HORIZON
INVESTMENT SOLUTIONS

March 2021 — Over the Horizon Market Commentary by David Offer

The Australian share market gently rose during the month of March, with the All-Ordinaries Index climbing 1.1% to close at 7,017 points. April has started on a much stronger footing and, for the first 10 business days of the month, is up 3.75% as at the time of writing. Our share market has risen month on month since September. In an historical context this is not unusual, with the market traditionally rallying through to the end of April at which time, historically, the market tends to give some ground back. Hence the stockbroking adage, 'sell in May and go away'. With the current share market rally being broad based, we are hoping for some level of pull back to occur to provide an opportunity to further add to quality blue chip shares.

Separate to a re-emergence of the pandemic, the financial catalyst most likely to put a wobble into our share markets is the spectre of inflation, whether domestically or abroad. While most financial commentators are saying inflation will be a non-event for years to come, history has shown that it is what is not expected that causes the most angst on financial markets. Interestingly, it is the Reserve Bank of Australia (RBA) that is most vocal in talking down the probability of inflation; suggesting that 2024 is the earliest any inflation is likely to occur. As the last 12 months has shown, a lot can happen in a year on investment markets, let alone three years. Looking at the Western Australian (WA) economy, and the shortage of labour that is starting to become evident, we are not willing to be so bold as to say there will be no inflation until 2024. Rather, we think that WA is on the cusp of experiencing it now. If WA's economic recovery is ahead of NSW and Victoria, in part due to emerging from COVID-19 lockdowns earlier, it could be that inflation is also felt on the East Coast of Australia within the foreseeable future.

The RBA Governor, Philip Lowe, has since stated his surprise about the current strength in the national residential property market. Interestingly, he has suggested that this time an overheated residential property market is not the RBA's problem to address; which is interesting as interest rate rises have historically been the primary tool to take excess heat out of property markets when required. Rather, Lowe has suggested that current overheating should be up to government and financial regulators to address, such as APRA putting controls on banks to limit how much they can lend. Australian banks appear to be making their own determination in this regard, having quietly pushed up their long term (4-year fixed rates) by approximately 20 basis points over the last few weeks.

Inflation in America is also a potential concern, as interest rate changes in America will impact interest rates globally. President Biden has already passed a US$1.9 trillion stimulus bill and is now seeking permission to spend an extra US$2.65 trillion over the next decade; funded in part from raising $2 trillion

via tax rises on large business through increasing the tax rate from 21% to 28%. Some commentators are suggesting that the stimulus being proposed is around three times larger than the output shortfall the US is considered to be experiencing and contrasts to the Obama stimulus following the financial crisis, which was half as large. While the US currently has an unemployment rate of 6%, this is already down from 14.8% in April last year. Should this extra spending be approved, due to inflation concerns and fears of higher interest rates, this may ironically be a catalyst to send the US share market down and, as we follow the lead of the US, possibly also our share market.

Evidence of inflation concerns is starting to appear on long term debt markets. While the RBA is artificially depressing Australian government bond rates out to 3 years, longer dated 5 and 10-year Australian Government bonds have been rising. From a low of 0.25% in November, Australian Government 5-year bonds are presently at 0.7% and Australian Government 10-year bonds are presently at 1.7%, up from 0.8% in November. Similarly, 10-year US Government Debt is up from 0.5% in August 2020, to presently yield 1.65%. Rising bond yields have resulted in bond funds recording negative returns over the last year, in contrast to strong share market performance. With bond interest rates still low in any historical context, there is scope for much more underperformance from bond funds from here.

To mix things up a little for this month's letter, the following are four speculative buys to consider. These shares are not suitable for all portfolios but for their own individual stock specific reasons, we feel these shares have scope to perform strongly over the next few years;

