Perpetual Equity Investment Company Limited

Morgans investment update

By Vince Pezzullo
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Vince Pezzullo, Deputy Head Of Equities and Portfolio Manager for Perpetual Equity Investments (ASX:PIC) spoke with the Morgans network. Vince provides his views on current market conditions and identifies investment opportunities for the PIC portfolio.

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-Edited transcript start -

In terms of our views on the market, we've been a pretty consistent and not much has changed. The market levels have changed a bit. In the left-hand box, as everyone knows; the state of market is still grappling with government stimulus growth is still going along. We're in the part of the cycle now where the markets are grappling with tapering. What does it mean? Typically, what it means to the economy, given the setup, the setup is the consumer balance sheets are still in pretty good condition. Net savings rates are higher. There are significant amounts of liquidity. What it means is, for any sort of taper, it's more of a market event than anything else really, given the extremes of money available in the private sector, given that most of this debt was nationalised during the Corona crisis.

So, it's all about which parts of the market you want to be avoiding as we move through a taper and as rates start to move around. It's not so much the absolute level of rates but the

volatility of rates which tends to cause markets nervousness. If you look at volatility at the moment, it's pretty much at record lows. So, any sort of shift in the big picture on whether rates may settle, you need to typically be in shorter duration companies with a bit of valuation arbitrage left in them still. Given that we're still in that period, where compared to the last 10/15 years fiscal policy is so dominant, you still need to be in those parts of the market where the cycle still has more to play out and, more importantly, where there's a lot more valuation arbitrage.

The energy sector is a good example. I still think it's quite under-owned. It's only 4% of our market. We've got quite a big position in it ourselves in the PIC. I think they're one of the sectors where you need to be exposed. When we look at the supply constraints there, it's a known known. There's nothing new there. But I think what is becoming more evident is that as we see the weak economic data printing the last couple of days, that's mostly because of supply, not because of demand. Because we can't deliver on purchases or jobs, you can't attract people into roles at the moment, etc. This point of the cycle is still seeing these supply-side issues but, more importantly, the old industrials sectors are showing an incredible amount of discipline not to go blow their brains out and build plants everywhere, which is what they have traditionally done. Even the high-end auto manufacturers have been talking about building on orders. So, you have to order first; then we build the car. There are plenty of these changes to price signals in the industrial market.

Along with this theme, you've got the unwinding of globalisation and trade wars still persistently running along, plus decarbonisation to contend with. We've done some work on the two biggest emitters: steel and cement. Those two big industrial sectors and looking at what happens to the price signals in Europe, in particular, because they've got a carbon tax. Basically, it's generally accepted that all costs will be passed on directly to the consumer. It's accepted by the European Commission. They all assume that, if companies have to invest in new plants and absorb higher operating expenses, that's going to be passed through in full. This is going to cause bigger issues later down the line because, demographically, it's going to hurt the lower income earners. So, there's going to have to be some sort of support by the government directly, money in people's pockets, at some point to offset this cost.

So where are we now? Our positioning compared to last year is that we are a lot less cyclically exposed. Now we're a little bit more balanced in that we're across the market a bit more. I think you have to have positions in many parts of the market because we are at a point in the cycle where policy mistakes can happen. Central banks will start to tighten and politically you may not get the next infrastructure package go through or the next spending package. That's going to knock some of the expectations of growth around. So, you can't just be in the pure cyclical parts of the markets. When you look at where the PIC is today, we're still on opening up, normalisation stocks. We're still on Qantas, we think there's more to go on that. We have also been buying more Crown. When it dipped below $9, we increased our weight again.

We're still invested in Aristocrat and Dexus (as you can see in the chart on the right) but the latter has done its work and we might be getting close to an exit there.

We're still very long insurance as, again, these are net beneficiaries from any sort of short end rising. Plus, we've got the tailwinds of a hardening insurance cycle with a short tail. We've added Nobleoak, which is a microcap where we participated in the IPO. It's a good little business and we like the management. We actually like life insurance because I think we're at that part of the cycle where APRA has done most of what it needs to do. Nobleoak is a small book but they can grow into that cycle, whereas a lot of others have exited the life insurance industry. On the industrial metals side, we have added a new name through buying some Buzzi Unicem, which is an Italian cement maker. About 50% of its business is actually in North America, Mexico and Brazil through infrastructure programs and you're only paying 9.5 times for it, whereas most cyclicals are trading on far higher multiples. This gets us real, direct exposure to the US infrastructure cycle and the capex increasing in the US over the next 12 to 18 months. We still like Ferguson PLC, which is a plumbing supplies' business redomiciling in North America. It's trading on 20 times, which is a bit high but, given the industrial multiples north of that, it's a really high-quality business and we still like it.

Lastly, on metals, we own Western Areas. It is about 3.5% of the PIC. The way we're playing it is that we're underweight iron ore, but we own Deterra Royalties, which is another way to play it. We don't own Fortescue or Rio. We own some BHP but we're very underweight. So, we're playing through the metals directly where we see there's benefits. Even though demand from China is weakening, Western demand is still growing for battery materials, etc. So, we like Western Areas and Oz Minerals, a smaller company but we like the positioning of it, and it's got high quality management.

In terms of the portfolio positioning as it stands today, we sold down some Française des Jeux (FDJ), the operator of France's national lottery games, after the new financial new year as it got closer to 50 euros. Then there was an announcement by the European Commission in which they made it clear that they don't like the fact that the French government handed a monopoly to FDJ. Unfortunately, they didn't charge them the right price. I don't know what that means but, given every other country in the world has monopolistic lottery businesses, but it's all about the price. We're not that worried about it. It has come back down to 43 euros but it's still a high-quality business. We have actually been adding to our position recently, buying it back.

Also amongst the top holdings is Crown, where we've gone from gone from about 4.5% of the portfolio to 5.5%. So, we bought a lot back there. We've got some banks in there. Westpac has underperformed materially, and we saw that the market had put absolutely no credence in their ability to take costs out. Well, that's good because that's in the price. So, for us, that's not a bad setup. And Oil Search is also in there amongst the top holdings as pretty much our only energy play. We've actually been adding to that position recently so it would be north of that 3.9% figure. We like the Oil Search/Santos merger, if it comes off. We like the structure of the

new business. I think the structure of the energy sector globally with no capital investment going in for the last 18 months all looks pretty good to us as demand is pretty much back to pre-Corona levels even without international travel. We have got a sneaking suspicion that OPEC plus is now more in the ascendancy versus Western oil reserves and companies. So, they will dictate prices and, while demand is still strong, you will need to have some energy in the portfolio.

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