Blackwattle Large Cap Quality Fund

February 2024

Blackwattle Investment Partners

About the Fund

Our investment philosophy is to own businesses with a competitive advantage and good corporate governance, priced below intrinsic value.

The fund aims to outperform the S&P/ASX 200 Accumulation Index (after fees and before taxes) over the long term. Quality companies at low or reasonable valuations underpin overweight positions while poor quality companies with high valuations facing near-term pressures underpin underweight positions. Risk is managed through portfolio diversification, strict exposure limits and process discipline utilising our proprietary valuation and portfolio construction tools.

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	30-55
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 29 February 2024

	1 month	3 months	6 months	2 Years p.a.	5 Years p.a.	10 Years p.a.	Inception p.a[2]
Fund (Net)	1.75%	9.70%	7.72%	-	-	-	7.77%
Benchmark[3]	0.79%	9.39%	7.42%	-	-	-	8.10%
Active Return	0.95%	0.31%	0.30%	-	-	-	-0.33%

[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 Active Holdings

Market Commentary

The S&P/ASX 200 Total Return Index increased by 0.8% in February and is now up 10.6% on a rolling one year.

While positive, the ASX200 has lagged US equity markets, with the S&P 500 and Nasdaq up 26% and 47%, respectively, over the year. The underperformance of the ASX 200 is highlighted by a much higher equity risk premium on offer, which is a measure of relative value to interest rates. The ASX 200 equity risk premium of 3.8%[1] compares favourably with long-run averages, while the USA equity risk premium of 2.4% is well below long-run averages.

The outperformance of global equity markets over the ASX 200 is driven by the strength of international technology companies (Nvidia) and more aggressive expectations of US interest rate cuts than in Australia.

Interest rate expectations are being set by moderating inflation, which in the USA was 3.1% annualised in January. Remarkably, the Federal Reserve has achieved this without significantly impacting employment. Core CPI in Australia is more elevated at 4.1%, reflecting a less dynamic labour market structure and nuances around housing inflation calculations.

China's economic policies also continue to weigh on the ASX 200 given its heavy commodity representation. We expect any China policy adjustment (which is more likely than not) to reignite economic growth which, coupled with interest rate cuts in developed countries, will spur global funds to reallocate to Australian equities. We are already seeing some early signs of this, as the ASX200 index is often seen as a proxy for Asian economic growth.

February was a significant month for the ASX market and equity portfolios, not because of the arrival of Taylor Swift in Australia but due to the plethora of news flow that accompanies the bi-annual reporting season that just passed.

While ASX disclosure rules should generally lead to few surprises, market volatility is always heightened during this month. Investors, and more notably quantitative/programmatic traders, are quick to react to "earnings beats and misses" or outlook statements contradicting analysts' forecasts.

The median share price movement of +/-4% of companies reporting on the day was near an all-time since the GFC, continuing the trend of higher volatility that took place in the June 2023 reporting period.

Some statistics from the February 2024 reporting season:

- 18% of companies reporting saw their stock prices increase/decrease by +/-10% on the day.
- Median and aggregate market EPS revision was +2% and + 4%, respectively.
- One-off items accounted for 25% of underlying earnings, prominent in resources and REITS.
- 28% of companies experienced a +/- 10% change in price earnings ratio.
- 18% of companies mentioned they are embracing artificial intelligence.
- The total mention of M&A ambitions increased by 20% year over year.

One notable trend we also saw was a pickup in corporate activity.

Since December 2023 there has been $31bn of takeover activity. Of more interest to us is that this activity has been spurred by trade buyers, who typically enter the foray late in the cycle, after private equity money.

This time around, it appears private equity has been absent and left hanging somewhere in a *Blank Space*. This could be reflective of current funding costs, or what's to come in a lower interest rate environment.

We also saw an increased number of companies mentioning "strategic review", which was met with positive investor enthusiasm, or short sellers covering, as the prospect of takeover activity gathers pace.

During the month, the strongest performing sectors were interest rate-sensitive sectors, despite an uptick in long term bond yields.