VGI Partners (VGI) $7.30. Market capitalisation of $500 million. VGI is a fund manager run by Robert Luciano that manages $3,050 million across two funds, $2,440 billion in a total return fund called VG1 Partners of which $1,420 million comprises of ultra-high net worth investors and $1,020 million in listed investment company VG1 and $610 million in a second Asian market focused listed investment company called VG8. On funds under management a base fee of approximately 1.5% is received. The Company is also entitled to be paid a performance fee of 15% on all money made for investors after costs. Hence VGI's profits are heavily influenced by underlying fund returns. The VG1 fund goal is to make 10 -15% per annum and has returned 13.6% per annum since inception in 2009 with very low levels of volatility achieved. Nevertheless, returns have not been and will not be linear. In the last 12 years, 5 years have generated returns approaching or exceeding 20%. In a 20% performance year, the performance fee on current funds under management would boost underlying profit from $14 million to closer to $67 million after tax. This would result in a Price Earnings Ratio of just 7 times on current prices. VGI has no debt and close to 80 million in cash and liquid investments, namely VG1 and VG8 shares. As such, it can afford a high dividend pay-out ratio of approximately 75%. A 20% performance return year would likely see VGI yielding 10% fully franked on current prices.

Many investors received VGI shares as part of subscribing to the VG8 fund last year at a discounted price of $5.50. The shares then subsequently rallied to nearly $18 on the back of the expectations of high investment returns that, due to COVID, did not materialise. The Company's investment performance now appears to be improving. We recommend buying at current prices to take advantage of a poor investment return year with scope to buy further should the shares fall closer to $5. Equally, we would look to sell north of $14 post a strong investment return year; knowing that at some point in the future a poor investment return year will eventuate.

I attach a recent VGI Partners investment presentation that includes information on the VG1 and VG8 investment portfolios as well as VGI Partners full year 2020 profit announcement.

Austal Ships (ASB) $2.45. Market capitalisation of $855 million. Austal is presently a very cheap share. Subtracting the $260 million cash the Company holds on its balance sheet, Austal is trading on a PE ratio of 7 times and cash-flow multiple of just 5 times. In addition, the Company owns substantial shipbuilding infrastructure asserts in Australia, America, the Philippines and elsewhere. Austal's challenge is that its two major existing US navy ship building programs are approaching winddown over the next few years and replacement contracts will be required to fill the void. In this respect, the outlook is promising. The Company has recently acquired a dry dock facility in San Diego, which will enable the Company to service existing warships built and it is doing an expansion of its Mobile dockyard in Alabama in conjunction with the US Navy to facilitate building steel ships. There are numerous upcoming military contracts to be awarded both in America and Australia. In addition, there are ongoing ferries to be built including the opportunity to replace the large but aging Spirit of Tasmania ferries. Austal continues to win work but stands to be re-rated substantially on the back of any significant long term contract wins.
Please see the attached February Result Presentation for more information as well as Macquarie research.

DUG Computing (DUG) $1.08. Market capitalisation $108 million. DUG specialises in high power computing with supercomputers based in Perth, Houston, Kuala Lumpur and London. The Company's bread and butter to date has been servicing the oil and gas sector which, due to COVID was hit particularly hard last year, but from January this year is in the process of recovering strongly. Over the last few years DUG is branching out to grow non-oil and gas clients with the Company identifying opportunities in numerous sectors including life sciences, astrophysics, healthcare, radio astronomy, medical research, engineering, climate and weather studies and universities.

DUG already generates over $US50 million per annum in revenue and underlying operations are profitable. With high fixed costs, additional revenue from contract wins as well as a resurgent oil and gas sector should boast profitability dramatically. The attached February result presentation sheds more light on the Company.

Beston Global Food Company (BFG) 8 cents. Market capitalisation $69 million. Beston has had a challenging history since listing in 2015 but the end is in sight for the Company's transformation into a high end, value adding milk processor. This is evident with the recent commissioning of a newly built lactoferrin plant at Jervois. As this plant ramps up, the Company should become profitable in 2022 with strong profit growth thereafter.

Lactoferrin has significant immune boosting properties and is used as a supplement including within infant milk formula. 50% of current demand stems from Japan alone and the price has risen 10-fold since 2015 and now sells for $1,500 a kilo. There are less than 10 global lactoferrin producers to meet this demand and Beston hopes to meet 5% of world supply. The attached research from respected research house MST gives a good overview of the Company. While we are not quite as bullish as MST, which values the Company at 31 cents, there is scope for substantial share price appreciation if Beston achieves its goals over the next 3 years. Key risks include securing increased milk supply, successfully ramping up lactoferrin production and lactoferrin price volatility.

If you would like to discuss any of the above shares or your portfolio in general, please do not hesitate to contact our office.

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