Blackwattle Large Cap Quality Fund

July 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.

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 31 July 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)	4.47%	5.72%	8.79%	-	-	-	15.23%
Benchmark[3]	4.19%	6.21%	7.31%	-	-	-	15.10%
Active Return	0.28%	-0.50%	1.48%	-	-	-	0.13%

[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 ASX 200 accumulation index returned more than 4% in July – a strong month by any measure. Investors were buoyed by relatively tame inflation numbers released for June, both in the US and Australia, paving the way for interest rate cuts by respective central banks.

Consumer Discretionary was the strongest performing sector in the market, with updates from retailers such as Accent and Universal Store showing strong same-store sales growth: +4.1% and +6.6% respectively for 2H24, representing a material acceleration from 1H24 growth rates in each case. These data points indicate that Australian households are navigating higher interest rates and cost-of-living pressures well, and certainly better than many investors expected. With inflation under control and a robust consumer, July seemed like a Goldilocks scenario come true, with the economy neither too hot nor too cold.

In a similar vein, Financials was the second-best performing sector in July, driven in large part by the major banks (with the notable exception of ANZ, which faced regulatory scrutiny around their government bond trading activities and alleged market manipulation). Total system credit grew a healthy 5.6% in June, year-on-year, with mortgages growing 4.7% and business credit growing 7.7%. Healthy credit growth, combined with easing net interest margin pressures and the lack of major bad debt concerns propelled bank valuations even higher, from arguably already lofty levels.

One area of market concern, however, was the economic softness in China. It was hoped by many investors that the third plenum – a major plenary session convened by China's Central Committee – would unveil a large-scale stimulatory package to boost Chinese economic activity. None was forthcoming. Consequently, there was broad weakness in commodity-related stocks in July, which flowed through to the Materials sector, as well as Energy and Utility sectors – the three worst performing sectors in July and the only ones to decline in an otherwise very strong month.

Contributing to the weakness in the Materials sector were several stock-specific developments. Among them was South32's US$554m write-down of their Worsley Alumina operations. This was driven by onerous conditions proposed by the Western Australian Environmental Protection Authority (WA EPA) on new bauxite mining developments required to supply South32's alumina refinery. Separately, a large ($1.9bn) block sale of Fortescue shares, representing around 3.2% of the company, was transacted at an almost 9% discount to the previous closing share price, weighing on the stock price towards the end of July.

It should also be noted that, in the early days of August, the stock market has since materially sold off. This was triggered by concerns of a weaker US economy, given a worse-than-expected jobs growth number for July: non-farm payrolls grew by 114k, slowing from 179k in the previous month and lower than the 175-185k expected by the market, raising the risk of a recession should the economy stall.

At the same time, a surprise increase in interest rates by the Bank of Japan also contributed to market fears. Even though the rate increase was modest (from a range of 0-0.1% to 0.25%), an unwinding of the yen carry trade (borrowing yen at very low rates to invest in foreign currency and other financial assets) has seen quite violent movements in both currency and equity markets.

Goldilocks is not quite out of the woods yet.

Portfolio Commentary

The Blackwattle Large Cap Quality Fund returned 4.47% in July, outperforming the ASX200 Total Return benchmark by 0.28%.

The Fund's overweight position in ResMed (RMD.AX, +11%) was the largest single stock contributor to this outperformance in July, marking a sharp reversal from the previous month when it was a large detractor due to concerns around GLP-1 drugs and recent drug study results reported by Eli Lilly. Ongoing evidence, however, suggests to us that these drugs are not a mortal threat to RMD's sleep apnoea devices – or even a material headwind, given many countervailing factors already noted in our prior commentaries (such as the benefit of combined weight loss and sleep apnoea treatment, higher rates of sleep apnoea testing and the side-effects and temporary nature of GLP-1 drugs). The company's FY24 result, announced early August, continued to confirm our thesis, with continued revenue growth (+11%) and improving gross margins – hardly a business that is succumbing to an existential threat.

Another stock that reversed from being a significant detractor from Fund performance to a large contributor in July was James Hardie (JHX.AX, +16%). Prior concerns over weaker end-market demand from US R&R (repair and remodel), higher input costs and higher operating expenses saw the stock sold down by investors in May. But the prospects of a looming rate cut in the US, spurring housing activity, drew market attention back to the growth potential for JHX (as well as the broader homebuilder names). We remain confident in the long-term prospects for JHX, supported by strong pricing power and ongoing market share gains against alternative siding materials such as vinyl.

Also contributing to performance was not owning South32 (S32.AX, -16%) and Fortescue (FMG.AX, -12%), which fell for reasons outlined above, dragged the index lower in July.

Fund positions in Consumer Discretionary detracted from performance, driven by stock selection withing the sector. An overweight in The Lottery Corporation (TLC.AX, -2%) underperformed its more cyclical consumer peers and the broader market, given the defensive, stable nature of its revenues (despite being technically discretionary). We remain confident in the investment and note the resilience of its sales through various economic conditions as a key strength of its business, supplemented by longer-term margin improvement as it grows its online penetration and game enhancements that drive larger jackpots and consumer interest.

