



Bondnado – Risk and reward when interest rates are rising

Paul Moore – PM Capital | August 2018

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Paul Moore

PM Capital's founder, CIO, first investor in our Global Companies Fund and its portfolio manager since its inception in 1998



BT Select Markets American Growth Fund

The fund was ranked Number 1 in its survey for every time period over 5 years

Period to December 1993	1 Year	3 Years	5 Years
BT Select Markets American Growth Fund	48.1%	183.3%	294.7%
MSCI North America \$A	8.7%	60.1%	110.8%

BT Retail International Equity group

Awarded International Equity Manager of the Year in 1995 and 1996. Ranked No 1 in the Micropal Asia survey of International money managers for the one and five year periods to December 1997.

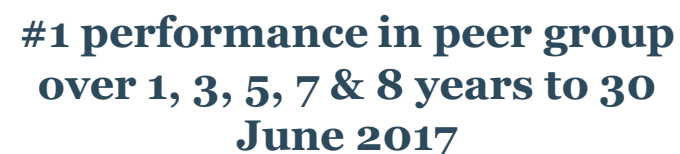
Period to December 1997	1 Year	3 Years	5 Years
BT Retail International Equity Group	58.2%	29.6%	25.6%
William Mercer Overseas Shares Survey	57.4%	28.8%	21.5%
Upper quartile FT/S&P World Index	56.6%	23.8%	17.7%

PM Capital Global Companies Fund

Funds using the PM Capital global equities strategy achieve #1 performance ranking in peer group over 1, 3, 5, 7, and 8 years to 30 June 2017

Period to 31 March 2018	Since inception (annualised)	Total return since inception
PM Capital Global Companies Fund	9.0%	433.3%
MSCI World Index (AUD)	4.4%	130.0%

**For every \$100,000 investing in 2012:
PM Capital \$362,500; MSCI \$272,400;
~\$90,100 more**



Long term performance

Performance (net of fees) As at 30 April 2018	1 Year	3 Years p.a.	5 Years p.a.	7 Years p.a.	10 Years p.a.	Since Inception	Total return Since inception
PM Capital Global Companies Fund	13.8%	9.8%	18.3%	16.0%	9.4%	9.1%	445.2%
MSCI World Index (AUD)*	12.2%	9.1%	16.6%	14.1%	7.8%	4.5%	136.4%

A history of recognition



Winner

Lonsec / Money
Management Global
Long/Short Equities
Fund of the year 2018



Finalist

Zenith / Professional Planner
International Equities
(Alternative Strategies)
Fund of the Year 2017



Winner

Zenith / Professional Planner
International Equities
(Alternative Strategies)
Fund of the Year 2015



Winner

Australian Fund Manager
Foundation **Best Australian
Based Global Equity
Manager of the Year 2015**

A unique track record

Guiding principles



**Investment
returns are
not in a
straight line**

Do not focus on discrete
time periods –

*it's the end of the
journey that counts*



**It is what's
ahead, not
behind, that
matters**

“The day after the
market crashed people
began to worry that the
market was
going to crash”
Peter Lynch



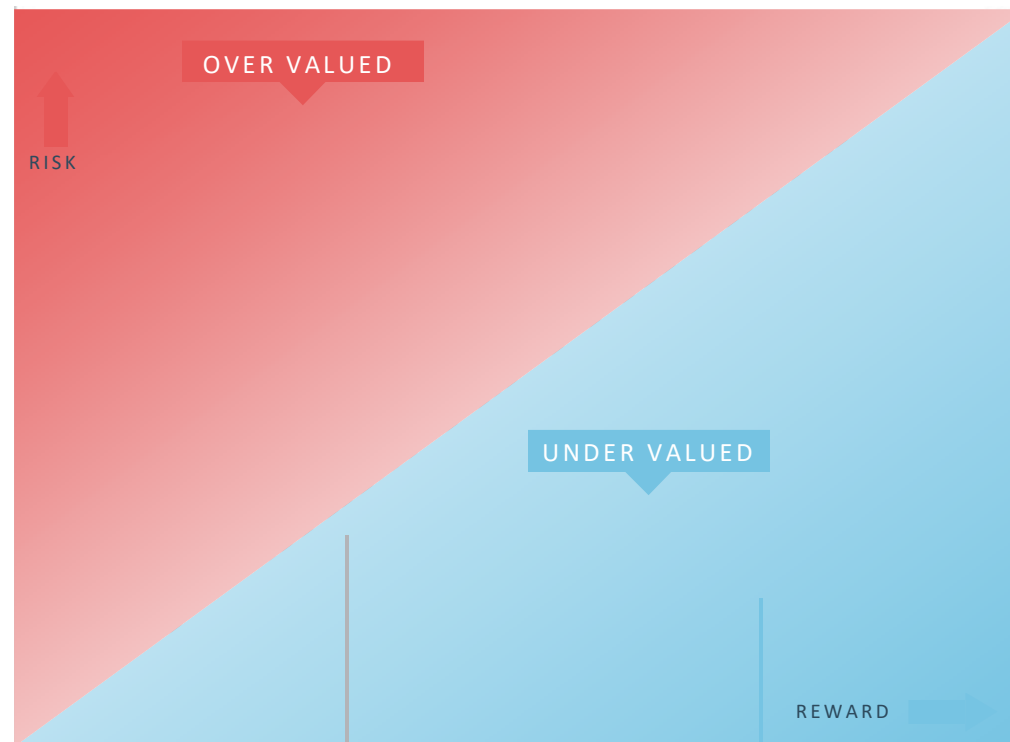
**Most
importantly,
patience and
conviction**

All great investments at
the time they're
purchased are either
questioned and,
in some cases, *ridiculed*

Information is a commodity idea generation is the IP



We focus on the anomalies



The majority of the market is well researched and fairly valued.

Limited opportunities are available for investors.

Risk vs reward: Identifying opportunities for investors

Identified	Risk	Reward
1989	Bank One	Wells Fargo / Westpac
2000	TMT	"Old" economy
2003	Budweiser	Heineken
2009	None	Exchanges
2009	Cash	Global credit
2011	Australian Dollar	Las Vegas property
2015	Australian banks	Global banks
2015	REITs	Macau casinos
2015	Traditional Asset Managers	Alternative Asset Managers
2016	Bondnado	Cyclicals
2018	Ronald McDonald	Value

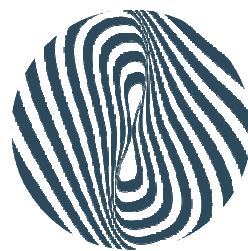
The greatest investment anomalies present themselves where significant change or new information is misunderstood by the broader market.

That is where we concentrate our efforts.

What creates anomalies



Fear and the avoidance of pain – investors look backwards not forward when constructing their portfolios (GFC)



Acting on perception and not fact
(Brands/ Bluechips)



A short term focus, making it difficult to assess true risk/ reward when faced with severe cyclical downturns or structural change (Viva Las Vegas)



Distraction - the most common being macro-economic (Brexit/ Trump)

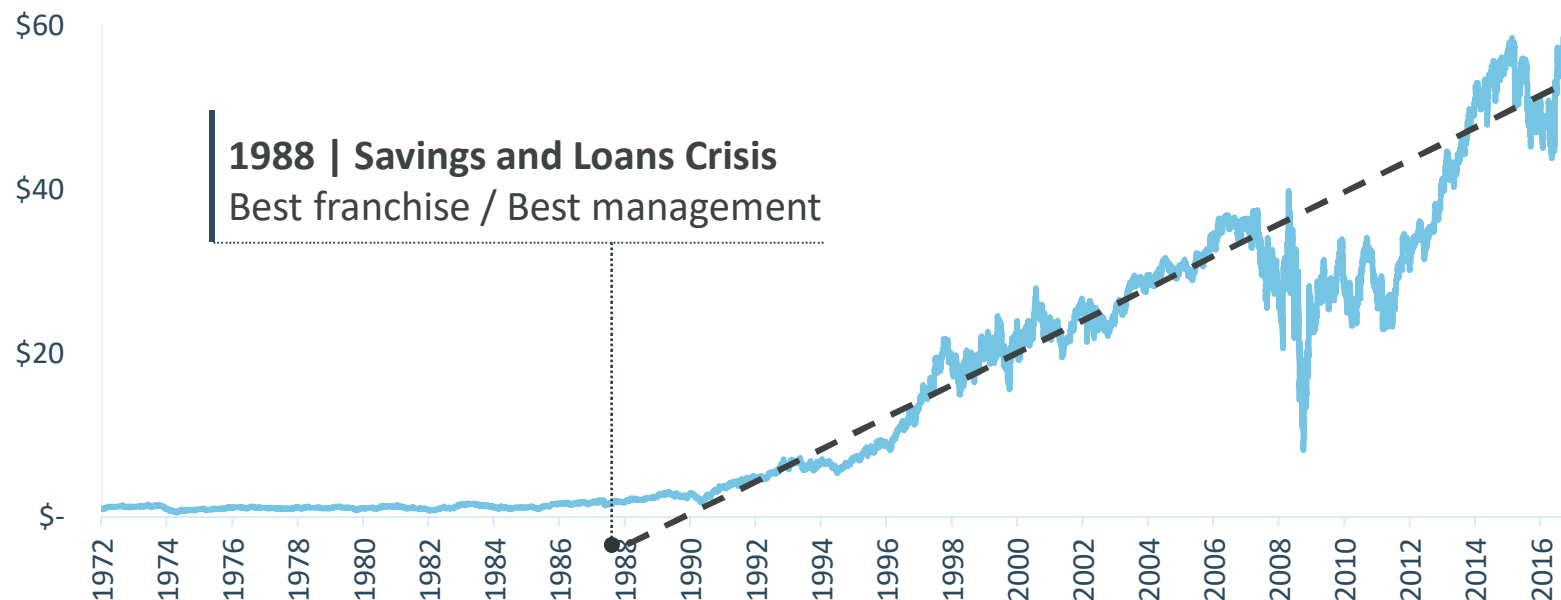


Conflict and misunderstanding

Good ideas are hard to find...

Wells Fargo & Company (WFC.NYSE)

A 13%+ compound return + dividends over 26 years despite the greatest financial crisis since the Great Depression, not to mention the Gulf War, Twin Towers and other events.

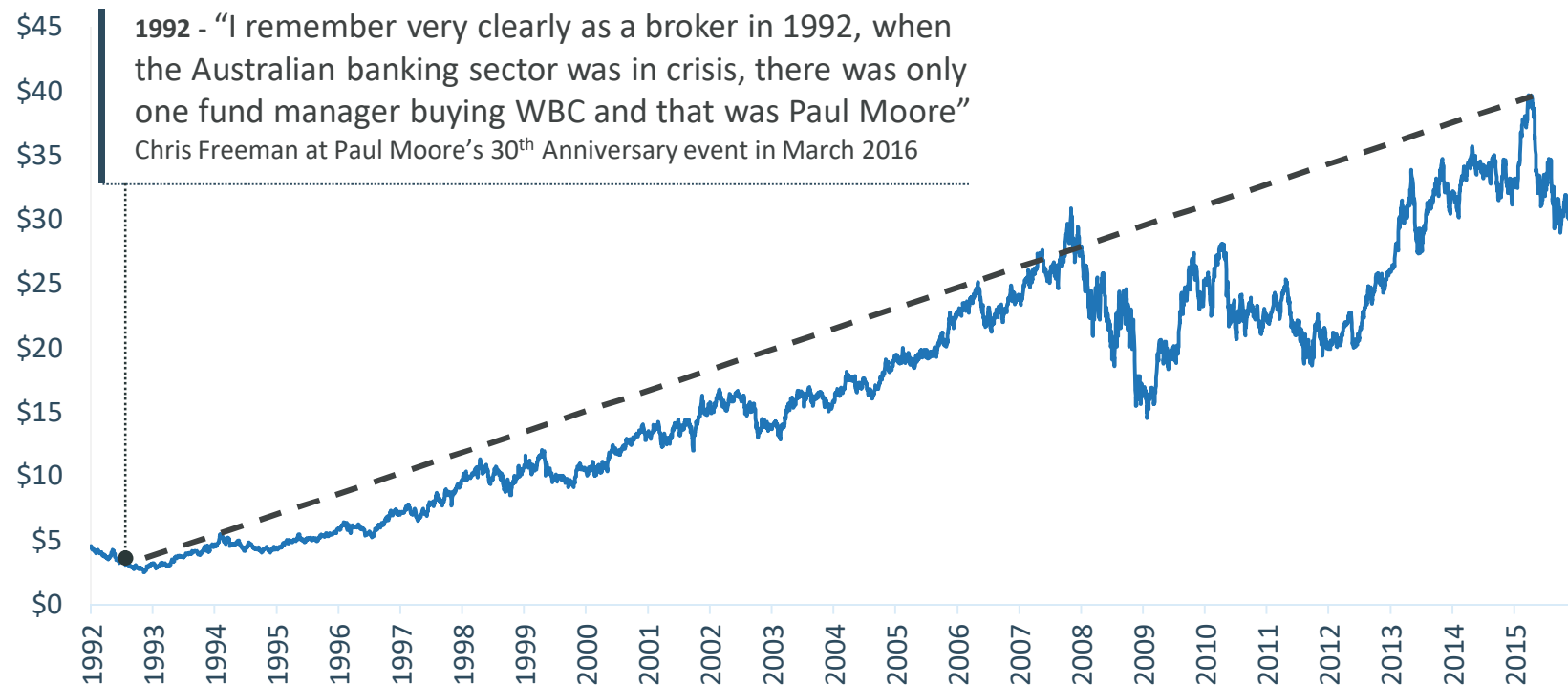


It's just not possible to know everything about everything all the time. What is possible is to wait for investment opportunities to meet your criteria and when the odds are heavily in your favour, back your judgement and invest and let it play out to its fullest extent

