redpoint Investment Management

**30 APRIL 2020**

# MONTHLY REPORT

## REDPOINT INDUSTRIALS SMA

| Model Portfolio performance as at 30 April 2020 | 1 month (%) | 3 months (%) | 6 months (%) | 1 year (%) | 2 years (% pa) [5] | 3 years (% pa) [5] | 5 years (% pa) [5] | Since Inception [4] (% pa) [5] |
|---|---|---|---|---|---|---|---|---|
| Model Portfolio return (gross) | 5.23 | -22.03 | -17.56 | -9.55 | -0.37 | -0.35 | 2.27 | 2.27 |
| *– Model Portfolio cash* | *0.00* | *0.82* | *1.59* | *3.76* | *4.83* | *4.71* | *4.83* | *4.83* |
| *– Model Portfolio price* | *5.23* | *-22.85* | *-19.15* | *-13.31* | *-5.20* | *-5.06* | *-2.56* | *-2.56* |
| Benchmark return [2] | 6.69 | -21.29 | -16.73 | -8.41 | 0.04 | -0.03 | 2.67 | 2.67 |
| Active return [3] | -1.46 | -0.74 | -0.83 | -1.14 | -0.41 | -0.32 | -0.40 | -0.40 |

*Source: Navigator Australia Limited*

*Past performance is not necessarily indicative of future performance.*

1. Redpoint Industrials Separately Managed Account (SMA) (Model Portfolio) – gross performance is before management fees and transaction costs (calculated by Navigator Australia Limited).
2. S&P/ASX 100 Industrials Accumulation Index – dividends reinvested (Benchmark).
3. Active return is the difference between Model Portfolio gross return and Benchmark return.
4. The Model Portfolio was established on 30 April 2015 with a nominal portfolio value of $100,000.
5. Returns for periods of 12 months or more are annualised.

## INVESTMENT OBJECTIVE

The Model Portfolio aims to provide a return in line with the Benchmark, after management fees, over rolling five-year periods. The Model Portfolio seeks to deliver the key income and growth characteristics of the Benchmark, while holding less than half the companies in the Benchmark. The Model Portfolio combines long horizon sustainable quality metrics and risk management expertise to exclude or underweight poorer rated companies. The Model Portfolio will usually hold 30-40 companies and aims to deliver a portfolio with low active risk relative to the Benchmark, while being tilted towards companies with better quality characteristics.

## PERFORMANCE COMMENTARY

### MODEL PORTFOLIO

For the month ending 30 April 2020 the gross return of the Model Portfolio was +5.23%. Over the same time period the total return of the Benchmark was +6.69%. As a result, the Model Portfolio underperformed the Benchmark by -1.46% (active return) for the month of April.

The gross return of the Model Portfolio (i.e. +5.23%) is comprised of two (2) major components: a cash income (dividend) return of nil (i.e. there were no dividends paid by companies in the Model Portfolio during April); and a capital (price) return of +5.23%.

### MARKET

The Australian equity market, as measured by the S&P/ASX 200 Index, rallied from its "bear market" status in March by posting a total return of +8.78%, one of its best months in history. The risk appetite of investors returned as confirmed cases and deaths from the COVID-19 pandemic began to slowly recede across the globe. Global equity markets, especially the United States, also rose as governments and central banks implemented extraordinary monetary and fiscal measures to support the global economy.

By contrast, the S&P/ASX 100 Industrials Index (Benchmark) rose by +6.69%, with all sectors of the market delivering positive total returns for the month, led by Information Technology (+26.2%), Real Estate (+16.0%) and Materials (15.8%). The worst performing sectors for the month were Financials (+2.4%), Utilities (+2.7%) and Consumer Staples (+2.8%).

## ATTRIBUTION COMMENTARY

The active return for the month (-1.46%) can be decomposed into two (2) key components:

- Benchmark stocks held by the Model Portfolio, due to better sustainable quality metrics and dividend income streams, detracted -0.33% from active return; and
- Benchmark stocks not held in the Model Portfolio, due to poorer sustainable quality metrics and dividend income streams, detracted -1.13% from active return.

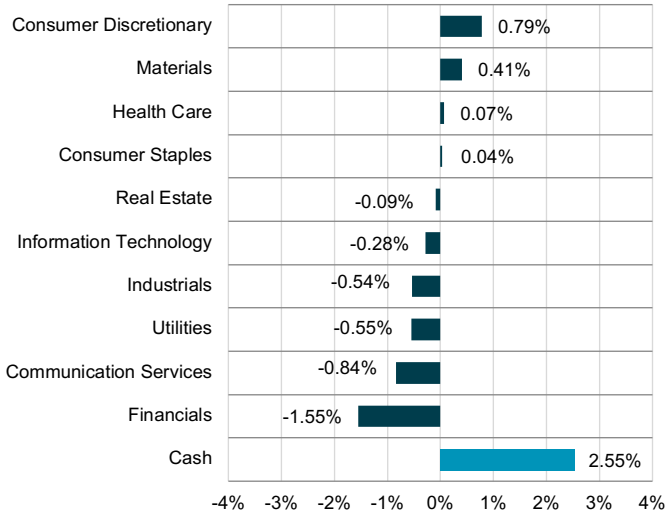
Furthermore, using a returns-based attribution, the active return of the Model Portfolio can be decomposed into two (2) alternative components:

- the sector positioning of the Model Portfolio detracted -0.04% from active return; and
- stock selection within the sectors detracted -1.42% from active return.

