



# Katana Capital Limited

## 30 June 2019 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 2019. Disappointingly, Katana returned a small investment loss for the year of -0.53%. Given the All Ordinaries Index increased by 6.51%, this resulted in under-performance of -7.04% versus the benchmark. Whilst the Manager is clearly disappointed by this performance, a little context will assist in providing a longer term perspective:

- This represents the largest relative under-performance since the fund was established in 2006
- In the 2018FY, the gross investment return of the fund was 17.15% ABOVE the benchmark.

### FY19 Financial Year Review

Year Ending	Katana Gross Investment Return	All Ords Index	Outperformance
2006	9.20%	6.90%	2.30%
2007	49.03%	25.36%	23.67%
2008	-6.41%	-15.49%	9.08%
2009	-23.57%	-25.97%	2.40%
2010	24.54%	9.55%	14.99%
2011	19.10%	7.75%	11.35%
2012	-11.19%	-11.25%	0.06%
2013	8.84%	15.47%	-6.63%
2014	26.79%	12.70%	14.09%
2015	-2.28%	1.29%	-3.57%
2016	4.85%	-2.58%	7.43%
2017	5.41%	8.54%	-3.13%
2018	26.27%	9.12%	17.15%
2019	-0.53%	6.51%	-7.04%
<b>Average</b>	<b>9.41%</b>	<b>3.42%</b>	<b>5.99%</b>

The 2019 financial year was a challenging one for our team of portfolio managers. The last 2-3 years have been characterized in many respects by an out-performance of growth and momentum styles on an unprecedented scale. As it has been well documented, momentum investing overpowered all attempts to rationally value stocks in the technology sector.

Being style agnostic, the manager is able to embrace growth and momentum stocks, but it refuses to do so:

- Solely to the exclusion of other opportunities
- Irrespective of value or fundamentals, which is the territory that many growth and momentum stocks now find themselves in.

This is worth expounding upon. Share prices of the soon to be infamous ‘WAAAX’ stocks (Wisetech, Appen, Afterpay, Altium and Xero) nearly doubled in price despite their already lofty valuations. As one simple example of this, Wisetech Global Ltd (WTC) will be trading on a PER of 112x earnings if it is able to meet the extraordinary feat of growing its earnings at 43% this year. And this is one of the cheaper alternatives!

Of course this is madness and of course we have seen this before. When we set out in our careers in the early 1990’s, momentum trading was also known as greater fool theory, because it relied on a greater fool paying an even higher price for the stock to be able to appreciate. Between 1998 and 2000, we watched in awe (and yes more than a little envy), as the then bellwether company Davnet (DVT) ran from 1.2c to \$6. By the end of 2001, Davnet’s share price had returned to 3.9c.