...and typically play out in other markets

Westpac Banking Corporation (WBC.AX)

Divest from Aussie banks, says investment manager: 'Speaking at a lunch in Sydney yesterday, PM Capital CIO Paul Moore said while SMSF trustees and even professional investors may be stuck with the habit of having a large allocation to bank stocks, major Australian banks are likely to be reaching the end of their rally' - 5 May 2015



Why investors don't invest in anomalies

“Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”

John Maynard Keynes

Investing in businesses at a discount to their inherent value (anomalies) is business common sense

Investment process

Idea generation – Industry consolidation

Observations by CIO Paul Moore – Global Brewing

1

**Anheuser
Busch**
20+ PE multiple

Coca Cola
A global brand
20+ PE

Heineken
A global brand
10 PE

2

- Historic poor use of capital
- Shareholder dilution due to market share acquisitions
- PM reads annual reports and clear that shareholders were putting pressure on management to reverse

3

- Premium brands emerging – globalisation – would allow for positive pricing
- Ambev – 90% of Brazilian market – wanting to diversify from Brazil – consolidation catalyst
- Experience / intuition / understanding numbers
- Simple idea simple business










4

- > 20 PE
- SAB/ABI merger



Investment process

Idea generation – Industry consolidation

	JUN 04	JUN 05	JUN 06	JUN 07	JUN 08	JUN 09	JUN 10	JUN 11	JUN 12	JUN 13	JUN 14	JUN 15	JUN 16	JUN 17	MAR 18
EUROPE															
Ambev	2%		ambev												
Interbrew/Inbev/AB InBev	3%	3%	3%	3%	2%	3%	4%	5%	4%	3%	2%	2%	2%		
Carlsberg	5%	3%	2%												
Scottish & Newcastle PLC			3%	3%		S&N									
Heineken Holdings		2%	4%	6%	7%	5%	5%	5%	5%	3%	3%	3%	4%	3%	
SAB Miller									2%				SAB MILLER		
AMERICAS															
Anheuser Busch Cos Inc			B		3%	5%		D							
Molson Brewing	2%							E	FEMSA						
FEMSA					1%					F					
Grupo Modelo					4%	3%	2%								
ASIA															
Kirin Brewery	2%	3%		2%											
Asahi Breweries	2%	4%	4%	2%	2%	2%	2%								
HiteJinro					1%	1%	1%	1%	1%						
TOTAL EXPOSURE	16%	15%	16%	19%	22%	14%	14%	11%	12%	6%	5%	5%	6%	3%	0%
<p>A. Merger with Interbrew D. Merger with InBev G. Acquired by Anheuser-Busch InBev</p> <p>B. Merger with Coors E. Beer business sold to Heineken</p> <p>C. Acquired by Heineken & Carlsberg F. Acquired by Anheuser Busch InBev</p>															



CIO Paul Moore and Staropramen-Brewery's Brew Master, part of Interbrew's Czech Business April 2004

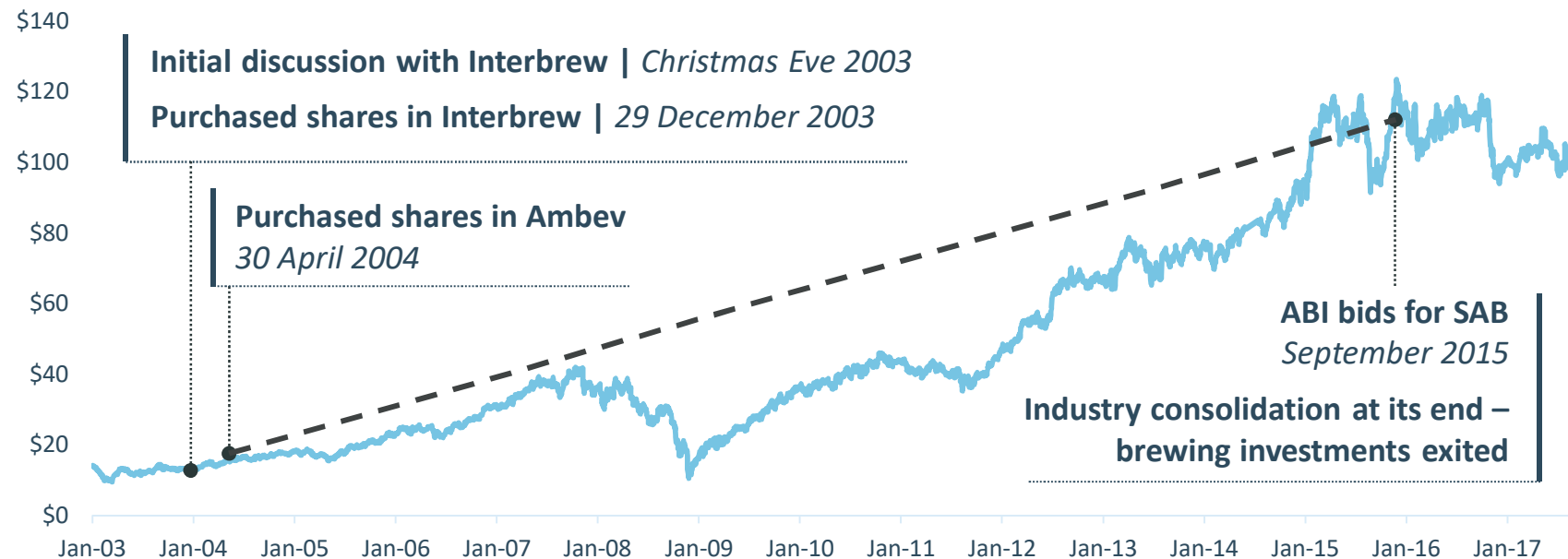


ASX position: Fosters **Asia positions:** Carlsberg Malaysia and Heineken Malaysia

One simple idea. 14+ years. 16 iterations

Anheuser-Busch Inbev

Closing stock price



Business risk

*HEIN - Simple business,
great brand, 100+ years*

Investment risk

*Double digit ungeared
yield*

Price action risk

*Patience and conviction
the only issue*

Price action is not investment or business risk – focusing on will preclude you from the very best investments

V



Moneyball



Why invest in anomalies?



Where to now?

Post-GFC

“ A once in a lifetime opportunity to invest in credit and a once in a generation opportunity to invest in equities ”

“ with record fiscal and monetary stimulus, the economy will recover, but will be characterised by a two steps forward one step back scenario ”

Opportunity cost

Calendar Year	PM Capital Global Companies Fund	MSCI World Net Index (AUD)
2012	41.63%	14.38%
2013	54.22%	47.00%
2014	14.39%	14.72%
2015	12.63%	11.50%
2016	3.13%	8.02%
2017	20.37%	13.32%
2018 CYTD	3.80%	3.46%
2012 – 2018 CYTD	262.5%	172.4%

**For every \$100,000 investing in 2012:
PM Capital \$362,500; MSCI \$272,400; ~\$90,100 more**

Post-Trump



Coincidentally, cyclical growth trends inflecting

Trump moving with the tide as pro-growth;

- Lower taxes, fiscal spending, lower regulation – the key brakes on growth that we have consistently alluded to

A different sub set of opportunities going forward

Bonds, Bond proxies – Property, Infrastructure, “Defensives” most at risk

Banks a primary beneficiary?

Do not under-estimate the magnitude of change and the implications for portfolio /manager composition

First innings – post tax reform, now in the second innings

2016: Negative rates

“ The reality is, that the future is always uncertain. Every year I comment that just when you think you have seen everything, something new comes along. The 1987 stock market crash, the 1990 “CNN” Gulf War, the TMT mania in 2000, Twin Towers, the Global Financial Crisis and now Brexit are the standouts (I am going to have to stop making that statement). So our ultimate objective as an investor is to find different businesses that we believe will provide us with a satisfactory long term return and remind ourselves that investment returns are not a straight line and that we are ultimately arbitraging short term investors’ lack of patience. ”



Paul Moore | 2017 PM Capital Investor Forum

+ Trump

+ Bitcoin

**Record
Government Debt
Record low rates**

Valuation

Risk Reward

Market behaviour

Post Trump Framework

Bondnado

Bondnado

The fundamentals

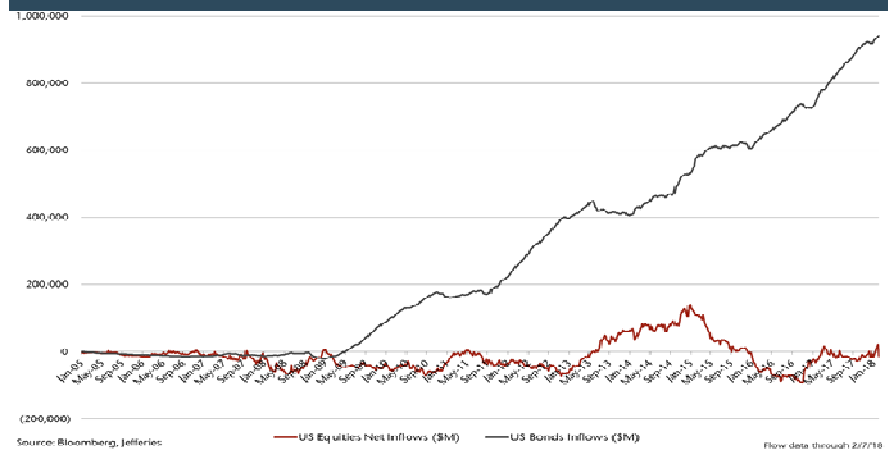
Quantitative

- **Absolute return makes no sense**; zero return - hard to make a positive return!
- **Real return**; inflation – priced as an impossibility!
- **Risk adjusted**; defaults – priced as an impossibility!

Qualitative

The bigger the crowd the bigger the risk

Cumulative inflows to US FI and Equity Mutual Funds and ETFs (\$M): 2005 - 2017



Bottom line

Financial system does not work with negative rates –
mis-allocation of capital - *It had become ridiculous*

Inflation 10%+
Interest Rates 20%+
Dan Aykroyd
Volcker

No wage growth
Negative Mortgage Rates
Inflation too low!

Ridiculousness

Opinions

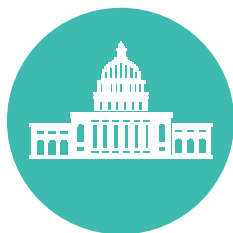
“ But our expectation was that growth would be stronger than most expected and that inflation, wages and interest rates would inflect.”

“ And investing's tough. It'll test your character. And you need patience and conviction. Why? Because all great investments at the time they're purchased are either questioned and, in some cases, ridiculed.”

2018, now a fact?



**Fed and ECB
reducing their
bond holdings
(liquidity)**



**Trump tax
reform
= fiscal stimulus**



**Rates are up –
US 10 yr more
than doubled**

But no wage growth?



**German union wins
right to 28-hour
working week and
4.3% pay rise**



**US 10-year yield
jumps to new 4-year
high of 2.92% after
hot inflation report***



**US inflation
surprises to upside,
pointing to faster
pace of rate hikes**

Surprised?

