Blackwattle Long-Short 130/30 Quality Fund

Blackwattle Investment Partners

June 2024

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 short 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 Long-Short 130/30 Quality
Inception Date	August 2023
Typical number of stocks	35-55 Long, 15-25 short
Cash limit	30% (typically +10% to -10%)
Cash Distributions	Semi-Annually
Redemptions	Daily
Constrained Capacity	$1.0bn
Objective	Outperform the benchmark (after fees) 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 Australian Long-Short 130 30 Quality Fund Performance (net of fees) as at 30 June 2024

	1 month	3 months	6 months	1 Year p.a.	2 Years p.a.	3 Years p.a.	Inception p.a[2]
Fund (Net)	0.56%	-0.64%	6.35%				12.24%
Benchmark[3]	1.01%	-1.05%	4.22%				10.47%
Active Return	-0.45%	0.42%	2.13%				1.77%

[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 8 August 2023. [3] S&P/ASX 200 Accumulation Index

Track Record of Investment Strategy

Historical performance of the investment strategy applicable to the fund[4] (net of fees) as at 30 June 2024

	1 month	3 months	6 months	1 Year p.a.	2 Years p.a.	3 Years p.a.	Inception p.a[2]
Fund (Net)	0.56%	-0.64%	6.35%	13.90%	13.08%	9.94%	14.41%
Benchmark[3]	1.01%	-1.05%	4.22%	12.10%	13.43%	6.37%	10.65%
Active Return	-0.45%	0.42%	2.13%	1.80%	-0.35%	3.57%	3.76%

[4] The Blackwattle Australian Long-Short 130/30 Quality Fund (Fund) has been operating since 8 August 2023. The Fund employs the same Long Short strategy, investment philosophy and investment universe that was used by Ray David and Joseph Koh who managed the Schroder Australian Equity Long Short Fund. To give a longer-term view of our performance using this investment strategy, we have shown longer returns for the Schroder Australian Equity Long Short Fund. Schroder Investment Management Australia Limited, ABN 22 000 443 274 was the responsible entity of the Schroder Australian Equity Long Short Fund and was managed by the investment team whilst they were part of the investment team at Schroder Investment Management Australia Limited. Returns shown for the period from 27 August 2020 to 31 March 2023 reflect the returns of the Schroder Australian Equity Long Short Fund calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation (historical performance). This historical performance has been provided for information purposes and has been adjusted to reflect the ongoing fees applicable to the Fund. Past performance is not a reliable indicator of future performance.

Top 5 Active Holdings

carsales ResMed RioTinto Telstra The Lottery Corporation

Market Commentary

The ASX 200 accumulation index increased by 1% in June, bringing total returns to 12% for the past 12 months. Considering official cash rates are near pre-GFC peak levels and inflation has persisted longer than expected, it's been a good year for equity investors.

The standout performance of ASX technology stocks mirrors that of the US market, where returns have been driven by mega-cap technology names as broader earnings growth becomes harder to achieve in tighter financial conditions.

For the year, the top three best-performing ASX stocks over the 12 months to June 2024 were: Pro Medicus (+119%), Altium (+86%), and Goodman Group (+75%).

Observing S&P 500 EPS expectations, earnings for S&P 493 (excluding the "Magnificent 7" companies) have been flat since January 2023. Meanwhile, earnings expectations for the Magnificent 7 have increased by 320%, largely due to Nvidia.

On the ASX, a similar dynamic is unfolding where the top 10 ASX companies have a flat earnings profile, except for Goodman Group (GMG). Goodman Group (GMG) has positioned itself to benefit from data centre demand, as land previously earmarked for industrial property has been pivoted to develop hot shell data centres with secured power.

Takeover activity also increased over the year, propelling several stocks, including Altium, CSR (+77%), and Boral (+51%), into the top ten best performers. IPO activity was revived by Guzman y Gomez (GYG), which listed at a 38% premium to the issue price, valuing the company at $3bn.

