



# Katana Capital Limited

## 30 June 2022 Investment Report

### Overview

Katana Asset Management Ltd ('The Manager') has completed a report on the performance of Katana Capital Limited's (Katana) portfolio for the 12 months to 30 June 2022. The Manager is pleased to announce the fund generated a gross investment return of POSITIVE 1.13% versus a loss of -11.06% for the All Ordinaries index. This is an outstanding result and represents a gross investment out-performance of **+12.19%** (before expenses).

Year Ending	Katana Gross Investment Return	All Ords Index
2006	9.20%	6.91%
2007	49.05%	25.36%
2008	-6.41%	-15.49%
2009	-23.57%	-25.97%
2010	24.54%	9.55%
2011	19.10%	7.75%
2012	-11.19%	-11.25%
2013	8.84%	15.47%
2014	26.78%	12.70%
2015	-1.57%	1.28%
2016	4.98%	-2.58%
2017	6.23%	8.54%
2018	26.27%	9.12%
2019	-0.43%	6.51%
2020	9.30%	-10.42%
2021	32.82%	26.39%
2022	1.13%	-11.06%
<b>Average</b>	<b>10.30%</b>	<b>3.11%</b>

## 2022 Financial Year Review

Financial year 2022 proved to be yet another volatile year for equity markets with a bout of macroeconomic and geopolitical developments. This year's events can best be summarised by the fact we started the year at one economic extreme and ended at the other. We moved from record low interest rates, supportive government stimulus, and near record high business and consumer confidence, to an overheated inflationary environment, with central banks aggressively tightening, confidence falling and the possibility of a recession. We also saw a reversal in sector performance. *Technology* fueled by low rates has been the standout over the past two years, but fell by 35% during FY22. *Energy* was the biggest laggard in FY20 and the second biggest in FY21, but rebounded to post the largest gain in FY22.

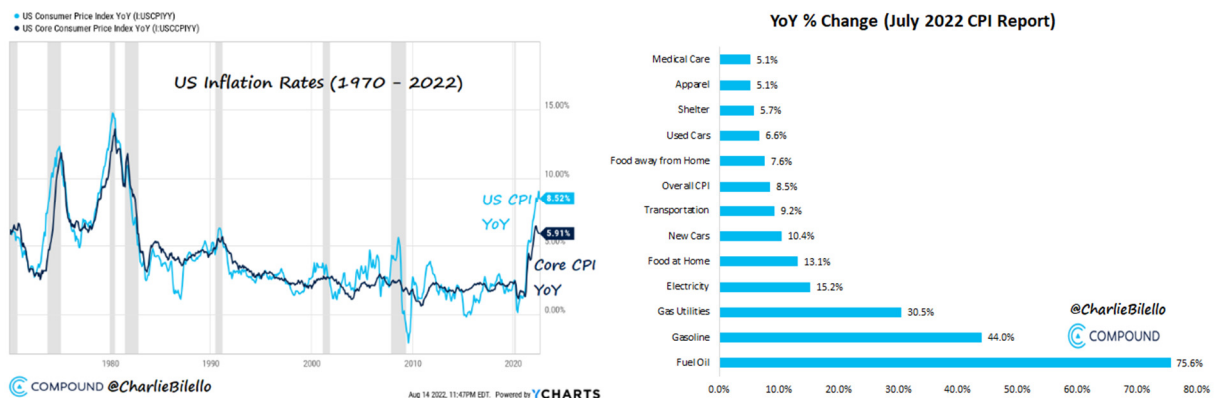
The first part of the year was dominated by discussion as to whether rising costs were transitory - driven by temporary supply chain and bottleneck issues - or if we were indeed seeing the early signs of inflation. The Manager viewed rising costs as more than transitory; a demand element was present driven by record low rates, excess savings and pent-up demand. We wrote from March 2021 that inflation is likely to keep rising and at some point bond yields will need to rise in response. Accordingly, we started the year with overweight positions in *Materials* and *Energy*, which have historically outperformed in an inflationary environment. We also moved underweight long duration and high PER (price to earnings ratio) stocks in *Technology*, *Healthcare* and *Staples*, on the premise rising bond yields would put pressure on valuations.

