# Auscap Newsletter

JULY 2024

AUSCAP ASSET MANAGEMENT LIMITED

# The Right Conditions To Back Active Versus Passive Investing

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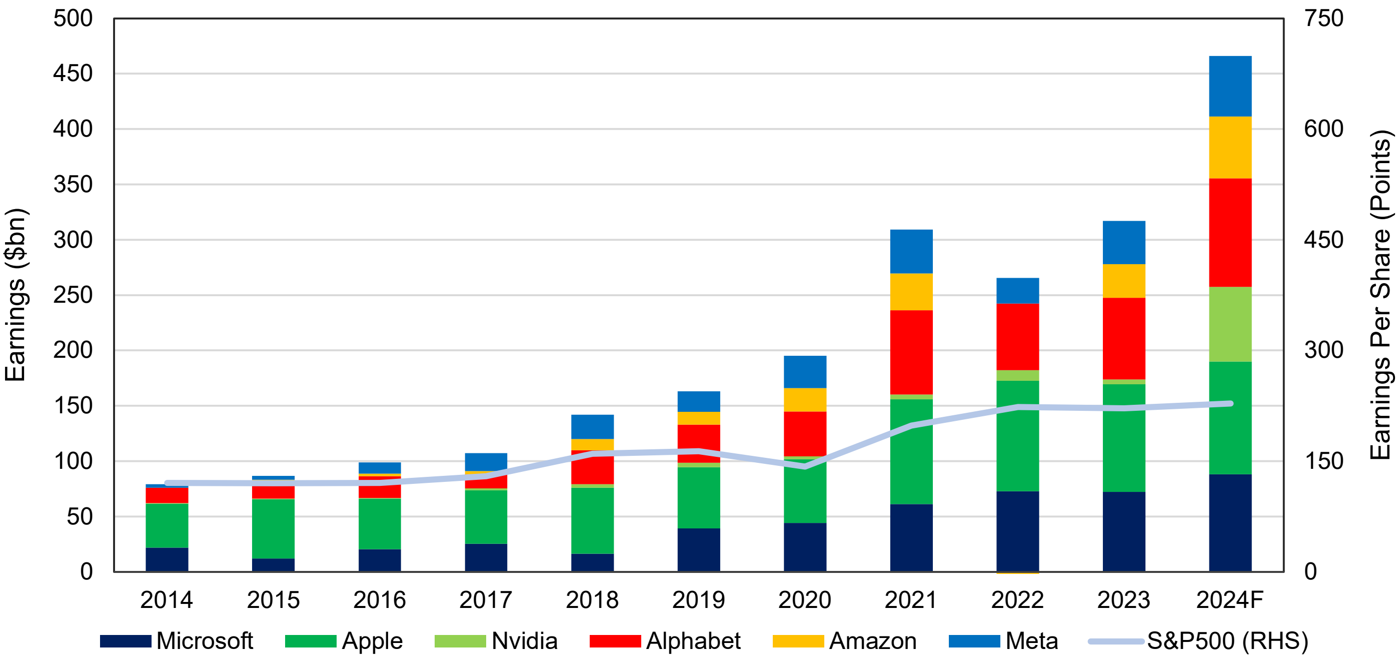
Passive investing is currently all the rage. This is in large part due to the strong performance of the US stockmarket, which very few active managers have outperformed in recent years, and which passive investors can get exposure to at low cost through an ETF. At the time of writing the S&P 500 total return index is up 18.0% year to date. It has annualised 15.9% over the last 5 years. The largest S&P 500 ETF, the State Street SPDR S&P 500 ETF Trust, charges a fee of just 0.0945% per annum. What's more, according to Morningstar less than 20% of active asset managers in the US have outperformed the S&P 500 in 2023 and year to date in 2024. What is going on? Why has passive investment performance been so strong? And does this void an argument for backing active asset management?

We think it is useful to start considering these issues by thinking about the ideal circumstances for a passive investment in a market capitalisation based, or size weighted, index. Such an index has its biggest exposure to the largest companies. So a passive index exposure is going to be a great investment when the biggest companies in that index are growing their earnings faster than most other companies in the index. If we look at the S&P 500 Index, its largest weights are currently Microsoft (7.2%), Apple (7.0%), Nvidia (6.7%), Alphabet (4.3%), Amazon (3.8%) and Meta (2.4%), because these are the largest companies in the US. These 6 companies account for 31.4% of the S&P 500 Index. They are also companies that are growing earnings a lot faster than the broader market, and in fact faster than most of the other companies in the Index. This can be seen in the chart below. Over the last decade the 6 current largest companies in the S&P 500 have compounded their earnings at 19.4% per annum. This compares to the Index, which includes these companies, which has seen compound earnings growth of 6.6%, implying the compound earnings growth of the other 494 companies has collectively been even lower than this.

