ARGO INVESTMENTS LIMITED
ABN 35 007 519 520

2016 Annual General Meeting
MANAGING DIRECTOR'S ADDRESS

Delivered by Mr. Jason Beddow at the 70th Annual General Meeting of Argo Investments Limited (Argo or Company) held at the Adelaide Oval on Wednesday 26 October 2016 at 10.00am.

I also welcome you to Argo's 70th Annual General Meeting.

Introduction

It has certainly been an interesting year for the global economy, politics and investment markets, both in Australia and around the world. Politics or geopolitics has probably dominated headlines more so than usual, with the UK's vote to leave the European Union, a close but long-winded Australian election and of course the much anticipated US election to take place in just under two weeks.

This has led to volatility in equity markets, somewhat buffered by ever increasing support and liquidity from central banks. Politics does not always impact markets, but material events like Brexit or significant changes to government policy can have a real impact on certain industries or trade flows and be very meaningful to confidence levels for both businesses and individual consumers.

Interest rates globally have continued to fall to historic lows, including in Australia, with the Reserve Bank of Australia cutting rates twice this year in May and August, to a record low of 1.5%. This has continued to push investors out of cash and into more risky, higher yielding asset classes, including equities, often inflating the valuations of these assets. Premiums are being placed on stocks that are delivering earnings and dividend growth, and we feel this is becoming excessive in some areas.

The Australian equity market rose 13% over the year to September 2016, although to 30 June, the one year performance of the index was relatively flat. There were marked variations in the performance of individual sectors. Retailing stocks were strong, with an average return of 44%, and both Food & Beverage stocks and Consumer Services stocks on average returned over 30%. Harvey Norman was the best performing stock in the Retail sector, while Treasury Wine Estates was the standout in Food & Beverages. Aristocrat Leisure was the best Consumer Services stock, up over 85% in this period. The Chemicals, Telecommunications and Insurance sectors all posted negative returns.

As the Chairman has mentioned, a feature of the local market over the last couple of years has been the outperformance of smaller company stocks over their larger counterparts, with the Small Industrials Index outperforming the S&P/ASX 20, which represents the 20 largest stocks, by approximately 25% over the past 15 months, and following the stimulus in China earlier this year, the Small Resources by an incredible 45%. We analyse and like to invest in some of these smaller companies, as they are often in different industries or market sectors to the larger companies.

Although having no exposure to small cap miners, Fortescue Metals Group or gold companies, has impacted our relative performance to the index by approximately -1.5% over the past twelve months, we are comfortable to be under represented in this space, as most of these companies are not paying dividends and a number do not even generate positive cash flow.

Investment Portfolio

For the 2016 financial year, the major purchases in the portfolio were:
Commonwealth Bank of Australia, DUET Group, Estia Health, McGrath, Origin Energy, Santos and Westpac Banking Corporation. Overall, we increased our holding in 23 existing stocks and added 7 new holdings to the portfolio.

Major sales during the financial year were:
Affinity Education (takeover), Broadspectrum (takeover), CIMIC Group, CYBG Group (the shares we received when National Australia Bank demerged its UK banking operations), Medibank Private, Milton Corporation and UGL. In total, we exited 10 holdings throughout the year, including three by takeover, with Colorpak being the third.

Since our 30 June balance date, approximately $53 million has been spent on further investment purchases, with the major ones being Asaleo Care, Estia Health, Qantm Intellectual (a recent IPO), Rural Funds Group and Vocus Communications. Although Estia Health has been disappointing, we have continued to add to our position at these lower price levels and I will talk to this more fully in a moment.

Overall, the portfolio currently has 99 holdings. We continue to assess any upcoming IPOs or new investments with rigour and we remain disciplined on any additional investment choices.

When comparing Argo's 20 largest equity investments, based on market values at 30 September 2016, to this time last year, Westpac Banking Corporation and Australia & New Zealand Banking Group remain our two largest holdings. Wesfarmers, Macquarie Group and Ramsay Health Care have moved up the order and Woolworths is the most notable fall. There are three new additions to the top 20, being AGL Energy, Brambles and Transurban Group, which replaced AMP, 21st Century Fox and QBE Insurance.