Bondnado (Sharknado) 2

1st liquidity rumbling

- Bitcoin / Short VIX funds

Market “scares” now about inflation (v economy)

Bondnado (Sharknado) 3/4/5

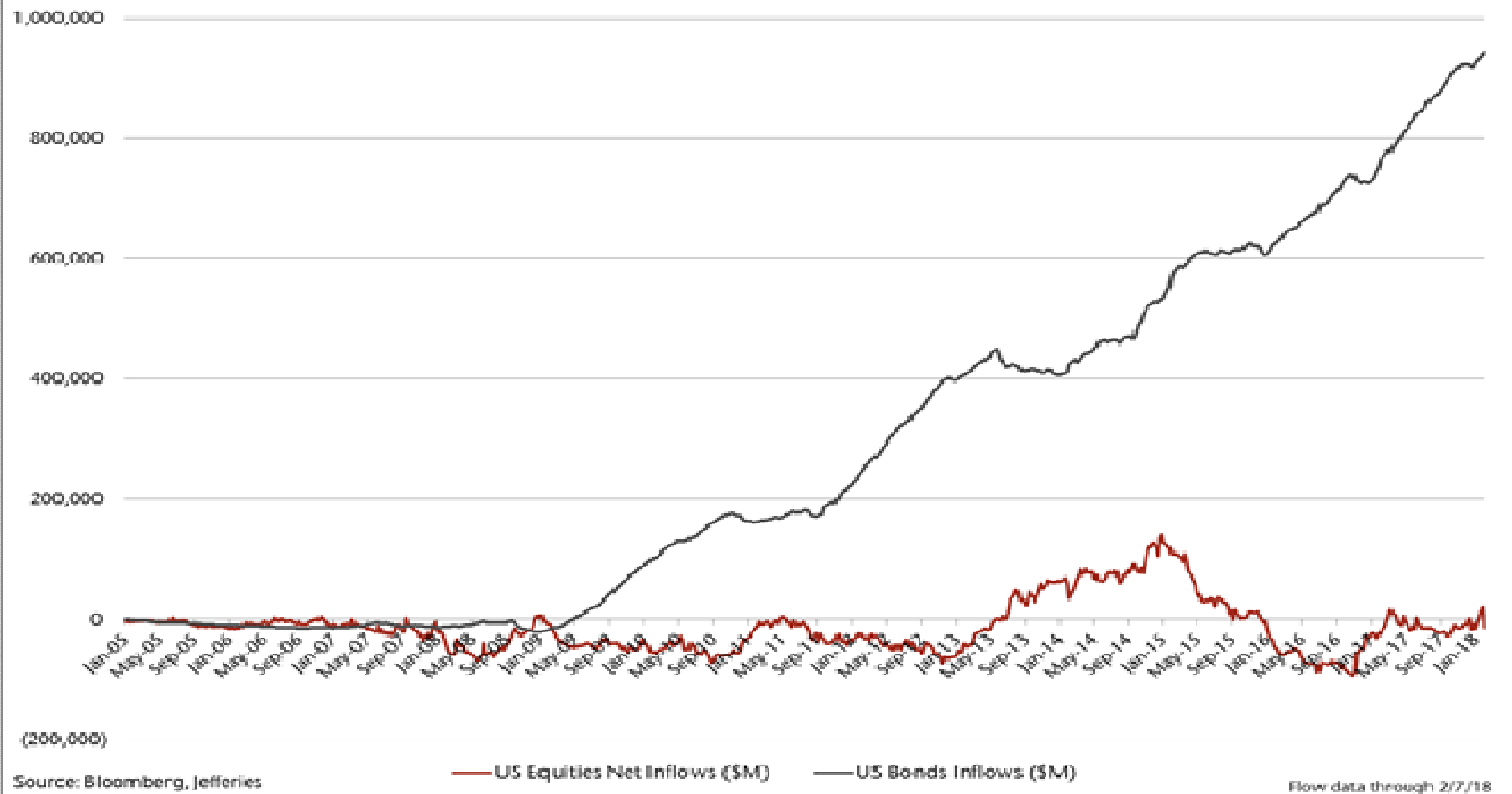
Everyone now on board?

Have they acted?

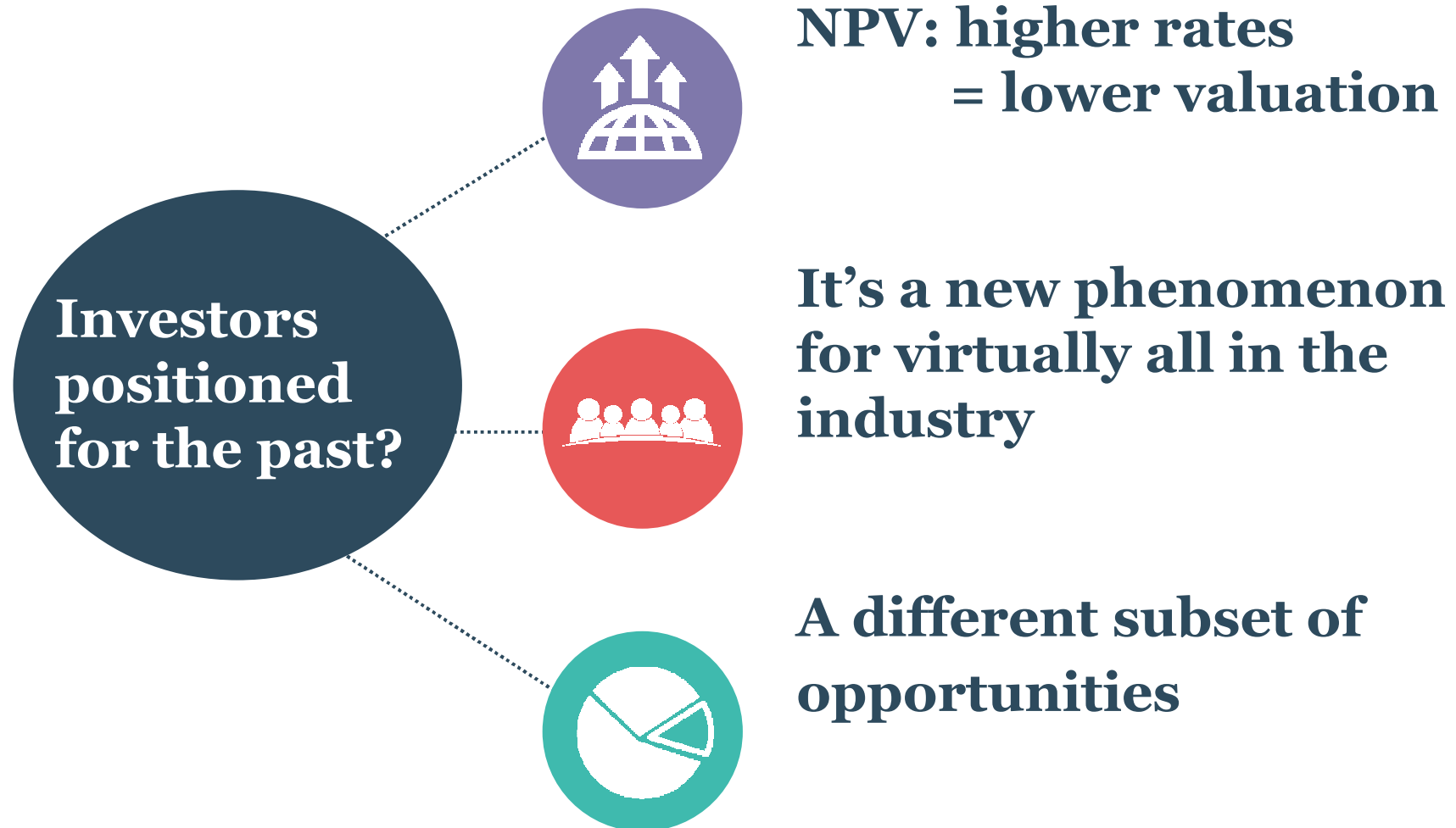
The bigger the crowd the bigger the risk



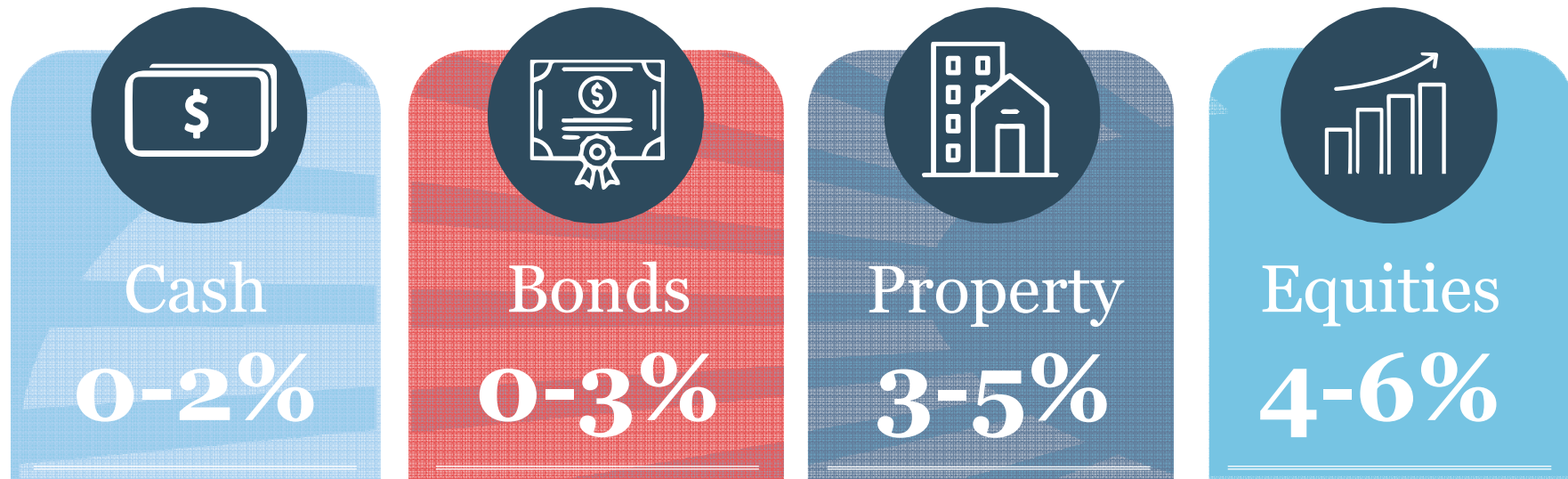
Cumulative inflows to US FI and Equity Mutual Funds and ETFs (\$M): 2005 - 2017



Why it's important?



Generic return expectations



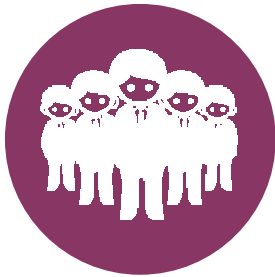
Blended portfolios **will not** meet objectives?

Neither will index funds?

High conviction (not benchmark aware)
managers required?

Bonds can be high risk?

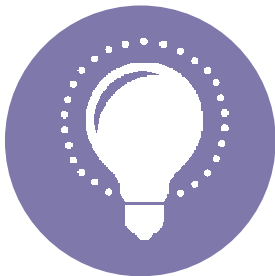
What does it mean?



