Selector High Conviction Equity Fund

Monthly report – May 2020

Market insights

Markets continued to rally over the month as Australia welcomed easing COVID-19 restrictions. While still behind pre COVID-19 levels, the local All Ordinaries Index closed 4.9% higher to 5,872 points. Dominating headlines has been trade tensions between Australia and China, recently introduced national security laws relating to Hong Kong, and the actions of central banks.

Sino-Australia trade tensions intensified as Beijing imposed fresh restrictions on Australian exports. The introduction of an 80% tariff on barley and a ban on red meat from four of Australia's main meat suppliers has been justified by China's commence ministry as a measured response to alleged subsidies and dumping that has "*caused material injury*" to domestic production. Despite the official rhetoric, the move followed a political spat spurred by the Morrison government's push for an independent COVID-19 inquiry.

China has also come under international criticism after approving a law that will allow it to set up *"agencies"* in the semi-autonomous Hong Kong to safeguard national security interests. The law bypassed Hong Kong's local Legislative Council and has been called a gross breach of Beijing's commitments to allow the city to operate as one country but under distinctive systems until 2047. Hong Kong's leader Carrie Lam defended the legislation, commenting that "*it will not affect the legitimate rights and freedoms enjoyed by Hong Kong residents*".

The move threatens Hong Kong's future as the region's financial hub with the U.S. considering revoking Hong Kong's special trading treatment. U.S. Secretary of State Michael Pompeo summarised, "*no reasonable person can assert today that Hong Kong maintains a high degree of autonomy from China, given facts on the ground*."

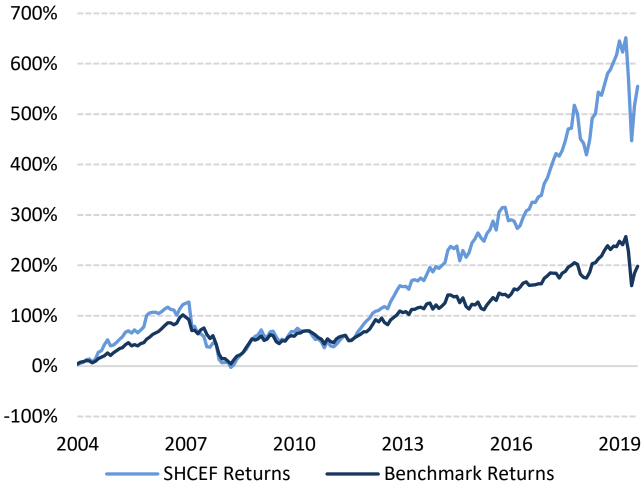
With each global crisis encountered, intervention by government authorities to smooth out the impacts further undermines the important role that markets play in setting price signals. This has blurred the lines for investors, providing bad incentives, encouraging greater financial speculation and fuelling more leverage. Weighed down by closures, economies now require even more debt to stimulate or sustain economic output, but this comes at an even greater long-term price.

Such actions to prop up the financial system is evident across bond and equity markets. Witness this month, the U.S. Federal Reserve (Fed) commenced a significant corporate bond buying program outsourced to two specialists, namely BlackRock and Pimco acting as agents, to invest potentially hundreds of billions in order to ensure market liquidity. While this is reminiscent of the role money managers played in the GFC, the remit here is significantly larger as the Fed seeks to quickly buoy substantial segments of the market. The move raises concern around how these systemically important institutions wield their voting power as shareholders and manage inherent conflicts of interests. The question must be asked; at what point will Governments stop financially engineering for economic outcomes that are becoming increasingly out of reach?

We continue to seek businesses with:

1. Competent management teams
2. Business leadership qualities
3. Strong balance sheets
4. A focus on capital management

Cumulative returns since inception



Inception Date: 30/10/2004
Before fees, costs and tax, and assuming reinvestment of distributions

Top holdings

Company name	Code	Weight (%)
Altium	ALU	5.92
Domino's Pizza Enterprises	DMP	5.25
ResMed Inc	RMD	5.01
Iress	IRE	4.98
James Hardie Industries	JHX	4.87
TechnologyOne	TNE	4.77
Aristocrat Leisure	ALL	4.70
Nanosonics	NAN	4.68
Cochlear	COH	4.66
Carsales.com	CAR	4.32