## TOP 10 HOLDINGS

| Company | Model Portfolio (%) | Benchmark (%) |
|---|---|---|
| CSL Ltd | 12.03 | 12.86 |
| Commonwealth Bank of Australia | 10.63 | 10.13 |
| ANZ Banking Group Ltd | 5.06 | 4.49 |
| Woolworths Group Ltd | 4.98 | 4.31 |
| Wesfarmers Ltd | 4.60 | 3.93 |
| Westpac Banking Corporation | 4.22 | 5.14 |
| National Australia Bank Ltd | 3.99 | 4.49 |
| Macquarie Group Ltd | 3.77 | 2.98 |
| Telstra Corporation Ltd | 3.63 | 3.33 |
| Transurban Group | 2.67 | 3.31 |

## SECTOR ACTIVE WEIGHTS




## MODEL PORTFOLIO FACTS

| Model Portfolio code | RISMA |
|---|---|
| Model Portfolio size ($) | 142,240,156 |
| Number of holdings | 40 |
| Inception date | 30 April 2015 |

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## ATTRIBUTION COMMENTARY (CONT'D)

### SECTORS

From a sector allocation perspective, overweight positions in the Materials, Real Estate and Consumer Discretionary sectors, which outperformed the broader market, and underweight positions in the Utilities and Communication Services sectors, which underperformed the broader market, collectively contributed +0.10% to active return. The overweight position in the Materials sector and the underweight position in the Utilities sector had the largest impact, contributing +0.05% and +0.03% respectively to active return.

This positive outcome was more than offset by an overweight position in Financials sector, which underperformed the broader market, and underweight positions in the Industrials, Health Care and Information Technology sectors, which detracted -0.06%, -0.03%, -0.03% and -0.02% respectively from active return (i.e. collectively detracted -0.14% from active return).

### STOCK SELECTION

Stock selection was best in the Industrials sector, which contributed +0.10% to active return. However, all of the remaining sectors detracted from active return, with the largest of these being the Real Estate, Health Care, Consumer Discretionary and Communication Services sectors, which detracted -0.34%, -0.26%, -0.19% and -0.18% respectively from active return.

This relative performance is disappointing and occurs against a backdrop of a reversal in fortune for equity investors that has been faster than in any bear market fall in living memory. The Benchmark is currently trading at a higher forward-earnings multiple than it was at the start of 2019 (19.0 versus 18.6) implying a high expectation that earnings will revert to 2019 levels quickly or that investors are exceedingly optimistic. The rally over the past month has been concentrated in high PE stocks within the Information Technology sector and a rebound in sentiment towards retail shopping centre property trusts.

This euphoric rebound occurred while more than 60 ASX listed companies raised over $11 billion in fresh equity capital from investors. Virgin Australia Holdings Ltd, however, succumbed to its debt burden and was placed into administration. Unlike the Global Financial Crisis of 2008-2009, the Australian economy is likely already in recession – the International Monetary Fund stating that it expects this contraction to be the most severe for our local economy since the Great Depression of the 1930s.

### ASSETS

#### CONTRIBUTORS

On a relative basis, some of the best performing stocks for the month were overweight positions in Downer EDI Ltd (Industrials), Aristocrat Leisure Ltd (Consumer Discretionary) and Qantas Airways Ltd (Industrials). These positions collectively added +0.34% to relative performance. The top 10 contributors were all overweight positions, which collectively contributed +0.73% to relative performance.

#### Downer EDI Ltd (ASX: DOW)

After underperforming in the first quarter, Downer EDI Ltd (ASX: DOW) rallied in April as the diversified engineering and infrastructure maintenance provider successfully refinanced $500 million in debt facilities, as well as deferring the payment of its March 2020 interim dividend until 25 September. We continue to consider the company a high-quality stock with a diversified business that is likely to maintain and grow its book of business in key areas of growth aligned with infrastructure spending. Our expectation is that the company is well placed to continue to pay dividends to shareholders based on their ability to maintain revenue through ongoing demand for their engineering services. At current prices DOW is forecast to pay a 7.75% grossed-up dividend yield over the next year.

