Australian Equities Fund

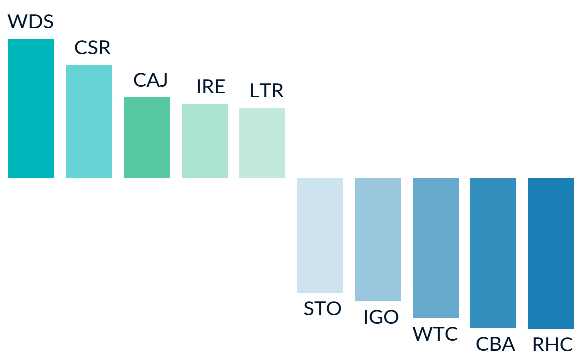
Investor Factsheet for the quarter ended 30 September 2024

	Quarter Performance	1 year	3 years*	5 years*	Since Inception*	Since Nov 2019*
Gross Fund Return**	6.94%	23.38%	10.81%	10.00%	5.54%	10.39%
S&P/ASX Accumulation 200 Index (50% Hedged)***	7.63%	23.36%	9.74%	8.93%	6.34%	8.83%
Out/under performance	**-0.69%**	**0.02%**	**1.08%**	**1.07%**	**-0.79%**	**1.56%**
Tracking error	n/a	1.58%	2.04%	2.52%	5.74%	2.44%
Information ratio	n/a	0.01	0.53	0.42	-0.14	0.64
Sharpe ratio	n/a	1.67	0.53	0.47	0.17	0.48

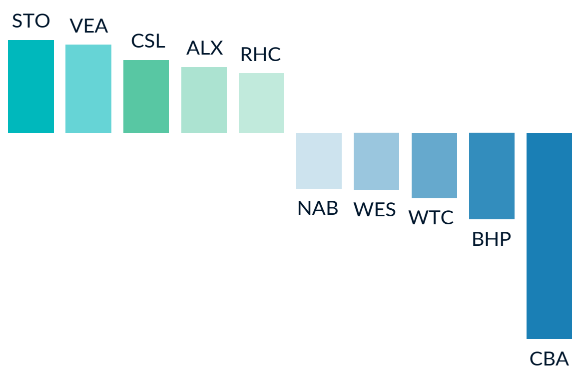
Key Fund Facts as at 30 September 2024

Fund Name	Australian Equities Fund	**Risk Indicator**	1 2 3 4 5 **6** 7
Inception Date	26/06/2008	**Market Index**	S&P/ASX Accumulation 200 Index (50% Hedged)
Fund Value (NZD)	$100,260,237	**Unit Price**	$1.9515

ATTRIBUTION (ROLLING 4QS TO 30 SEPTEMBER 2024)



PORTFOLIO CONVICTION (AS AT 30 SEPTEMBER 2024)



The fund in its macro context

Australian equities surged in the September quarter rising 7.12%, outperforming both the New Zealand equity market and MSCI ACWI, which rose 6.37% and 6.61% respectively over the same period. The broad equities rally was driven by increased bets on a soft landing for the global economy, supported by a resilient labour market and a decisive 50bp rate cut by the US Federal Reserve (the "Fed"). This easing cycle is expected to continue, with inflation now approaching target levels across most major global economies.

Outside of the US, the Australian economy appears to be one of the healthiest in the developed world and on track for a soft landing where inflation returns to target without a recession or large-scale job losses. Right now, growth remains modestly positive, supported by migration, and the country is producing twin surpluses in terms of its current account and the government budget.

The Reserve Bank of Australia (RBA) has held the cash rate target at 4.35% for around 11 months. This level is still well below the peak, and current, cash rates of other comparable economies in Canada, the US, the UK and New Zealand. Not surprisingly, these countries have typically seen weaker labour markets and greater progress on core inflation. This will likely see a slower and shallower easing cycle in Australia once it begins. Importantly, that is because underlying economic momentum is stronger, a theme which should support corporate profits as input cost pressures dissipate.