The IT/technology index was up 19% in the month. *Call it What You Want*, but we suspect investor enthusiasm of technology stocks was aided by the euphoria around artificial intelligence and Nvidia's eye-watering performance.

Renesas' knockout bid for Altium (ALU) also got investors thinking about who else could be the next *Big Star.*

The Consumer discretionary sector also performed strongly up 8% for the month, led by better-than-expected trading updates. Despite successive interest rate rises and cost of living pressures, consumers were able to *Shake it Off*, leading to positive EPS revisions across the board.

The Financials index also outperformed, up 2.8% in the month. During the period Commonwealth Bank (CBA) updated the market, which showed sound credit quality and a resilient net interest margin. The effect of higher interest rates doesn't appear to be impacting either retail spend or indebtedness levels yet, though perhaps this may change in *August*.

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[1] Equity risk premium as 29/2/2024, Source ASR

Due to lower realised prices and higher costs, the materials and energy sectors experienced a *Cruel Summer*.

The materials index declined 5%, while the energy index declined 6.7%. At current commodity prices, especially those of lithium, alumina, manganese, and base metals, returns on new projects aren't far off the cost of capital. This will have implications for future forecast supply growth.

Portfolio Commentary

The Blackwattle Large Cap Quality Fund returned 1.75%, outperforming the benchmark by 0.95%.

Our holding in Altium (ALU) contributed to outperformance. The rationale for holding Altium centred on the company's dominant position in the PCB design software market, particularly within smaller enterprises. We anticipated strong revenue growth from Altium's evolving product suite, as well as the growing need for circuit boards due to the artificial intelligence investment cycle.

As with other SAAS journeys, the shift to cloud-based products would also underpin higher average customer revenue over time. But more exciting was the growing penetration within enterprise customers, where revenue per customer was substantially higher.

As a global leader subject to a previous offer from Autodesk in 2021, we believed Altium's software would be well sought after, particularly as hardware and software systems converge in an increasingly digital world.

Also contributing to performance was a long position in Reliance Worldwide (RWC). As a manufacturer of leading behind-the-wall plumbing supplies, particularly push-to-connect products, Reliance's valuation had been marked down due to market concerns regarding large customers seeking supply chain savings.

We believe these concerns would be balanced by customers valuing the security of supply over cheaper imports. Leveraging its domestic network of manufacturing plants, Reliance is better positioned to meet the stringent quality and logistical service requirements of major retailers like Home Depot.

Additionally, we expect Reliance to benefit from an eventual uptick in renovations following a post-COVID lull.

The fund also benefited from overweight positions in several discretionary retailers, namely ARB Corporation (ARB) and Premier Investments (PMV). These two businesses are very high-quality retailers led by excellent stewards aligned with high levels of equity ownership.

Our thesis for owning these companies is also underpinned by both ARB and Premier Investments' differentiated offerings and strong global presence, which have taken years, if not a few decades, to build.

Premier Investments, in particular, while owning mature apparel brands such as Just Jeans and Jacqui E, houses hidden growth brands such as Smiggle and Peter Alexander. These are undervalued due to the market applying a conglomerate discount, placing the group on a low 13x price-to-earnings multiple. A strategic review might unveil these brands' growth prospects, potentially leading to a higher valuation, like Lovisa (LOV) and Breville Group (BRG).

The fund benefited from an overweight position in Carsales (CAR). The company's continuous product innovation in the domestic business, catering to price-sensitive dealer customers, has led to a unique suite of products in the auto classifieds sector.

Innovative offerings such as dynamic pricing and digital retailing/trade-in and Guarantee position Carsales well to deploy these products in offshore markets, particularly across recently acquired Trader Interactive.

Outlook

Looking ahead, we acknowledge increasing takeover activity bodes well for investors focusing on the intrinsic quality of a business and prevailing valuations. This forms the bedrock of our process. For example, if a business with strategic assets faces transient issues, it's more likely to attract potential suitors that may enhance shareholder returns through improved stewardship.

This played out in our recent holding in Boral (BLD).

For anyone seeking a history lesson in identifying takeover candidates, they would do well to read "Barbarians at the Gate"—an all-time favourite of mine that chronicles the buyout of RJR Nabisco. Joseph and I believe there are a few wayward RJR Nabisco companies on the ASX (and in our portfolio) with strategic and valuable assets, which, could become targets if the takeover wave continues.