#### Aristocrat Leisure Ltd (ASX: ALL)

Aristocrat Leisure Ltd (ASX: ALL) rose by 19.4% in the month of April but, at about $25 still trades well below its peak of $37.69 in mid-February. ALL has suffered due to the closure of casino sites, but has benefited from growth in its digital gaming, which now accounts for over 40% of revenues. The company suspended its interim dividend ($0.25 per share expected in May) at the end of April and put in place a range of cost cutting measures. This leaves the company in a strong position with over $1 billion in available liquidity to weather the current COVID-19 lockdowns. ALL has consistently grown its annual dividend payout from $0.17 per share in calendar 2015 to $0.56 per share in calendar 2019. The company is well placed to reinstate returns to shareholders as activity in key gaming sites across the globe reopen.

### LARGEST CONTRIBUTORS

| Company | Model Portfolio Average Weight (%) | Benchmark Average Weight (%) | Contribution (%) |
|---|---|---|---|
| Downer EDI Ltd | 0.78 | 0.21 | 0.16 |
| Aristocrat Leisure Ltd | 2.06 | 1.35 | 0.09 |
| Qantas Airways Ltd | 1.19 | 0.49 | 0.09 |
| Computershare Ltd | 1.01 | 0.52 | 0.08 |
| Lend Lease Group | 1.12 | 0.61 | 0.07 |
| Xero Ltd | 1.36 | 0.76 | 0.06 |
| Orica Ltd | 1.22 | 0.64 | 0.05 |
| Incitec Pivot Ltd | 0.81 | 0.34 | 0.05 |
| ASX Ltd | 1.66 | 1.49 | 0.05 |
| Macquarie Group Ltd | 3.31 | 2.88 | 0.05 |

### LARGEST DETRACTORS

| Company | Model Portfolio Average Weight (%) | Benchmark Average Weight (%) | Contribution (%) |
|---|---|---|---|
| Afterpay Ltd | 0.00 | 0.49 | -0.22 |
| ResMed Inc | 1.63 | 0.94 | -0.17 |
| Scentre Group Ltd | 0.52 | 0.99 | -0.16 |
| Vicinity Centres | 0.00 | 0.39 | -0.12 |
| James Hardie Industries Plc | 0.00 | 0.81 | -0.12 |
| Tabcorp Holdings Ltd | 0.00 | 0.54 | -0.10 |
| Boral Ltd | 0.00 | 0.28 | -0.10 |
| AGL Energy Ltd | 1.87 | 1.09 | -0.07 |
| Telstra Corporation Ltd | 4.49 | 3.53 | -0.07 |
| JB Hi-Fi Ltd | 0.05 | 0.35 | -0.07 |

**Note**: Contributions shown in the above tables are to the active return of the Model Portfolio. Period: 31 March 2020 to 30 April 2020.

#### DETRACTORS

Offsetting these positive stock contributions were overweight positions in ResMed Inc (Health Care), AGL Energy Ltd (Utilities) and Telstra Corporation Ltd (Communication Services) along with underweight positions (i.e. not held by the Model Portfolio) in Afterpay Ltd (Information Technology), Vicinity Centres (Real Estate), James Hardie Industries Plc (Materials), Tabcorp Holdings Ltd (Consumer Discretionary) and Boral Ltd (Materials), which collectively detracted -0.97% from active return. Underweight positions in Scentre Group Ltd (Real Estate) and JB Hi-Fi Ltd (Consumer Discretionary) detracted a further -0.16% and -0.07% respectively from active return.

#### Afterpay Ltd (ASX: APT)

Afterpay Ltd (ASX: APT) was the best performer in the S&P/ASX 100 Industrials Index in April, rising by about 66% over the month. This surge occurred in the face of large earnings downgrades across the street: consensus FY2020 earnings per share (eps) dropping from $0.05 to -$0.20 and FY2021 from $0.25 to -$0.10. In early May, it was revealed that Chinese internet communications firm Tencent Holdings Ltd had taken a substantial shareholding in the company. The stock remains unattractive according to our sustainable quality metrics. APT does not pay dividends and at current cash burn rates and lack of profitability there is little expectation of dividend returns in the near to medium term.

### ResMed Inc (ASX: RMD)

Respiratory therapy company ResMed Inc (ASX: RMD) defied general market sentiment in the March quarter by a posting a total return of +13.0%, primarily on the basis of its capacity to provide life-support products (ventilators, masks and other accessories) to help fight the COVID-19 pandemic. With the peak of the pandemic in sight, and the concomitant ramp up in production by RMD and others (including automobile companies), there is likely to be sufficient ventilators available and the demand for new ones may dry up over coming months or years. The market reacted negatively to this prospect and as a result RMD experienced a total return of -5.22% for the month. An overweight position in the stock detracted -0.17% from active return. Despite this short term setback we remain optimistic about RMD's future as the company's core business is medical equipment for use outside the hospital setting (i.e. sleep apnea machines), so a sudden need for ventilators to keep COVID-19 patients alive in intensive care units isn't going to have much of an impact on RMD's earnings in the long term.