In the first half our viewpoint got continuously tested. In July bond yields broke through support and fell roughly 60 basis points from their peak. We wrote at the time that it appeared nonsensical as inflation is clearly on the rise with the US headline rate touching 5% (a 13 year high). Just two months later *Technology* stocks rallied more than 10% from their lows, once again outperforming the market. This again tested our thinking, with many turning to the sector as being potentially immune to inflation due to their low input costs. We considered this but held our nerve and saw valuation risk from rising yields as the longer-term driver.

In November the highly infectious Omicron variant started to spread particularly in the US, Europe and China. At the same time the US Government announced they would commence releasing oil reserves when prices first reached US\$80/bbl. The potential demand destruction from new Omicron restrictions, and increased supply from reserves saw our local energy sector drop over 8% for the month, or 17% from the prior month's peak. We viewed the impacts of Omicron and oil reserves as transitory and maintained our overweight position. Fundamentally there was still sizeable underinvestment in oil and gas projects, and stock prices still materially lagged the recovery in the underlying commodity. This positioning was ultimately vindicated as the sector climbed more than 30% over the coming months.

Oil moved over US\$100/bbl in February 2022 following news of Russia's invasion of Ukraine. This impacted many commodities in addition to Oil including LNG, and wheat, with Russia and Ukraine collectively accounting for in excess of a quarter of global wheat exports. We increased our cash weighting to the highest level year to date during the violent 11% sell off in January, which we maintained as rumors of the invasion escalated. We also maintained our overweight exposures in energy and other commodities, as we finally saw our theme for the past year gain traction.

The war perhaps put the nail in the coffin for those still clinging to the transitory viewpoint. Soaring energy prices (particularly in Europe who rely heavily on Russia for energy), rising transport costs, and further food inflation, saw extraordinary price increases YoY (see charts below).



January proved to be a pivotal moment for markets with Fed commentary that they were “now open to the possibility of raising rates”. This was the trigger many needed to accept inflation was ‘out of control’, rising costs weren’t simply transitory, and central banks might be forced into an aggressive tightening cycle. This saw US 10 Year Bond Yields spike 18% and created panic in long duration and high PER sectors. The All Ords entered a technical correction falling over 10% for the month. In particular *Technology* fell 18%, *Healthcare* 12% and *Staples* 9%. Having written about the need for bond yields to rise, and our cautious stance against these sectors since March 2021, we were well positioned for this move but further increased our cash weighting to protect against the volatility.

By April, bond yields had risen above 3% which we viewed as having three broad impacts, all 3 of which exert downward pressure on equity performance:

- Valuation on long duration assets needed to retrace
- The rising cost of borrowing would impact company earnings
- Cash yields would provide a ‘real’ alternative to equities.

Our focus shifted to what sectors perform best in a rising rates environment. The fund started building exposure to more defensive holdings in *Healthcare* and *Telecommunications*, and reduced exposure in individual names lacking pricing power, or excessively impacted by rising input costs. The fund remained underweight banks. Our initial thinking was rising rates would benefit lenders and support their Net Interest Margins (NIM). But studying previous tightening cycles confirmed banks almost always enter an earnings downgrade cycle. As rates rise the economy slows which is bad for lending volume and bad debt provisioning. This thinking ultimately proved correct as the major banks continued to fall (17% to the time of this report) from the commencement of the RBA tightening cycle.

Heading into the final months of the year investors became fixated on inflation prints as a guide to how aggressive rates would rise and the possible duration of the cycle. Many were hopeful for a controlled tightening cycle, as an aggressive cycle is a worst case for equity markets and often leads to a recession. The May US CPI print released in June triggered a second violent sell off in equities. Inflation rose to 8.6%, the highest since 1981 and above estimates of 8.3%. The All Ords fell by around 11% for the month and ~16% from its April Peak. However, the index held up better than the S&P 500 which officially entered a bear market down over 20% from its March peak, and the Nasdaq which was down over 30% from its peak in December.

### All Ordinaries 2022 – Two Key Pivots



This became another pivotal moment with many leading indicators now pointing to a recession in the US. All but two bear markets (post WW2) have been followed by a recession. Recessions were almost always preceded by a tightening cycle (currently underway), and the US 10 Year/2 Year yield curve inverted which historically has a high probability of predicting a recession.

