CI Australian Equities Fund

QUARTERLY COMMENTARY | MARCH 2024

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

"All too often, forecasting in the 21st Century looks much like 19th Century medicine" – **Tetlock & Gardner**

"The only function of economic forecasting is to make astrology look respectable" – **John Kenneth Gailbraith**

"Stop trying to predict the macro; study the micro like mad in order to know your subject better than others.Understand that you can expect to succeed only if you have a knowledge advantage... merely possessing readily available quantitative information regarding the present won't give you above average results, since everyone else has it" – **Howard Marks**

MARKET AND PORTFOLIO PERFORMANCE

The portfolio returned 6.0% for the March quarter outperforming its benchmark, the S&P/ASX 200, by 0.7%. This outcome was driven by outperformance during the reporting season in February.[1]

Key positive contributors included **QBE** (growing confidence in North American turnaround), **WiseTech** (continued execution on long-term opportunity set), **Orica** (supportive operating environment) and Reece (result significantly beat subdued expectations).

Detractors included **BHP** (production downgrades, lower iron ore price), **Seek** (weak job ad trends), **Commonwealth Bank** and **Westpac** (both not owned during the rally in banks), and **Nine Entertainment** (tough operating trends).

While the outperformance was primarily driven by stock selection, Subset of Value allocation provided an incremental tailwind given our overweight exposure to Growth and underweight in Bond-Like Equities.

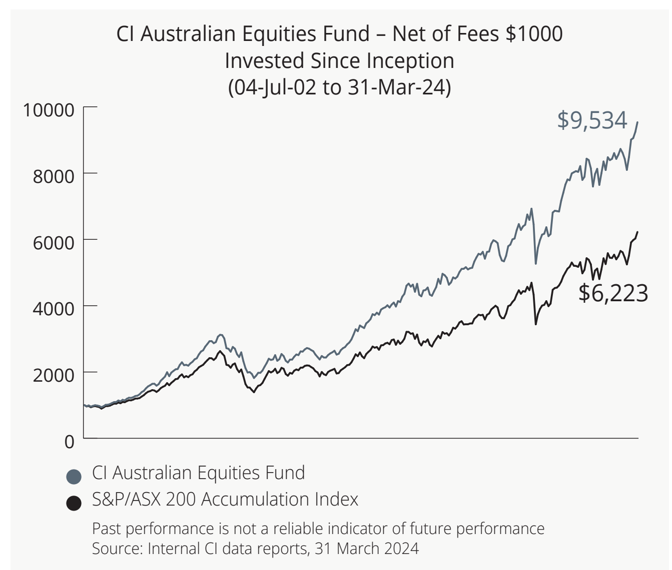
REPORTING SEASON OBSERVATIONS

As a long-horizon investor, we tend not to clamour over reporting season. Indeed, the commotion around (usually relatively minor) "beats" or "misses" bemuses us. Given that we run a relatively concentrated portfolio, our attention is more focussed on observations that give insights into whether our overall investment theses are on track or not, rather than broad-sweeping macro commentaries.

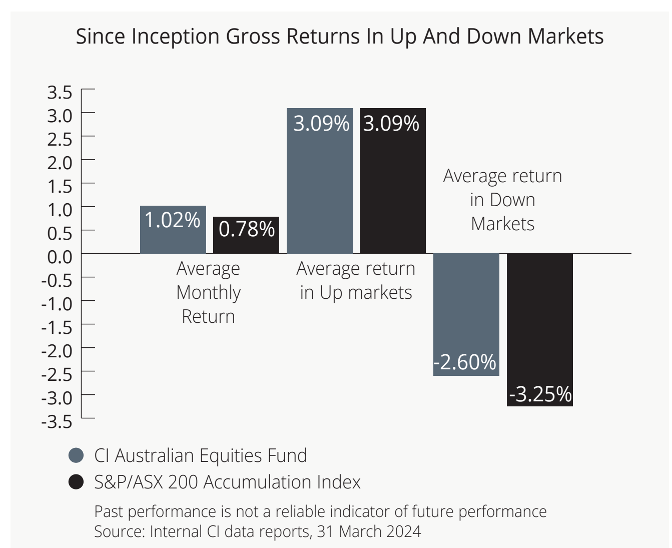
1 Past performance is not a reliable indicator of future performance.