* Annualised

** Gross Fund Returns are calculated before deduction of taxes and fund charges but after deduction of trading expenses and including imputation credits where applicable. Market index returns do not have any deductions for fund charges, trading expenses or tax.

***For periods prior to April 2018, the market index/benchmark return used is an unhedged variant of the S&P/ASX Accumulation 200 Index in New Zealand dollars.

Portfolio performance

For the quarter 30 September, the Australian Equities Fund delivered a gross return of 6.94%, modestly underperforming the funds' market index return of 7.63%.

For the four quarters to 30 September, the fund delivered a gross return of 23.38%, in line with the funds' market index return of 23.36%.

There was a common theme across three of our top performing positions in the 12 months to 30 September. Despite being spread across three discrete sectors, they were all the target of M&A activity. We have discussed CSR in our previous quarterly update but the two other top contributors to performance were our overweight positions in diagnostic imaging provider, Capitol Health (CAJ) and fintech platform provider, Iress.

CAJ provides critical service to its patients, but the company (and the healthcare sector) have struggled in the last few years with three key issues. First, high inflation has put meaningful upward pressure on their cost base, in particular the healthcare workforce. Secondly, the pandemic had the impact of both delaying and destroying demand for surgeries and health diagnostics as the population became more cautious about visiting their GPs and other healthcare providers, this in-turn drove a decline in imaging and patient volumes. And finally, the company struggled to lift their fee rates at the same pace as their cost base, compressing their margins, with fee rates meaningfully exposed to government funding of Medicare.

These three factors drove the share price to depressed levels and we continued to build our position. We remain of a view that demand for healthcare would continue to grow over time and cost pressures were easing which would restore profitability to normal levels. In the end we didn't have to wait for fundamentals to recover as sector peer Integral Diagnostics launched a merger proposal at a 33% premium to last close.

Fintech company Iress (IRE) provides software to the financial services industry. It had been the subject of a takeover offer for $3.1b (or $15.91 per share) by private equity back in 2021 which did not proceed. After a weak FY23 result, and suspended dividends, the share price fell dramatically to $6.44. IRE had some attributes we liked with its defensive revenue streams, solid cash flow profile and scope for efficiency gains so we added to the position. The shares have since performed strongly with Australian media suggesting interest from another private equity player, Blackstone.

Key detractors from performance for the four quarters to 30 September were our underweight positions in Commonwealth Bank, which we discussed last quarter, software provider Wisetech Global (WTC) and real estate fund manager, Goodman Group.

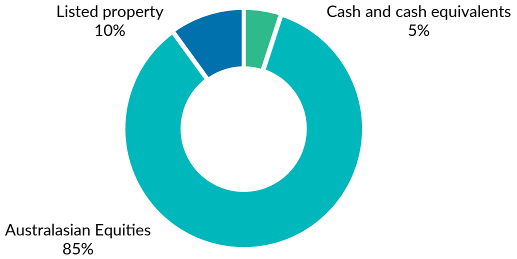
WTC surged 30% in the September quarter as management delivered a very strong FY24 result, beating expectations and providing FY25 guidance 5-6% above consensus forecasts. Earnings revisions remain positive, but the share price has moved materially. The recent acquisition of DB Schenker by DSV in the freight forwarding space could see groupwide rollout of WTC's 'Cargowise' platform in the period ahead, which presents revenue upside for the company.

Goodman Group (GMG) has had a very strong 12 months, well ahead of the broader real estate sector as AI hype boosted sentiment on its rapidly scaling data centre platform. The company has a large and diverse portfolio globally, with strong medium-term earnings growth and low leverage versus other real estate plays. Management have leaned into the growing thematic around data infrastructure where there are deep capital pools and projects offering much higher development margins in the current environment.

