Argo Investing in Australia

ARGO INVESTMENTS LIMITED
ABN 35 007 519 520

2018 Annual General Meeting
MANAGING DIRECTOR'S ADDRESS

Delivered by Mr. Jason Beddow at the 72nd Annual General Meeting of Argo Investments Limited (Argo or Company) held at the Adelaide Oval on Monday 22 October 2018 at 10.00am.

Market review

A couple of weeks ago as we began preparing for today's meeting, we were looking at record levels across most of the stock indices in the US, including the Dow Jones and Nasdaq. While in Australia, the broader market had reached levels not seen since the Global Financial Crisis. How quickly things can change, with equity markets across the globe enduring a relatively traumatic start to October.

The catalyst for the recent market ructions remains obscured, with commentators speculating on various different contributing factors including US/China relations. Trade relations between China and the US have been strained for some time and, while they are still escalating, this is not a new factor.

Increasing interest rates in the US is another reason given for the market sell-off. While the risk of accelerating inflation is real and negative for asset prices, the US Federal Reserve is currently raising rates in line with market expectations. In September, the central bank raised rates for the eighth time in two years, to 2.0% as expected and in line with its well-telegraphed dot plot of forecast rate moves over the next two years. In contrast, in Australia the Reserve Bank has maintained a flat 1.5% cash rate for over two years.

As we commented at our annual result, we thought valuations were generally stretched, with limited earnings growth outside of a few offshore names and energy companies. With the valuation of high price to earnings ratio stocks relative to the industrials at recent highs, we also thought this part of the market was susceptible to a correction and this seems to be occurring in some names.

Argo takes a conservative approach to investing and was underweight or did not own most of the high price to earnings ratio and more speculative stocks. While these stocks have significantly outperformed the broader market over the past two years, recently they have fallen a lot harder than the overall market.

While a number of sectors are still trading towards 52-week highs, including Healthcare, IT and Energy, some value is appearing in other sectors, which are very close to one-year lows, such as Financials and Utilities, although both of these sectors have their own risks.

Looking back to financial year 2018, it was in some ways quite a challenging year for investors. Global markets saw strong growth in the share prices of high growth industries, particulary Technology. In turn, investors in Australia have chased and paid up for these more limited growth opportunities in our market. In this environment, value-orientated investment strategies have found it hard to match index returns.

Specific sectors, particularly Energy and Mining, enjoyed above-index returns with the benefit of higher commodity and oil prices and a falling Australian dollar. Argo holds an underweight position in Mining stocks, and more particularly the smaller and mid-size resources companies which rose over 40% as a group, and this contributed to underperforming the benchmark index this year.

The difference between the winners and losers during the year was large, even in the larger capitalised companies. For example, a very strong positive contribution to Argo's relative performance came from being underweight the four major banks, particularly Commonwealth Bank of Australia, and being overweight Macquarie Group, which is our largest overweight individual stock position. This sector positioning added 1.6% to our performance relative to the benchmark.

The Banking Royal Commission

Headlines from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry have dominated for most of this year. Combined with low credit growth, increased regulation and compliance, not to mention the increasing fines and penalties, this has caused the banks to significantly underperform the overall market.

In September, the Commission's Interim Report was released and banking and wealth management bore the brunt of the Commissioner's criticism, with a focus on remuneration, disclosure and managing of conflicts of interest, remediation processes and responsible lending.

The Commissioner also expressed concern around the vertically integrated structures in the areas of advice and mortgage broking. We expect that the final recommendations will result in higher regulatory and remediation-related expenses as well as an elevated level of fines.

In contrast, Macquarie Group is a truly global business with multiple avenues of growth and has relatively little exposure to the impacts of the Royal Commission. A key strength of Macquarie is its entrepreneurial culture, the quality of management and the company's ability to pivot the business when they see opportunities. Macquarie has been focusing on less-cyclical businesses and is no longer just an investment bank, but more a vertically integrated global asset manager.

Macquarie has proven to be the number one infrastructure manager globally, based on assets under management, and with infrastructure spending likely to increase around the world, this will provide further opportunities into the future. Macquarie has delivered double digit earnings growth over the last five years and looks likely to continue to deliver further growth. The Green Investment Bank acquisition in the UK will also open up opportunities in renewables and green infrastructure.