	**Portfolio	#Benchmark	Relative
3 months	6.03%	5.33%	0.70%
1 year	13.94%	14.45%	-0.51%
3 year*	10.89%	9.61%	1.28%
5 year*	11.17%	9.15%	2.02%
7 year*	10.49%	8.59%	1.90%
10 year*	10.30%	8.27%	2.03%
Since inception*	12.02%	8.77%	3.25%
Since inception^	1080.62%	522.32%	558.30%

* Annualised
^ Cumulative (since the inception date of 4 July 2002)
** Gross of fees and expenses
\# S&P/ASX 200 Accumulation Index
Past performance is not a reliable indicator of future performance
Source: Internal CI data reports, 31 March 2024



Past performance is not a reliable indicator of future performance
Source: Internal CI data reports, 31 March 2024



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Source: Internal CI data reports, 31 March 2024

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Alas, we are still frequently asked for such reflections. For what it is worth, high-level themes observed across the market during this period included softening margins (albeit, inflation is becoming less of a talking point), rising interest expenses (a natural consequence of higher interest rates), consumer resilience (very little evidence of the much-anticipated "mortgage cliff"), and growing commentary on the impost caused by regulation and red-tape.

High share price volatility around results was another feature. While the tendency towards recency bias would suggest this is a recent phenomenon, the chart below from J.P. Morgan shows that on-day stock price volatility has been elevated for the past half decade.

Notwithstanding, it was still the third most volatile reporting season in the past 15 years. We suspect that the step-up in volatility reflects a variety of factors, including more momentum-driven behaviour, an increasing preponderance of investors with very short time horizons (e.g. hedge and quant funds) and lower visible liquidity (likely part structural, part cyclical).

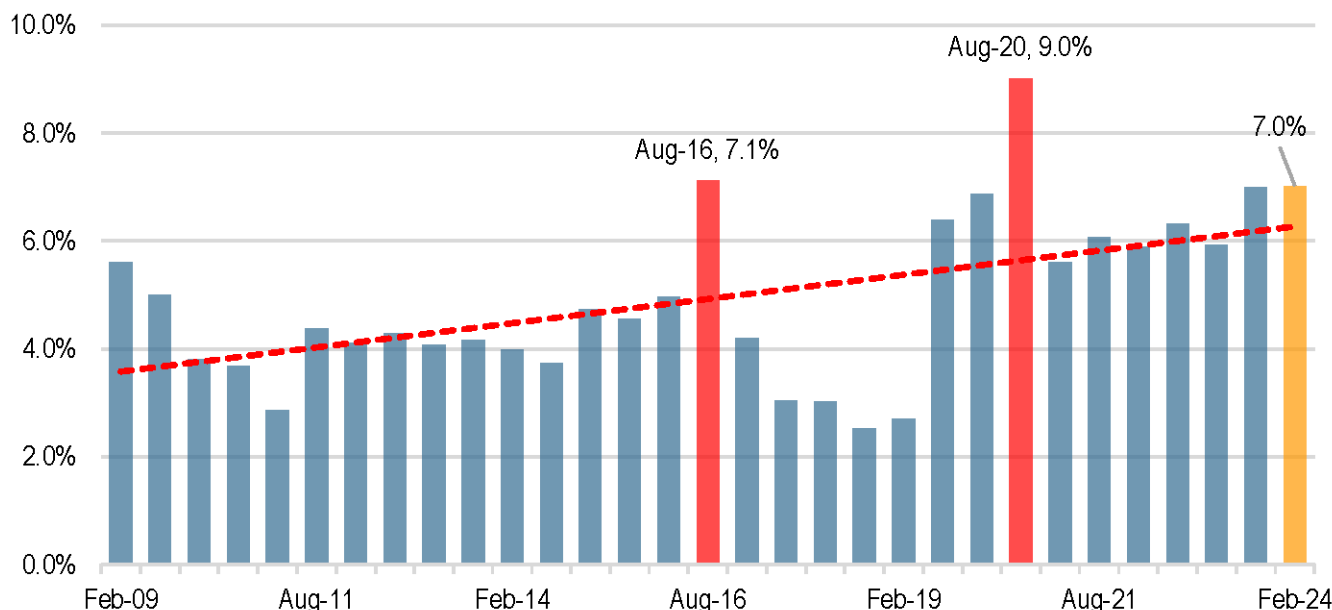
While such price volatility - especially when reflecting conjecture rather than reality - can be frustrating in the short-term, we also see it as an opportunity for investors with a truly long-term horizon. In cases where sell-offs have occurred, but our assessment of the investment proposition remains unchanged, we have responded to this improvement in our assessment of risk-adjusted value latency by adding to positions.