**Industry may need to re-think
it's accepted wisdoms – lazy AA**

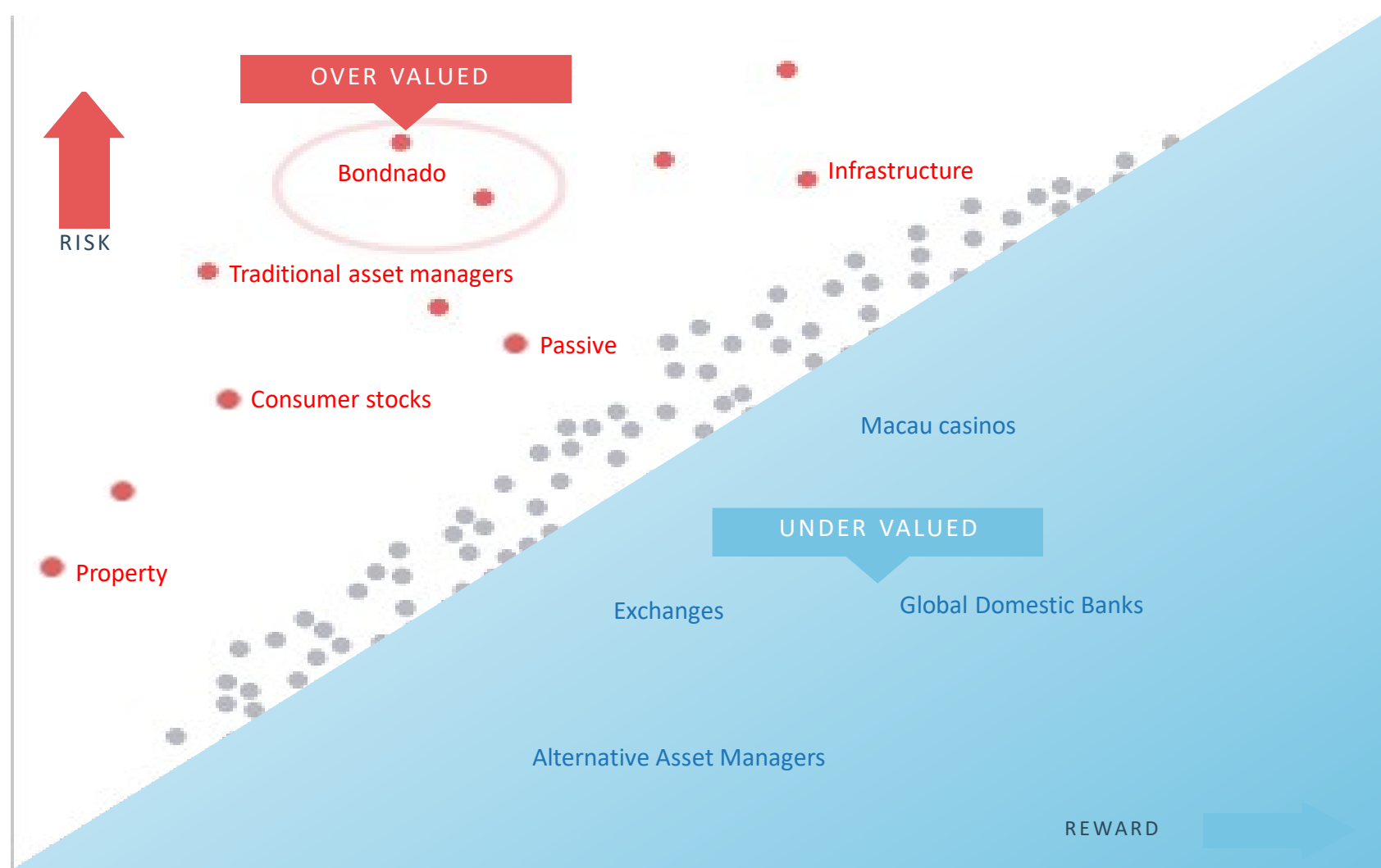


**Not to be feared – if the tide
has changed, ask the right
questions and adapt**



PM Capital - business as usual

Looking forward

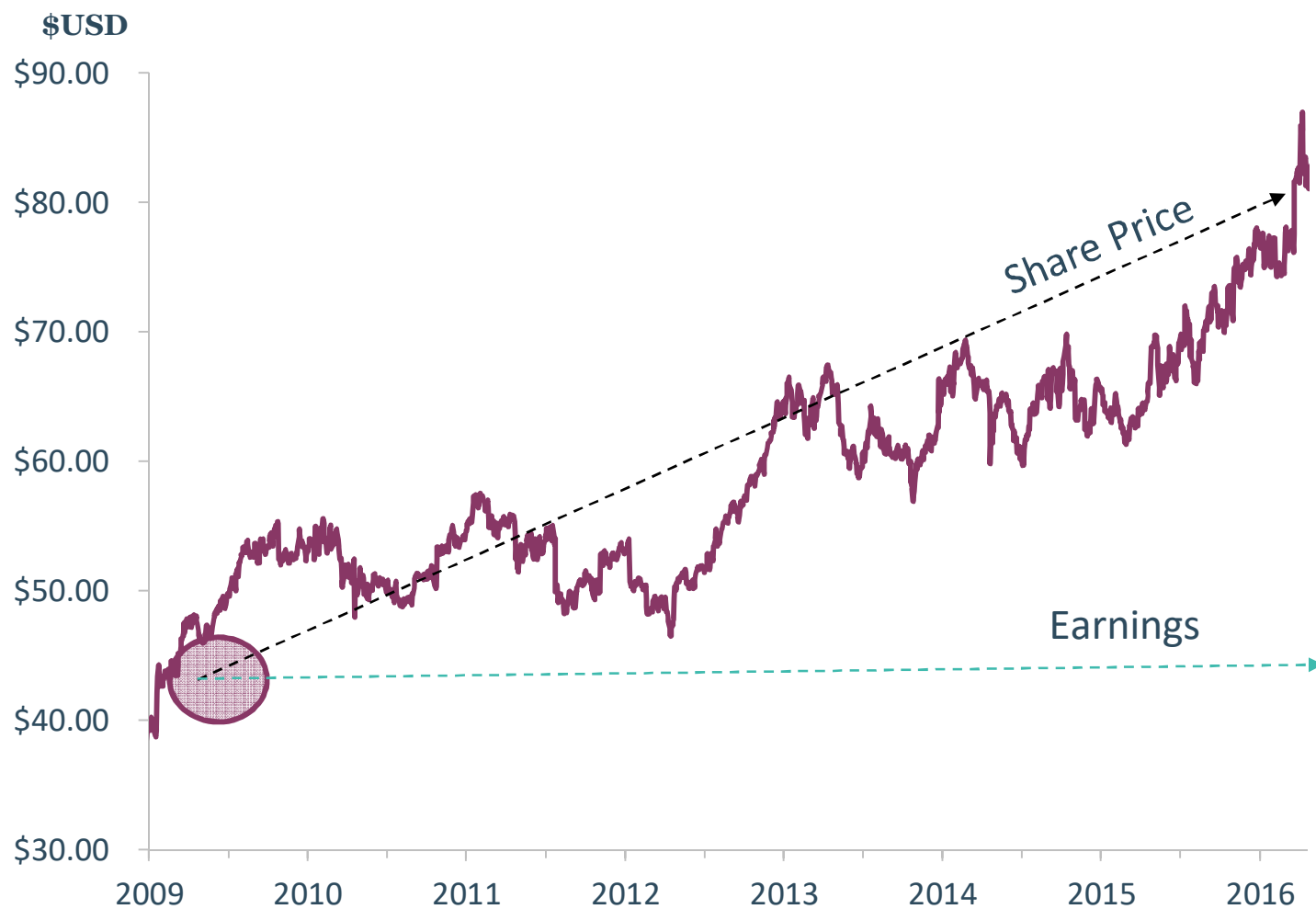


Consumer – perception vs fact

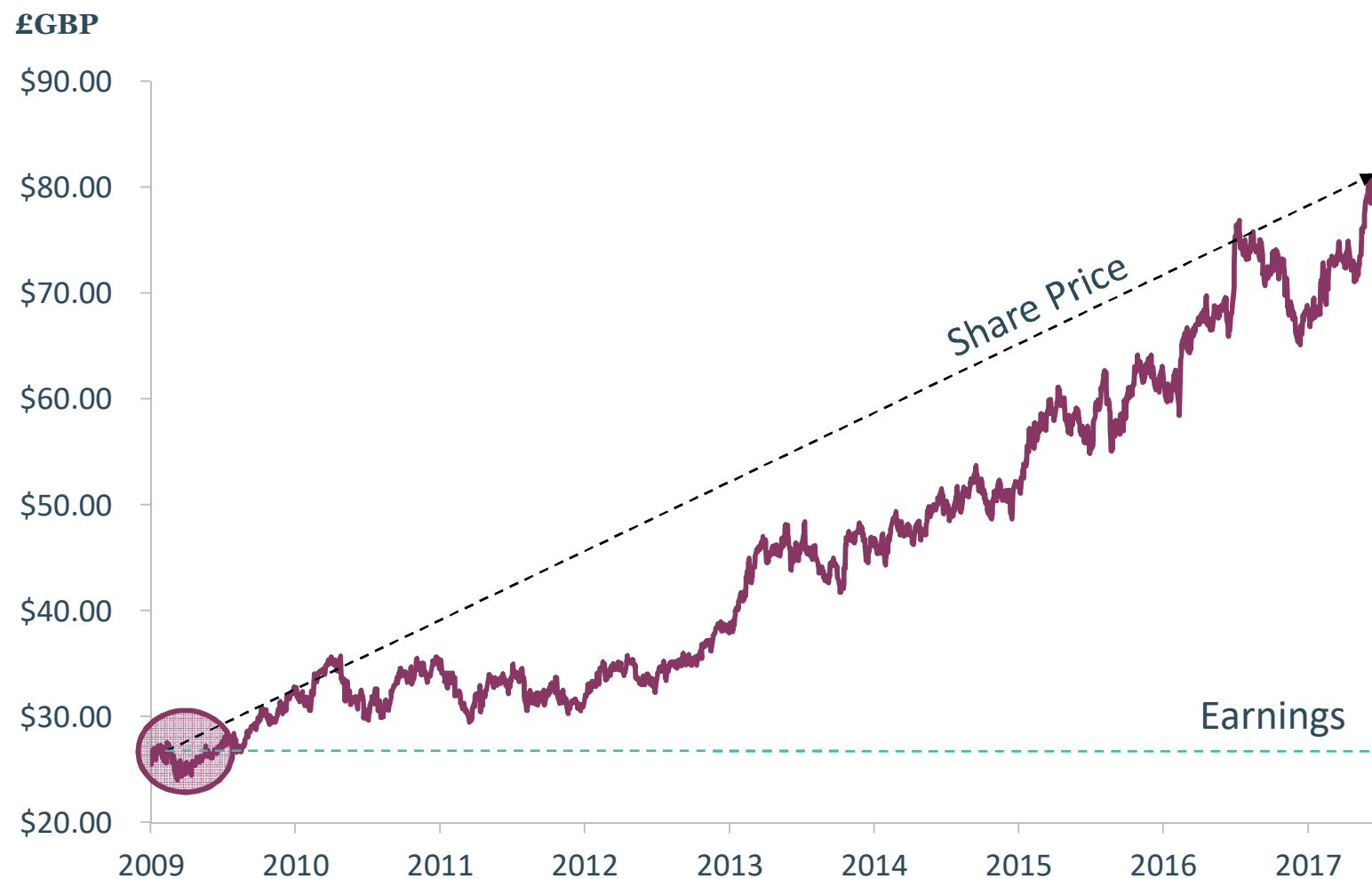
Company	EBIT / EPS 2009/10	EBIT / EPS 2017/18	
Campbell Soup	1360	1392	Canary in the coal mine
Kellogg	2000	1860	ZBB
Proctor and Gamble	?	?	M&A BB
Unilever	2004 – 2009	?	Euro
Danone	3.04	2.79	Steven Bradbury Euro
Nestle	3.3	3.3	M&A BB Euro
Coca Cola	2.01	1.8	M&A BB