The transition from inflation to recession seems subtle, but it has profound impacts. *Materials* and *Energy* which are the top performers in inflation, become the worst performers in a recession as demand for everything from copper to oil collapses. We acknowledged that the violent move in June wasn't normal, it will pass, and our cash weighting provided protection. Nevertheless, we began reducing exposure in *Materials* and *Energy* and added to defensive names.

The Manager remains committed to maintaining a low risk diversified portfolio, with a strong focus on capital preservation and long-term compounding. Consistent with previous years, the fund held an average of 59 individual stock positions throughout the year, and it remains particularly rare for any position to exceed 5% of the portfolio.



## Outlook

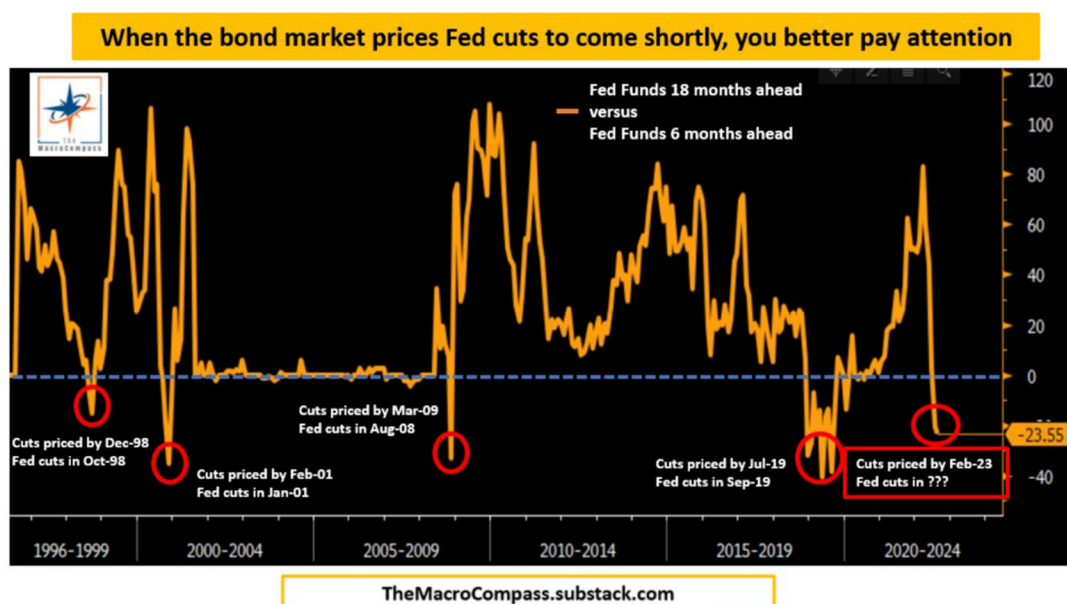
The speed with which markets are pivoting is difficult to comprehend and indeed stay in front of. In some regards it is erroneous to attempt to write an outlook statement annually, as the line of sight has contracted to the point that at best a monthly outlook is feasible. What we write here will hold merit for months at best.

Over the medium term, there are always a plethora of reasons to be negative and underweight equities. The well-worn adage *'the market climbs a wall of worry'* highlights this very reality. Our task is to sift through these potential drivers and prioritize in a manner that enable us to filter out the noise. And to focus on probabilities and not possibilities. However, this year we are notably more circumspect than in prior periods. There is clearer sense that the markets *'get worse before they get better.'* To this end, there are a number of noteworthy observations.

Positive Drivers	Uncertainties
Market positioning is heavily skewed to the short side	Inflation driven interest rate rises – <i>'Don't Fight the Fed'</i>
Strong liquidity / cash remains at high levels	Inflation – Impact on household spending, confidence and flow on to business confidence
Bond market trend has finally turned negative after 4 decades	(Further) Deteriorating US-China relations
Bond market signaling rate cuts Q1 2023	Earnings forecasts are overly optimistic / require a round of downgrades
Market indices and valuations have retraced a little	China Property Market – structural deficiencies mean this lever is considerably less effective
Market rises 4/5 Years	Economic impact of China's mis-handling of Covid-19 / flawed policy of zero tolerance
	Recession – GDP contracts
	Ukraine – Russia War impact on inflation, GDP declines; access to energy
	Quantitative Tightening (QT) has hardly been mentioned but will materially impact bond yields
	Impact of property market declines on banking et al sectors
	Interest Rates now offer viable alternative
	Geopolitical tensions escalating: the new cold war has evolved: democracy versus autocracy

#### Positive Drivers

As always there are some positives and as always it is difficult to know precisely how much has been factored in. The shortest positioning in 4 years indicates that we have already taken some of our medicine. Also, the bond market is now pointing to the strong likelihood that interest rates will need to be cut as early as Q1 2023 Calendar Year. If that is the case, then clearly many of the risks will become drivers.