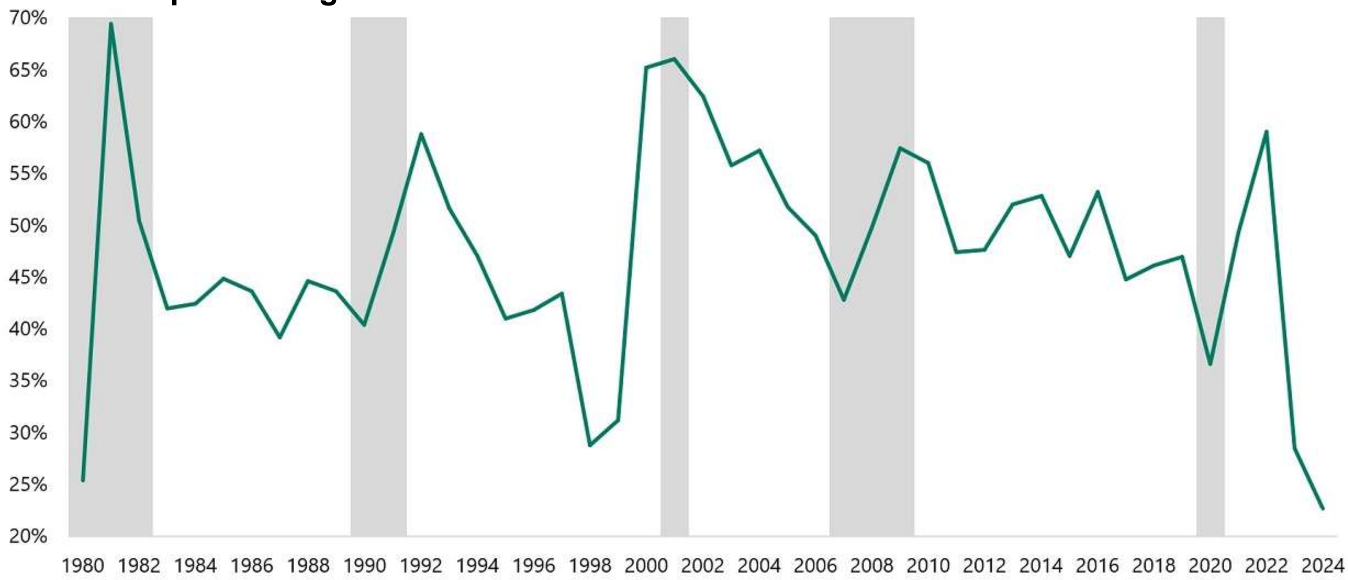
**Earnings Growth Over Last Decade**




Source: Bloomberg, Auscap

The result is that a passive US index exposure in recent years has given investors a low cost overweight exposure to a group of companies with significant earnings growth. So significant is the earnings growth and corresponding stock market performance of these six largest companies in the US that less than 25% of individual companies are outperforming the S&P 500 Index, a record low number over at least the last forty years.

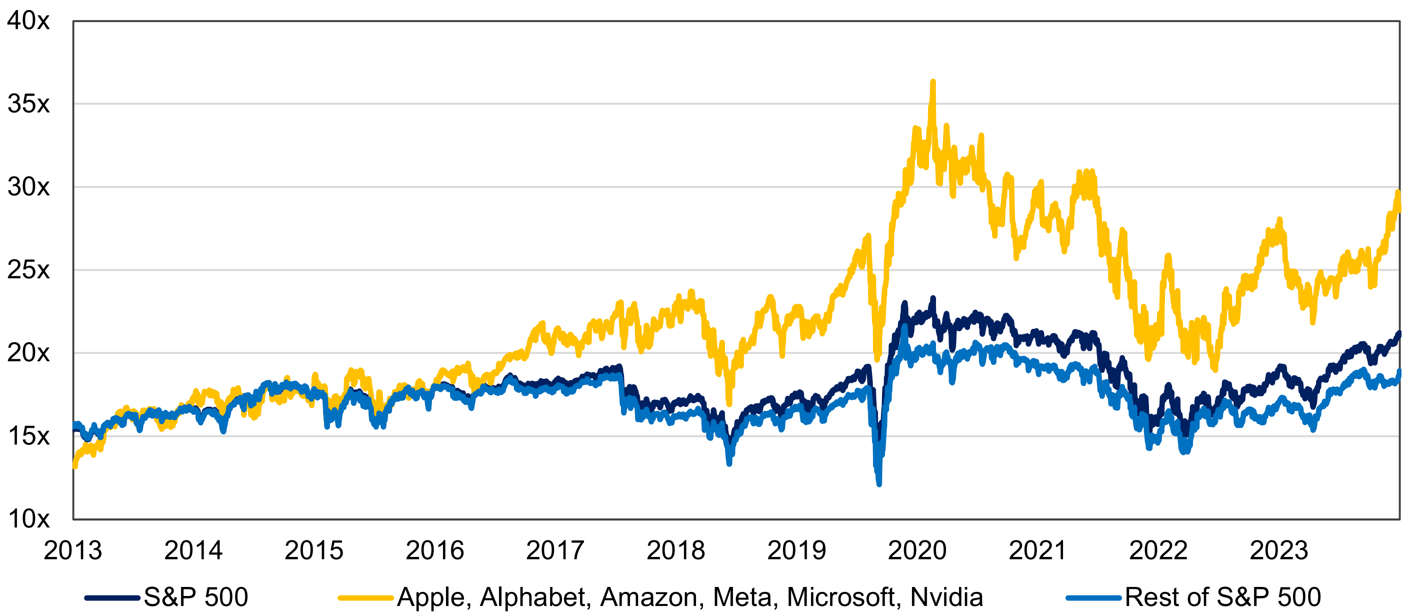
**Stocks Outperforming The S&P 500 Index**




Source: Apollo Academy

In such an environment, a passive index approach is very difficult to beat as an active manager. To do so, a manager needs to find stocks that will outperform the index by a margin that exceeds their management fees. If strong earnings growth continues to be a feature of the largest companies in the US market, we suspect it will continue to be a very difficult market for active managers to outperform. We should note for completeness that the multiple of earnings investors are willing to pay for these large companies and the broader market has also increased recently, aiding index performance.

