Activity Report

September - November 2019

Providence
Independent Investment Advisory

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About this Report

Information Only, No Action Required

As part of our ongoing commitment to being a trusted partner for our clients, Providence reviews a number of products each month, searching for investment opportunities that fit our clients' individual requirements. Being an independent company, each opportunity is assessed solely on its merits regarding risk and return.

True to Providence's promise of transparency and independent analysis, we share the basis of our decisions with our clients in this Activity Report.

Acceptances

1. Ardea Real Outcome Fund

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We met with Gopi Karunakaran, a Portfolio Manager for Ardea, to discuss their Real Outcome Fund. It is an absolute return fixed income fund which targets CPI + 2%. The fund invests in government bonds, semi-government bonds and inflation linked bonds which will constitute 90% of the fund. The remaining 10% will be cash, interest rate derivatives, inflation linked derivatives and cash repurchase agreements. The fund has minimal duration risk (interest rate risk) as this is removed by the inclusion of derivatives. Offshore foreign currency risk is hedged out and the fund does not use gearing to add additional bond exposure. The strategy is best explained as relative value arbitrage within government bonds, and there are structural inefficiencies within bond markets as certain investors are not necessarily "rational" investors (e.g. insurance companies or passive bond ETFs). The manager takes advantage of the relative value that exists between government bonds and corresponding interest rate futures. This strategy benefits from bond volatility but does not rely on duration, unlike long only bond managers.

Declines

1. VGI Partners Asian Investment Company
2. KKR Global Credit Opportunities Fund
3. Westpac Share Purchase Plan
4. Acure Asset Management - Currie St Adelaide Commercial Property
5. CBA Perls XII Capital Notes

1. VGI Partners Asian Investment Company

VGI announced they would raise additional funds (target $800m) for a new Asian investment strategy which would complement their existing global strategy. They were able to raise $500m through the offer and listed at $2.50 per share. We declined the investment as we have sufficient Asia exposure through existing global managers and are wary of ASX listed vehicles. At the time of writing, VG8 was trading at a discount to its listing price, currently at $2.30.

2. Fortius Central Park Retail

Although we have a high level of confidence with the fund manager, we are not looking to add to our retail exposure in property at this stage of the cycle.

3. KKR Global Credit Opportunities Fund

KKR Credit launched their Global Credit Opportunities Fund which is listed on the ASX via a LIT structure, raising $925m (they increased the maximum raising size by $100m). KKR is a global firm, mainly known for their private equity arm, and has 120 investment staff managing credit in loans and high yield. The fund will be 85% senior and 15% subordinated, targeting a return of 6% - 8% p.a. net of fees. Although the manager has a strong track record in the US, we have not been active in seeking credit through ASX listed vehicles which can be impacted by secondary market liquidity.

3. Westpac Share Purchase Plan

Over the quarter the Providence Direct Equity Team reviewed the Westpac (WBC) Placement and Share Purchase Plan, with WBC seeking to raise $2bn under an institutional placement and a further $500m under a Share Purchase Plan, with both offers priced at $25.32 per share. Providence elected not to participate, based on our concerns about the headwinds affecting the banking sector in general, along with any potential risks associated with the imminent release of the findings from both the Reserve Bank of New Zealand and AUSTRAC.

Subsequent to the closure of the Placement and during the investment window for the Share Purchase Plan AUSTRAC released its Statement of Claims against WBC, and in doing so announced that it had commenced proceedings against the bank in relation to an alleged contravention of WBC's Anti-Money Laundering (AML) and Counter-Terrorism Financing obligations.

Whilst we cannot know what the outcome of the claims may be, we are comfortable not participating in the Share Purchase Plan for any clients. Outside of any potential ethical issues that may arise from the bank's alleged AML control failures, we see the potential for a substantial fine for the bank, which, along with a significantly reduced participation in the share purchase plan may necessitate further action by the bank to increase its capital position.