**Recurring non-recurring items /
M&A / financials messy / upscaling**

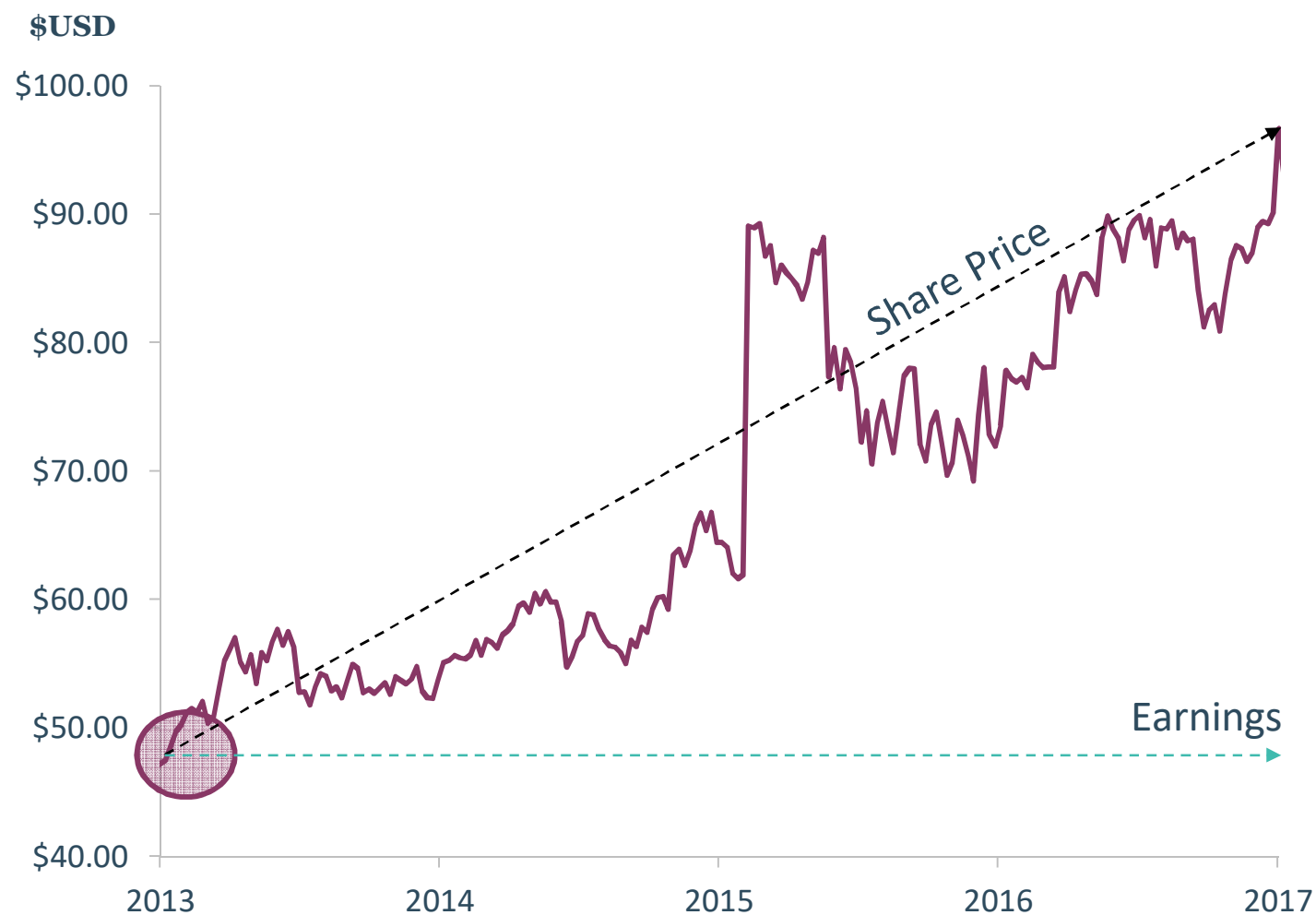
Kellogg



Reckitt Benckiser



Kraft-Heinz



So why going up?



Perception - defensive



Financial engineering - buybacks



Technical – ETFs



**Corporate – Kraft Heinz –
zero based budgeting**



Interest rates?

But what is really going on?

- **Saturated markets, changing demographic and consumer behaviour, disruption**
 - AMZN, ice-cream (halo top)
- **Nestlé sales growth weakens to slowest in decades**
- **Proctor and Gamble – first price decline in 7 years**
 - Unable to pass on rising commodity prices
 - Margins lower

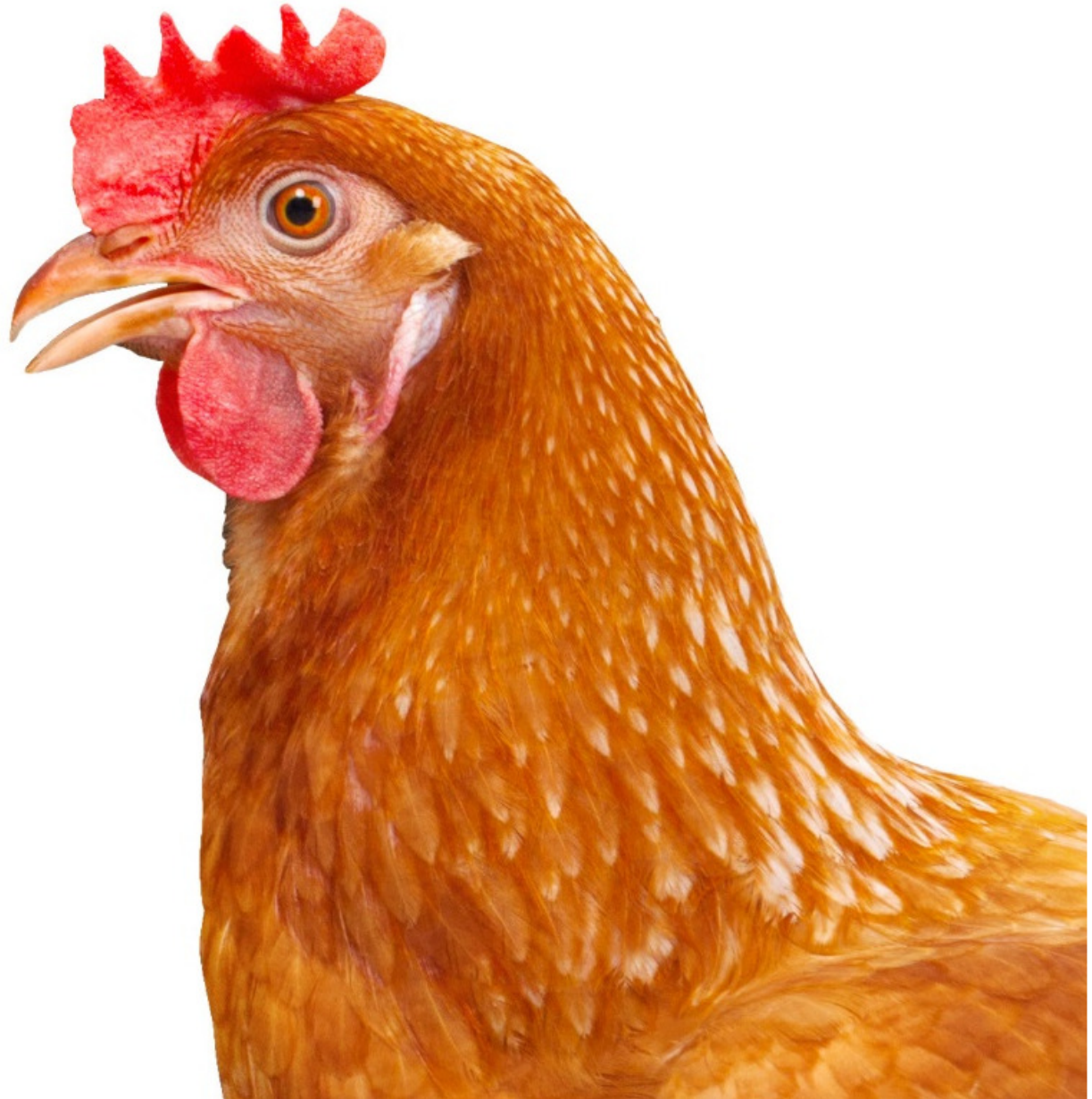
“Productivity improvement will be critical to fund investments for sales and market share growth while continuing to expand profit margins.” *

An omen?

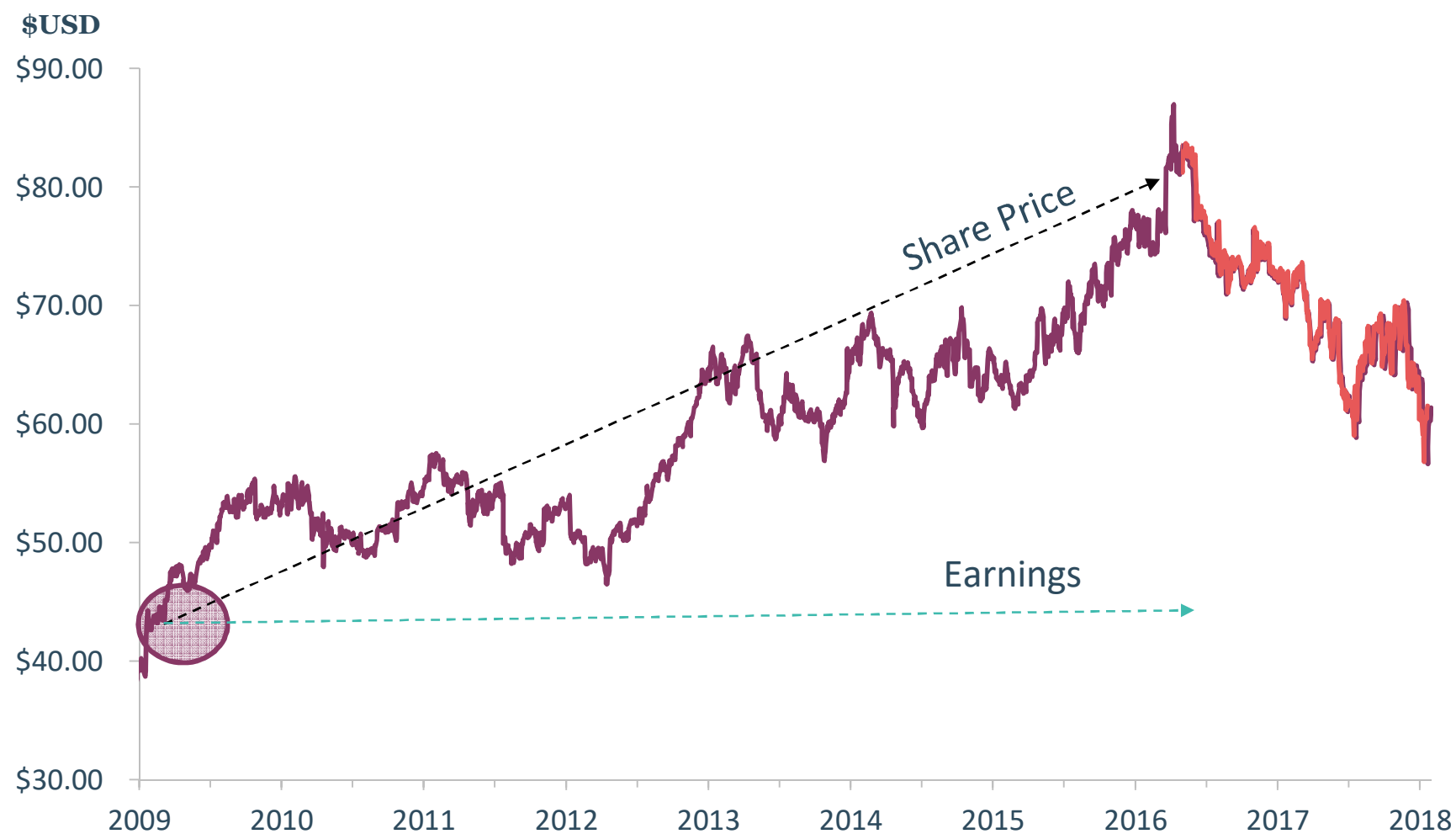
**KFC closes
across the UK
due to a
shortage of
chicken***

