Blackwattle Large Cap Quality Fund

April 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 (or up to 25bps of the benchmark)
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 30 April 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)	-2.70%	2.91%	15.45%	-	-	-	9.00%
Benchmark[3]	-2.94%	1.04%	15.17%	-	-	-	8.37%
Active Return	0.24%	1.87%	0.28%	-	-	-	0.63%

[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 declined by 2.9% in April, reversing gains from March.

Equity markets responded to a third consecutive month of CPI surpassing expectations in March, reaching 3.5%.

While inflation is proving more persistent than anticipated, the silver lining for investors is economic growth and corporate earnings, crucial inputs into equity valuations, have also been remarkably resilient. This is an astounding achievement considering the rise in interest rates over 2022-23 has been one of the most aggressive and fastest tightening cycles since 1988-89.

In normal times, investors cheer on robust economic conditions and resilient corporate earnings. However, “a lack of progress on inflation in recent months," to quote Federal Reserve Chairman Jerome Powell, was contradictory to market expectations.

The year's rally in risk assets and equity markets was rooted in previous expectations of five to seven interest rate cuts, a narrative now adjusted to only one rate decrease before November.

It is this waxing and waning of investor expectations and sentiment that can drive short-term market volatility, creating opportunities for active investors. We don’t profess to be experts in economic forecasting, but what we can do is price risk and odds when they are in or out of our favour when assessing investment opportunities.

Such is the flippant nature of forecasting; some market commentators are now calling for higher interest rates. While a possibility, the probability is moderate in our view, as there are signs that tighter monetary policy is beginning to take effect.

Recent updates from supermarkets underscore a consumer base more attuned to promotions, exhibiting value-seeking behaviour than ever before.

Personal savings rates have plummeted to a new low of 4%, significantly below pre-COVID levels of 6-7%. Meanwhile, Australian credit card balances are on the rise for the first time since 2020, while in the USA, credit card debt has soared 10% in 2023, reaching an all-time high of $1.1 trillion. These trends, reflective of a consumer grappling with higher rates and cost-of-living pressures, suggest a potential slowdown in consumption and business investment may not be far off, eventually alleviating inflationary pressures on the economy.

Central banks continue to walk a tightrope, balancing inflation, and growth. To date, the moderation of inflation without damaging the economy has been engineered much better than anyone would have predicted.

To borrow a metaphor from AMP economist Shane Oliver, monetary policy lags are akin to turning on the hot water in a shower. The more you adjust settings without waiting for temperatures to adjust, the more you risk getting scalded.

Amidst this backdrop, market volatility is likely to persist until a clear trajectory for monetary policy and the economy emerges.

Though discomforting, such volatility may unveil opportunities to acquire quality companies at more appealing prices, previously unattainable due to our aversion to inflated valuations.

To quote Morgan Housel;

“Valuation changes have a majority impact on your overall returns early on because company earnings are likely the same or marginally higher than when you made the investment. But as earnings compound over time, changes in any given year’s valuation multiples have less impact on the returns earned since you began investing.”

To date, we have been taking advantage of higher market volatility, selectively adding to companies with quality characteristics when valuations are depressed and reducing positions in companies where valuations have reached excessive levels.

Portfolio Commentary

The Blackwattle Large Cap Quality Fund fell by 2.7%, outperforming the benchmark by 0.24% after fees.

ResMed (+10% in the month) remains the funds top active position, contributing to outperformance. ResMed delivered a result that was above market expectations, alleviating market concerns on the threat of GLP drugs.

The company in our view is one of the most innovative medical equipment providers globally and has a history of reinventing itself under the leadership of Michael Farrell. This innovation is showcased by cloud connectivity now spanning 25m devices providing data to payers, digitally enabled resupply programs which aid distributors, and market leadership in sleep apnoea treatment while competitors have stumbled.

To not waste a crisis, ResMed has turned the GLP threat into an opportunity. Patient funnel flow into CPAP diagnosis is accelerating due to ResMed’s efforts to raise awareness of the combined benefits of GLP weight loss therapy with its CPAP products.

In addition, profitability is accelerating due easing freight inflation, and the transition to ResMed's new Airsense 11 platform. This platform is a meaningful step up from the previous CPAP platform, featuring increased connectivity functions such as personal therapy and care check-in settings which have been years in development.

For context, the fear around GLP drugs saw ResMed de-rate from a valuation ratio of 44x forward EPS in 2021 to 20x Forward EPS in 2023. Even after the recent share price outperformance, ResMed's forward PE of 24x is still at a hefty discount to the 10-year average.