4. Acure Asset Management - Currie St Adelaide Commercial Property

Providence met with the manager at the start of October to review what was a largely vacant (29% occupied) commercial property asset in the Adelaide CBD. The proposed raising would have consisted entirely of equity, and was being purchased as a defensive, sub-replacement cost 'vacancy play' with a view to steadily finding tenants without the pressure of servicing a large (or any) debt burden. We declined to participate due to concerns around the leasing strategy assumptions (specifically the potential for increased leasing incentives), and the potential difficulty in finding tenants – which would place pressure on prospective returns.

5. CBA Perls XII Capital Notes

CBA launched a new hybrid security (CBAPI) targeting to raise $750m with a bookbuild margin of 3% - 3.2% above swap. Upon review of the new security, which we expect would be raised at the low end (3% over swap) it was not favourable compared to existing bank hybrids in terms of offer margin and duration. One of the issues with newer hybrids is their extended duration - CBAPI has a first call of 7.5 years and mandatory exchange of 9.5 years which is longer than we would prefer. Trading margins have been compressing, meaning credit is relatively expensive and conditions of capital trigger events and non-viability events may lead to conversion to equity. At the time of writing, CBAPI was trading at $100.73, which includes accrued interest.

Presentations

1. JP Morgan Quarterly Update
2. JP Morgan Fed Reserve Update
3. JP Morgan Asset Management 2019 Global Research Summit (Singapore)
4. RARE Infrastructure Fund
5. Holowesko Partners – Global Fund
6. BCA - Research Outlook
7. BCA - Global Strategy Report
8. Octopus – Early Stage Innovation
9. Sage - Market Neutral Fund
10. Colchester - Global Bond Fund
11. Revolution - Private Debt Fund
12. State Street Global Advisers - Floating Rate Fund
13. MLC Private Equity – Co Investment Funds Update

1. JP Morgan Quarterly Update

JP Morgan Asset Management's quarterly update in October highlighted the 'unconventional policies' employed by Central Banks in many economies, such as: forward guidance, FX intervention, cheap bank loans to try and lift liquidity, negative rates in some instances and QE (bond buying).

In the near term the risks are essentially all political.

The globe is currently impacted by the spread of manufacturing and capex weakness and the multiplier effect of this. Interestingly, JP Morgan noted the 'robust' dispersion of those who think the US economy is in a good or a bad position – thus not heavily skewed one way or the other. However, limits are being tested in some economies regarding monetary policies and their effectiveness now and looking forward.

With regards to Australia, confidence is still lacking, suggesting the need to step up government spending to help stimulate the economy (government spending is currently ~23% of Australian GDP). Much has been said about the unemployment level in Australia and JP Morgan noted the significance of part-time work as a driver of present employment and a lack of wages growth. Household leverages also remain a headwind for the economy.

JP Morgan are cautious of global equities, as earnings appear to be coming down and are likely to continue downwards, while valuations in some markets appear stretched.

JP Morgan Asset Management presented their Global Research (fundamental) Enhanced Index Equity Fund in October which we attended. The fund's aim is to achieve a long-term return in excess of its benchmark via a broad market exposure to international stocks. Excess returns to its benchmark since inception (2008) have been ~0.75% p.a. We will review the fund as a potential low fee inclusion to our international equities exposure that is 'index plus'.

2. JP Morgan Fed Reserve Update

In September we joined a JP Morgan Asset Management webcast following the most recent US FED meeting. The FED remains dovish and therefore in JP Morgan Asset Management's view the bias for interest rate easing remains in place. There appears to be some divergence with FED committee members, thus creating a more opaque message regarding what to expect from the FED. The FED discussed the strength in labour market and rising pace of household spend. JP Morgan noted the new narrative from the FED that US exports have been weakening. JP Morgan don't expect a prolonged rate cut cycle and expect one more possible cut in 2019 and one cut in 2020. However, they observed that the market expects three more cuts from the FED. The importance of that statement is that there is scope for disappointment from the market about the lack of future FED interest rate cuts. Some inflationary pressures remain present (core at 2.4%, best since 2008) and financial conditions remain easy in the USA. JP Morgan Asset Management's closing remark was that they are starting to question the effectiveness of Monetary Policy.

