Argo Investing in Australia

2019 Annual General Meeting
MANAGING DIRECTOR'S ADDRESS

Delivered by Mr. Jason Beddow at the 73rd Annual General Meeting of Argo Investments Limited (Argo or Company) held at the Adelaide Oval on Monday 21 October 2019 at 10.00am.

THE YEAR IN REVIEW

As we travelled around Australia this time last year for our AGM and shareholder roadshow, equity markets across the globe were falling heavily. Increased concerns of a global growth slowdown, fears that higher US interest rates may lead to a recession and soft data out of China all compounded at once. Ultimately equities recorded their largest quarterly fall since 2011 over the December 2018 quarter. In fact, roughly two thirds of the S&P/ASX 200 Index companies delivered negative returns in calendar year 2018.

From the beginning of the 2019 calendar year however, markets have been strong, shrugging off evidence of a slowing global economy due to the escalating US/China trade war and ongoing geopolitical concerns. In Australia, the Hayne Royal Commission's final report released in February and the surprise result of the May federal election were both relatively positive developments for local markets. In particular, investor sentiment was buoyed as the proposal to remove cash refunds of franking credits and changes to negative gearing were removed. The Australian share market reached a new all-time high in July, some 12 years after the previous peak.

However, the biggest driver of markets has been accommodative monetary policy from the US Federal Reserve and other central banks around the world, including the Reserve Bank of Australia (RBA). In 2016 as the US economy slowly recovered from the Global Financial Crisis (GFC), the US Federal Reserve began to raise interest rates and in December 2018 it again raised rates to 2.5% in what was to be the last rate hike of the cycle. However, in January this year, the US central bank abruptly changed its stance and has since cut rates twice in the past few months, back to 2.0%.

In Australia, earlier this calendar year it was largely expected that interest rates would increase towards the end of 2019. Instead, we have experienced three rate cuts in quick succession, with the RBA lowering the cash rate by 0.75% to a record low rate of 0.75%. Historically, falling interest rates are supportive of asset valuations, in particular for infrastructure and real estate valuations.

DIVIDENDS

While the psychological impact of the Australian share market reaching all-time highs has been positive, the S&P/ASX 200 Accumulation Index, which includes all dividends paid by the constituent companies, recovered its pre-GFC high back in 2013. The Accumulation Index has since risen further and is now up over 70% from that level. Dividends remain a key component of the Australian market's total return, generating about half of the total return to shareholders and even more for those that can take advantage of the imputation system and franking credits.

Argo's investment team spends considerable time analysing company dividends as part of our investment process. We assess dividend sustainability, growth rates and the level of franking, now and into the future. This is in line with our objective to grow the income stream from our investee companies at a rate that delivers a growing earnings per share (EPS) profile for Argo and allows us to sustain and grow the dividend we pay to our shareholders.

We are pleased Argo has been able to continue to grow dividends to shareholders. Annual dividends have increased every year from 26 cents per share in 2012, to 33 cents per share in 2019, all fully franked. This is a compound growth rate of over 3.0% per annum. While this may not sound significant, it is above the earnings growth rate of the market over the same time frame.

Importantly for investors, this growth has occurred in a period when interest rates have fallen from 4.75% to 0.75%, making it extremely difficult for investors who have been relying on interest from cash deposits for their income.

SOURCES OF DIVIDENDS

While the banks and some of the larger 'blue chip' companies pay good dividends, few of them have been able to grow them consistently over this period and indeed, a number have cut their dividends in recent times.

For Argo to achieve its own dividend growth, we have had to derive a growing yield from other investments. When we look at our portfolio over this seven-year period, there are 21 companies that have increased dividends in each of those years, including 14 which have increased by more than 5% per annum. While we have added and trimmed some of the positions over this time, it is this group of companies have been the prime contributors to Argo's continued dividend growth. Importantly, approximately 25% of our portfolio is held in these 21 companies and this has allowed us to continue to grow our dividend, despite dividend cuts from other companies.

INVESTMENT PORTFOLIO

During the 2019 financial year, Argo purchased $343 million of long-term investments, including reinvesting the proceeds of $256 million from sales and takeovers.

The major purchases in the portfolio were: Bega Cheese, Boral, Oil Search and Transurban Group. New positions added to the portfolio throughout the year were Eclipx Group, James Hardie Industries, The Star Entertainment Group and Viva Energy. Coles Group was also added to the portfolio following its demerger from Wesfarmers during the year. Overall we increased Argo's holdings in 34 existing stocks.

Major sales were: Asaleo Care, BHP Group, Coca-Cola Amatil, Incitec Pivot, Milton Corporation, Navitas, Rio Tinto, and Twenty-First Century Fox. A number of these companies were fully sold from the portfolio.

RECENT PORTFOLIO PURCHASES

With markets looking relatively expensive, there have been relatively investment purchases since our 30 June balance date. The largest addition to the portfolio has been the $18.9 million of additional AP Eagers shares we received by accepting the AP Eagers all-scrip bid for our holding in Automotive Holdings Group. AP Eagers' takeover has given it a market-leading position, with the company now responsible for approximately 12% of all new car sales in Australia.

