

# Wingate Global Equity Fund – Wholesale Units

## Quarterly Update

March 2018

---

### Contact Details

---

**Wingate Asset Management**

**A** Level 48, 101 Collins Street, Melbourne, Vic, 3000

**T** +613 9913 0700

**W** [wingateassetmanagement.com.au](http://wingateassetmanagement.com.au)

**Duncan Knight**

Head of Key Accounts

**T** (03) 9913 0727

**E** [dknight@wingate.com.au](mailto:dknight@wingate.com.au)

Signatory of:

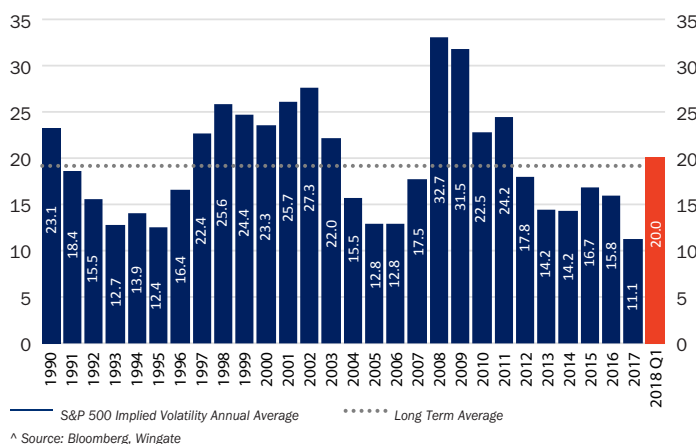


# Investment Insights

**After delivering the market’s highest January monthly return in eight years, a remarkable change of fortune saw equity markets reverse course over February and March. It was somewhat inevitable that with sentiment at a peak, based on tax reform and supportive economic data, the opportunity for disappointment was heightened.**

US long bond yields, which have now doubled from their lows in less than two years, appear a large contributor to the increasing perception that the current expansion in both the economy and equity markets are very late stage. Increasing global trade tensions further destabilised sentiment which in turn triggered rising uncertainty and volatility. Within equity markets the inherent risk – which was until recently suppressed – is finally being reflected in daily market movements.

**Exhibit 1: VIX Index**



The VIX Index – a proxy for market volatility – has for most of the past five years been both in steady decline and at historical lows but is now back trading around its long term historical average – and more than double its 2017 average. In our view this represents more appropriate risk pricing and enables a far higher return for our implementation strategy for each dollar of capital invested.

While some have been quick to dismiss the return of volatility as being due to technical factors, we believe it marks the start of a transition period as the global economy comes to terms with the move from an accommodative monetary bias to a restrictive one.

The highly accommodative action of central banks globally, culminating in record low and even negative interest rates 18-24 months ago, has now worked its way through the system. This has supported the current market narrative around synchronised global growth, record low unemployment, strong earnings growth and optimism from both consumers and corporates.

Importantly, these are all lagging indicators and purely reflective of past financial policy decisions. They tell us nothing about future market returns nor do they capture central banks shifting from an easing bias to a tightening bias.

With the introduction of a rate hike cycle in the US, financial conditions have been slowly tightening since December 2016. US long term rates have more than doubled and short term rates have risen six times with more expected. European central banks have also acknowledged tightening is on the near term agenda. US mortgage applications have already declined alongside a 100bps increase in borrowing rates while oil’s 50% price rally acts as a further dampener on activity.

A clear observation from tightening financial conditions is that rising interest rates are not the friend of equity market valuations. In fact, in all of the past eight prior tightening cycles P/E ratios have contracted, with an average decline of 2.5 times. It is therefore unsurprising that the entire market pullback in February and March was a P/E contraction, as earnings estimates were broadly higher.

**Exhibit 2: S&P 500 P/E’s have declined in all of the past 8 Fed tightening cycles**

Rate Hike Cycle	Period Start	Feb-72	Feb-74	Nov-76	Apr-83	Nov-86	Jan-94	May-99	May-04	Dec-16
	Period Finish	Aug-73	Jul-74	Apr-80	Aug-84	May-89	Feb-95	May-00	Jul-06	???
P/E Multiples	Start	19.4x	12.2x	11.0x	12.5x	16.9x	22.8x	28.9x	19.3x	20.5x
	Finish	15.1x	9.9x	7.0x	10.7x	12.8x	16.2x	27.3x	16.0x	???
	P/E Decline	-4.3x	-2.3x	-4.0x	-1.8x	-4.1x	-6.6x	-1.6x	-3.3x	???