3. JP Morgan Asset Management 20019 Global Research Summit

Providence attended the JP Morgan Asset Management Global Research Summit in Singapore. Providence has been conducting due diligence on a number of JP Morgan Asset Management Funds, as well as using their research capabilities as an input to our internal investment decision making process. As such, the opportunity to attend this conference and hear from 50 members of their senior leadership team including portfolio managers, strategists, the chairman and the CEO, provided deep insight into their approach. It was evident that there is an emphasis on client outcomes and an approach that aims to solve the needs of their investors. Additionally, there was a keynote speech from Dr Condoleezza Rice which provided useful political insight into the current state of geopolitical tensions including Turkey's entry into Syria, the US approach to tensions in the Middle East, the US/China trade conflict and of course Brexit. Overall, the conference provided deep insight into the state of the world and the global investment universe.

4. RARE Infrastructure Fund

In the current low-income environment, Providence has continued exploring global infrastructure investments. We met with RARE Infrastructures Co-Founder and Senior Portfolio Manager, Richard Elmslie and Senior Investment Analyst, Matt Bushby for an update on the integration of Clearbridge and the RARE business including a number of operational and senior management changes. How these significant developments will affect the operation of the fund requires further review. Both the income and value strategies warrant further exploration given reasonably attractive IRR's and we will continue our due diligence on these opportunities.

5. Holowesko Partners - Global Fund

Providence met with John Crone from Holowesko Partners regarding the Holowesko Global Fund. The Portfolio Manager and Founder, Mark Holowesko, was previously a Director, CIO and Director of Research at Templeton Global Equity Group (a renowned global asset manager) with a portfolio management track record since 1987. The fund takes a value-oriented approach to investment based on proprietary fundamental research and implemented via a long/short strategy. Long-term performance has been impressive with returns achieved through both the long and short sides of their portfolio. However, recent performance has been impacted by the relative underperformance of value as a factor. Recent portfolio changes, specifically the addition of credit, will require further due diligence before any investment decision can be made.

6. BCA - Research Outlook

In October we reviewed the BCA Research Outlook. BCA expect US growth to soon rebound and for the FED to maintain easing bias for now. They expect the USD to weaken which would benefit emerging markets and boost global PMI (Purchasing Manager Index - a precursor indicator of global growth). BCA remain of the view that a US recession will be avoided and the 'mid-cycle' slowdown is ending (a narrative they have had for some time).

They see improvements in US housing and household spending (via the strength of household balance sheets), a stabilisation of the manufacturing sector, limited inflation and pick-up in money and credit trends. Debt servicing in the US now only represents ~10% of disposable income, the lowest in 45 years.

Globally, central banks are maintaining a dovish bias aimed at lifting inflation back to historical levels. Does this therefore provide scope for some economies to overheat? BCA noted that a good proxy for the global economy (Singapore's GDP) continues to point to weaker core CPI for the OECD, for now.

BCA Global Strategy Report Following the Saudi Oil Facility Attack (September)

BCA noted the drone attack on the Saudi oil facility removed 5.7mm bbl/day of oil output, or 5.5% of world crude output. The attack impacts critical infrastructure in a way that threatens global stability. BCA expect commercial inventories of oil to be drawn down hard, especially in the US. BCA's initial geo-political view is that the US will likely conduct a limited retaliatory strike. It will also assist the US to gain support for tighter sanctions with Iran. BCA expect the US will continue to build up forces in the region to deter Iran. Should any oil-price shock become prolonged, BCA's view is that the negative impact on the global and US economy will grow. This may create an incentive for Trump to engage in war. Interestingly in May 2019, BCA said in a report that the risk of a US war with Iran stood at ~22%... that's ratcheted up now in BCA's view. If nothing else, it highlights the vulnerability of the Gulf region.