On the other hand, investor enthusiasm for electric vehicles and associated beneficiaries waned significantly, with the bottom three performing stocks in the ASX 100 being Liontown Resources (-68%), IGO Limited (-61%), and Arcadium Limited (-51%). Investors were reminded of the adage that high prices cure high prices as new supply flooded the market.

Australian banks also outperformed relative to the ASX 200, driven by optimism that bad debts will stay at cyclically low levels and through ongoing share buybacks. This optimism contrasts with the experience of UK and Canadian banks, where investors have been more concerned about rising bad debt levels and soft economic conditions.

While bad debt levels in Australia are minimal, savings rates have plummeted, and credit card debt is growing again. For bad debts to remain at cyclical lows, interest rate reductions will be needed, or earnings are likely to come under pressure. That said, skyrocketing Australian house prices continue to provide mortgage holders with a buffer and an ever-growing source of wealth, thanks to record migration and a housing undersupply.

For the year, Commonwealth Bank (CBA) delivered investors a 32% return compared to the ASX 200's 12%. This outperformance was entirely driven by the PER valuation increasing from 17x to 22x. Compared to JP Morgan (JPM) at 12.8x PER or Lloyds Banking Group (LLOY) at 9.0x PER, this makes CBA one of the most expensive banks in the world.

Portfolio Commentary

The Blackwattle Long Short Quality Fund increased by 0.56% in June, underperforming the benchmark by 0.45%.

ResMed (-7%) detracted from fund performance, as it sold off after Eli Lilly released results of its study on GLP-1 drugs, which showed a 63% reduction in the apnoea hypopnea index (AHI). While it seems AHI could be resolved by GLP-1's, potentially impacting demand for CPAP, a closer look at the study results show a large share of patients in the trial remained with moderate AHI, an improvement from severe. Post-study discussions with sleep physicians indicate that moderate AHI would still require intervention, likely from a combination of GLP-1 and CPAP therapy.

Conversations with physicians and insurers also indicate that side effects such as nausea and diarrhea make GLP prophylaxis treatment difficult to comply with. Without a lifestyle change, weight loss trends are fleeting. Medibank even commented that bariatric surgery rates are increasing again due to the side effects associated with GLPs. Feedback from sleep physicians indicates that demand for CPAP remains strong, as patients seeking GLP treatment are also being prescribed CPAP given the benefit of combined treatment.

Mineral Resources (-24%) detracted from performance due to its exposure to weakening lithium markets. While lithium mining accounts for 30%-50% of the valuation (the upper level when including mining services), high debt levels due to the construction of the Onslow Iron Ore project has unsettled investors. During the month, Mineral Resources announced the sale of a 49% interest in the Onslow Iron Haul Road for $1.3bn. The proceeds, in addition to funds from divestments of holdings in listed companies (AZS, DVP), should see debt levels decline, providing further balance sheet capacity to ramp up Onslow Iron Ore production from 35mt to 50mt over 2024-25.

Onslow Iron is the first new major iron ore project in Australia, developed for $3bn (35mt) that will have a C1 cost of A$45/t, including the cost of mining services and logistics 100% paid to Mineral Resources' mining services division. On this rare occasion, the project is on time and on budget, a testament to Mineral Resources' engineering capability. At stage1 ramp-up (35mt), Mineral Resources' share of the project should generate shareholders $670m to $1.2bn of EBIT based on an iron ore price of US$80/t to US$105/t.

Currently, lithium markets are oversupplied following the response to 2022 boom-time prices, and it will take time for markets to balance. Our research indicates that Chinese lepidolite all-in cash costs are near US$10,200/t, translating into a SC6 spodumene price of US$962/t. African costs are also near the US$900/t-US$1000/t levels, close to current SC6 spodumene prices of US$980/t.

At current prices, new projects, such as Pilbara Minerals (PLS)'s P2000, don't stack up (ROIC <11%), with PLS banking on a real SC6 price of US$1500/t. If prices continue to decline, this could illicit a supply response, however developments by Liontown (LTR) and Wesfarmers (WES) Covalent Lithium are still progressing. This highlights the importance of owning tier 1 assets that are low on the cost curve, such as those of Mineral Resources and IGO Limited (IGO).