Investment Portfolio

During the 2018 financial year, Argo purchased $259 million of long-term investments, including reinvesting the proceeds of $201 million from long-term investment sales.

The major purchases in the portfolio were:-

Tabcorp Holdings, Boral, Westpac Banking Corporation, Ramsay Health Care, Event Hospitality and Entertainment, Suncorp Group, Telstra Corporation, Speedcast International, Aristocrat Leisure, Reece and two new stocks to the portfolio, Oil Search and Nufarm.

We increased our holding in 30 existing stocks and the overall number of stocks in the portfolio fell to 93.

Ideally, good quality companies that deliver earnings and dividend growth will perform well against the broader market over time. However, this is not always the case.

Ramsay Health Care is a good example of this. While earnings and dividends have continued to grow, the Ramsay share price has fallen heavily after peaking in September 2016. This de-rate has not been due to a drop in the company's actual earnings, but rather a reduction in the pace of earnings growth and what investors are prepared to pay for this slower growth profile into the future.

This fall has had a negative 0.7% impact on our relative performance against the S&P/ASX 200 Index. However, we believe Ramsay's fundamentals remain intact. Its portfolio of now over 220 hospitals globally generates annual revenues in excess of $9 billion. We remain attracted to the company's fundamentals and the tailwinds provided by an ageing population, which together with the increasing burden of healthcare costs to governments globally, will support Ramsay's future growth.

Major sales were: -

BHP Billiton, Milton Corporation, Rio Tinto, Wesfarmers, Woolworths and Worley Parsons. Westfield Corporation was fully sold out of the portfolio following a takeover bid from Unibail-Rodamco.

Unfortunately, we have to report that in February 2018, CBL Corporation was suspended from trading. Unbeknown to the equity market and investors including ourselves, the Reserve Bank of New Zealand (RBNZ) was investigating CBL and had imposed strict confidentiality orders on the company seven months earlier in July 2017, largely associated with concerns around the solvency of CBL's regulated insurance entities in France. Despite the RBNZ's imposition of these confidentiality orders, CBL continued to trade on the New Zealand Exchange and the ASX, release results and update the market, all without any suspension up to the date of its eventual trading halt. In an environment of continuous disclosure, this both surprised and greatly disappointed us.

CBL shareholders have effectively remained in an "information void" since this time. This is extremely frustrating for all CBL shareholders, including approximately 20 other institutions and many retail shareholders. Following the suspension, Argo wrote down its investment to zero value as we continue to wait for an update on the group's financial position.

21st Century Fox

Following a heated takeover battle, we are in the process of fully exiting our position in 21st Century Fox, the latest edition of the company that started as News Limited, which has been in our portfolio since 1993. In July 2018, The Walt Disney Company, which owns and operates networks such as ABC and ESPN, and Fox shareholders approved the merger between the two companies.

News Limited was created in 1923 in Adelaide. In 1949, Sir Keith Murdoch took control and when he died in 1952, his son Rupert inherited a controlling interest.

News Corporation itself was created in 1979 and grew into an extensive global media company. In June 2012, News Corporation's assets were split into two publicly traded companies, one orientated towards media, and the other towards publishing. Most of its media properties, such as the Fox Entertainment Group, 20th Century Fox and the BskyB holding, were renamed 21st Century Fox, with Rupert Murdoch as CEO. The two new companies began trading on the Nasdaq on 1 July 2013.

Since this time, traditional media companies globally have de-rated as Netflix and other mediums, including social media platforms like Facebook, grew their user numbers and eyeballs. While we were always likely to sell this holding at some time because Fox was no longer listed on the ASX, we knew the business well and while the share price was doing little, earnings continued to increase. We also were relatively confident that we would see a weaker Australian dollar, which would provide a much better time to realise any sale in Fox.

This is an excellent example of the strong returns that we can achieve as a long-term shareholder, with pre-tax proceeds of around $100 million coming from this investment. More importantly, it is a great example of how a small Australian company can grow to be a large international success, with CSL probably the best current example of this.