^ Source: Bloomberg, Cornerstone Macro, Wingate

So what is the rationale behind this observation? In simple terms, tightening financial conditions will dampen economic activity and cause leading economic indicators, such as the ISM and PMI indices, to roll over. As the market worries about the strength of growth expectations, valuations decline as equity multiples compress. In the early stages of a transition, this can happen while earnings are still being revised up, as seen this quarter. Eventually though, reduced economic activity flows through to company earnings and subsequent EPS downgrades take the market lower.

Given this back drop and our expectation that these dynamics will play out for some time, how should we position the portfolio? In our opinion, a noteworthy development occurred in March regarding market leadership. High growth sectors like Technology, which drove market returns in recent years, and economically sensitive sectors like Financials, initially held up but finally buckled in March. Defensive sectors like Utilities and Real Estate were notable outperformers in March. Again, we think such performance is very consistent with the transition from an accommodative monetary policy into a tightening policy, or more simply from risk on to risk off.

Historically these risk off periods are long lasting and we believe we are only in the early innings. We have been repositioning the portfolio to reflect this expected market development with a sharp decrease in Financials exposure and a steady increase in Utilities. We have also focused on strengthening the portfolio’s overall balance sheet to withstand a weaker economic backdrop whilst maintaining our absolute focus on valuation.

# March 2018 Quarterly Performance

**Though equity markets started extremely strongly, the quarter ended with a whimper as initial optimism from the passing of US tax reforms was overshadowed by fears of a possible trade war.**

The S&P 500 fell 1.2% over the period while European shares were notably weaker. The Stoxx 600 fell 4.7% led by declines in export and commodity sensitive markets like Germany and the UK. Japan also underperformed declining 5.8%. The Australian Dollar weakened against the US Dollar, ending the quarter 1.7% lower at US 76.8 cents. Most notably, the market's measure of volatility - the CBOE VIX Index - rose from 11 to 20 by quarter end.

The Wingate Global Equity Fund - Wholesale returned 0.81% over the quarter. However what we believe is of most importance for investors is that the Fund delivered on expectations in the more volatile months of February and March - delivering consecutive months of positive returns in AUD despite the market's decline.

Portfolio performance was driven by positive contributions from investments in Utilities, IT and Consumer Discretionary holdings.

**Distributions:** The Fund's March quarterly distribution of 1.3 cents per unit took its 12 month distribution return to 7.6%.

Our portfolio has increased exposure to Utilities over several months, attracted to the stable cash flows and valuations after the recent rise in long bond yields. UK energy supplier Centrica and Ohio based utility FirstEnergy were among the best performers. Better than expected interim results and a recommitment to its dividend supported Centrica, while FirstEnergy benefited from a share placement to prominent institutional investors. Ralph Lauren was a strong contributor following Q3 results which demonstrated good progress on the company's turnaround plan. Gross margin improvement, strong cost control and further strengthening of the balance sheet leave the company well positioned.

Cisco, the largest networking firm globally, reported solid 2Q results led by growth in recurring revenue and an improved gross margin. However, after a strong share price rally we no longer see the value we did 12 months ago and have subsequently exited the position.

A disappointing outlook provided by media agency WPP saw the stock fall in March. The company lowered its organic growth outlook for the current year. Although the advertising market is in a difficult place at present with pressures on ad budgets and new competition from social media, we continue to believe that a cyclical decline in revenues is being mistaken for a structural decline. We used post-result weakness to write additional put options and increase exposure.

During the quarter we increased exposure to Utilities including First Energy and Spanish firm Red Electrica. We also increased existing exposures in WPP, CVS Health, Hydro One and Roche. Stocks exited included Cisco, Walmart, Tokio Marine and Next on valuation grounds.

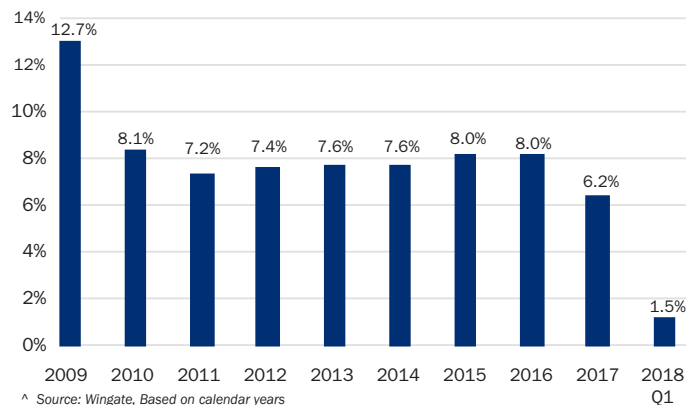
The return of volatility and a more cautious economic growth outlook have provided investors with a timely reminder that markets do not go up in a straight line. Our investment objective is to compound the real wealth of our investors over time. We seek to do this by delivering a less volatile return profile, minimising drawdowns and producing a consistent income stream. Given economic conditions and the increasing uncertainty in investment markets we believe our investment strategy is well positioned to deliver on its objectives.