**P/E ratios (market capitalisation / next 12 month net income)**

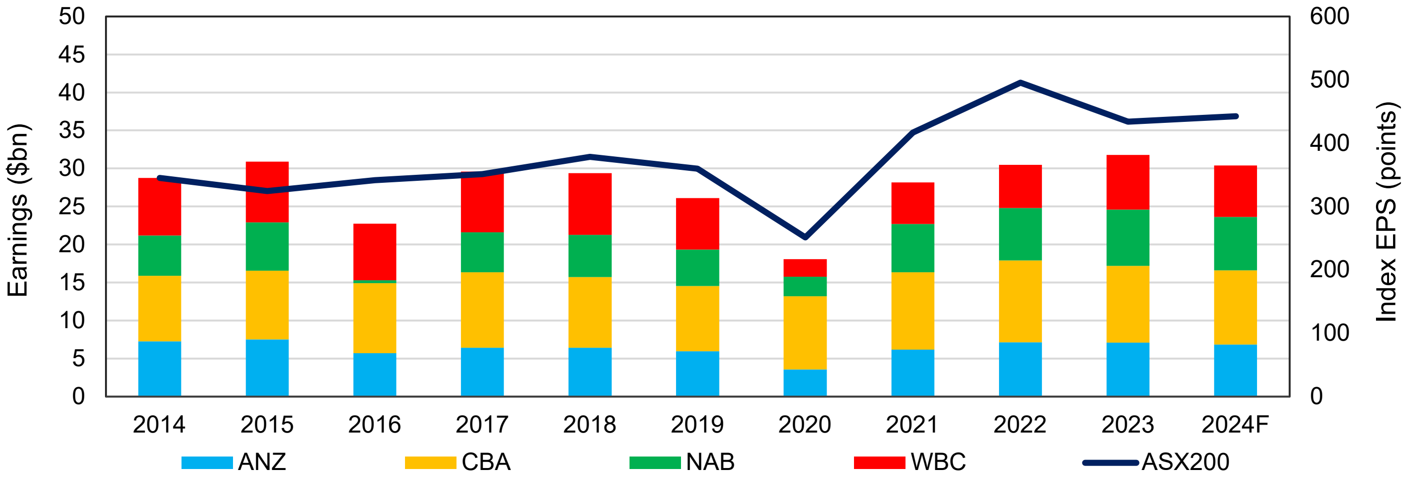



Source: Factset, Auscap

On the other hand, we suggest that there are also certain conditions that make an ideal environment for active investing. These conditions include an index that is materially overweight large companies that are likely to exhibit low, or even negative, earnings growth over future periods. This is particularly the case when the particular market has plenty of other companies that should see strong earnings growth over time.

The argument for active management in Australia appears to us to be as strong as the argument for passive investment has been in the US. Australia does not have large technology companies dominating the domestic stockmarket. The largest weights in the ASX200 are the Commonwealth Bank of Australia (9.3%), BHP (9.3%), CSL (6.3%), National Australia Bank (4.8%), Westpac (4.1%) and ANZ (3.8%). Australia's largest six companies, four of which are the large banks, account for 37.6% of the ASX200. If we focus on the four retail banks, collectively they account for 22% of the Index, yet they have failed to grow earnings meaningfully over the last decade. With the large banks continuing to display a more risk averse approach to lending, facing increasing competition in residential mortgages and business lending with the emergence of private credit providers, and having to deal with rising cyber security, information technology, compliance and employee costs, we struggle to see tailwinds for material earnings growth in the future.

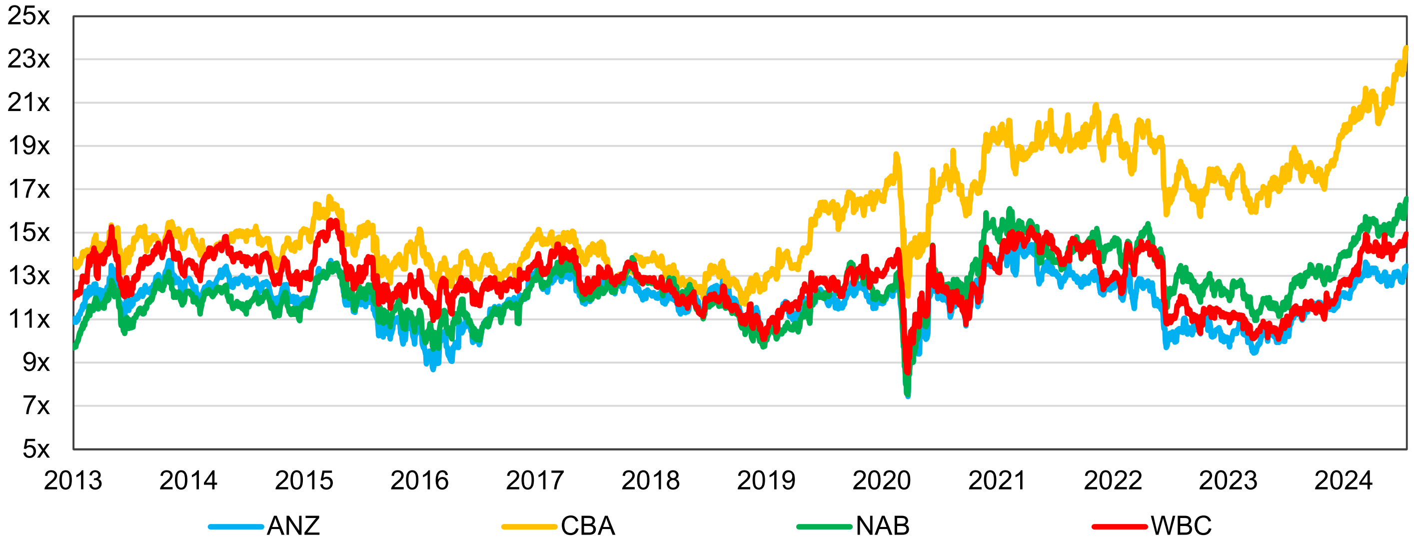
**Major Australian Retail Bank Earnings Over Last Decade**




