Blackwattle Large Cap Quality Fund

September 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 no. 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.
Research Ratings	Zenith - Recommended Lonsec - Recommended

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 September 2024

As at 30 September	1 month	3 months	6 months	1 Year p.a.	2 Years p.a.	3 Years p.a.	Inception p.a2
Fund (Net)	2.57%	7.50%	5.85%	20.63%	-	-	15.95%
Benchmark3	2.97%	7.79%	6.65%	21.77%	-	-	16.38%
Active Return	-0.40%	-0.29%	-0.81%	-1.13%	-	-	-0.43%

[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. Returns greater than 1 year are annualised' or "calculated on an annualised basis.
[3] S&P/ASX200 Accumulation Index

Top 5 Active Holdings

Market Commentary

The S&P/ASX 200 Accumulation Index returned +3.0% in September. Equity markets were buoyed by two major macro-economic developments in the month: a larger-than-expected rate cut by the US Federal Reserve and a set of policy measures announced in China aimed at stimulating the local economy.

In the US, the Fed (unlike the ECB in Europe) has the dual mandate of pursuing both maximum employment and price stability. With the Fed's victory in its fight against inflation looking secure, attention has turned to supporting economic activity. While not entirely unexpected, the rate cut saw short rates fall but long-term bond yields rise. The inverted yield curve, typically a precursor to a recession, uninverted, signalling the market's growing confidence in further rate cuts boosting economic activity and avoiding a recession.

Later in September, China came out with a series of announcements from both its central bank (PBOC) and the Politburo, encompassing monetary and fiscal policy changes designed to stimulate the economy (and financial markets). Economic activity has been slowing in China for some time, and concerns have been building that the government was accommodating the slowdown as it addressed various imbalances in the economy – particularly in the previously over-heated property sector. Since 2021, the number of new homes sold has been steadily declining and secondary home prices steadily falling; total mortgage balances started shrinking in 2023. In response, the local stock market has seen its P/E derate significantly since the start of 2022 (from about 17x to 11.5x), while the yield curve had flattened considerably and threatened to invert.

Chinese authorities finally intervened in September, and while many details are still to be worked out or confirmed, the stimulus measures included:

- A 50bps cut in the bank reserve requirement ratio (RRR), expected to free up RMB 1tn (about US$142bn) in loan capacity, with another potential cut flagged later this year
- A cut in the 7-day repo rate (1.7% to 1.5%) and existing mortgage rate cut to below 4%
- A RMB 800bn 'liquidity support' for equity markets through a swap facility for participants, and a re-lending facility of RMB 300bn for share buybacks and cross-holdings
- Counter-cyclical fiscal measures in the order of RMB 2tn and more support for low-income households and the long-term unemployed
- The removal of various home purchasing restrictions and a lowering of minimum deposits for second-home buyers

The prospect of a stronger, resources-hungry Chinese economy boosted commodity prices in the month. Iron ore was up around +8% in September, while copper, nickel, alumina and aluminium were all up between +4% and +9%. The A$ strengthened in response, +2.2% to 0.6913 against the US$.

Materials was consequently the strongest sector in the S&P/ASX 200 index, +11.0% for the month. Meanwhile, with the world's two largest economies lowering rates more aggressively in September than anticipated by the market, defensive sectors such as Health Care and Consumer Staples lagged. September also saw the Financials sector – heavily weighted towards the 4 major banks - give back some of its year-to-date outperformance, with the sector flat in September. Australian banks still trade at a significant valuation premium to international peers, and despite last month's moves they have still significantly outperformed the broader market and resource names in particular.

Portfolio Commentary

The Blackwattle Large Cap Quality Fund returned -0.40% in September, underperforming the benchmark return of 3.0%

Underperformance was driven largely by positions in the Consumer Discretionary sector, due to stock-specific developments.

Light and Wonder (LNW, -17.6%) announced that Dragon Train, one of its most popular games and a key driver of growth in the near term, was subject to an injunction barring further selling or leasing of the game. This was due to legal action taken by Aristocrat claiming the misappropriation of trade secrets. It has come to light, as part of the legal process, that one of LNW's game designers had taken a copy of a math model (which was subsequently used to develop Dragon Train) from Aristocrat, her former employer.

To put the impact in perspective, the company has reiterated its guidance of $1.4bn in adjusted EBITDA in 2025, of which 5% had previously been expected to come from Dragon Train. As one of the three main providers of slot machine games in the US, LNW has a relatively deep library of new and established games which it can offer customers as a replacement for Dragon Train, and so far US customers leasing Dragon Train units have not sought to remove the units (suggesting that they may be willing to simply replace the software for a different LNW game).

We remain constructive in our view of LNW, and we are of the opinion that near-term issues around Dragon Train will likely not materially affect its long-term prospects. The industry is characterised by strong cash flows, consolidated competitors, a fragmented casino customer base and relatively defensive revenues underpinned by a stable, older demographic of slot machine players.