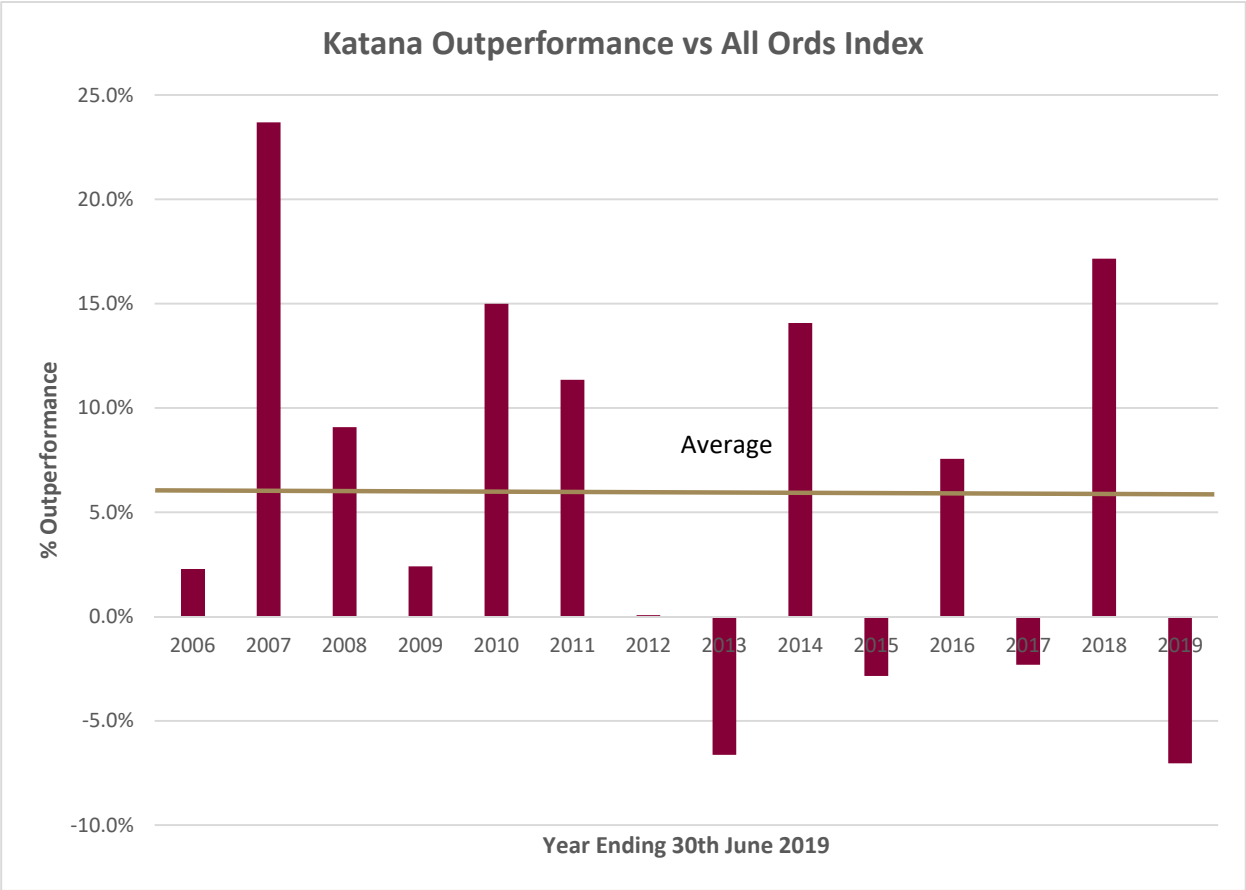
Of course we are not suggesting that these companies will retrace to the same extent, as they do hold considerably more promise. But we are in the most certain of terms, highlighting that these companies are heavily overvalued and in the fullness of time, will retrace significantly from the current levels. Indeed, as it has recently been reported, Australia now has the highest priced tech sector in the world, and hence it is no coincidence that vendors are coming from as far away as Israel to list on our bourse.

Accordingly, our team has worked hard to remain true to label and more importantly true to what we know works over the longer term. More than 20% of the money we manage, belongs to our team. Our goal is first and foremost to preserve our capital. If we do this, then in time the broader market will recognise the inherent quality in the companies we own and the winners will bubble to the surface.

Whilst the manager does not see it in this light, investors are likely to see the other main ‘thesis failure’ as being the persistently above average cash weightings over the past year. As a manager, we will always put preservation before performance. Whilst this may not generate the most spectacular returns in the short term, we believe that this inherent conservatism yields the best risk-adjusted returns over the longer timeframe, and our performance since inception would seem to confirm this viewpoint.

Of course, we still need to be held accountable for all decisions – including cash weighting. And it is clear that whilst our philosophy is not in question, our execution – ie how much cash we have held – has been wrong. Whilst it initially worked in our favour in the December 2018 quarter, the subsequent rally in the 2nd half of the financial year negated this and then some. We are constantly reviewing our cash weighting, and have deployed further capital post year end based on key technical indicators.

The bar chart below illustrates the Manager’s track record of outperformance in each of the past 14 years together with its average level of gross investment outperformance over this period.



The Manager held an average of approximately 45 individual stock positions and a relatively high level of cash throughout FY19. The Manager is committed to maintaining a diversified portfolio, which it believes provides better risk adjusted returns compared to achieving that same outcome with a concentrated portfolio.

There were several changes in the Fund's top 10 holdings in FY19. Whilst Mineral Resources (MIN) once again held the top position at balance date, the top 5 included a number of new companies including Macquarie Group, South 32 and Synlait Milk. It is important however to realise that we are in fickle, range bound markets, which require swift and decisive responses. For example in the case of Mineral Resources, whilst it closed out our year as the largest holding, it oscillated between 0% and 7% weighting over this timeframe.