### Scentre Group Ltd (ASX: SCG)

Scentre Group Ltd (ASX: SCG) is owner and operator of 42 Westfield shopping centres across Australia and New Zealand. The COVID-19 lockdown and social distancing measures have had a material impact on these centres and their tenants. SCG rallied almost 50% in April from a price of $1.50 to finish at $2.33. This change in sentiment was driven by continued flattening in the number of confirmed COVID-19 cases, which increased the prospect of retail shopping centres returning to more normal operating conditions in coming months. There remains great uncertainty over the timing of the relaxation of social distancing requirements and if so whether the broader population will immediately return to congregating in retail shopping centres. Further headwinds due to growing unemployment will also impact retail trade in coming months. The company is trading at approximately half of its February closing price of $3.46. Assuming the company can return to normal operations and reinstate dividends, the stock would be trading at a 10% cash yield (using 2019 dividends). The Model Portfolio maintains an underweight position: we hold the stock for risk management purposes due to its large weighting in the Real Estate component of the Benchmark.

## POSITION CHANGES

At month end the Model Portfolio holds 40 of the 80 companies in the Benchmark universe. We undertook a detailed assessment of the dividend expectations for all stocks in the Benchmark towards the end of April. This, along with risk management protocols and assessments of company quality, resulted in the removal of offshore toll road owner Atlas Arteria Ltd and the Australian securities exchange ASX Ltd from the Model Portfolio. At the same time, we added home entertainment retailer JB Hi-Fi Ltd, Sonic Healthcare Ltd and freight rail operator Aurizon Holdings Ltd. The Model Portfolio also reduced its existing positions in Telstra Corporation Ltd, National Australia Bank Ltd and Westpac Banking Corporation, while adding to existing holdings in Macquarie Group Ltd, AGL Energy Ltd and Magellan Financial Group Ltd.

Our quality and sustainability metrics have continued to weaken for the major banks. Our shareholder and customer loyalty metrics have turned as negative as they have ever been. Our preferred exposures remain Commonwealth Bank of Australia and ANZ Banking Group Ltd, though we maintain holdings in all four (4) major banks for risk management purposes versus the Benchmark. The Model Portfolio remains overweight Macquarie Group Ltd and Magellan Financial Group Ltd and this was reaffirmed in our latest rebalance of the Model Portfolio, as we estimate greater certainty in dividends from these companies in the near term.

The Health Care sector has generally proven a safe haven in the current market sell off. Sonic Healthcare Ltd has recently partnered with the Australian government for COVID-19 testing and remains well placed to return to normal diagnostic work as lockdown measures are lifted. The company is well placed from a capital perspective, assuming that the COVID-19 lockdown does not extend through 2020. At current prices it is trading at a 3.7% grossed-up dividend yield versus health care giant CSL Ltd at grossed-up dividend yield of 1%.

Queensland coal and freight rail provider Aurizon Holdings Ltd (ASX: AZJ) was also added to the Model Portfolio, replacing toll road operator Atlas Arteria Ltd (ASX: ALX). We have greater confidence in the earnings and dividend stream from AZJ versus ALX at this time. AZJ is continuing to guide for no material change to rail volumes, however, the share price is still more than 30% below its February highs. This implies a grossed-up dividend yield of 7.4%.

## DIVIDEND INCOME

In our March quarter report, we estimated a dividend yield of 1.06% for the June quarter. This was based on dividends from ANZ Banking Group Ltd, National Australia Bank Ltd, Westpac Banking Corporation, Macquarie Group Ltd, Aristocrat Leisure Ltd, Orica Ltd and ResMed Inc during the month of May: collectively a 0.73% cash yield. After changes to their respective dividend policies, these companies are now expected to provide a cash yield of approximately 0.25%. Companies in the property trust sector are expected to pay their dividends at the end of June: collectively our forecast was for a cash yield of 0.33% in June. Our revised expectation is that this could be closer to zero, depending on how office, commercial and retail rental revenue has been impacted.

While the current price falls and dividend cuts are unpleasant, we note that many good quality stocks are now trading at attractive prices. Our current estimate is that the Model Portfolio is trading on a 12-month forward dividend yield of 3.88% versus the Benchmark at 3.74%. Based on historical dividends the cash yield is about 5.20% for the Model Portfolio and about 5.05% for the Benchmark. We retain our conviction of investing patiently for the long term in companies that our proprietary metrics believe have superior financial strength and are being managed sustainably for the long term. Markets will likely remain volatile and challenging for the remainder of 2020 (and possibly beyond). Looking through this uncertainty via a disciplined and unemotive investment management approach is expected to deliver improved outcomes going forward.

## KEY CONTACTS

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