While the top 20 stocks make up approximately 60% of the overall portfolio, there has been a more meaningful bias towards investments outside of our top 20 over the past 12 months, with 70% of additional purchases being to companies outside of our top 20.

We continue to believe that one of the strengths of Argo's portfolio is its diversification. This is illustrated by its spread across industry groups. Since this time last year, the main changes have been an increase in our weighting to Consumer Discretionary, Utilities, Healthcare and Other Financials and a decrease in our Energy, Materials and Consumer Staples weightings.

Dividends

Since the Global Financial Crisis in 2008 and 2009, the overall quantum of dividends paid by listed Australian companies has regularly increased. This has attracted a large number of self-managed super funds and other retail investors into the share market as interest rates have fallen.

The combination of weak commodity and oil prices, additional capital requirements of the banking industry and some company specific issues, has seen the forecast dividend growth for the market turn negative for the first time in eight years. This has mainly been in the larger companies and has had a meaningful impact on the absolute level of dividends expected to be paid by listed Australian companies. While 2016 is expected to be the low point, the absolute level of dividends paid by the market is not expected to reach new heights until 2019, although this will be somewhat dependent on commodity and oil prices.

Over the past year, a number of bellwether stocks have reduced their dividends, particularly those companies directly exposed to falling commodity and oil prices in the Mining and Energy sectors, such as BHP Billiton, Origin, Rio Tinto and Santos. In addition, companies indirectly exposed as providers of services to these industries, such as WorleyParsons, have also cut dividends.

In the recent corporate reporting season, this trend became more widespread, with dividend cuts from ANZ Banking Group, IAG, Wesfarmers and Woolworths.

We have looked back at the top 20 ASX listed companies by market capitalisation from three years ago and the recent cuts to some of their dividends are clearly evident. While some of these companies are no longer in the top 20 companies, 9 of the 20 have cut their dividends in the past 12 months. We expect further challenges to dividends from a number of companies and we are particularly cautious about those that may have unsustainable dividend payout ratios or policies. The banks have been large contributors to the market's dividend growth over a number of years. However we are not expecting to see much, if any, dividend growth from them in the short term.

Outside of this group, Argo has investments in a number of mid-sized companies that have been growing their dividends strongly over the past three years, such as Harvey Norman, Challenger, Macquarie Group, Boral and Perpetual, with only Macquarie Group and QBE currently in the S&P/ASX 20.

As we look forward over the next few years for the increasingly elusive combination of quality companies which are providing earnings and dividend growth at reasonable value, we are encouraged by the outlook for a number of the companies in our portfolio. Although some of them are relatively small or the dividend growth is from a low base, they should be able to sustainably deliver double digit earnings and dividend growth over the coming 12 months. These investments represent approximately 9% of Argo's portfolio.

Aged Care Sector

I would like to speak about a sector that has fallen from grace as a market darling. The listed Aged Care sector is relatively new, with three companies coming to market via IPO during 2014. From the beginning of calendar year 2016 the three companies, Estia Heath, Japara and Regis Healthcare, have de-rated in price by 40% to 65%. Some of this is deserved, a combination of missing prospectus and investor expectations on earnings, management changes and negative changes to the government funding of the industry. However there remains a lot of confusion and even misinformation as to the health and viability of the industry.

Argo largely avoided these stocks at the time of their IPO's due to their high valuations. However as the company values have continued to fall throughout this year, we have been adding to our holdings in this sector. This is premised on a few key points, which I will quickly highlight; firstly demographics, secondly healthcare funding and the pressure on Government budgets, and thirdly the projected demand growth in aged care places that will be required into the future.