Postscript: *The military inaction post the Saudi strike by the US is quite telling…*

BCA Research Report (September)

BCA's Research Team noted that their Global Economic Indicator has moved off its lows and usually leads global Purchasing Manager Indexes (PMIs) by a few months. BCA noted that global financial conditions have eased, and that the current financial conditions suggest that global growth could rebound swiftly. BCA expect China to further increase stimulus and noted a recent statement from the Chinese State Council which promised to further increase bond issuances to finance infrastructure projects, while cutting interest rates and reserve requirements.
BCA do not see an escalation of trade war or hard Brexit as likely. Their view is that China will want to do a deal rather than hold out until after the next Presidential election and risk negotiating with an even more emboldened Trump. They expect bond yields to rebound in the coming months as global growth stabilises. As a result, they recommend remaining overweight equities and will likely look to upgrade EM and Europe later in the year. They expect in the UK that Boris Johnson will be forced to make a deal with the EU. As such, BCA are advocating to buy the pound on any dips. BCA are calling that the GBP will probably be the best performing currently in the G7 over the next 5 years (a new narrative, drawing some sort of line in the sand, albeit with a long investment timeline).

In summary they noted that a situation could arise where global growth picks up in coming months, creating an environment where the lagged effects of easier monetary policy are hitting the economy just as the manufacturing cycle is picking up. Thus, equities should do well, long term bond yields will likely move higher and the Dollar should weaken.

7. BCA - Global Strategy Report

In August we reviewed the BCA Research Global Strategy paper. Provided the US/China trade war does not spiral out of control, they remain of the view that global equities will outperform bonds over the next 12 months. The manufacturing sector should benefit from any turn in the inventory cycle over the remainder of the year. They expect the USD to weaken once global growth picks up. They expect it might take a few more months for data on global growth to improve.

In August we attended a webcast hosted by Garry Evans, Chief Global Asset Allocation Strategist, BCA Research. BCA are of the view that the current scenario in the US is akin to

1998. Thus, the FED will cut rates perhaps once (soon) but not by 4 times as is currently priced and expected by the market to occur over the next 12 months. BCA feel that global government bond yields have probably hit the bottom.

They see upside for US equities as somewhat limited, as a lot of multiple expansion already has occurred. Garry noted that BCA are more positive on Australian equities and have increased their Australia weighting to neutral as a hedge against China reflation (a new narrative). BCA note that global non-manufacturing services are still holding up well, thus indicating it's a manufacturing slowdown, driven by China. BCA still expect a pick-up in activity in the second half of 2019.

In the USA, BCA remain of the view that inflation is trending up and a bottoming of the global cycle will/would see an end to USD appreciation.

A slowdown in global manufacturing can be attributed to China. BCA noted that the annual change of total social financing in China is picking up. The lag is typically 3-6 months before it is reflected in activity.

For the European Union (EU), they cite the correlation to adjusted social financing in China and EU activity (albeit with a longer lag). The EU is very much a beta economy to global growth (very dependent and reactive to global growth).

For Australia, BCA monitor Australia's relationship (the Australian equities market) with the Global Industrial Metals Price Index, which has broken down since 2017. The question then is whether the relationship re-asserts itself (thus bullish for Australian equities). BCA are of the view that the Australian 'financials' stocks (think Royal Commission etc) caused the de-coupling of this relationship with the Global Industrials Metals Price Index. So the question BCA raise is now that the Royal Commission is out of the way, will Australian equities gather pace? As for the AUD and the sharp decline in the 2019 calendar year, the AUD has now fallen below fair value on BCA models.

8. Octopus – Early Stage Innovation

Providence met with the team from Octopus regarding their Early Stage Innovation Company 2 (Octopus ESIC2). Providence had previously met with Octopus about their ESIC1 opportunity and little has changed for this strategy. The ESIC2 strategy provides access to the construction phase of a renewable energy project and is structured to provide some reasonable tax incentives. Though an attractive opportunity from an environmental perspective, we do not believe that the target return rewards investors enough for the level of risk.

Providence continues to explore opportunities that provide solid risk adjusted returns while embracing a proactive approach to Environment, Social and Governance (ESG) issues.

9. Sage - Market Neutral Fund

We met with Sean Fenton, portfolio manager for Sage (ex Tribecca) to discuss their Market Neutral Fund. The fund targets 10% per annum with equity like volatility over 3-5 years. The fund will restrict beta exposure to +/-0.15 and is highly diversified with 100 stocks (50 long and 50 short) within ASX200 stocks. The process involves both quantitative valuation scores and qualitative scores, which is different to other market neutral funds which tend to focus more on the quantitative screens. We reviewed their quantitative screens and risk controls (beta, liquidity, size, overall thematic positions, correlation, macro and stock specific risk). We like the manager, having shown strong results at Tribecca with much larger FUM and drawing from a similar team. We will continue to watch the fund as it progresses.