Unit prices as at 31 May 2020

Entry price	$2.8135
Mid price	$2.8065
Exit price	$2.7995

Performance as at 31 May 2020*

	1 Month	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years	15 Years	Since Inception
Fund (net of fees)	6.01	(3.88)	(12.93)	0.18	14.41	11.93	13.13	10.27	10.67
Fund (gross of fees)	6.28	(2.66)	(12.12)	2.80	16.76	14.11	15.29	12.35	12.81
All Ords Accumulation Index	5.04	(9.04)	(14.12)	(6.21)	4.72	4.56	7.25	6.90	7.27
Difference (gross of fees)	1.24	6.38	2.00	9.01	12.04	9.55	8.04	5.45	5.54

*Performance figures are historical percentages, calculated using end of month redemption prices, and do not allow for the effects of income tax or inflation. Returns assume the reinvestment of all distributions. For periods greater than one year, returns are annualised. Performance can be volatile and future returns can vary from past returns.

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Portfolio commentary

James Hardie Industries (JHX:ASX)

Leading fibre cement producer James Hardie recorded a strong fourth quarter and full year performance, continuing to deliver on CEO Jack Truong's long-term transformation strategy. Since being officially appointed CEO in early 2019, Truong has very clearly articulated his intention to integrate lean manufacturing processes while engaging with both the builders (creating pull demand) and distributors (push demand) in pursuit of above market growth.

Management has made significant progress on this transformation, resulting in four consecutive quarters of strong results. For the year, the company lifted net sales 4% to US$2,606.8m while the reported net operating profit improved 17% to US$353.8m. James Hardie reported an earnings before interest and tax (EBIT) margin of 25.9%, exceeding the top end of the company's long-term target range. In addition, the company generated US$29m of lean savings for the year, exceeding internal targets in the first year of their three-year plan to see US$100m of annual costs removed from operations.

Considering the increased uncertainty created by the COVID-19 pandemic, the company has not provided full year guidance for FY21. Instead, the group has indicated that they expect to maintain a leverage ratio less than 2x (currently 1.9x) and liquidity greater than US$600m (currently US$509.8m) for 30 June 2020. In terms of demand, for the month of April and into the first half of May, the company has observed North American volume declines of 3%, while Australia remained flat and Europe recorded falls of 16%.

James Hardie has a market capitalisation of $11.9b with net debt of US$1.2b.

Blackmores (BKL:ASX)

This month, leading vitamin producer Blackmores successfully raised $90m in fresh capital, after costs, through an institutional placement. Of this capital injection, the company has earmarked $40m for accelerating growth in Asia and continued investment in an efficiency program. The remaining $50m will be used to fortify the balance sheet through debt reduction.

Through investment in their digital capacity, focusing on key target demographics, and by deepening the strategic relationship with Kalbe Farma across Indonesia, Blackmores expects Asia to generate significant growth over the coming years. The company has also highlighted potential partnership discussions in China as well as further expansion in Asia, including India. Asian markets now represent 50% of group revenue growing by double digits.

Blackmores also flagged targeted investment in driving operational efficiencies. Initiatives such as the introduction of high-speed tableting lines, product rationalisation and reformulation, is expected to deliver $50m in annualised gross operating profit benefits by FY23.

In December 2019, the company reported net debt of $119m resulting in a leverage ratio of 1.6x. Following the partial repayment of these facilities, the company expects pro forma liquidity of $236m and a leverage ratio of 0.7x. In addition to the placement, a complementary Share Purchase Plan (SPP) seeking to raise an additional $25m is currently underway.

Blackmores has a market capitalisation of $1.6b.

Performance contributors

Top five	Contribution (%)
James Hardie Industries	0.71
Seek	0.61
Nearmap	0.59
Carsales.com	0.57
Altium	0.52
Bottom five	**Contribution (%)**
CSL	(0.48)
TechnologyOne	(0.16)
Nib Holdings	(0.12)
Jumbo Interactive	(0.10)
Iress	(0.07)

Industry exposure

Industry group	Weight (%)
Software & Services	27.22
Consumer Services	17.80
Health Care Equipment & Services	16.95
Media & Entertainment	9.36
Capital Goods	6.38
Diversified Financials	5.05
Materials	4.87
Pharmaceuticals, Biotech & Life Sciences	3.93
Household & Personal Products	3.23
Insurance	2.45
Automobiles & Components	1.32
Consumer Durables & Apparel	0.98
Cash & Other	0.47

About Selector

Selector Funds Management ("Selector") specialises in high conviction, index agnostic, concentrated portfolio management (AFSL 225316). The investment team have a high level of experience, are owners of the business and invest in the funds alongside clients. Selector has a long-term track record of performance.

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