An underweight in the Financials sector, particularly within banks, also detracted from performance. As mentioned in prior commentary, Australian banks are significantly more expensive than international counterparts (at PER premiums of 50-100%+), while achieving similar returns on equity and servicing a more leveraged household sector (hampering long term credit growth prospects).

Outlook

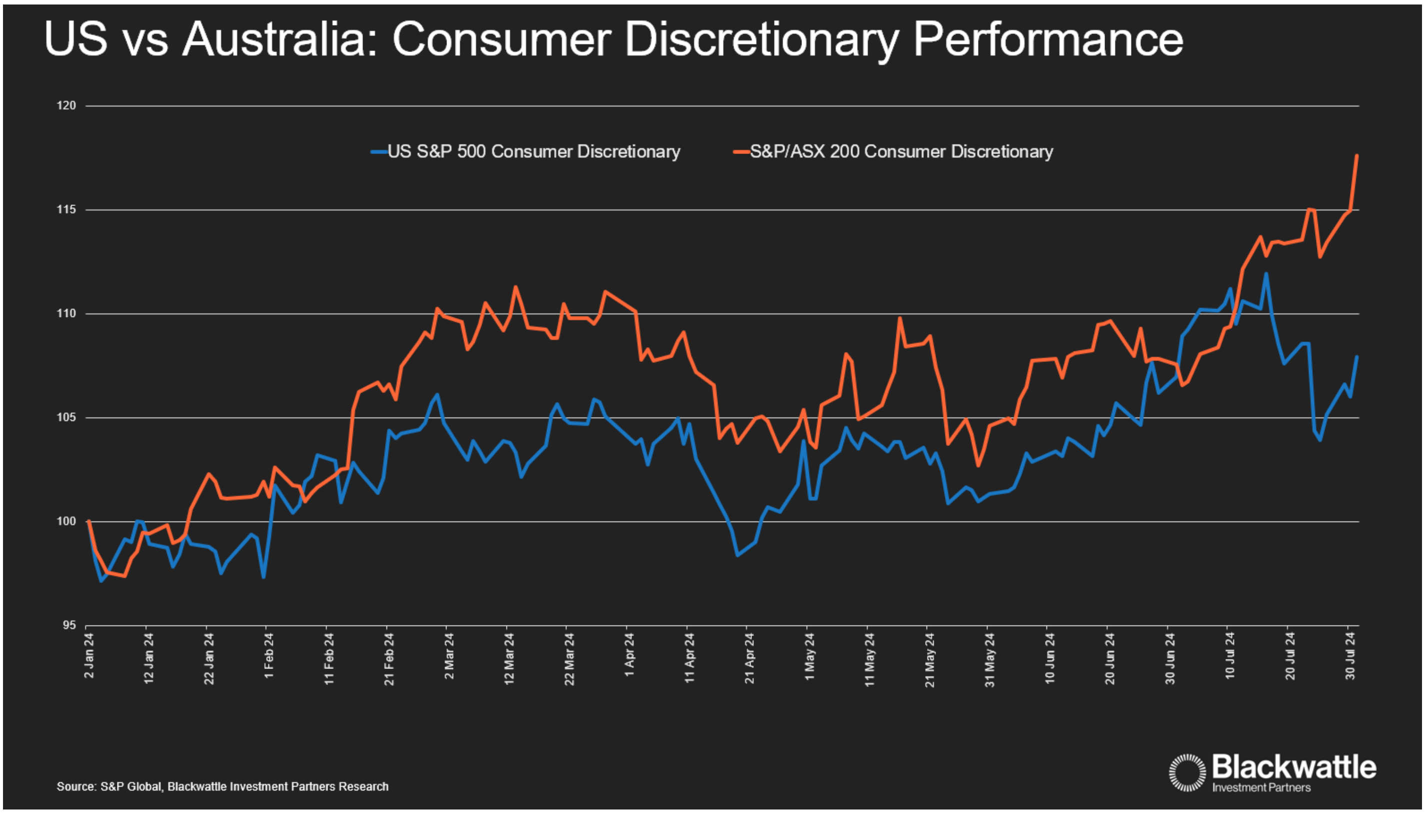
The same factors that contributed to lower inflation and the prospect of lower interest rates in the US and elsewhere (supporting market optimism in July) are now leading to market fears of a recession. Weak macro data from China and the lack of major new stimulus packages from the government is only adding to such worries.

Which is to say, the market is fickle and overly focused on short term results. Stocks that were unloved one or two months ago have become celebrated the next. Market exuberance can turn to dismay – or even panic – just as quickly. The investment maxim of Kenneth Fisher remains: "T*ime in the market beats timing the market."* With market volatility increasing and a very weak start to August, it is tempting to sit on the sidelines until clarity emerges. But complete clarity and certainty is an illusion, the pursuit of which will distract from investing for the long term.

Ray David, Joseph Koh and David Meehan

Chart of the Month

Household debt to GDP in Australia is about 110%, compared to the US at around 73%. But that has not hampered Australia's Consumer Discretionary stock performance this year, relative to US peers.



How to Invest

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