COLLINS ST
ASSET MANAGEMENT

06 March 2020

We have the ideas. We have the cash. We await the opportunity

"I call investing the greatest business in the world...because you never have to swing…All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it"

Warren Buffet, Chairman of Berkshire Hathaway Inc.

The Australian Stock Market Has Been Expensive for Over Three Years

As far back as March 2017 we warned that the markets had become expensive. We took the step of materially adjusting the Collins St Value Fund's sector exposures to protect against what we thought would be the straw that broke the camel's back – our view that the Australian residential property market would 'correct' and pull the equity market down with it.

We were wrong.

After declining for a year, residential property markets recovered and equity markets continued to become more expensive.

As flagged in our December 2019 Quarterly Report. whilst it's easy to identify mispricing based on fundamental research, it is much more difficult to predict when and how that mispricing will be rectified.

Rather than 'jump on the band wagon' we stayed true to our core investment philosophy, continued to challenge the status quo and implement positions in the Collins St Value Fund that were quite different to what many of our peers were doing.

Since 2017, and unperturbed by our 'early call' on broader equity market valuations, we have increased our cash position as we saw markets seemingly disconnect from value to 30% today. Additionally, we have built positions in a basket of gold mining companies (~8%) and have eliminated all exposure to ASX Top 20 stocks, with the market valuing these shares at a level that in our view was beyond anything remotely near to our calculation of fair value.

Our differentiation proved profitable with the Collins St Value Fund delivering a 36% gross return in calendar year 2019, placing it in the top five rated funds during that period.

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While the strong uplift in our unit price in 2019 was pleasing, our primary responsibility is to preserve investor capital. Our remuneration is performance based and requires a positive uplift in the value of the Fund (above a high water mark and a risk free rate hurdle) before becoming relevant. Put simply, we eat our own cooking and it is 100% in our best interests to protect capital and invest as if it were our own money – which it is because our staff invest right alongside our investors.

Against this backdrop, we'd like to comment on the events of the last week where we have seen global equity markets off by as much as 20%, and domestic markets down by between 12% and 15%. The catalyst being the Corona Virus.

The Corona Virus

Far too little is known about the origins and impact of the coronavirus. It is believed to have originated in Wuhan, China and in the past month has spread all around the world.

The Infection Rate is currently said to be approximately 1:3 (meaning on average, each infected person passes it on to three others), with the fatality rate being 2-3% of those infected, with the vast majority of those deaths being confined to the elderly or ill.

Though the outbreak has not yet resulted in fatalities of more than 3,500 globally – which compares to over 650,000 annually from the various common flu viruses, the uncertainty around infection rates, the long term effects, and optimal containment measures has seen air routes, markets, and local commercial enterprises shut down.

<u>Economic impact</u>

The impact of travel bans and the ceasing of delivery of products across borders will necessarily impact GDP data over the rest of year. Our prediction is that a technical recession is a certainty in Australia – making it the first in 28 years!

Nevertheless, a recession by itself is not necessarily a problem.

We view the current challenge as one that will (mostly) be resolved in the fullness of time. While consumers currently cannot fulfill all their purchasing wants, there is a growing desire that will ultimately be filled. For example: A consumer wanting to buy a new iPhone may not be able to take delivery due to a lack of production in China, but nor can they access Samsung phones from South Korea. Instead, the consumer is forced to wait for borders to re-open and full production to resume, at which point they will fulfill their purchase.

This kind of scenario suggests that rather than experiencing a protracted rebuilding of a system, a recovery in supply of consumables and the customers willing to purchase them will occur in a shorter timeframe than many expect.

Many investors might look at the last (global) recession and assume that any recession that follows will be the same. That is a mistake. In 2008 we saw the global financial system put under severe stress due to irresponsible lending and the gross mispricing of securitised debt instruments. The impact of such an occurrence cannot be compared to the current situation.

That said, there are risks (beyond the health risk).

Our View

Notwithstanding our expectation that consumption will rapidly recover once the virus is better understood and managed, many companies will suffer in the near term due to the weakness within their balance sheets. You see, while revenues may only be delayed, debt repayments are due on time, every time! Companies unable to fund their debt payments in the next few months may find themselves in breach of banking covenants, and in sudden need of capital.

In the near term this could cause considerable angst for existing shareholders but could provide substantial value and opportunity for investors willing to invest in any capital raising.

During the Global Financial Crisis, we saw many times that good quality businesses with small capital issues could raise money to resolve their issues. Despite the outcome producing a much stronger balance sheet, pricing was done at fire-sale prices.

Our portfolio management approach has been to avoid indebted companies and actively seek out businesses and thematic uncorrelated to economic activity. Companies like Litigation Capital Management are likely to be net beneficiaries from global turmoil, while our exposure to nuclear energy is unlikely to be negatively affected by the current market concerns. To that end, we could not be more comfortable in this environment.

Rather than concerning ourselves with the long term prospects of our investments in these times, our greatest concern is what the share prices are doing in the near term.

What’s next for the virus and what should investors do?

Israel and the United States have already announced that they have (independently) developed a vaccine due to be completed and tested in the next 90 days. It is expected that new fast working treatment for Corona Virus will be available by late in the northern hemisphere summer with a vaccine available for distribution by the end of the year.

In the medium to long term, we expect that the impact of the Corona Virus will pass.

In the meantime, we would advise investors to seek out fund managers who have the flexibility within their fund mandate to hold as much or as little cash as they deem fit. From an investor’s perspective, I can imagine nothing more frustrating than identifying clouds on the horizon yet being hamstrung by a mandate that doesn’t allow for maximising investor outcomes.

Worse, most funds are fully invested by mandate, thereby harming their returns on the way down, while being unable to take advantage of lower prices while the markets are at their lowest due to their non-existent cash holdings.

We've aligned our interests with our investors. Our zero fixed management fee coupled with our significant personal interest in the Fund means that we are looking out for the best risk adjusted returns for you.

You won't find us taking the 'safe route' of investing in well-known brands like BHP, TLS or CBA because we simply don't believe that value resides there at this time. Instead, we continue to identify good quality businesses, with sound balance sheets, and excellent prospects for profit. Afterall, our job is to generate the best returns possible.

We embrace market volatility. Volatility drives irrational behaviour. Irrational behaviour drives mispricing, and mispricing drives the profits we will deliver for our investors.

We don't wish ill on anyone. But considering that on average 90% of a year's returns are generated in less than five trading days, and that most of the markets best days have historically been on the heels of its worst days, we are happy for other market participants to provide us with this opportunity.

We've identified a number of investment opportunities to act on this year and are ready with our capital to execute purchases when the price is right. Our hope is that the markets remain emotionally driven long enough for us to become fully invested in those wonderful businesses.

About the Collins St Value Fund

The Collins St Value Fund is a high conviction, benchmark unaware Australian Equities Fund that is monthly priced and available to wholesale investors only through an Information Memorandum.

Currently the Fund holds a portfolio of ~20 positions across a selection of gold, uranium, financial services, retail and pharmaceutical names as well as currently holding a ~30% cash allocation for impending opportunistic asset acquisitions.

Investors in the Collins St Value Fund do not pay any fixed management fees. In order to align the interests of investors and the portfolio management team, and to ensure a strong focus on capital preservation and capacity management, the only remuneration received is performance based. This arrangement requires portfolio returns to be above the risk-free rate and is subject to a high-water mark.

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Collins St Asset Management

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