The Manager has maintained its selective exposure to quality small and mid-cap stocks, which it believes have more potential upside than many larger cap stocks. The manager remains focused on stocks that have strong balance sheets and produce robust cash flows. Katana's top 10 holdings as at 30 June 2019 are shown below.



## Outlook

As highlighted in the outset, the 2019FY represents our most pronounced relative under-performance since establishing our fund in 2006.

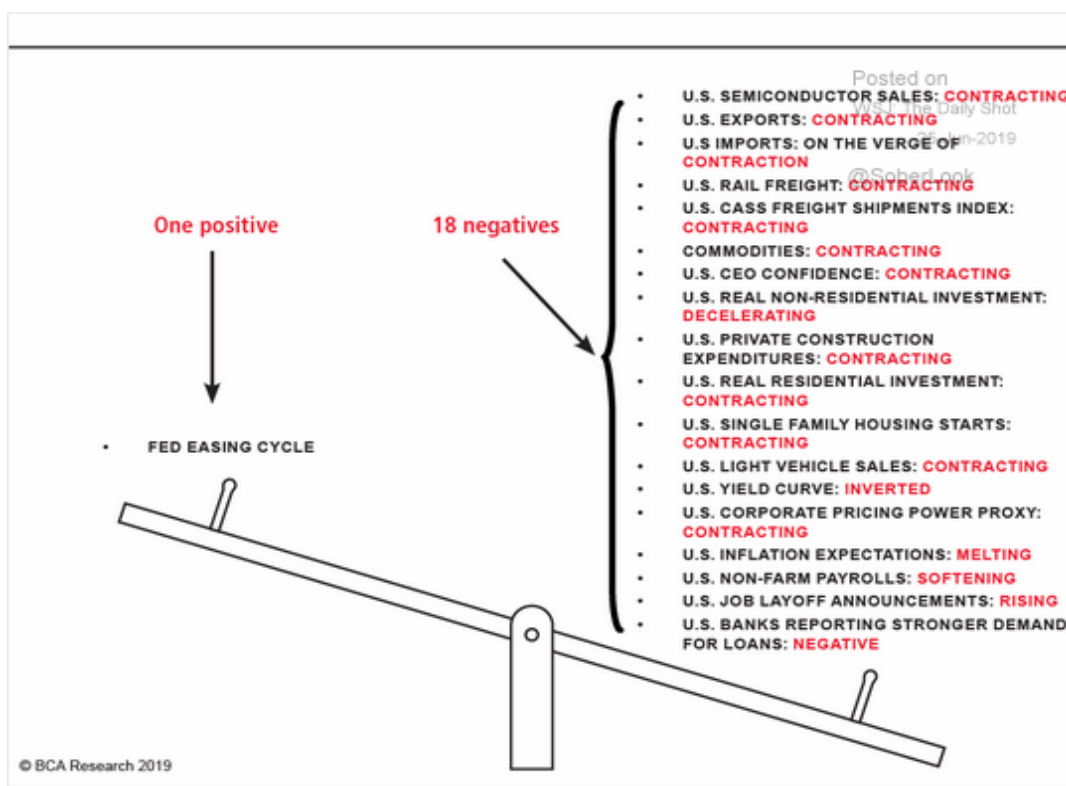
Since that time, our team has under-performed our benchmark on 4 occasions (including the current financial year). On the prior 3 occasions, we have bounced back strongly the following financial year. Investors who have been with us for more than a little while, will have seen this first hand. In the 2017 FY, our fund generated a gross investment return of 5.41% versus the All Ordinaries index of 8.54%. Once again we remained true to our philosophy and approach. In the subsequent year (the 2018 FY), we generated a gross return of 26.27% versus our benchmark of 9.12%.