Premier Investments (PMV, -12.7%) reported its July FY24 results, which showed weakness in its mature Apparel Brands (-6.4% on FY23) and Smiggle (-7.4% on FY23, but -13.2% in 2H24, year-on-year). Trading in the first 7 weeks of FY25 were also softer than expectations. While some headwinds from weaker household spending are apparent – especially in the younger-family demographic for Smiggle – management have also highlighted issues around product range. Recent management changes at Smiggle (including the departure of its CEO and other senior management) have added to concerns around this division. The restructuring of the group, following on from a strategic review, has also been delayed as the company assess the merger proposal with Myer (MYR).

Nevertheless, PMV's Peter Alexander division goes from strength to strength, with FY24 sales +6.2% on FY23. Any pull back of premium sleepwear demand post-Covid has not been sufficient to stop the brand's continued growth, and PMV is set to enter the UK market, with 3 store openings before Christmas planned. If successful, the UK represents a large new market opportunity for PMV and in our view other countries would likely be added over time. Excluding PMV's stakes in Breville (BRG) and Myer (MYR), and property holdings, PMV trades on a low double-digit PE and a very large discount to peers such as Lovisa (LOV) at over 30x. We expect some of this discount should fall over time as the group resolves some of its near-term issues, particularly around Smiggle.

Partly offsetting the performance drag from Consumer Discretionary names was the Fund's underweight in the Financials sector – particularly in the major banks. As mentioned in prior commentary, Australian major banks trade at PE premiums of around 50-100% to global peers, and long-term growth prospects are hampered by an already highly leveraged household sector. While in the past Australian banks have offered investors attractive, fully franked dividend yields, this is no longer the case given their (still elevated) stock prices and rising interest rates. CBA currently trades on a dividend yield of approximately 3.5%, compared to Telstra at 4.9% for FY25f (and CBA's own 12-month term deposit of around 4.4%).

In Materials, while the Fund's overweight positions broadly kept pace with the rally in commodity stocks in September, underweight positions in higher-cost miners detracted from performance.

Outlook

It will take time for the announced measures in China to fully impact the economy, even if financial markets have responded immediately. To date, falling interest rates (since 2018) have failed to re-accelerate growth. The risk remains that China's slowdown continues despite the government's best efforts, and parallels can be drawn with Japan's long drawn-out economic stagnation after a period of stunning growth.

With both US and China stimulating their economies, an upcoming US election (with government policy implications) and rising tensions in the Middle East, there will likely be a period of higher volatility in the markets, which will no doubt present good, long-term investment opportunities.

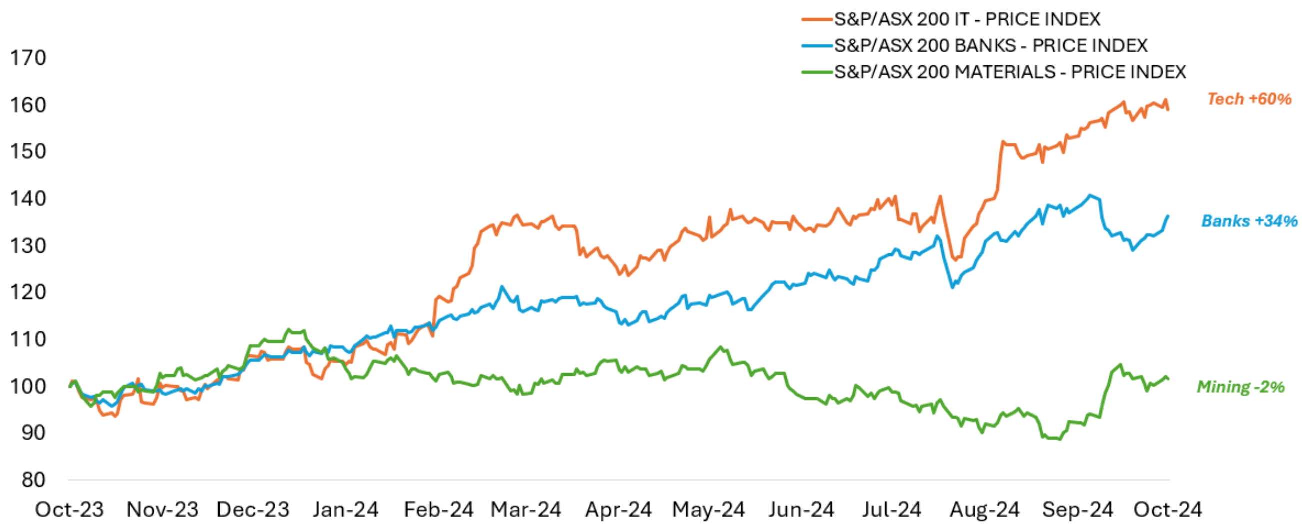
As always, we are invested alongside our clients.

Ray David | Joseph Koh | David Meehan

Chart of the Month

The jump in mining stocks towards the end of September, on the back of Chinese stimulus announcements, has only partially closed the performance gap with banks.

ASX GICS Sector Performance



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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