Blackwattle Large Cap Quality Fund

August 2023

Blackwattle
Investment Partners

About the Fund

We aim to buy businesses with a competitive advantage and good corporate governance, priced below intrinsic value at the right price.

The fund aims to outperform the S&P/ASX200 Total Return Index (after fees and before taxes) over the long term. Fundamental research and sound risk management drives fund investments. Risk is managed through portfolio diversification, strict exposure limits and process discipline.

Blackwattle Investment Partners

Blackwattle is a new generation, highly aligned, Australian investment manager investing in quality businesses and people.

Alignment
Shared staff ownership, zero personal trading, profit and personal salary reinvestment, and most importantly significant personal investment alongside our clients.

Quality
We aim to buy businesses that have a forward advantage, trustworthy aligned management, priced below intrinsic value.

Trust
We believe that honesty and transparency builds trust with our clients, stakeholders, and community.

Invest Better. Live Well.

Key Information

Fund Name	Blackwattle Large Cap Quality
Inception Date	August 2023
Typical number of stocks	30-45
Cash limit	10% (typically +5% to -5%)
Cash Distributions	Semi Annually
Redemptions	Daily
Constrained Capacity	$5.0b
Objective	The Fund aims to outperform the S&P/ASX 200 Total Return Index (after fees and before taxes) over the long term.

Portfolio Managers

Ray David B.Eco, Gdip Fin
20+ years' investment experience. Previously Portfolio Manager Long-Short Schroders, and Director of Emerging Companies UBS.

Joe Koh B.Bus, CFA
25+ years' investment experience. Previously Portfolio Manager Long-Short Schroders, and for Regal across Absolute, Market Neutral and Long-short funds.

Fund Performance[1]

Blackwattle Large Cap Quality Fund Performance (net of fees) as at 31 August 2023

	1 month	3 months	1 Year	2 Years p.a.	5 Years p.a.	10 Years p.a.	Inception p.a[2]
Fund (Net)	0.05%	-	-	-	-	-	0.05%
Benchmark[3]	0.64%	-	-	-	-	-	0.64%
Active Return	-0.59%	-	-	-	-	-	-0.59%

[1] Returns are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance. Source: Apex.
[2] The inception date for the Fund is 8th August 2023.
[3] S&P/ASX200 Accumulation Index

Top 5 Holdings

Commentary and Outlook

Despite the surge in living costs and 12 successive increases in the cash rate to 4.1% since April 2022, the consumer was out in full force in the June half. During this reporting season, low expectations were met with better-than-feared results, leading the Consumer Discretionary index to outperform in August (+5.7%). Investors are now wondering if the consumer can keep climbing up this tightening cycle, warranting the recent outperformance.

Our view is retailers are fragile businesses in the best of times, and the sales base (except for travel) is elevated relative to history. Given the current tightening cycle is the most aggressive since the mid-1980's, we expect pressure will build in the all-important December half, especially for discretionary household retailers. The lags of the fixed rate mortgage roll off have cushioned the impact of rising rates to date, however by December, mortgage payments as a percentage of income will hit a record high of 42%.

Corporate Australia reported earnings mostly in line with expectations, with only 31% of companies missing (and about as many exceeding expectations). Operating margins have started to contract, as wages were the most significant headwind, partially offset by falling input prices. Interest cost burden increased to levels not seen since 2011, with the REIT sector hit the hardest given a limited ability to reduce costs and highly geared balance sheets. With a deteriorating outlook and geared balance sheet structures, the fund retains an underweight across the REIT sector.

Corporates with pricing power, such as Carsales (+13%), REA Group (+5%), and Brambles (+5.5%), in which the fund is overweight (REA through Newscorp +12%), reported strong results, aided by mid-single to low double-digit price growth, well ahead of inflation. While double-digit price growth always raises the spectre of incentivising increased competition, these businesses operate network models that are difficult to replicate, benefiting from higher barriers to entry.

The cost to build anything, whether mining development, housing, or infrastructure, has skyrocketed since the pandemic. The implication is that incentive pricing and required returns to bring on new supply will be significantly higher than pre-Covid. Commodity prices are likely to be supported by rising cost curves and capital costs, and any mine or productive asset developed pre-Covid now has a capital advantage.

Portfolio positioning

Underweight positions across consumer discretionary stocks and overweight positions in Coles (-11%) and Resmed (-24%) detracted from fund performance. For Coles's, the company over-indexed to a rise in theft (+20%) and shrinkage, which impacted gross margin, falling short of market expectations. To us, rising theft is clearly the canary in the coal mine for a consumer under pressure, bolstering the case for underweight positions across the sector. Despite our sombre view on the consumer, the fund does own Harvey Norman (+6%), as the valuation of the property holdings now exceeds the market capitalisation. The fund bought into Resmed after the stock sold off following a weak quarterly result. Share price weakness (-12%) persisted on concerns the number of patients with sleep apnoea could diminish in the future given the rising popularity of weight loss drugs (such as Ozempic).

Reporting season is always volatile for share prices, as it's easy to get caught up in assuming the best- or worst-case scenario when prices are moving aggressively. In fact, this August reporting season was the most volatile since 2011, highlighting the short-term focus of market participants on earnings revisions. Ultimately, company valuations are governed by their long-term cash flow and the duration of a business's return profile relative to the cost of capital. Our job is to find the companies where there is a mismatch.

Regards,

Joe and Ray.

How to Invest

To invest click on the link www.blackwattlepartners.com/invest/ or call 02 7208 9922.

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