Source: Bloomberg, Auscap

All four banks have recently experienced strong share price appreciation, but this largely appears to be a function of the market paying a higher multiple of earnings for these companies than representative of a lift in their earnings growth. In fact, analyst forecasts suggest the market expects anaemic earnings growth for the big four banks over the next 5 years.

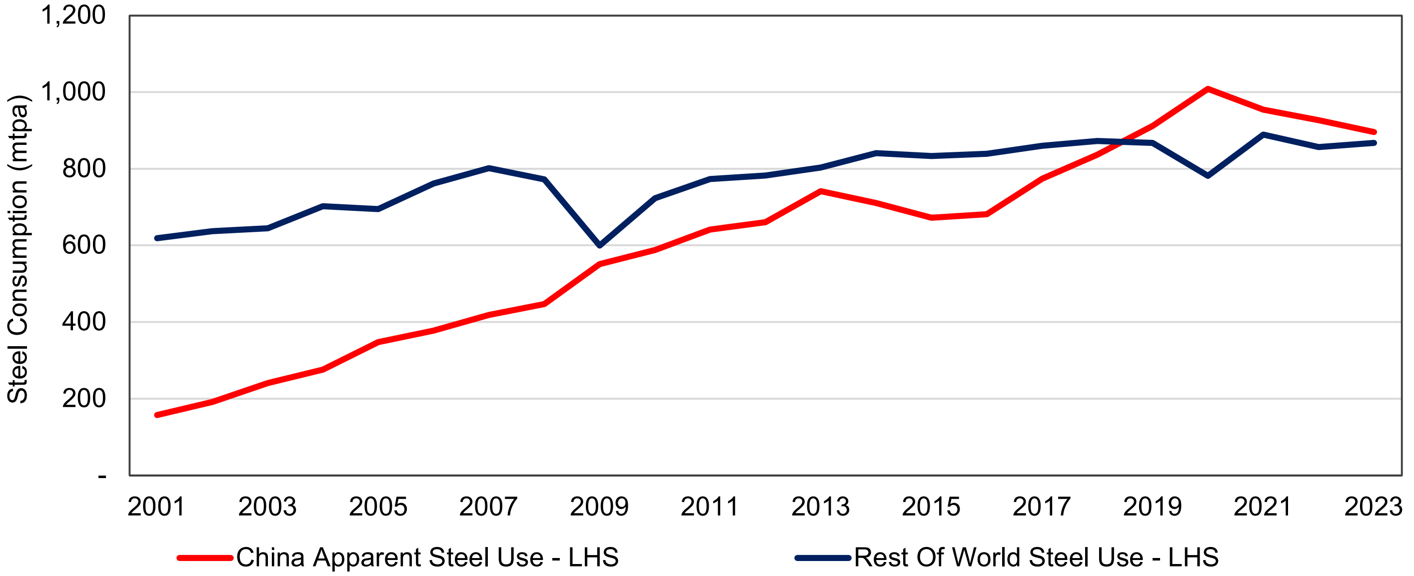
**Major Australian Retail Bank Forward Price to Earnings Multiples**




Source: Factset, Auscap

BHP, RIO and Fortescue account for a further 12.8% of the ASX200 Index. Their largest commodity exposure is iron ore. Yet it would appear that China's steel consumption, and hence iron ore consumption, peaked in 2020. This is extremely significant. In 2023 China accounted for 53.9% of the world's steel production and 50.8% of the world's steel consumption.