Of course, history cannot be any guarantee of future returns. But what it (hopefully) can do is confirm to investors that our team is being true to our approach, and that – more importantly – in the fullness of time the market is likely to recognise the inherent value in many of the companies that we have chosen to invest in. And this to us is the critical point. Yes we are adjusting valuation metrics around growth stocks, tweaking weightings and staying open minded on growth oriented investments, but essentially we are continuing to focus most of our attention on our current holdings to ensure that the reasons for investing in them remain intact. If each investment continues to stack up, then in the fullness of time, this will be recognised by the wider market.

## Strategy

There are few truer adages than ‘markets climb a wall of worry’! Indeed as we sit here today we have almost every worry imaginable present in some form. We have a deteriorating trade war between the 2 largest economies in the world. We have burgeoning debt, deteriorating PMI’s, lackluster inflation and emerging pockets of deflation. We have nearly half of all bonds ex-US trading on a negative yield to maturity. Extraordinary. We have trade allies tearing up long-standing agreements, the death of globalisation and rising nationalism. We are on the doorstep of a no-deal BREXIT. A reticent Italian Government with escalating debt and budget deficits. Declining earnings growth and more!

This diagram of the key financial and economic indicators in the US (courtesy of BCA Research), whilst a little strong in its stylisation, paints a somber outlook.



In short, it would be hard to argue that the macro backdrop is anything but highly challenging.

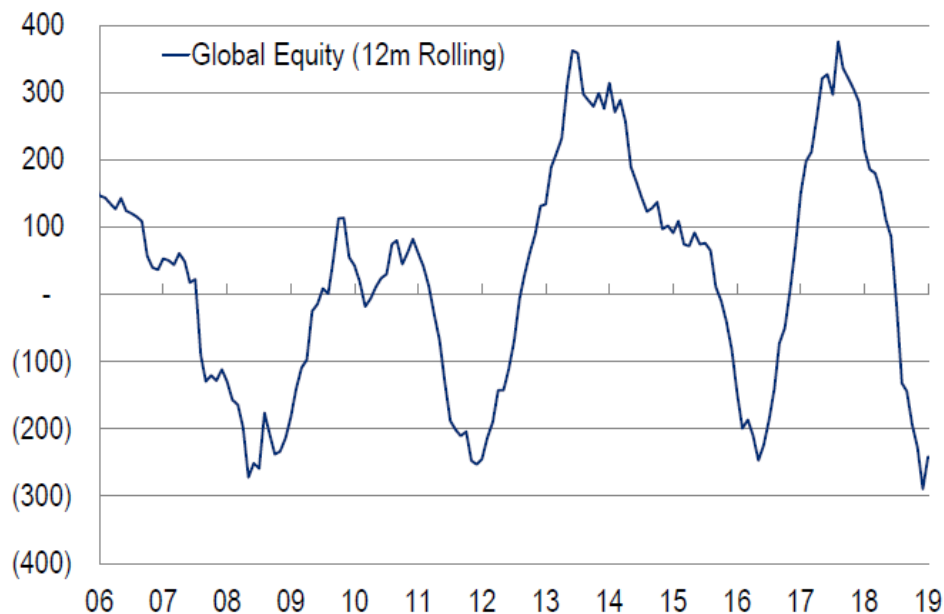
However in many respects, all of this is market theory. In reality, the market is driven by other factors that may well necessitate it going higher despite the bleak macro outlook. We see 3 Key Drivers that are likely to dominate in the coming 12 months.

The first of these is the ‘Powell Put’. Post the December quarter Taper Tantrum, US Federal Reserve Chairman Jerome Powell, ‘succumbed’ to the significant pressure that fell on his shoulders from everyone from Wall Street to President Trump. This may in fact be a little harsh, as whilst the popular view is that Powell succumbed to equity market pressures, the reality may be that he got a glimpse of how fragile the debt markets are, and turned dovish to prevent debt contagion. Whatever the case, what this episode demonstrated, is that the US Fed and US Government stand ready to ‘do what it takes’ to soothe the local markets. This twin put, is a powerful backstop.

Secondly, there is a large amount of cash sitting on the sidelines and the majority of investors would appear to be cautious - if not nervous - and positioned accordingly. Anecdotally, investors in our circle are underweight equities. This chart below from Citi, aptly demonstrates that Global Equity Out-flows are on a scale not seen since the GFC – ie the flows that exited equities DURING the crash. As John Templeton astutely observed “...bull markets die on euphoria.” Many equity managers are nervous, under-invested and as a result under-performing. This level of pessimism as indicated by the sustained out-flows, is not representative of the euphoric final stage.