**KFC reports
gravy shortage,
following
chicken crisis**

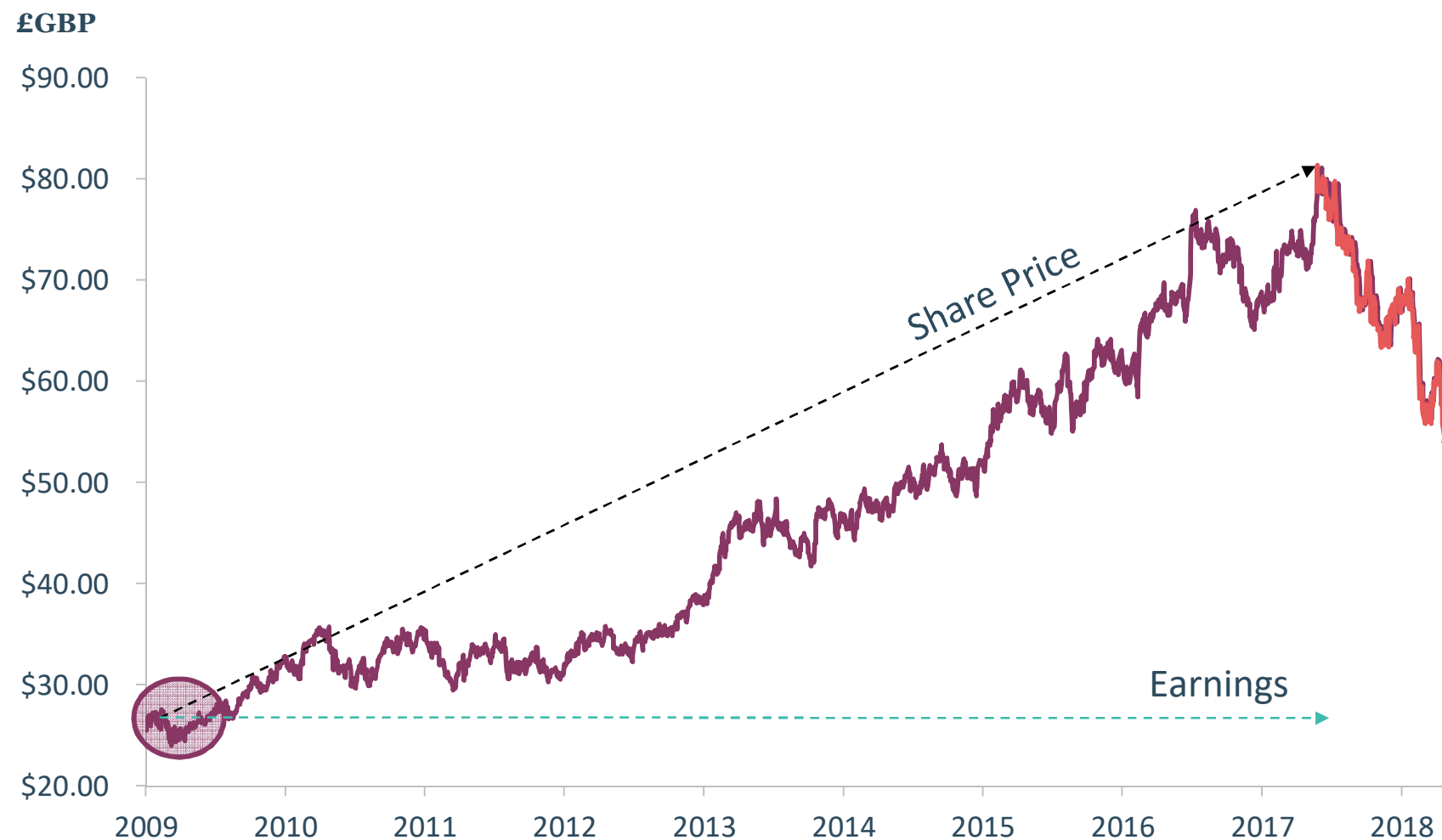
CO₂ !