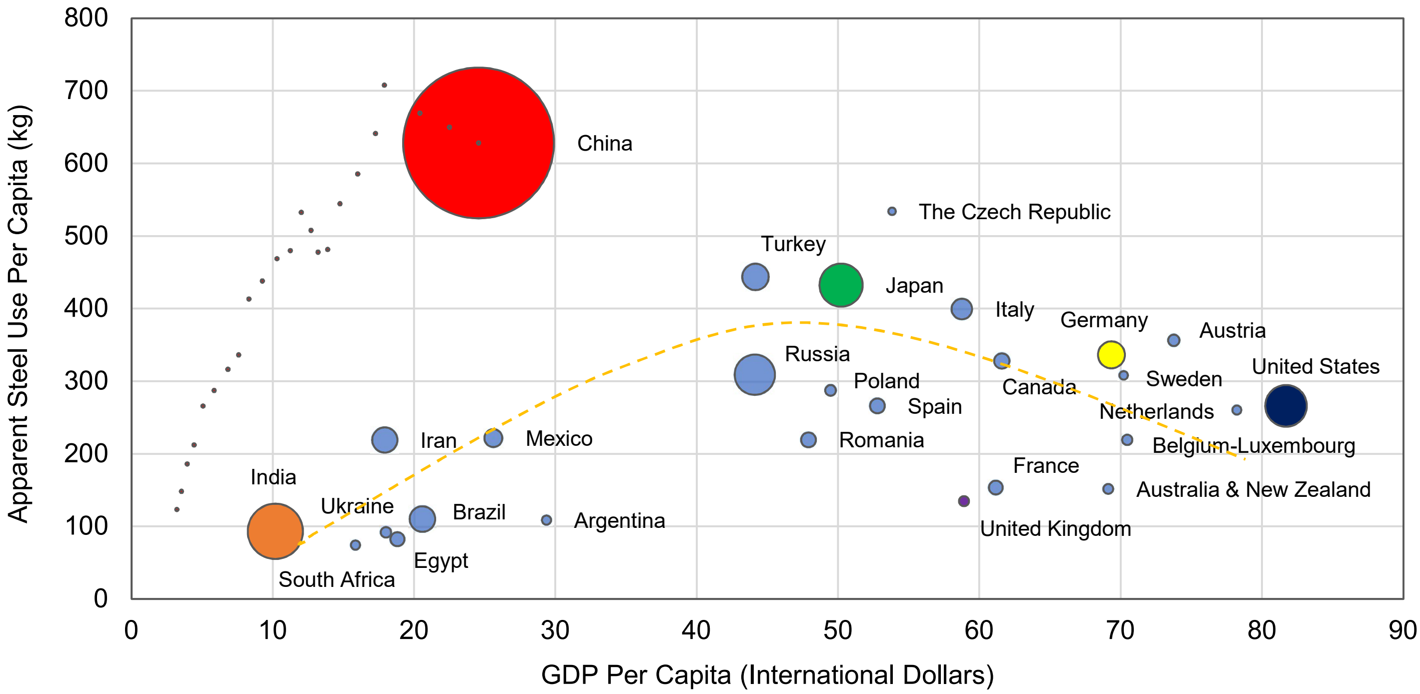
### China & Rest of World Steel Consumption




Source: World Steel Association, Auscap

China's industrialisation has been rapid. Its growth in steel consumption per person since 2000, shown by the small red dots, demonstrates this accelerated development. Following peak consumption in 2020, we expect China's steel consumption to continue to decline over time to levels that are similar to other developed countries. The size of the bubble represents the aggregate consumption by the individual country.

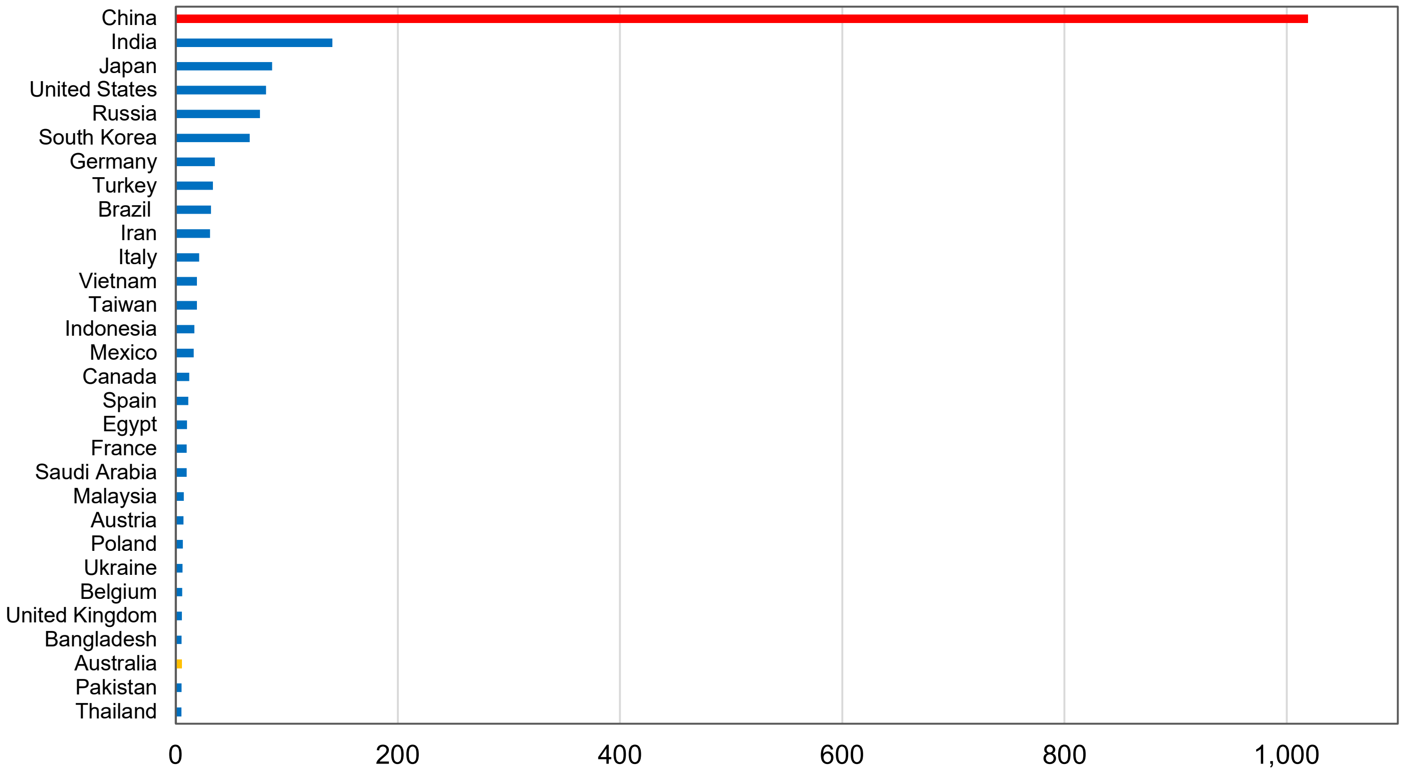
### Steel Use vs Income Per Capita (2023)