10. Colchester - Global Bond Fund

We have been increasing Australian Government Bond exposure and have been reviewing the merits of global sovereign bonds. The benefits for global bonds, over domestic bonds, is the increased size of the universe which can have steeper interest rate curves or higher absolute interest rates relative to Australian rates. Global bonds may also benefit from superior macro views, different interest rate sensitivity and ability to take advantage of currency (if unhedged). Colchester have had a long track record in investing in global government bonds actively and we have met with them to discuss the merits of their Global Bond Fund.

11. Revolution - Private Debt Fund

We met with Bob Sahota regarding the Revolution Asset Management Private Debt Fund. Private debt typically includes loans which are backed with assets (backed by business goods or property) and can also include leveraged loans. With the illiquidity of private debt, investors require greater return for the illiquidity of funds. We note banks have been stepping away from this space which has led to a number of new private debt funds being developed. We have been cautious in reviewing the private debt funds - our preference is for managers with a track record through illiquidity events, and a preference for higher quality credit.

12. State Street Global Advisers - Floating Rate Fund

We met with Simon Mullumby from State Street Global Advisers (SSGA) to discuss the State Street Floating Rate Fund which invests in Australian floating rate notes (FRNs). The fund invests predominantly in liquid FRNs, but also has cash and ADI certificates of deposits for liquidity, targeting an overall return of RBA cash + 1% - 1.5%. Given the size of SSGA, investors can buy into and sell out of the fund with little spread cost. Unlike fixed rate government bonds which lose capital value with rising interest rates, FRNs benefit from rising interest rates with increasing interest coupons. The fund only invests in higher rated institutions, with an average credit quality rating of A+/A for the fund.

13. MLC Private Equity – Co Investment Funds Update

We met with Sege Allaire regarding MLC Private Equity Fund 1 and MLC Private Equity Fund 2.

Fund 1 which commenced investment in November 2013 has since delivered a return of 23.4% p.a. IRR since inception with the value of invested capital $33m growing to $114m (of which $35m has been distributed back to clients). The fund is still in the harvesting phase while it is exiting original investments.

Fund 2 which commenced investment in May 2017 is still in the investment phase having invested circa 70% of committed capital. The fund has invested $98m and has grown to $116m, with majority still marked near their cost value. It is still early on, as the fund has 5 years of investment (until May 2022). To date, the fund is currently at 13.7% p.a. IRR although much of this is unrealised.

We are conscious of private equity valuations being relatively expensive at present, as there is a considerable amount of funds being invested in the space over the past years leading to private equity managers bidding up assets. We are particularly mindful of technology companies which are trading at high multiples in both listed markets and pre-IPO.

Appendix 1: Providence Investment Committee

Steven Crane

Steven has over forty years of investment experience having started in financial markets in the early 1970's. He has held such positions as Senior Portfolio Manager and member of the Asset Allocation Committee at AMP. For seven years he was the Chief Executive of ABN Amro. Steve currently holds a number of board positions, including Chairman of nib holdings limited, Director of Australian Pipeline Limited, Chairman of the Taronga Conservation Society Australia and Chairman of Global Valve Technology Pty Limited.

Chris Grubb

Chris has held senior fund management and broking positions within the Jardine Fleming Group in Japan, Hong Kong and Singapore. He was also a Director of Jardine Fleming Ord Minnett and Chairman of Investor's Mutual and Investor Web and is currently a Director of several Asian-focused investment funds. He also chairs Boardroom Australia and is a Director of Boardroom Limited in Singapore. Chris also acts as an executive coach.

Stephen Roberts

Stephen has over 40 years of experience as an economist and financial markets strategist in banking, broking and funds management. He has worked as Chief Economist with Equitilink and UBS. He worked on the Secretariat of the Australian Financial System Inquiry (Campbell Committee) in 1980, helping draft recommendations that led to the deregulation of the Australian financial system. He is an honours graduate in Monetary Economics from the London School of Economics.