The latest intergenerational report, released in 2015, highlighted a number of demographic trends and changes occurring in Australia which are common across the developed world. The key demographic trend is that people are living longer. By 2035, it is expected that one million people in Australia will be aged over 85. For many of them, at some point in time, Aged Care facilities will not be a choice but a necessity.

This trend is not just impacting aged care but all health spending. There is rising demand and a shortage of supply leading to increased waiting times for hospital beds, retirement alternatives and aged care facilities. The forecast increase in health care spending is a major problem for Federal & State government budgets today and will only get worse in the future. Aged Care expenditure is forecast to rise from 0.9% of GDP in 2015 to 1.7% of GDP by 2055. In today's dollars, that is an additional $80bn.

The government has made some regulatory changes through its "Living Longer, Living Better" reforms, and in July 2014 means-testing and user-pays were proposed as part of the long-term solution. With rising household wealth, there is greater capacity for some participants of the baby boomer generation to pay, with residential housing a potential funding source. While further reforms are still being discussed and debated, it has placed uncertainty over the funding model of the sector.

The current Aged Care industry structure is largely a mix of not for profit and private operators, with a small percentage run by government. Smaller not for profit and private operators have limited capacity to fund new facilities or expansions, and the consolidation of small unprofitable operators while necessary, will not provide additional supply. The private sector has been encouraged to invest, and this has led to the emergence of the ASX-listed operators.

It is projected that over 6,500 additional places annually will be required in Australia out to 2022 and beyond, to meet the increasing demand of an ageing population. Only a small number of private sector operators will have sufficient capital to be able to provide these places.

However, to incentivise the private sector operators, they and their shareholders will need a stable Government funding policy, which allows them to make reasonable returns on capital invested or it will simply not be allocated to the sector. We remain hopeful that a reasonable compromise can be reached between all parties.

Outlook and Conclusion

The major influence on markets is little changed from a year ago, with the world continuing to be fuelled by accommodative monetary policies. The US is currently contemplating only its second rate hike in twelve months following the December 2015 upward move of 0.25%, remembering that the projection this time last year was for four 0.25% rate hikes during 2016. We have also had further quantitative easing in Australia, Europe and Japan.

Concern about the imbalances this has created and the overall health of the global economy are never far from the minds of investors. Some are well telegraphed, like a potential slowdown in China or an increased pace of interest rate increases in the US. Others are newer unexpected worries, such as the impact of Brexit on the UK and Europe, with the pound having fallen 25% against the US dollar in the past three months, and of course there is also potential fallout from the upcoming US election.

Looking forward over the next 12 months, markets will be facing regular political uncertainties from Europe, with an Italian referendum on December 4, Article 50 to be acted on by the UK before the end of March 2017 to trigger their departure from the EU, closely followed by elections in France in April 2017 and in Germany later in the year. These events present plenty of scope for further market disturbances.

In Australia, the recent reporting season of corporate earnings was fairly good compared to subdued expectations, although with the market already trading at fully valued levels after a strong start to the financial year, we don't feel this alone is enough to drive markets materially higher in the short term.

We expect the domestic economy will continue to grow, with unemployment relatively low and interest rates at historical lows, although we are also wary of what appears to be an overheated housing market, particularly apartment developments in most capital cities.

Technology take-up seems to be accelerating and playing a larger role in everyone's daily life, whether we like it or not. These technologies are also disrupting businesses. Not every advance will be a breakthrough and not every emerging technology will change an industry, but some do have the potential to disrupt and change the status quo of the way people live or work. We continue to follow these changes as best we can, as some may become investment opportunities in their own right, while more often, others may be impacting industries that we currently invest in.

The Company's investment philosophy has stood the test of time and we remain dedicated and committed to maximising long-term returns to shareholders. We remain comfortable with our diversified portfolio of quality companies and while we are mindful of our recent performance, we will continue to invest prudently for the long term benefit of Argo and its shareholders.

I would also like to make a closing comment to acknowledge the efforts of our small team at Argo and the contribution from the Non-executive Directors, who continue to challenge, advise and support us.