Source: World Steel Association, World Bank Group, Auscap

Given China's consumption was 6.7x that of the second largest consumer of steel, India, and its production more than 7.2x that of India's production, this leaves us muted on the outlook for iron ore demand.

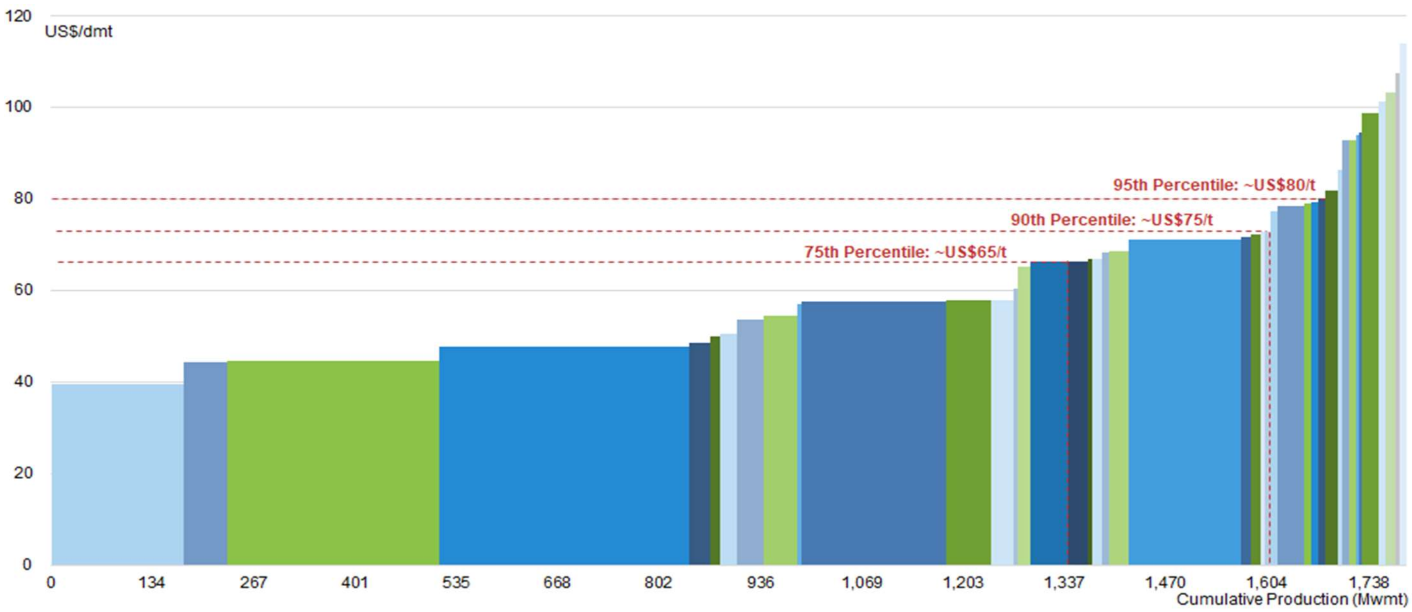
**Steel Production by Country (mtpa in 2023)**




Source: World Steel Association, Auscap

Yet over the next few years, Mineral Resources is expected to add 50mtpa of new low cost iron ore supply, and the development of two significant deposits in Simandou in the Republic of Guinea should add a further 120mtpa. We suspect declining demand and increasing supply is a recipe for lower prices and hence declining earnings for the iron ore majors.

**Global Seaborne Iron Ore Production Cost Curve**




Source: Goldman Sachs Global Investment Research. Costs are in US$/dmt, grade adjusted, freight adjusted, including China domestic production. Inputs assumed (in addition to freight, royalties included in all-in unadjusted cost curve), lump premium US$10/dmt, 58% realisation vs 62% of 84%, blast furnace pellet premium of US$30/dmt, Fines premium/discount over 62% for every 1% of 4%).

There is also political pressure on the margins for the large supermarkets, Woolworths and Coles (2.7% collectively of the ASX200 Index), and energy transition issues facing Australia's large energy companies, Woodside and Santos (3.2% collectively of the Index). All of these stocks are in the largest 20 companies in the Index.

In contrast to the US market, we think there is a strong argument for relatively anaemic growth out of many of the largest weights in the domestic Index. But that is not true of all constituents within the Index. Our caution around the outlook for earnings growth in the biggest domestic companies stands in contrast to our view on the attraction of investing in the Australian stockmarket. Australian equities have returned 13.0% per annum from 1900 to 2023. This compares favourably with US equities, which have returned 9.9% per annum over the same time period.