Examples over the past year include:

- Adding to our position in **WiseTech (WTC)** when it sold-off sharply in the prior reporting period on short-term margin concerns. This helped us generate significant alpha when it rebounded in this reporting season on a stronger result,
- Adding to **CSL (CSL)** during periodic bouts of weakness, including when FY24 market expectations were downgraded in mid-2023 given overly optimistic expectations around the Behring margin recovery trajectory and the stock pulled back into the mid-$260s; and
- Adding to our position in **Reece (REH)** from July to August last year when the stock price was still under pressure due to concerns around the operating environment. Again, this gave us increased leverage to the subsequent rebound in the price recently.

Similarly, we seek to apply sell discipline when valuations push to such extremes that our assessment of risk-adjusted value latency diminishes sufficiently. Examples in this quarter included exiting two companies where we like both the business and management but are concerned that the skew of operating trend risks and value latency are no longer clearly skewed positively: **Aristocrat (ALL)** and **Computershare (CPU)**.

On-day standard deviation by reporting season



Source: J.P. Morgan estimates, Bloomberg Finance L.P.

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PORTFOLIO POSITIONING

Following recent changes, the portfolio is now overweight Cyclicals and underweight Stalwarts. This is not predicated on a bold macro call, but rather an outcome of the continued execution of our VoF investment process that seeks to allocate capital where risk-adjusted value latency is most attractive at any point in time.

The Cyclicals overweight is driven by industrial cyclicals (not commodity or consumer cyclicals). Examples of where we see attractive risk-adjusted value latency include Orica (ORI), Worley (WOR) and Incitec Pivot (IPL).

Our Stalwart underweight is driven entirely by our position in the banks (adjusting for this, it is neutral). We have, however, reduced our exposure over the last year to those Stalwarts where material outperformance had diminished risk-adjusted value latency, such as Brambles (BXB), Telstra (TLS) and Woolworths (WOW).

STOCK OBSERVATIONS

During the quarter, we initiated a position in Mirvac (MGR). Mirvac is a Bond-like Equity (through ownership of a high-quality commercial property portfolio) that has cyclical characteristics (predominately through a residential development business).

The monetary tightening cycle observed over the last couple of years has put pressure on commercial property valuations, along with sentiment towards commercial property equities. This cycle has also caused national new home sales to revert to 10–20-year lows, positioning Mirvac's residential development business at the bottom of the cycle. We have recently observed signs that sales rates are stabilising and even early indications of a partial recovery in certain markets.

The combination of these factors created the opportunity to initiate a position in the stock at prices below our estimate of a marked-to-market net tangible asset value (after considering further devaluations in the commercial property portfolio). This represents compelling risk-adjusted value latency, with substantial return on offer as the residential cycle recovers. Further upside potential would prevail if bond yields fell as we move out of the tightening phase of the cycle. However, this is not the basis on which the investment proposition has been founded.

We also increased our Worley (WOR) holding during the quarter, taking advantage of share price weakness in response to several events. The primary issue was a commercial arbitration tribunal finding against Worley that money it was seeking from Ecuador for work rendered was not payable on the basis that there was corruption present in the award of those contracts. The Tribunal did not explicitly outline corruption by Worley but did find they were wilfully blind to corruption by a subcontractor and that Worley exercised undue influence in the process. Worley is adamant that there is no evidence of corruption on their part and are considering whether to appeal the decision. Separately, Ecuador is seeking (through the Ecuadorian courts) the repayment of US$370mn paid to Worley.