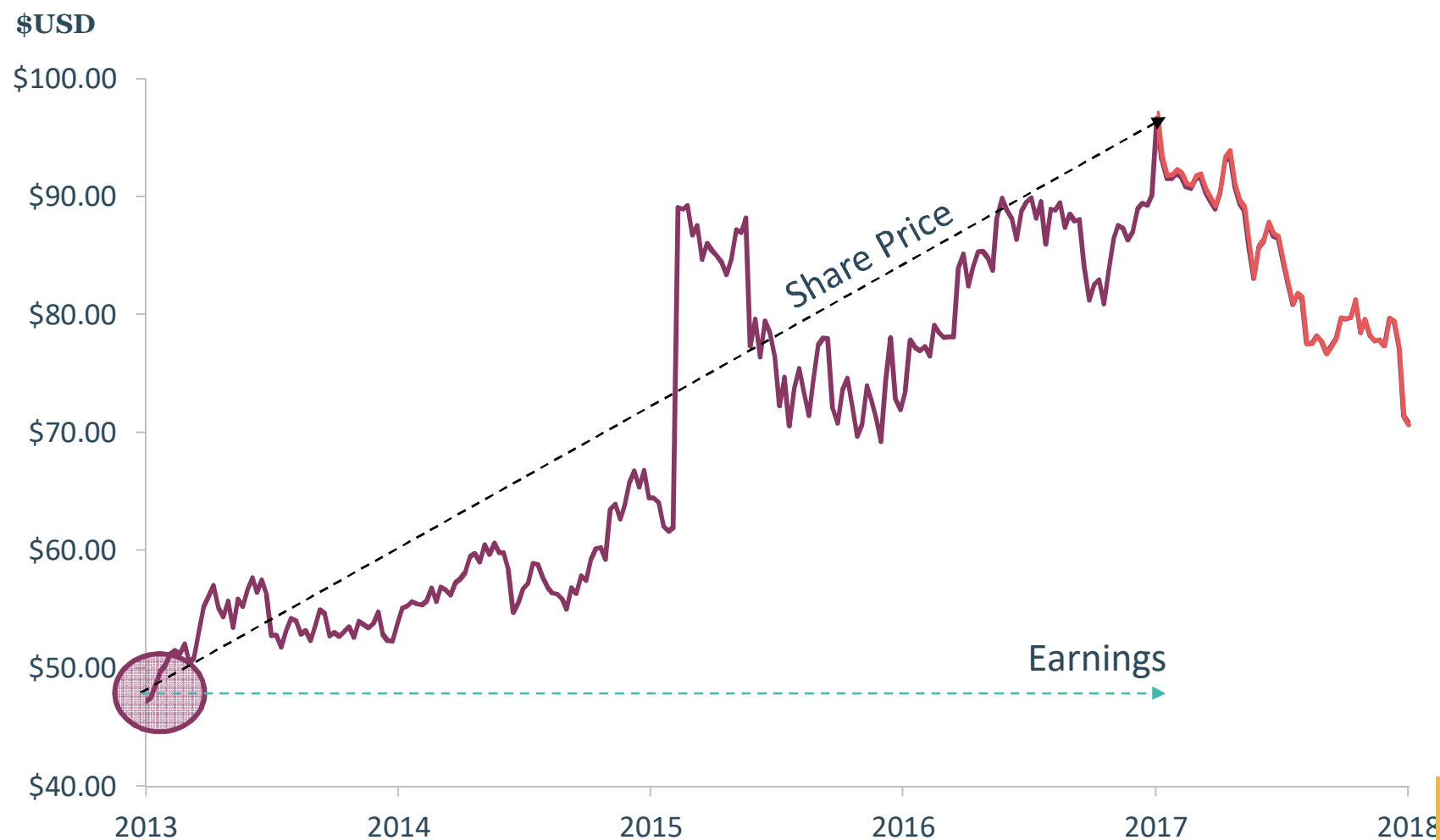
Kellogg

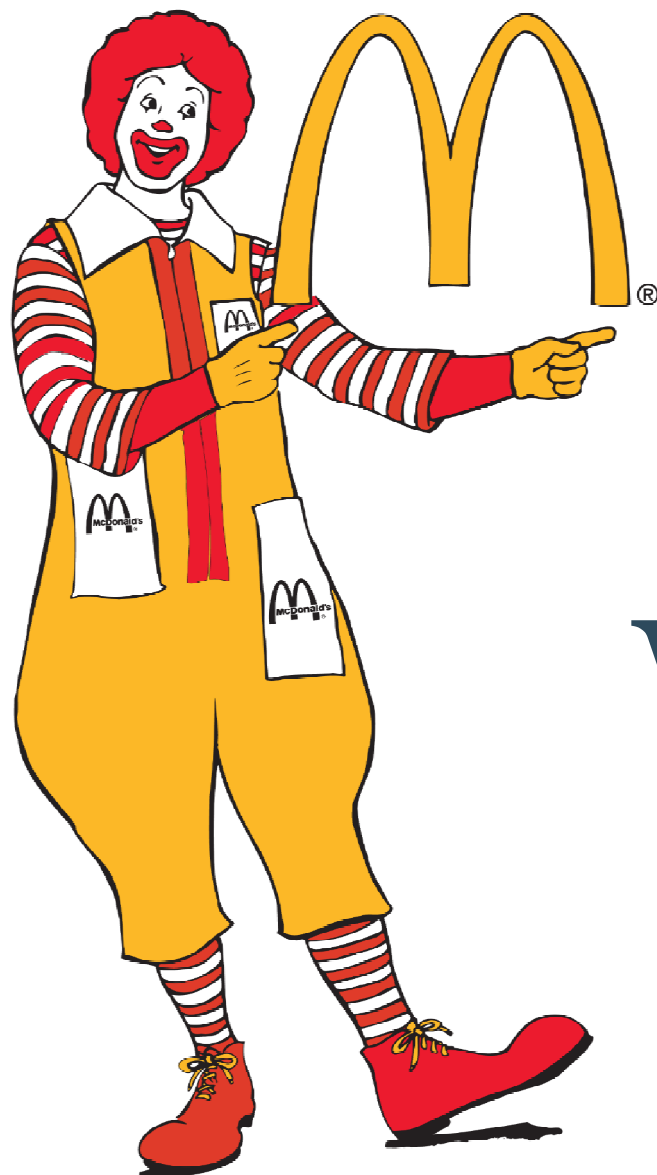


Reckitt Benckiser



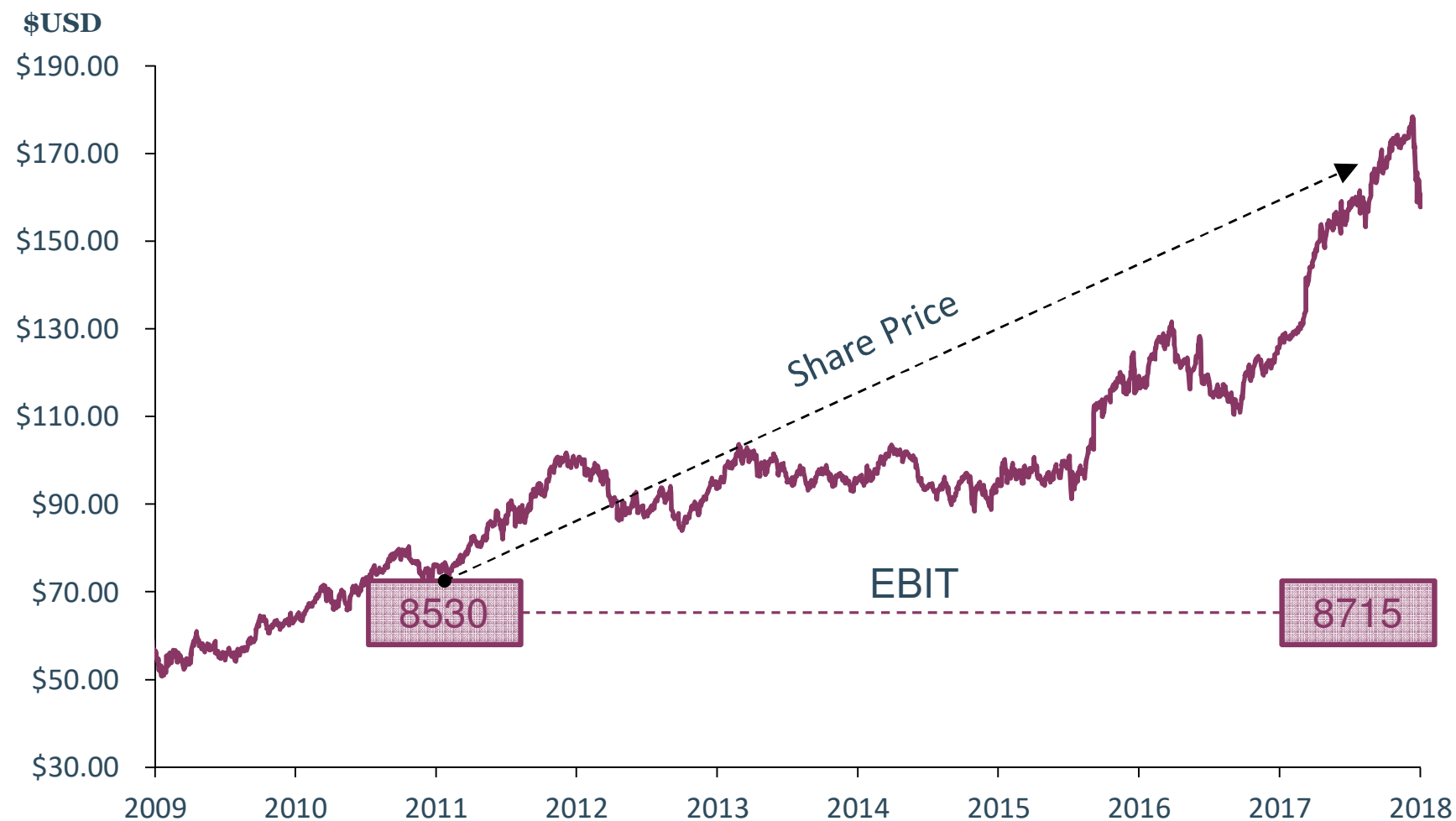
Kraft-Heinz





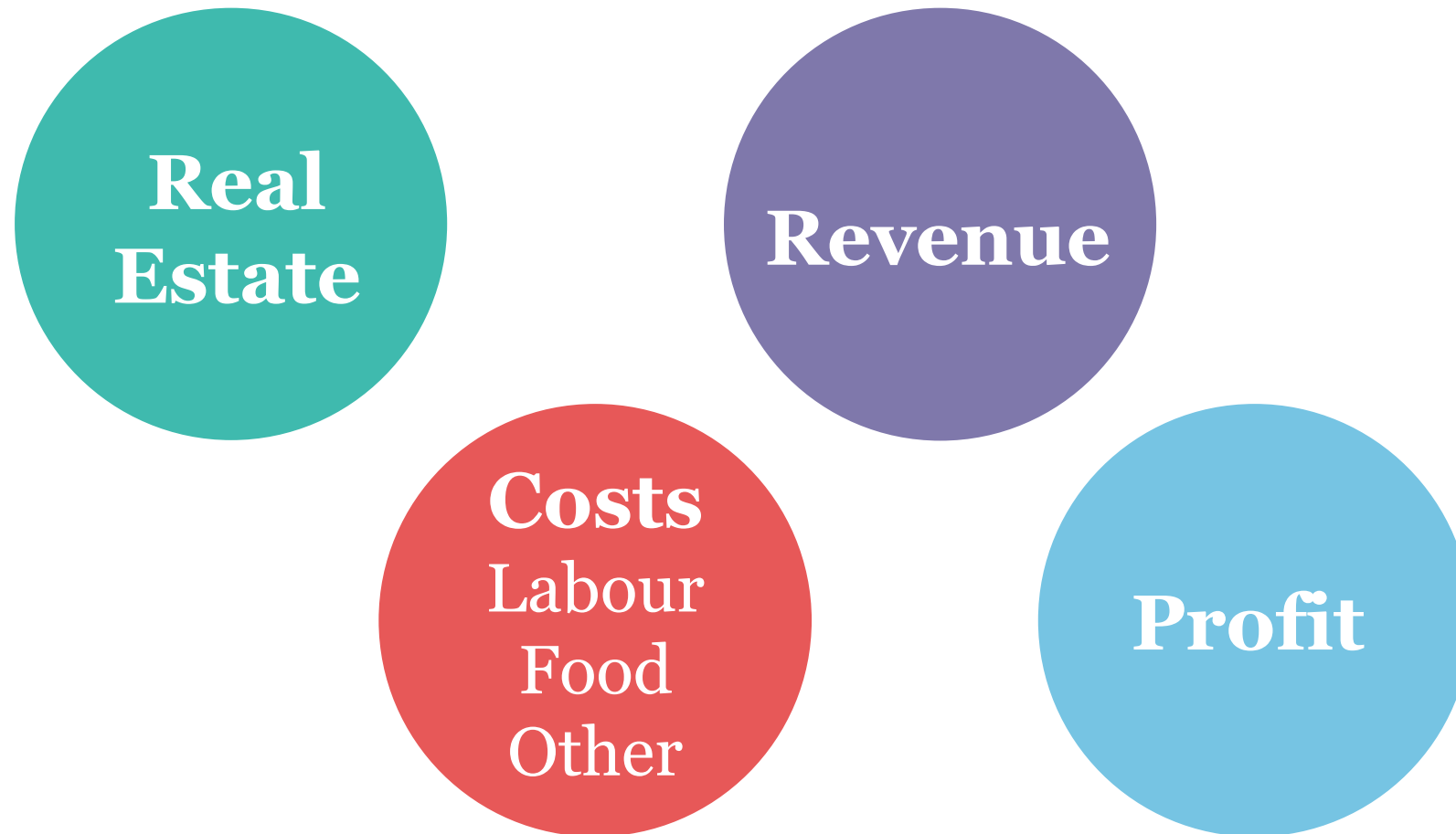
Where else?

McDonald's



Original business model

Own and operate



What type of business are we?

Fixed Assets	
Land & Building	21,258
OA	1,056
Total	22,314
Funded by:	
Debt	24,732

“We are not technically in the food business. We are in the real estate business. The only reason we sell fifteen cent hamburgers is because they are the greatest producer of revenue, from which our tenants can pay us our rent.” *

New business model

Control and others operate?

- 1** Franchisor sells property and right to run the restaurant – receives royalties
 - Capital released / + debt / buy back stock

- 2** Franchisee runs the business
 - Borrows to by franchise
 - Royalty
 - Rent
 - Labour, food and other costs
 - Interest expense

- 3** Franchisee sells the real estate to an investor

- 4** Real estate investor borrows to purchase real estate

Interest Rates facilitated maximum gearing at the point of inflection?

Industry dynamics

McDonald's 35% of a saturated industry

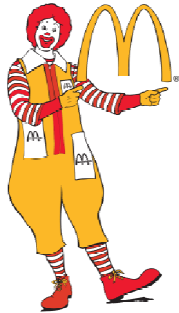
“ It's a market share fight. We don't see really any significant broader market growth this year...”

Stephen J. Easterbrook

*President, Chief Executive Officer & Director, McDonald's Corp.**



Where are the real anomalies?



1. Observation

Restaurant Franchise or property business?

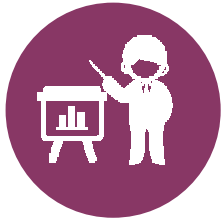


2. Confirm thesis

Review Restaurant ecosystem

- Franchisors: Burger King, Dunkin Donuts, Wendy's, etc
- Franchisees: Carrols, Meritage, etc

Never black or white



It's not easy



A lot of work



Simplifying the complex



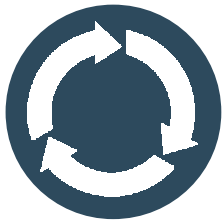
Last 10% makes the difference

Post Trump Third innings



Dealing with structural issues – trade

- Perpetual trade deficit
- Transfer of wealth to Asia
- Hypocrisy on free trade
- Risk premium



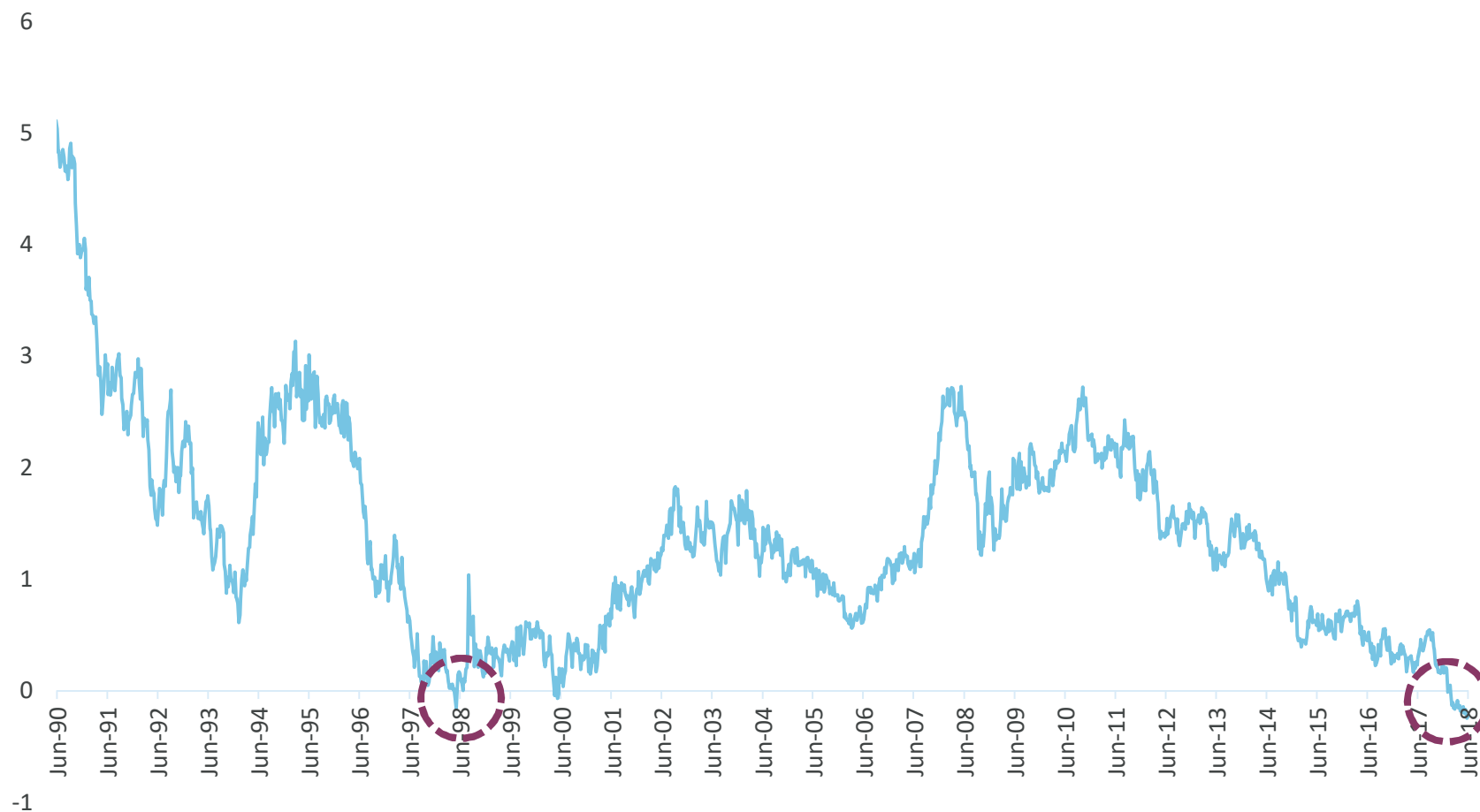
+ Higher long term rates = end of cycle?



Market consistent and trying to work out way forward

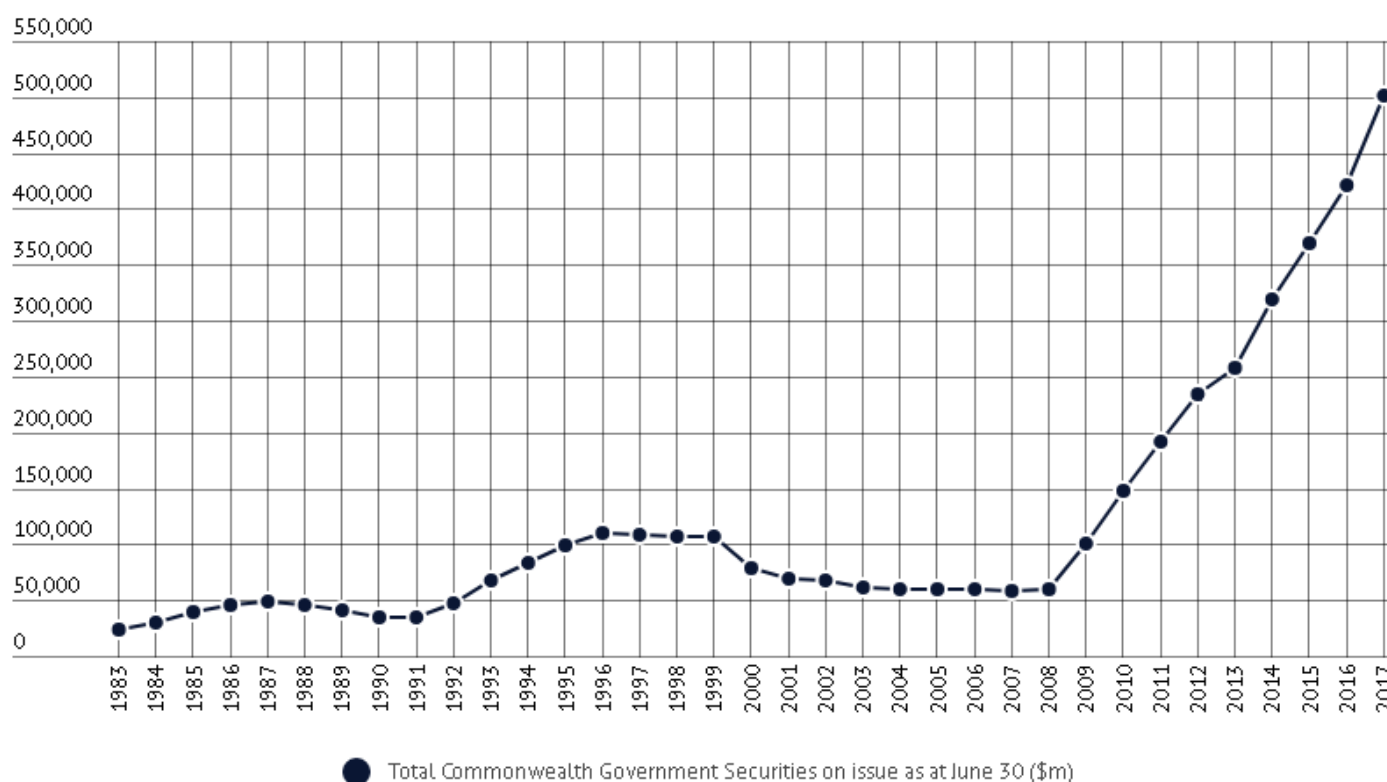
- China / \$A / European Banks

Ten year Bond Spreads



Market insights

Total Commonwealth government securities on issue (\$m)



Source: Australian Office of Financial Management

Focus on the stocks

Company	Sector	2019 PE
Toll Brothers	Home Builder	7
ING	Domestic Bank Europe	9
Bank of America	Domestic Bank USA	10
KKRs	Alternative Asset Manager	11
Pfizer	Pharmaceutical	12
Deutsche Bourse	Futures Exchange	20
Alphabet	Service Monopoly	24
Visa	Payment Processor	24

What are the risks?