## Option Premium

The portfolio wrote 1.5% in option premium in the first quarter of 2018. Increased volatility, as seen by the VIX rising from a cyclical low of 11 to a more normal level of 20 during the quarter, saw our portfolio receive higher levels of option premium than had been the case in recent quarters.

As volatility follows the ebb and flow of the economy we believe this elevated level of option premium will provide a tailwind for portfolio returns, irrespective of the direction of equity markets.

## Exhibit 3: Option Premium Received



## Stock in focus: Lawson

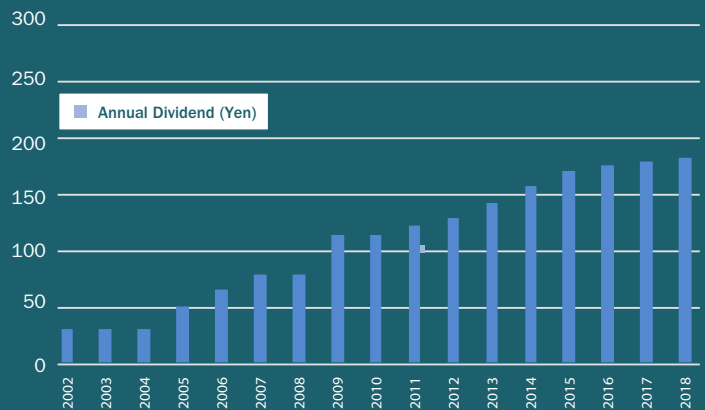
Japanese retailer Lawson has been a portfolio holding since mid-2017 and contributed positively to quarterly performance. With over 13,000 stores, Lawson is the third largest convenience store operator in Japan – a sector of the retail market that has shown good long-term growth aided by the secular tailwinds of a rapidly aging population, a rise in two income households and a rise in general health needs.

Our investment is predicated on the low *implied* future returns from the company's current investment plans for its store network as well as IT and infrastructure upgrades to improve efficiency.

Current market expectations are for Lawson to produce levels of profitability over the next 3 years which are the lowest in its long history. We believe this provides an attractive opportunity for long term investors as its current share price reflects expectations for profitability to remain at all time lows in perpetuity.

Over the last 10 years Lawson has generated a return on assets of around 11% on recurring profit. Management's strategic plan involving store rollouts and investment in IT infrastructure will amount to a 30% increase in the asset base of the company over the coming four years. Current levels of implied profitability embedded in the share price suggest this incremental investment will yield little to no return. We do not believe this will be the case given management's track record and the industry's structural tailwind. We believe Lawson's 30% increase in its capital base will deliver more than the 10% increase in operating profits implied by its current valuation.

Exhibit 4: Lawson's excellent dividend growth



<sup>^</sup> Source: Wingate, Bloomberg, Based on calendar years

Lawson is solidly cash generative with high fixed asset intensity being offset by negative working capital intensity. The opportunity to re-invest capital back into the business at double digit returns is balanced with a high payout ratio and progressive dividend. Lawson's dividend yield is currently 3.5% which, as shown in the chart above, has grown at an average 12% p.a. over the last 15 years.

From a corporate governance and ESG perspective it is pleasing to note that over one-third of directors are female and two-thirds are from outside the company. In our recent meeting with management in Tokyo the company reiterated its aim to have 30% of management positions in the group filled by women by 2020.

# Wingate Global Equity Fund - Wholesale Units

## Top 10 Holdings\*

Company name	(% weight)
WPP	6.9%
McKesson	4.9%
Sanofi	4.9%
Centrica	4.7%
Nestle	4.0%
Hydro One	3.8%
Canadian Natural Resources	3.7%
Roche	3.5%
Pfizer	3.4%
Oracle	3.4%

\* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

## Performance at 31 March 2018

Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	1.40%	-0.59%	0.81%	66%
3 months	1.40%	-0.79%	0.61%	63%
6 months	2.52%	0.75%	3.27%	64%
1 year	7.63%	-1.46%	6.17%	62%
3 years p.a.	7.63%	-3.86%	3.77%	61%
5 years p.a.	9.88%	1.78%	11.66%	60%
7 years p.a.	8.38%	2.29%	10.67%	61%
Since Inception p.a.	6.94%	-0.87%	6.07%	62%