There are several risks that stem from these claims, but the most concerning for us would be any impact on Worley's ability to win future work. We are confident this will not be the case, evidenced by numerous new awards after this news came to light. The allegations relate to work undertaken from 2011-2017, and there is no evidence that Worley itself was corrupt.

We remain attracted to Worley's exposure to a potential super-cycle in engineering and construction (E&C) work driven by the energy transition. Worley is well positioned to benefit from the material investment required to achieve, or even get close to, global emission-reduction targets.

CSL (CSL) underperformed in the quarter following the failure of drug candidate, CSL112, in phase 3 trials, and a lacklustre update for the Vifor business at the company's 1H24 result in February.

CSL112 did not meet its primary efficacy endpoint of reducing Major Adverse Cardiovascular Events in patients that have previously suffered a heart attack. The result was disappointing given the scale of the trial, the market opportunity and the passing of earlier futility milestones.

Vifor, the iron deficiency and renal therapy business acquired for US$11.7bn in August 2022, saw sales growth expectations effectively downgraded for the next few years. Vifor is facing a range of headwinds, including earlier than anticipated generic competition and US insurer step edits requiring patients to start with cheaper low dose IV iron products. At the same time, new products highlighted at the time of the acquisition have not met expectations (i.e. Korsuva).

Despite these challenges, management is standing firm on the medium-term opportunity for Vifor, primarily around the extension of the iron franchise to new treatment areas (i.e. patient blood management) and expansion into new geographies.

These issues impact, but do not undermine, our CSL investment proposition. CSL112 was not in our base valuation given the elevated risk around trial results, but it was a meaningful value latency if successful. Additionally, Vifor's performance has resulted in downgrades to our estimates for that business, but it is only ~13% of earnings and our expectations were already modest.

The impact of these issues is outweighed by the upside we see from Behring (plasma) and, to a lesser degree, Sequiris (vaccines) over the medium to long-term. This should deliver substantial compounding growth. We believe the market underappreciates the multi-year improvement in Behring's economics from operational efficiencies on both the collections and manufacturing side of the business. We see a clear pathway for Behring margins to return to, and comfortably exceed, pre-Covid levels. On the flu side, we see little to no value in the current share price for opportunities around self-amplifying mRNA (sa-mRNA) vaccines, with CSL and partner Arcturus launching the world's first sa-mRNA vaccine in Japan later this year.

During the quarter, Orica (ORI) undertook a $465mn equity capital raising to partially fund the acquisition of Cynanco. Cynanco is a North American-based supplier of sodium cyanide to the gold mining industry. The acquisition expands Orica's exposure to the sodium cyanide industry, complimenting their existing manufacturing capability at Yarwun in Australia. The acquisition of Cynanco to expand Orica's mining chemicals footprint is aligned with management's stated strategy and is likely to deliver reasonable returns over the medium term.

This represents the third major acquisition since Sanjeev Gandhi became CEO in 2021 (the previous two being Axis Mining and Terra Insights), representing $1.8bn of total upfront investment and just under $1.2bn of equity capital raised over the last three years. The number of shares on issue has increased 17.8% since the end of 2021. We are supportive of the management team's deployment of capital to create value and see each of these acquisitions as strategically aligned, with the potential to generate attractive returns and create value over the medium to longer term. However, this will require excellent management execution given the entry price for Axis and Terra Insights in particular.

That said, our preference is for growth to be supported by organic cash flow generation, which minimises the need for dilutionary equity capital raisings. We also look to see evidence of value creation, and the related cash flow generation, achieved from these acquisitions before any further large-scale M&A is considered.

Management also updated the market regarding Orica's performance for the 2024 financial year, indicating that operating trends remain supportive and that the major manufacturing facility maintenance turnarounds being undertaken have been progressing smoothly. We continue to see attractive risk-adjusted value latency in Orica, with management executing well operationally to continue to improve the performance of the core business while also building out the opportunity for longer term value creation through the deployment of technology and digital solutions in the mining industry.

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