It is also worth highlighting, that it is counter to our experience and instincts to have the fund aligned with the consensus viewpoint. If the majority of investors are already positioned in a certain way, then who is left to continue that positioning? If the majority of investors are already short, then who is left to short/sell/reduce holdings? Where is the marginal seller?

Despite this observation, the majority do 'get it right' at different stages of the cycle, and this in and of itself is not sufficient to alter a viewpoint. Further, there is room for the 'majority' to have underestimated the severity of the next down leg.

### Uncertainties for the Year Ahead

When we scan through the column of 'Uncertainties', the quantity and magnitude when taken as a whole, clearly tip the scales in favor of caution. The first and second derivative impacts of inflation are too pronounced and too likely. In past cycles, we have been prepared to look for the 'Powell Put' when the markets became a little edgy. But that was in an environment where 'Main Street' (the middle class) were not impacted. When Wall Street had a tantrum, the (US) Federal Reserve could capitulate and reverse course because there was no material impact on *Main Street*. Now, if Wall Street kick and scream, the Fed won't blink. To do so would be to allow inflation to run rampant and to do that would be to inflict enormous damage on the working class. The landscape has now changed, and we must change our positioning accordingly.

Indeed, whilst we are hesitant to make definitive comparisons, The similarities to 2008 are worth acknowledging. And this comparison is beginning to garner some media and investor interest.



In summary, we enter the 2023 financial year more cautious than at any time in recent memory. From both a top down and bottom-up perspective, the environment has become more challenging. This could of course all reverse tomorrow, in which case we would pivot as soon as it is recognised. But as we sit here today, we shall remain notably cautious, do less rather than more and continue to add to cash reserves.

## Strategic Positioning

In forming any view as to how to position the portfolio during the coming financial year, the starting point is consideration of the mid-June pivot. For the first half of June 2022, investor rhetoric was centered around the impact of inflation but then rapidly pivoted to recession (as outlined above). This change in investor focus further narrowed the companies that could potentially provide a positive outcome. Indeed, it would be valid to state that there are less sectors that appear 'investable' at the current juncture than at any time in the fund's history. Whilst fluid, some examples of these niche segments that remain potentially attractive include:

- EV / Decarbonization; difficult to replicate in the Australian landscape given the lack of leading technology; lithium and copper producers provide the best pathway to exposure.

- LNG – Russia’s ill devised invasion of Ukraine has created a structural change in global energy markets, spear headed by LNG; regardless of the outcome of the war, European nations will never again place themselves in a position where their energy security is reliant on Russian gas.
- Metcoal – a very narrow field indeed but worth the effort; similar to LNG, the structural change in European energy has necessitated the re-commissioning of thermal coal plants. This increase in demand at the same time that Russian coal has been banned, has driven thermal coal prices to double that of metcoal. This is unprecedented. Over time we expect substitution to occur, leading to a normalization of the price gap.

The funds active share remains high at 76% up from 73% in FY21, and turnover of 1.2 stabilised from 1.6 in the prior year. The speed at which markets are pivoting is startling, and the ability for managers to remain active and ready to pivot is growing in value.

## Corporate

Katana Capital Ltd finished FY22 with 34,027,927 shares on issue. During the period from 1 July 2021 to 30 June 2022 1,601,135 shares were bought back on market and were subsequently cancelled. The shares were acquired at an average price of \$1.09 with the price ranging from \$1.04 to \$1.15 per share. The buyback also provided liquidity and increased the underlying net asset backing for all existing shareholders.

Katana paid four quarterly dividends, totaling two cents during FY22. Once again, the dividends were all fully franked.

The Manager remains committed to outperforming its benchmark and rewarding shareholders with solid dividends. The Fund has declared and paid a 0.5 cents fully franked dividend subsequent to the year end.

On behalf of all of the staff at Katana Asset Management, we take this opportunity to once again thank Katana Capital’s valued shareholders for your support.

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