Peter Hooker

Peter has held such positions as an Industrial Analyst at BZW Australia (now ABN Amro), Director reporting to Head of Research, was on the Equities Executive Committee and Director and Head of Industrial Research. He has a B.Sc. in Chemistry, B.E. in Chemical and Materials Engineering, and Graduate Diploma in Finance and Investment. He has over 25 years of experience in investment markets.

Jonathan Pain

Jonathan has 30 years of international investment experience. He has held such positions as Chief Investment Strategist of HFA Asset Management, Chief Investment Officer of Rothschild Australia Asset Management, Head of Investments at Gulf International Bank in Bahrain and Chair of the International Asset Allocation Committee at Paribas Asset Management in London. He holds a joint honours degree in Economics and Politics from Keele University and a Masters degree in the Economics of Finance and Investment from Exeter University.

Ian Wenham

Ian has over 30 years of experience in equity research, investment strategy and portfolio management. He has held such positions as Equity Analyst with Meares and Philips and Research Director of BZW Australia covering equity strategy and industrial research. He was also Regional Research Director with BZW Asia and Director of Asian Research at Lehman Brothers Asia where he chaired the Investment Policy Committee and was the firm's supervisory Analyst for the Asia-Pacific Region. He has also managed strategic global equity investments for the Lowy Family Private Fund. He currently heads his own investment firm.

Richard Nicholas

Richard has over 30 years of experience in private client portfolio management in London, Hong Kong and Australia. Richard started his career with Deloittes in London before cutting his investment teeth with the Rothschild family. He was the founding Research Director at S&P Fund Research UK and Investment Director at Hill Samuel Pacific in Hong Kong. He has also held senior positions with Hambros Pacific in Hong Kong, Alliance Capital in Asia and ANZ Private Bank. He is currently Director at Peak Investment Partners.

Marc Wait

Marc has over twenty years of investment experience. he began his career in Sydney with HSBC and Citigroup Global Asset Management (CGAM) managing Fixed Income and Money Market portfolios. Marc has also held positions in London with CGAM as a Fixed Income Portfolio Manager and Fidelity International where he was the Group Leader, Short Dated Bonds and chaired the Fixed Income Asset Allocation meetings for the firm. Marc was subsequently the Head of Treasury at the Abu Dhabi Investment Authority. Marc has a B.Agr.Ec(Honours) from the University of Sydney and is a Chartered Financial Analyst.

Grant Patterson

Grant has over 30 years of experience in equity markets. Prior to forming Providence he was a Director of ABN Amro and Head of Retail Broking. He has also held other senior positions such as Senior Institutional Dealer, Head of the Sydney Institutional Dealing Desk and also Head of Corporate Liaison. Grant is currently an Ambassador of the ASX Refinitiv Charity Foundation.

Michael Ogg

Michael has over 20 years of experience in investments, starting his career at JPMorgan Investment Management in London in the early 90s. In Australia, Michael worked for AMP Asset Management holding senior roles in Institutional Equities and for Deutsche Bank as a Client Advisor in Private Banking. Michael has an MA (Honours) Economics from Aberdeen University.

Stephen Christie

Steve has over 20 years of investment and finance experience, including as Director and Head of Private Wealth for Ord Minnett, Chairman of the Ord Minnett Investment Committee and Head of Asset Allocation for Goldman Sachs JBWere Private Wealth Management. Steve holds a PhD in Applied Finance and is a Trustee Director and Chairman of the Investment Committee of major industry super fund QSuper.

James Smith

James has over 20 years of investment market experience (cash equities). Prior to joining Providence, he held the position of Deputy Head of Domestic Sales at CIMB Securities (Australia) and was a member of the CIMB Equities (Australia) Management Committee. He has also held positions as Director - Sales at RBS, ABN AMRO and Sales at Deutsche Bank. James was responsible for Melbourne Sales/Account management in his previous roles over the last decade and in the last two years, was also responsible for New Zealand.

Safe Passage

DISCLAIMER: General Advice Only

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