<sup>1</sup> Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions

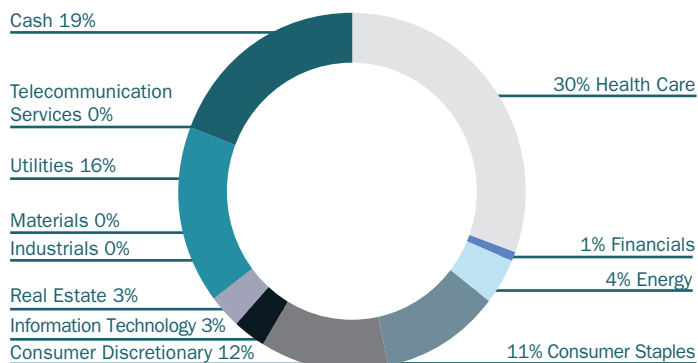
<sup>2</sup> Inception date for performance calculations is 18 August 2008

<sup>3</sup> Income Return includes realised capital gains

<sup>4</sup> Past performance is not a reliable indicator of future performance

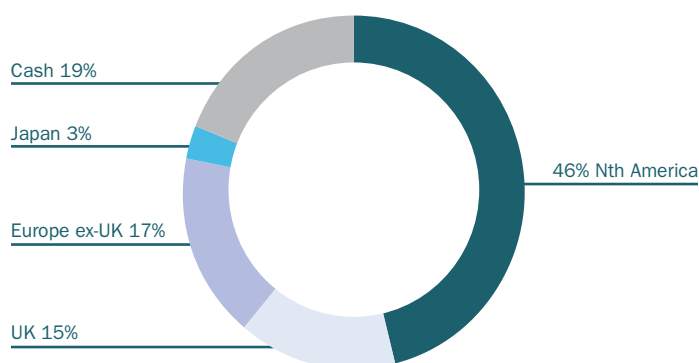
<sup>5</sup> Average Market Exposure based on delta-adjusted exposure of underlying portfolio

## Sector Allocation



Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

## Country Allocation



## Quarterly distribution

Period	Cents per Units	Reinvestment price
March 2018	1.3000	\$0.9214
December 2017	1.0000	\$0.9286
September 2017	0.8000	\$0.9145
June 2017	3.8802	\$0.9235
March 2017	1.0369	\$0.9349
December 2016	0.9000	\$0.9652
September 2016	0.7000	\$0.8974
June 2016	0.0000	N/A
March 2016	1.5000	\$0.8655
December 2015	2.2000	\$0.9482
September 2015	2.0000	\$0.9708
June 2015	6.8453	\$1.0002

## Asset allocation

Asset allocation	% weight
Global equity	59.5%
Cash - put option cover	21.1%
Cash	19.5%
<b>Total</b>	<b>100.0%</b>

## Portfolio contributors#

Portfolio contributors#	Portfolio detractors#
Centrica	Canadian Natural Resources
Ralph Lauren	CVS
Cisco	McKesson
FirstEnergy	Nestle

# Wingate Global Equity Fund - Wholesale Units

## Fund Snapshot

APIR Code	AUS0035AU	Inception Date	18 August 2008
Management Fee	1.16% p.a. of the net asset value of the Fund plus Recoverable Expenses	Liquidity	Daily
Recoverable Expenses	Estimated to be 0.12% of net asset value of the Fund each Financial Year	Exit Price	\$0.9320 (31 March 18)
		Buy / Sell Spread	0.25% / 0.25%
Platform Availability	AMP North, Asgard, Ausmaq, BT Wrap, BT Panorama, CFS FirstWrap, Freedom of Choice, Hub24, IOOF, Linear, Macquarie, Netwealth, Powerwrap	Distributions	Quarterly
		Minimum Investment	\$5,000
Fund Size	\$236m	Strategy assets under management	\$294m

### Important Information

Wholesale Units in the Wingate Global Equity Fund (the Fund) are issued by Australian Unity Funds Management Limited ABN 60 071 497 115, AFS Licence No. 234454. Wingate Asset Management Pty Ltd ABN 67 130 534 342, AFS Licence No. 333732 is the investment manager and distributor of the Fund. References to "we" means Wingate Asset Management Pty Ltd, the investment manager. The information in this document is general information only and is not based on the objectives, financial situation or needs of any particular investor. In deciding whether to acquire, hold or dispose of the product you should obtain a copy of the current Product Disclosure Statement (PDS) for the Fund and consider whether the product is appropriate for you. A copy of the PDS is available at [australianunity.com.au/wealth](http://australianunity.com.au/wealth) or by calling Australian Unity Wealth Investor Services team on 13 29 39.

Investment decisions should not be made upon the basis of the Fund's past performance or distribution rate, or any ratings given by a rating agency, since each of these can vary. In addition, ratings need to be understood in the context of the full report issued by the rating agency itself. The information provided in the document is current at the time of publication.