We also added to our Ramsay Health Care holding when the Paul Ramsay Foundation sold down its stake in the company from 32% to 21%. We acquired the shares at an attractive discount and we have spoken previously about our positive outlook for this business.

Freedom Foods is a fast-growing food and beverage company, with a wide selection of brands across dairy, cereals and plant-based beverages like almond milk. The company distributes across Australia and South-East Asia, providing growth opportunities. We added this holding to the portfolio last year and have continued to increase our position.

The final acquisition of note is Downer EDI, which designs, builds and maintains a wide range of assets, infrastructure and facilities in Australia and New Zealand. Infrastructure continues to a focus for governments, with spending in this area forecast to increase well into next decade as a means of supporting and stimulating the overall economy. Downer EDI should benefit from continued high infrastructure spending and the growing trend of government and corporate outsourcing.

PORTFOLIO COMPOSITION

I would like to spend some time looking at Argo's top 20 holdings. We publish this list each month with our monthly NTA release to the ASX and, while it does not change much from month to month and consists of largely well-known large-cap companies, they are an important part of Argo's portfolio. These investments represent 59% of our entire portfolio by value and equally, if not more importantly, these companies provide over two thirds of our dividend income.

As with our entire portfolio, we can categorise these top 20 holdings by the role they play in the portfolio. For example, some companies are providing large fully franked dividends, like the banks, but are not likely to provide meaningful dividend growth. Other companies are growing strongly although their yield is low.

We can break our top 20 companies into several groups.

First is a group of large Australian domestic businesses, that while mature, are still growing as the Australian population continues to grow at roughly 1.5% per annum, which is the fastest growth rate of any western economy. These businesses also pay a relatively high fully franked dividend to shareholders. The group comprises Wesfarmers, Telstra Corporation, Woolworths and Origin Energy. Collectively, this group is worth $671 million or 11% of our portfolio and, including the Coles demerger from Wesfarmers, increased in value by 5% during 2019. Dividends increased in line with this and provided a fully franked yield above 5% to the portfolio.

Next is a group of companies that have successfully grown their businesses beyond Australia and are meaningful players in their global industry. Macquarie Group, Aristocrat Leisure and QBE Insurance make up 8% of our portfolio and increased in value by 11% over the past financial year. We feel that the runway is long for these businesses to continue to grow over time. These companies often have many more investment opportunities and tend to pay lower dividends in favour of reinvesting in their businesses. As a greater proportion of their earnings come from offshore, fewer franking credits are attached to their dividends.

An area of great success for Australian companies has been in the healthcare industry. CSL is possibly the most successful, however Ramsay Health Care and Sonic Healthcare have also successfully grown overseas. These three stocks are worth $460 million or 8% of the portfolio and grew in value by 20% in financial year 2019. While we earned a more modest $8.1 million of dividends from these companies, collectively their dividends increased 23% on the previous year. We think these are exceptionally high-quality companies and we are constantly looking to purchase more when we believe the price is attractive. However, when considering how much of Argo’s capital can be allocated to these and other lower dividend paying companies, we need to be aware of the impact on the dividend yield that Argo can pay to its shareholders.

Some offset to these lower yield groups is provided by three of Australia’s most successful infrastructure companies, Transurban Group, Sydney Airport and APA Group. Argo’s holdings are worth $360 million, or 6% of the portfolio, and have provided strong long-term strong share price returns over the past 12 months, increasing in value by 25%. This recent performance is largely in response to the fall in interest rates. These companies all own unique assets that continue to grow earnings and have leverage to the economic and population growth of Australia.

BHP Group and Rio Tinto are two of the largest mining companies in the world. In the past few years they have generated enormous profits for their shareholders and the Australian Tax Office from their highly profitable iron ore businesses, which currently makes up over 50% and 80% of their past year’s earnings respectively. Argo has $520 million or 9% of its portfolio in these two companies. In addition, both companies have been increasingly focused on shareholder returns and simplifying their extensive portfolios by selling a number of non-core assets. The proceeds have been returned to shareholders in a combination of special dividends and both on-market and off-market buy-backs, which is reflected in the very large increase in dividends received, up over 100% in 2019 and the current yield of almost 8%. We believe the outlook for these companies remains solid, particularly as China’s demand for steel to support its real estate and infrastructure investment remains robust. However, this period of excess dividend returns and capital management is likely to slow with a moderating iron ore price.

The final and biggest group is the large retail banks, being 17% of the portfolio. Although Argo has had an underweight position in the banks relative to the index for some time, we still have over $1 billion invested in the four major Australian banks. While their value increased only marginally, by around 2% in financial year 2019, they did provide Argo with $63 million in fully franked dividends, approximately 25% of our total annual dividends received. This was flat on the previous year and the Australian banking industry has a number of challenges looking forward.

ENGAGEMENT WITH THE BANKS

This time last year at the height of the Royal Commission, there were many questions from shareholders about the banks in general and our holdings. Questions ranged from what we could we do about the banks' poor conduct, to why we still own them.