Outlook

It is becoming clear that economic conditions are slowing, and the ability to lift prices to offset inflation is becoming more challenging. This is distinct from the conditions in 2022-23, where most industries were able to pass on cost inflation, with some sectors even recording profit margins, such as consumer discretionary, banking, consumer staples, and select industrial companies.

The underperformance of telecommunications, healthcare and materials sectors is starting to create opportunities to add companies to the portfolio at valuation levels we haven't seen for some time. We believe that reduced expectations and lower valuation multiples should mean reduced investment risk for our portfolio, particularly if the balance sheet is strong and companies possess a durable competitive advantage with aligned management.

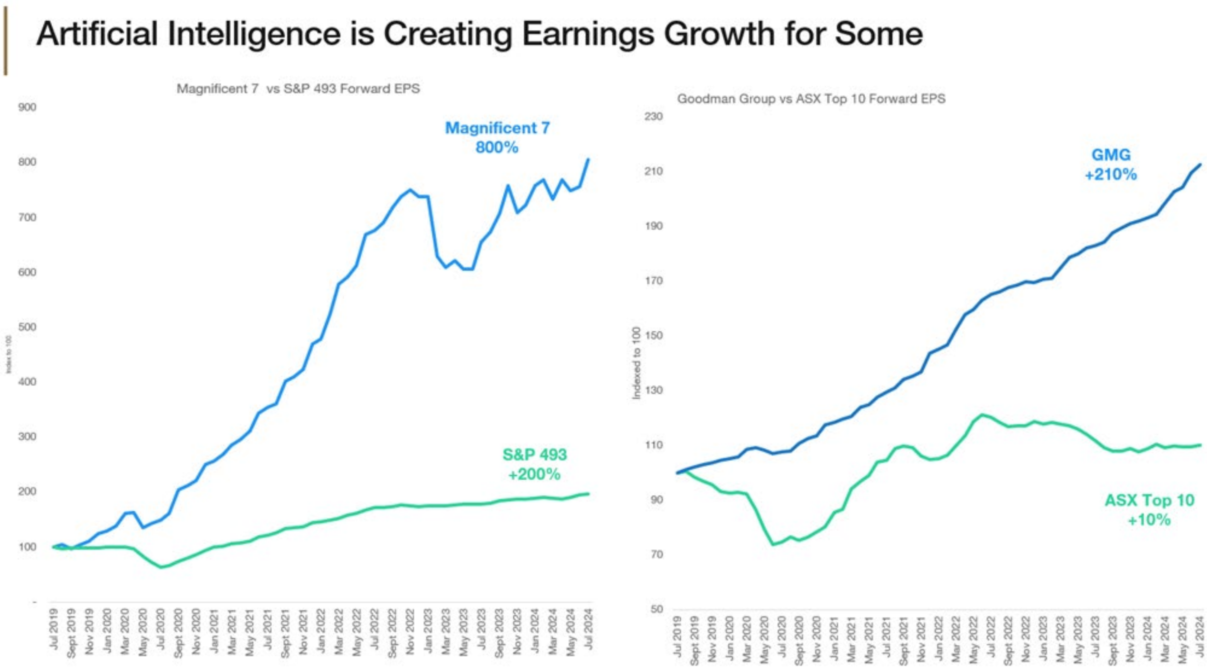
In our view, it's unlikely that yesterday's winners, such as banks and consumer discretionary sectors, will continue to maintain record profit margins as conditions slow. For the technology sector, business models are more robust and less economically cyclical, but we are wary of elevated valuation multiples, which could compress if business models face their own GLP-1 moment.

As the top winners and losers list of 2024 shows, investor expectations play a significant role in setting market prices, and yesterday's winners can become today's losers. For the active manager, investor schizophrenia around short-term earnings headwinds can create opportunities to pick up companies out of favour and reduce positions in companies that have become overpriced.

Ray David, Joseph Koh and David Meehan

Chart of the Month

Artificial intelligence has driven EPS growth for the Magnificent 7. On the ASX, Goodman Group (GMG) has also been a beneficiary.



Source: IBES Estimates, Blackwattle Investment Partners Research

How to Invest

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

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