TOP 10 FUND HOLDINGS AT QUARTER END

Security	Weight
BHP Group Limited	8.0%
CSL Limited	6.7%
Commonwealth Bank of Australia Limited	5.8%
Westpac Banking Corporation	4.5%
National Australia Bank Limited	3.8%
Australia and New Zealand Banking Group Ltd	3.3%
Macquarie Group Limited	3.2%
Rio Tinto Limited	2.7%
Telstra Group	2.5%
Santos Limited	2.4%
Major holdings as % of total portfolio	**42.9%**

TARGET ASSET ALLOCATION



Portfolio positioning

The latest CPI indicator for August was positive and showed an easing in trimmed mean or 'core' inflation from 3.8% YoY to 3.4% YoY: the equal lowest level since January 2022. This remains above target, but a continuation of this trend should pave the way for the first easing to occur either late this year or more likely, in early 2025.

We have already seen long-term interest rates fall sharply in the September quarter with the benchmark Australian 10-year government bond yield falling by 37bp to 3.96%. This drove a change in equity market leadership, with the strongest gains in the Real Estate and Utilities sectors which have the greatest interest rate sensitivity.

Investment Philosophy and Thesis

Octagon is an active investment manager. Our investment philosophy focuses on developing a repeatable process that systematically looks for short-to-medium term inefficiencies in market pricing of securities with a solid economic basis and a good management team to deliver long term, measurable alpha.

The most common and persistent market inefficiencies we find are:

- thin research coverage
- excessive focus on near term earnings
- market dislocations and liquidity events
- temporary governance failures
- irrational investor behaviour

For Octagon, “value” means not overpaying for the promise of future growth by developing a fundamental understanding of a business, its financial metrics, return on invested capital and then scenario testing the investment model under different macro conditions.

We remain overweight Utilities with Atlas Arteria and Origin Energy being significant positions. Atlas Arteria is highly leveraged, and dividends should benefit from a modest downward trend in yields over the coming quarters as the global cutting cycle plays out. We have rising confidence that real estate assets are closer to fair value given asset value write-downs have slowed, posing less risk to sector balance sheets, and we continue to add exposure in this sector.

We are overweight the energy sector with Santos our top pick. Oil prices collapsed in the earlier part of the September quarter as US and global growth concerns shook the market. Oil weakness reversed later in the quarter as stronger GDP and jobs numbers out of the US, combined with escalating conflict in the Middle East threatened some of the Gulf region’s oil infrastructure. Higher prices will boost sector cash flows with Santos and Karoon Energy controlling quality projects well outside the conflict zone.

New Chinese stimulus efforts were the focus in September and Australian equities performed strongly on the back of it. We saw a meaningful rotation into the mining sector which has the greatest exposure to Chinese growth. We also recognise there are downside risks to Chinese economic activity stemming from the US election as both candidates propose steep tariff increases on Chinese imports. The key question is whether Chinese authorities will respond to these headwinds with further stimulus, if so, we have likely seen the worst for resource equities, with valuations offering further upside.

Conclusion

The portfolio underperformed slightly in September quarter with our underweights in three very high-quality companies driving this outcome. We have a large underweight position in Commonwealth Bank of Australia, which is trading nearly three standard deviations above historical levels at ~3x book value per share.

GMG is an excellent company with sound management but it’s current valuation premium versus the sector suggests limited scope for outperformance with material growth priced in, after adding to our holding on weakness in August/September we remain modestly underweight.

In respect of WTC, we continue to view long term execution risks as mispriced, with the market overly focused on near term earnings and capitalising recent strength into material outer year upgrades. Indeed, long term success is already well priced with a number of sell-side DCF valuations having a majority (80%+) of the company’s valuation derived from cash flow beyond the next ten years. WTC is a high-quality company, but we continue to not own the stock on a valuation basis.

Portfolio Manager

Jason Lindsay, CA
Head of Equities

OCT7166-03-(AEF)-November 2024