but below consensus expectations.

WEB (-8.8%) – Fell despite delivering a strong earnings result which saw revenues increase 26% y/y, earnings per share increase 36% y/y. Forward guidance however was weaker than expected and softness in the B2C market, low cashflow conversion and a potential downgrade to incremental earnings from Thomas Cook weighed on the stock.

Sector Exposure

Sector	Weight (%)
Consumer Discretionary	6.4%
Consumer Staples	4.2%
Energy	0.0%
Financials	20.2%
Health Care	6.6%
Industrials	12.2%
Information Technology	5.1%
Materials	10.0%
Real Estate	5.4%
Telecommunication Services	0.0%
Utilities	2.9%
CASH/LIQUIDITY	27.1%

Top 10 Holdings in alphabetical order

Code	Company Name	Sector
ALX	ATLAS ARTERIA LTD	Industrials
AMC	AMCOR LIMITED	Materials
APA	APA GROUP	Utilities
BHP	BHP BILLITON LIMITED	Materials
CBA	COMMONWEALTH BANK OF AUSTRALIA	Financials
CSL	CSL LIMITED	Health Care
MQG	MACQUARIE GROUP LTD	Financials
NAB	NATIONAL AUST. BANK	Financials
NXT	NEXTDC LIMITED	Information
TCL	TRANSURBAN GROUP	Industrials

Outlook

Our concerns over the strength of the global economy, the ongoing impact of trade wars, heightened geopolitical risk and the fragility of company earnings have all become an unfortunate reality. In such an environment, we continue to think that it will be difficult for equity markets to rally much further, especially given current valuations.

There is a lot of hope in the markets that central banks will provide additional monetary stimulus and that the US and China will reach a trade deal and that this will drive markets higher. We struggle to see the benefit of lower interest rates when it has not worked anywhere in the world. We have said it before, but if excessively low interest rates helped equities and economies, then Japan, Germany and Switzerland would be experiencing exceptional economic growth and their equity markets would be spectacularly higher – neither is happening.

Valuations are expensive because central banks have created an exorbitant amount of liquidity and investors have limited options with which to deploy it. Investors are being forced to buy expensive assets for cashflow irrespective of the risks. This doesn't seem like a smart or responsible strategy, but it is unfortunately the investment world that we current live in. It is likely to end badly but the timing is uncertain as central banks, politicians and investment pundits are highly incentivized to keep valuation high and volatility low. As we saw with the Global Financial Crisis (GFC), however, is that this is ultimately unsustainable and markets will need to rebalance.

We consider this to be a difficult investment environment given high valuations, multiple market risks and weakening earnings fundamentals are being countered by excess liquidity, low interest rates and a lack of investment options. As we have said for a number of months, with the Australian equity market up ~21% since the start of the year despite weakening fundamentals, we do not think that this is the appropriate environment to be deploying our available leverage and we continue to have a large cash balance.

We maintain a balanced portfolio and are overweight quality yield stocks which should continue to benefit from a lower interest rate environment. However, these have rallied hard since the Reserve Bank of Australia (RBA) cut interest rates and are not as attractive as they once were, with dividend yields reaching record lows for many of these stocks.

We also remain overweight offshore growth companies despite the weaker global economic environment as we think they can deliver superior earnings growth compared to domestically orientated companies over the medium term. They are however creating short term portfolio volatility as they demonstrate high beta to global markets, but they should benefit from a weaker Australian dollar if the RBA continues to cut interest rates or if the price of iron ore continues to fall.

Important Information