Absolute risk has changed



Business risk



Emotion

- Short term headlines / macro and political distraction
 - Slogans - Value Growth GARP Quantamental
-



Size

- Passive / ETFs reduce liquidity
-

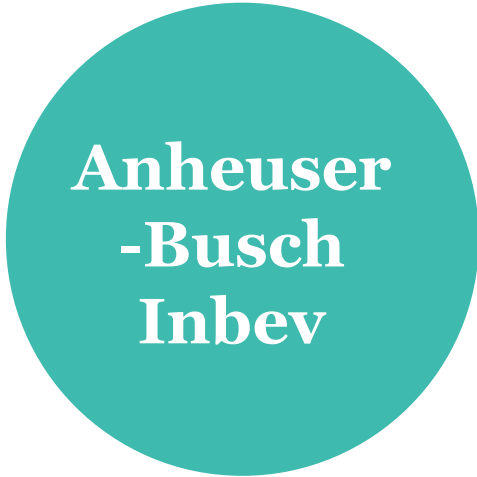


Inflation

But biggest risk is.....

A short term horizon

Risk is ultimately a function of time and objectives



**Anheuser
-Busch
Inbev**



Apollo

Investment process



Idea generation

– severe cyclical downturn + process

Observations – Alternative investment managers

1

**Fees fall in
2014/15 - but
transitory**

**< 10 PE
> 10% Yield**

**Inflows
favouring alt.
mgrs**

2

- 2014/15: share prices declined as the performance fee cycle peaked.
- Significant valuation difference between traditional and alternative managers.
- Partnership structure acts as a barrier to institutional investors.

3

- Good businesses, easy to understand – sharpest minds on the Street.
- Secular demand for alternatives has risen.
- Conducive market environment for capital allocation, generation of performance fees.

4

- Generational ownership change likely
- Tax reform incentivises possible C Corp structure - facilitating index inclusion
- Sell >15PE Fully Taxed
- Sell >Traditional Fund Manager PE

Investment process

Severe cyclical downturn



Portfolio weightings as at end of period - <i>PM Capital Global Companies Fund.</i>	Dec 14	Jun 15	Sep 15	Dec 15	Mar 16	Jun 16	Sep 16	Dec 16	Mar 17*	Jun 17	Sep 17	Dec 17	Mar 18	Jun 18
KKR		1.9%	2.4%	2.6%	3.7%	3.4%	3.8%	4.2%	4.6%	4.4%	4.5%	4.1%	4.3%	5.1%
Blackstone				1.7%	2.1%	2.0%	2.0%	2.0%	2.0%	2.1%	2.0%	2.3%	3.0%	2.9%
Apollo			0.9%	1.5%	3.5%	3.5%	3.9%	4.0%	4.6%	4.7%	4.9%	3.8%	3.2%	3.6%
Fortress									1.0%*					
Ares											0.9%	1.9%	3.0%	2.8%
Total Exposure (%)	0.0	1.9	3.3	5.8	9.3	8.9	9.7	10.2	12.2*	11.2	12.3	12.1	13.4	14.4

*Portfolio position initiated in Fortress Investment Group early Feb, 2017. Takeover offer accepted mid-February, providing an immediate 40% return.

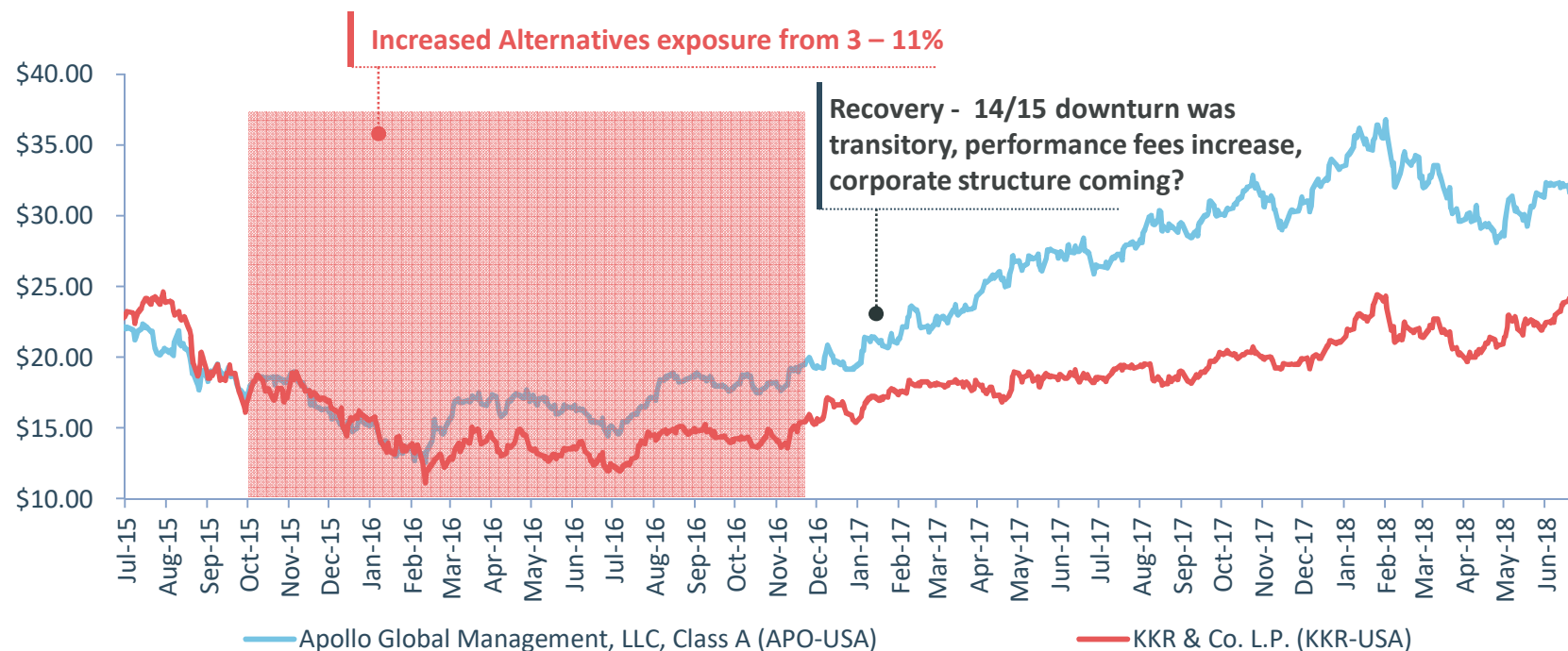
“Our model isn’t just nimble – it’s resilient and transcends the ups and downs of the market.”

Stephen A. Schwarzman - Chairman, CEO and Co-Founder, Blackstone. Annual Chairman’s Letter, 2016.

One simple idea. Many iterations.

Apollo; KKR

Closing stock price (USD)



Business risk

Sweet spot of industry –
smartest management

Investment risk

>10% Yield

Price action risk

Patience and conviction the
only issue

Price action is not investment or business risk – focusing on will preclude you from the very best investments

Where are we now?

Alternative manager valuations have risen, but remain below traditional managers

- Traditional managers: ~15x 2019 forecast earnings*
- Alternatives: ~11x 2019 forecast earnings*
- 5% yield on locked in management fee

Fund flows continue to be strong

- Fund flows favouring alternative managers over Traditional Fund Managers
- Strategy to broaden their investor base

Conversion to corporate structures now happening

- Corporate tax cuts make transition from partnership to corporate structure more attractive (Ares, KKR)
- Allow introduction to indices; broader shareholder base

Process creates perverse outcomes - NPV / Tax

The good news is...

Equity & Strategy Focus Point

The ETF-ization of the S&P 500, Part I

02 July 2017

Bank of America Merrill Lynch

Is the S&P 500 as liquid as it seems?

The percentage of US domiciled equity fund assets that are passively managed has nearly doubled since the crisis, from 19% in 2009 to 37% today. The percentage of S&P 500 market cap held by Vanguard alone has doubled since 2010, to 6.8% today. Vanguard currently is a 5%+ shareholder of 491 stocks in the S&P 500, up from just 116 in 2010. The actual shares available, or "true float" (float shares less shares held by passive funds) for S&P 500 stocks, may be grossly overestimated. This, and other structural changes, are playing out in the market with implications for US investors.

How big can passive get? Apparently a lot bigger

We are often asked how much further this active to passive rotation can go before markets become dysfunctional. In Japan, nearly 70% of the assets under management (AUM) of Japan-focused equity funds is passive (granted, the BoJ has been buying ETFs) and their markets are still functioning. This is almost double the proportion of US passive. The victim in Japan has been active equity managers. Over the past three years of extreme ETF inflows, Japan-focused active funds suffered benchmark outperformance rates 12ppt lower than prior decade's average. As the ETF-ization of US stocks is likely to continue, we highlight four implications.

1. Avoid crowded stocks (especially right now)

Over the short-term, positioning matters more than anything; buying under-owned stocks has led to stronger three-month returns than investing in low P/E, high growth or high ROE stocks. Crowded stocks have generally underperformed neglected stocks as mutual funds are net sellers and passive funds are net buyers. Crowding risk is particularly acute at quarter-end when allocators tend to rebalance: in the first 15 days of the quarter, positioning alpha is 10x higher than average.

2. ETF fads can drive massive PE distortions

The meteoric rise in Low Volatility ETFs (150% annual asset growth since 2009) was a key driver of the 200%+ surge in relative valuations of low beta stocks to never before seen premia. Where might the next fad be? Our work suggests that the next ETF influx may be into Value ETFs, ESG strategies and short-term quant strategies.

3. Know your risk: a screen for stocks with low "true float"

Stocks most held by passive investors have seen higher volatility than the market, measured by both price declines and standard deviations. And the average price volatility of stocks with low "true float" (i.e. those with a high proportion of float held by passive) tripled in the last 12 months. But the earnings multiples of these stocks have generally been in-line to higher than that of the market, not necessarily reflecting heightened liquidity risk, in our view. (See inside for a screen of stocks with the lowest float-to-market ratio.)

4. Time horizon arbitrage

Our analysis shows that fundamental signals have significantly improved in efficacy over longer time horizons, whereas algorithm-driven signals perform well in the short term, but the decay rate is extreme. Valuations explain almost 90% of the S&P 500's returns variability over a 10-year time horizon — we have yet to find any signal with even close to that level of predictive power over the short-term. And ironically, what should be an increasingly efficient market has shown signs of becoming less efficient over the long term — alpha opportunities, measured by the range of market prices, have shrunk on a short-term basis, but have demonstrably risen on a long-term basis.

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But where are those opportunities?

Offshore?

Greater breadth and
better risk reward?

1% of SMSF assets invested in International equities

P Trackers Go 2025

No dilution to shareholders

All initial costs paid by PM Capital

7 year redemption safety net at NTA

Choice to convert to PGF shares with CGT roll over relief

A more efficient way to invest offshore

Offer of ground-breaking advancement in LIC securities to be listed on ASX.

Access global equity markets using an award winning and leading Investment Manager via a new form of LIC designed to put your interests first.

PM Capital's core competency



Genuine long term valuation anomalies



Exhibited over 30+ years



Simple ideas, simple businesses, many iterations



Our credentials as a core international equities manager