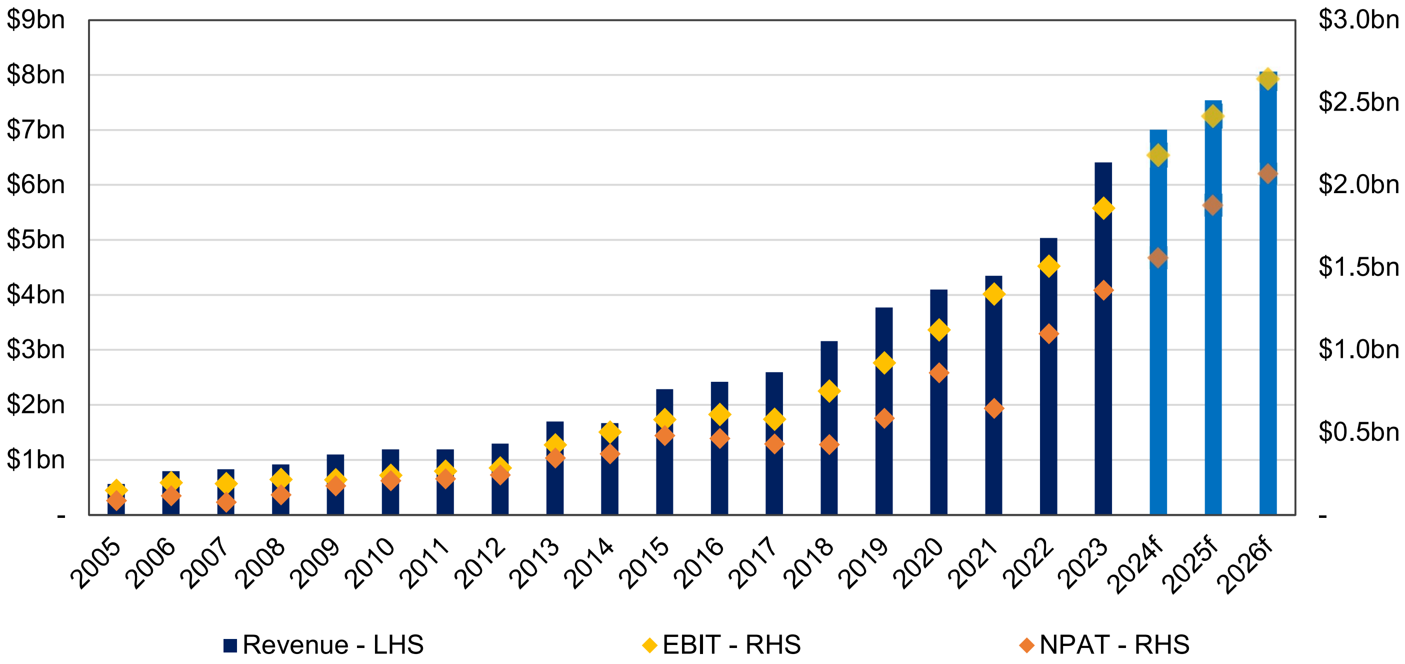
We are firmly of the view that the Australian economy is well placed to experience growth as strong as any developed economy on a go forward basis. This is likely to be driven by structural advantages which include: strong population growth; an abundance of natural resources that will continue to be in demand globally through the energy transition; proximity to the growth of the emerging nations in Asia; a sound democracy with an established rule of law and firm private property ownership protection; a solid Government fiscal position; an educated population and a business culture with a track record of innovation and entrepreneurship. We continue to believe that the domestic economy will present great opportunities for investment over time. Indeed there are currently many companies in the mid cap universe that are significant in scale with strong competitive advantages, have high return on capital metrics and plentiful opportunities for organic growth. This should lead to these companies experiencing strong earnings growth over time.

What does this mean? We think investors should expect their long term return from investing in equities to approximate the sum of the earnings growth and dividend yield delivered over time. A passive investment in an Australian index appears to us to be overweight many companies that will struggle to grow earnings at attractive rates. Such a market is one in which active management should outperform over time, if that active management is based on identifying businesses that are reasonably priced that will grow their earnings at healthy rates by reinvesting capital into attractive opportunities. We see many such opportunities in the domestic Index, particularly in the mid-cap space. One such opportunity that we have invested in over the last year is ResMed. We discuss this investment in the next section.

# ResMed And The Risk That GLP-1s Ruin The Runway For Growth

Investors would be aware that ResMed became a significant position for the Auscap funds in the second half of 2023. It is a founder-led business that sells CPAP (continual positive airway pressure) devices to sufferers of obstructive sleep apnea (OSA). Following a recall by its major competitor, Phillips, ResMed is the dominant player within its sector, having grown earnings per share by 15% per annum for the last decade with a consistent return on equity above 20%.