As we have discussed, Australia's four major banks are a significant component of the economy and a form a large portion of the share market by market capitalisation. Many Australians are bank customers and/or shareholders, either directly or through their superannuation. Therefore, the distressing findings which emerged from last year's *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Royal Commission) generated widespread condemnation from the public, government and shareholders alike. The significant media coverage of the Royal Commission focused attention on poor organisational culture and misconduct within these institutions.

The particularly disturbing findings that emerged from the Royal Commission included charging fees for no service, overcharging and inappropriate services being sold. The Royal Commission also highlighted inadequate governance practices and remuneration structures which led to inherent conflicts with customers' best interests. These revelations have led to an erosion of the public's trust in these companies.

We have always maintained regular dialogue with our investee companies on behalf of you, our shareholders. Over the last year, we have increased our engagement with the banks, specifically engaging with their boards to express our concerns and those of many of our shareholders. Through written correspondence and meetings with the Chairs of each major bank, we have argued for better conduct, increased accountability and remuneration structures focused on mitigating risks and generating performance. We also stressed the importance of the banks' customers. In our view, companies that overlook their customers and other external stakeholders will ultimately experience an adverse financial impact.

The banks have taken several proactive steps in response to the issues arising from the Royal Commission and we are encouraged by their progress to date in several areas. These include addressing remuneration and incentive structures, making changes to key personnel, remediation efforts, divesting conflicted businesses, reducing or eliminating fees, and a greater focus on non-financial risks. They have also increased their spending on compliance and focus on culture, and simplified their businesses.

However, the banks have more work to do in addressing the Royal Commission's recommendations and broader community concerns. To date, the banks' collective remediation costs have been in excess of $8 billion and are likely to increase further. The Royal Commission has also resulted in increased public and government scrutiny of the banks, with the current ACCC inquiry into the banks not passing on rate cuts being one such example.

The banks face a number of other challenges to their outlooks including:

- Lower interest rates impacting on net interest margins
- Slower credit growth due to tighter lending standards and increased competition from new entrants
- Customers' increased ability to switch financial institutions through new open banking regimes
- Higher capital needs to meet APRA's 'unquestionably strong' capital requirements
- Increased spending on technology to stay competitive, although this will cut some ongoing operating costs

Overall, we are cautious in our outlook for the banks as we expect earnings will come under pressure and, as a result, dividends may be cut. However, as their yields remain relatively attractive in this low interest rate environment, we are comfortable with our current underweight position.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES (ESG)

Following a discussion of the corporate governance and culture of the banks, we believe it is worth discussing ESG issues more broadly. While Argo does not automatically exclude companies from the portfolio based on ESG factors alone, consideration of these issues forms an inherent part of our investment process as they can have a significant impact on a company's long-term value and its returns to shareholders.

An assessment of the potential financial implications of a company's exposure to ESG issues is incorporated into our investment approach. We proactively engage with management when researching and evaluating the ESG issues facing each company we invest in, or hope to invest in. Over the last financial year, we have had hundreds of meetings with companies and over fifty meetings with company board members regarding these issues. Potential liabilities and future growth implications arising from ESG issues are factored into our company forecasts and valuations.

For example, environmental regulation is likely to have a significant impact on the future profitability of many businesses. Companies that anticipate regulatory and investor scrutiny of the environmental impact of their operations, and adjust their businesses accordingly, may offer enhanced returns or a lower risk profile relative to their underprepared competitors.

We pay particular attention to corporate governance policies and practices. In our view, companies with poor corporate governance are less likely to achieve strong long-term financial performance. Therefore, we carefully consider every proxy vote of each company in our portfolio, conducting in-depth internal research and engaging a company's board as required. We pay particular attention to remuneration reports. Taking a pragmatic approach, we favour incentive structures which focus on maximising returns to shareholders through a combination of short and long-term incentives which focus on achieving measurable financial targets, while also considering non-financial risks.

OUTLOOK

While sentiment has been boosted by central banks globally, a number of unresolved geopolitical and trade-related issues remain, which creates a challenging outlook for the coming year. In addition, increasing Middle Eastern tensions and random events, like the attack on Saudi oil production in early September, are difficult to predict.

We commented at our annual result in August that we thought company 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 at recent highs relative to the market, we also thought this part of the market was susceptible to a correction.

However, despite consistent downgrades to future earnings expectations, the Australian equity market has been resilient, preferring to ignore this and other issues. While valuations are elevated when compared to history, record low interest rates are helping to support these valuations. This valuation distortion is even more pronounced among the industrial companies.

In Australia, tax cuts and three interest rate cuts should help support the consumer. We expect the domestic economy will continue to grow, although the rate of growth is slowing and is clearly of concern to the RBA given their rapid interest rate response.

Corporate balance sheets remain lowly geared and further capital management from a number of companies in 2020 is likely.

Argo remains a low-cost, relatively low-risk investment proposition for shareholders. The major external research houses are independently supportive of our business, providing 'highly recommended' ratings.

We continue to balance our focus between adequate growth opportunities and providing our shareholders with a growing, fully franked dividend. With relatively high cash levels, we are in a strong position to take advantage of any further volatility in the markets.

I would like to acknowledge the efforts of our small hard-working team at Argo and to acknowledge the contribution from the Chairman and Non-executive Directors.