We still consider this an attractive valuation relative to ASX Industrials given ResMed generates superior returns on capital, generates strong cashflow, and has tailwinds from an aging population and obesity rates, despite the birth of the GLP drug class.

We also believe the competitive landscape will be benign for some time as its likely to take years for Phillips to build back trust given its high-profile recall. The situation with Phillips reminds me of my first stock I started covering in 2002, Blackmores (BKL).

At the time I completely underestimated the years of benefits that Blackmores would enjoy following a major recall by its competitor Pan Pharmaceuticals. For businesses such as ResMed, brand trust is as important as the product's efficacy, given the conservative nature of sleep physicians recommending CPAP products.

Detracting from performance was the fund's position in James Hardie (JHX), which declined 12% during the month. The rise in the US 10-year bond yield to 4.6% has led to higher 30-year mortgage rates, which have reached 7.2%. This is the highest level since 2009 and will likely have a dampening effect on James's Hardie's end markets of new home construction and renovations in the short term.

Despite this, there are still signs of pent-up demand. An underbuild in homes since the GFC has market analysts estimating a shortfall of 3 million homes in the USA. Renovations are also likely to be underpinned by an aging stock of homes which will require new siding at some point, as 35% of housing stock was built pre-1969 and 14% pre-1979 built, mostly with wood and stucco. As rates ease, we expect James Hardie to enter a strong upturn in activity given these factors.

Also weighing on investor sentiment to James Hardie is rising input costs. While this may be a short-term headwind to earnings, countering this is in our view is James Hardie's scale and trusted branded status, which should translate into a high degree of pricing power as a potential offset.

Rather than fret about short term quarterly results, our approach is to use market volatility to either add or decrease the position size in the fund based on our assessment of market price at the time compared to our estimate of intrinsic value. The market's focus on short term quarterly results presents an opportunity for those investors who can take a longer-term view, especially when the earnings power of a company is fundamentally unchanged.

Outlook

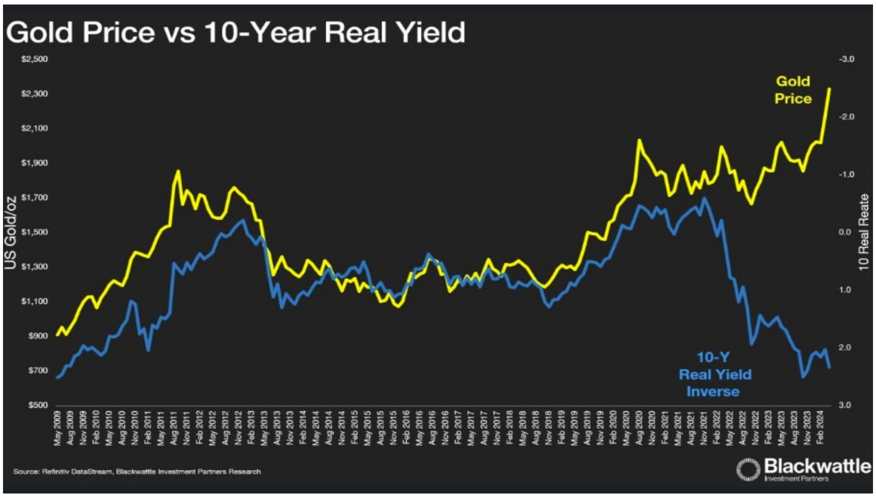
We remain optimistic that several long portfolio holdings which have not contributed to performance should benefit from self-help initiatives given renewed boards/management teams that have a greater focus on shareholder returns.

In addition to this, we continue to see compelling value within the mining sector, which we believe will eventually benefit from a lift in commodity prices (which we are starting to see) given a dearth of investment, supply shortages and demand from decarbonisation. Our patience is supported by these holdings having long life assets, strong balance sheets and with mining operations that are in the first or second quartiles of the cost curve.

Ray David, Joseph Koh and David Meehan

Chart of the Month

Gold has broken its long-term inverse correlation with real yields. No one actually knows why, but it has. This has bought out a few gold bugs, and gold companies eager to engage in capital market activities. It is hard for us to get too excited by gold mining companies as these businesses are generally depleting by nature, which tends to stoke the need to engage in value destructing mergers and acquisitions.



How to Invest

To invest click on the link www.blackwattlepartners.com/invest/
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