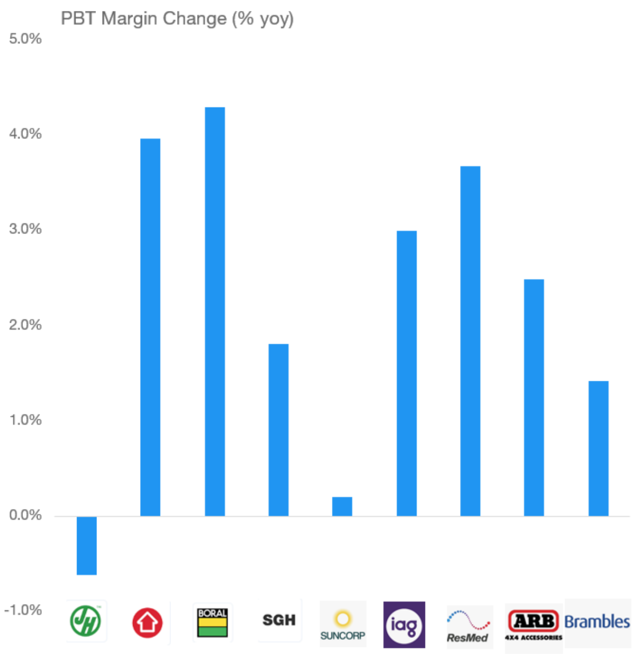
Conversely, businesses with challenged underlying economics or inflated valuations are less likely to attract potential suitors. Businesses with weak business models and poor cashflows are unlikely to be leveraged up in a buyout. Companies trading on excessively high multiples are also less likely to be bought out.

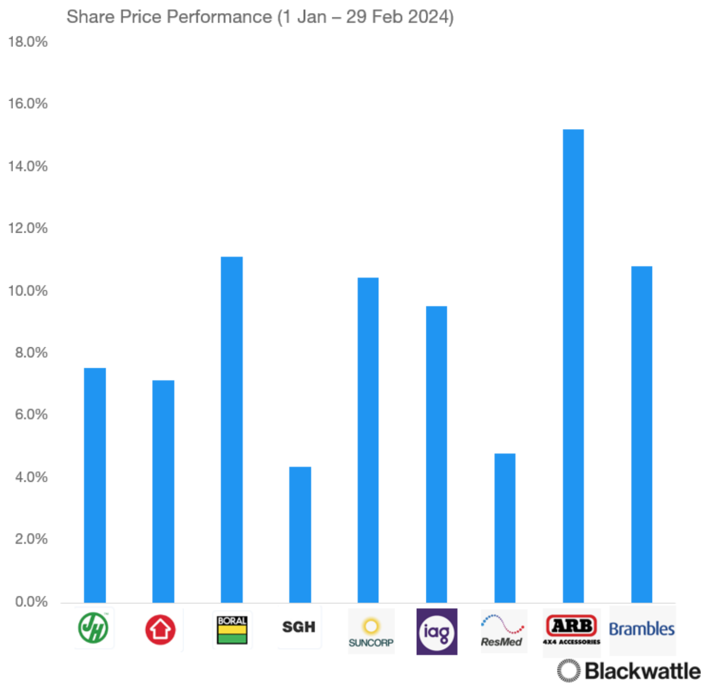
The heightened market volatility observed during the reporting season underscores the influence of fast money in the markets. For investors with a longer-term view of fundamental value, this volatility presents an opportunity to acquire outstanding companies at discounted values. Conversely, fast moving prices of companies lacking a sustainable competitive edge are prone to result in capital losses when the market aligns with reality.

Chart of the Month

The February 2024 reporting season once again showed the benefit of pricing power that better quality companies can assert in the face of rising costs or slowing volumes.

Pricing Power and Inflation – Divergent Margin Performance (Winners)





* Source: Blackwattle Investment Partners Research, IBES consensus forecast, Share price performance 31/12/23-29/2/24

How to Invest

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

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