Recent Portfolio Purchases

Since our 30 June balance date, a number of further investments have been made, a large portion of which was supporting companies raising capital to help finance acquisitions. We participated in the capital raisings of Transurban Group to partly fund their latest acquisition, WestConnex; Rural Funds Group following their purchase of additional beef cattle properties; and Bega Cheese as they funded their acquisition of the Koroit dairy processing facility from Saputo. Other major purchases included adding to Boral and taking new positions in Eclipx Group and Star Entertainment. We also participated in the Viva Energy IPO.

Portfolio Composition

When comparing Argo's 20 largest equity investments, based on market values at 30 September 2018, to this time last year, Westpac Banking Corporation remains our largest holding, however the other major banks have dropped down the list as their share prices have fallen. While these are significant holdings in dollar value, and pay substantial dividends, Argo holds a large underweight position in the big four banks compared to the index and this has benefitted our relative performance.

Significant share price rises in Macquarie Group, BHP and CSL has seen these three holdings increase by over 1% of the overall portfolio. It must be remembered that a 1% move in the portfolio value is almost $60 million. There are two new additions to the top 20, being Transurban Group, following participation in the recent capital raising, and Aristocrat Leisure, a combination of a 37% increase in the share price over the past 12 months and some additional stock purchases. These companies replace Amcor, which has suffered from lower beverage volumes and increasing input costs, and AGL Energy, falling in value due to energy retailers and electricity prices being in the political firing line.

At a stock level, Argo's best performers in absolute share price appreciation in the 12 months to 30 September were Santos, up over 80%, and Washington H. Soul Pattinson, CSL, Premier Investments, Macquarie Group, BHP and Computershare, all increasing in price by 40% to 60%. As always, some of these strong moves were offset by falls in others, with AMP, Automotive Holdings Group, Pact Group and Estia Health, all falling between 20% and 30%.

We continue to own a well-diversified portfolio, and this is illustrated by its spread across industry groups. Since this time last year, the biggest change has been the large fall in the value of the Australian banks, shrinking over 3% from last year. This has mostly been redistributed to Energy, Healthcare and Resource stocks within Materials, all increasing by over 1%.

Outlook

In Australia, the recent reporting season of corporate earnings was fairly good, with profits and dividends declared largely in line with our expectations. Earnings estimates have fallen, but Australian companies are still expected to continue growing at circa 7% on average in FY2019, and profits are expected to grow in every sector except Telecommunications and Transport.

While we are wary of what appears to be an overstretched consumer at a time of high household debt levels and increasing costs of living, including the surge in energy prices, we expect the domestic economy will continue to grow, with unemployment relatively low and interest rates at historical lows.

Outcomes from the Royal Commission, combined with a softening housing market and tighter credit, overlaid with a run into the next Federal election, are potential areas of concern as we move into 2019.

Internationally, the US economy in particular continues to perform quite well, with most economic indicators remaining positive and the US Federal Reserve likely to continue to lift interest rates throughout 2019. However, any acceleration in the pace of interest rate rises in response to higher inflation could be dangerous for asset prices. Commodity and oil prices have been strong and may further impact any uptick in inflation.

However, the current increase in market volatility is likely to persist as the US Federal Reserve continues to raise rates and markets digest the ebb and flow of geopolitical risk and trade wars.

We continue to believe that the best investments that Argo can make are into companies and industries that have sound fundamentals and are likely to grow over the medium-to-long term. We continue to balance our focus between adequate growth opportunities and providing our shareholders with a growing, fully franked dividend.

Argo is a low cost, relatively low risk investment proposition for shareholders. The major external research houses are independently supportive of our business with two highly recommended ratings.

Thank you

I would also like to make a closing comment to acknowledge the efforts of our small hard-working team at Argo and welcome our newest employee, Meredith Hemsley, to help as a Communications Manager. I would like to acknowledge the contribution from the Non-executive Directors and congratulate Russell Higgins in his new role as Chairman of Argo and I look forward to working with him as we work for you, the shareholders.

I would also like to congratulate Ian Martin on his wonderful career at Argo and thank him in particular for his friendship and for mentoring me in my time here. I thoroughly enjoyed working with you Ian for your 14 years at Argo, particularly in the six years that you were Chairman. I wish you the best for any future endeavours.