In time we would expect these flows to normalise, and drive the indices higher.

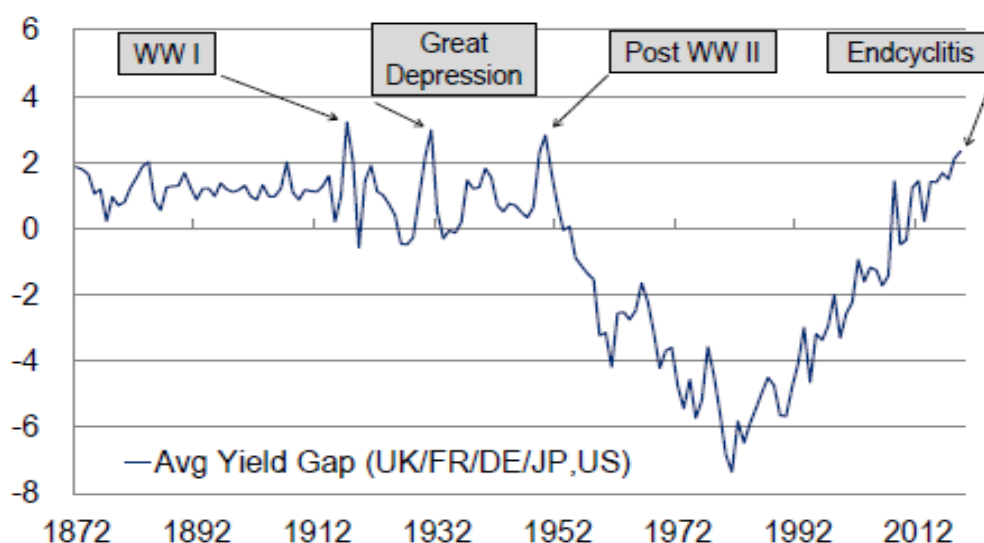
**Figure 11. Global Equity Fund Flows (12m rolling, US\$bn)**



Source: EPFR, Citi Research

Thirdly, we may be on the cusp of one of the most ‘reluctant rallies’ in history, but it will be a rally nonetheless. As we can see (below), the average equity-bond yield gap is approaching the highest level on record. A level that has not been seen since just after the Second World War. During the prior 3 events where the equity-bond yield gap blew out to this extent, there were enormous global dislocations caused by 3 of the most significant events of the 20th century: WWI, the Great Depression and WWII. It is interesting that Citi have labelled the current event as ‘Endcyclitis’, which (apparently) is defined as ‘the fear that the global economic cycle is about to turn for the worse.’

This fear supports the thesis outlined in point 2 above. But it also has created a situation whereby the differential between bond yields and equity dividends will in time drive investors to switch at least a portion of their capital.



Source: Global Fin. Database, DataStream, Citi Research

And there is an additional point to consider. Not only is the relative difference likely to drive investors to increase their equity exposure, but the absolute cash/bond rates are also at a level that will – reluctantly or otherwise – force investors to take on more risk. For example, if retirees are rolling over cash at sub 2%, with inflation running at almost the same level give or take, then in real terms they are breaking even (or perhaps worse if tax is payable). And ‘breaking even’ won’t fund the vast majority of retirees, let alone younger generations.

For these reasons, we see that whilst there are a plethora of concerning macro issues, there is likely to be net capital flowing into not out of equities. And marginal buying is what drives asset prices.

## Corporate

Katana Capital Ltd finished FY19 with 41.7 million shares on issue. During the period from 1 July 2018 to 30 June 2019, 1,340,430 shares were bought back on market and were subsequently cancelled. The shares were acquired at an average price of \$0.74 with the price ranging from \$0.715 to \$0.775 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 and a half (2.5) cents during FY19. The dividends were all 100% franked.

The Manager remains committed to outperforming its benchmark and rewarding shareholders with solid dividends. The Fund has declared and paid a 0.5 cent 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.

Brad Shallard

Romano Sala Tenna

Investment Managers

Katana Asset Management Limited