**ResMed Profitability**



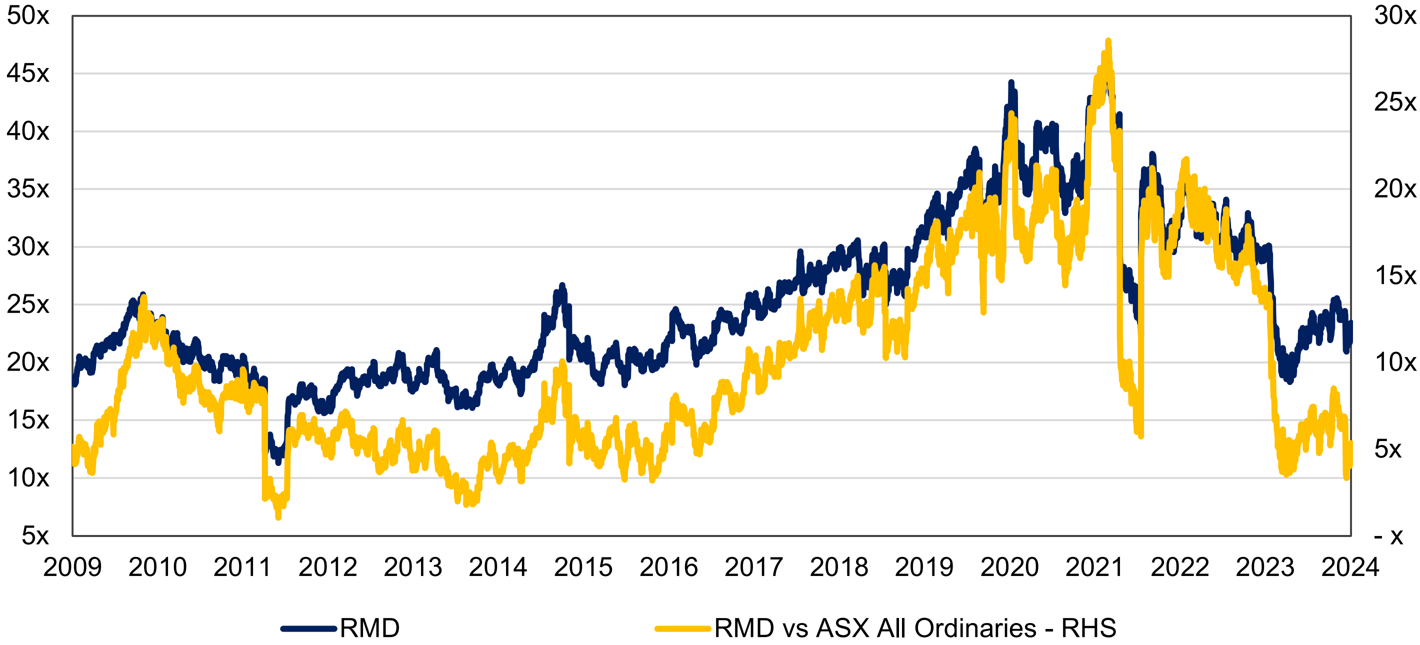

Source: FactSet, Auscap

ResMed sold off in the last year due to the perceived potential impact of a class of drugs referred to as Glucagon-Like Peptide 1 agonists, or GLP-1s, which assist patients in losing significant amounts of weight. There is a strong correlation between OSA and weight. GLP-1 drugs could potentially reduce the number of patients that suffer from OSA thereby reducing the size of its market. However, the evidence is far from conclusive. ResMed noted that a current study of 660,000 patients with GLP-1 initiation and an OSA diagnosis saw a 10.5% *increase* in the likelihood that the patient would initiate positive airway pressure (PAP) therapy if they are prescribed a GLP-1 drug. Patients on GLP-1s also had higher PAP resupply rates 1 and 2 years post setup.

A recent high-profile study called SURMOUNT-OSA has driven another sell off in recent weeks. Having spoken to many industry participants, the concerns currently appear overblown. There remain many outstanding issues with concluding that GLP-1s should be the primary treatment for OSA. The benefits of GLP-1s take time, with the weight loss and health benefits of the SURMOUNT-OSA study measured over 52 weeks. CPAP by contrast delivers benefits immediately, and untreated OSA can increase all-cause mortality. Patient adherence, noticeable side effects from GLP-1s and whether patients can maintain the weight loss post treatment are all ongoing issues. Ultimately it may be the case that a combination of treatments is most effective for OSA. The cost of GLP-1 drugs is currently extremely high and it is not clear to what extent reimbursement will be available.

Feedback suggests that ResMed remains the strongly preferred CPAP standard of care, with physicians tending to view GLP-1s as an adjunctive OSA therapy to CPAP. Significantly, demand trends for the CPAP sector remain extremely strong. It also appears that the sudden focus on weight and health that has arisen from the GLP-1 fervour has substantially increased awareness of OSA, an under-diagnosed condition, which is increasing the number of patients looking for a solution. ResMed management estimates the current global OSA market to be roughly 1 billion people, and in FY23 ResMed had just 23.5 million connected devices in market. Awareness is likely to increase further with Samsung's new Galaxy Watch which detects signs of sleep apnea.

**ResMed 12 Month Forward Price to Earnings Ratio**




Source: FactSet, Auscap

ResMed is currently trading on a forward price to earnings multiple that is a discount to where it has traded historically, and even more so relative to the broader market, which we think is a great opportunity to buy in at an attractive price for long term investors. We see a significant runway for earnings growth for ResMed over the coming years.

Auscap Asset Management

# Auscap Long Short Australian Equities Fund

## Fund Performance*

| Period | Auscap | All Ords |
|---|---|---|
| June 2024 | (2.6%) | 0.7% |
| Financial Year To Date | 17.5% | 12.5% |
| Since Inception (Dec 2012) | 400.3% | 182.6% |
| Annualised Returns | 14.9% | 9.4% |

## Fund Exposures

| June 2024 Average | % NAV | Positions |
|---|---|---|
| Gross Long | 96% | 39 |
| Gross Short | 0% | 0 |
| Gross Total | 96% | 39 |
| Net / Beta Adjusted Net+ | 96% | 113% |

## Portfolio Commentary*

The Fund returned negative 2.6% net of fees during June 2024. This compares with the All Ordinaries Accumulation Index return of +0.7%.

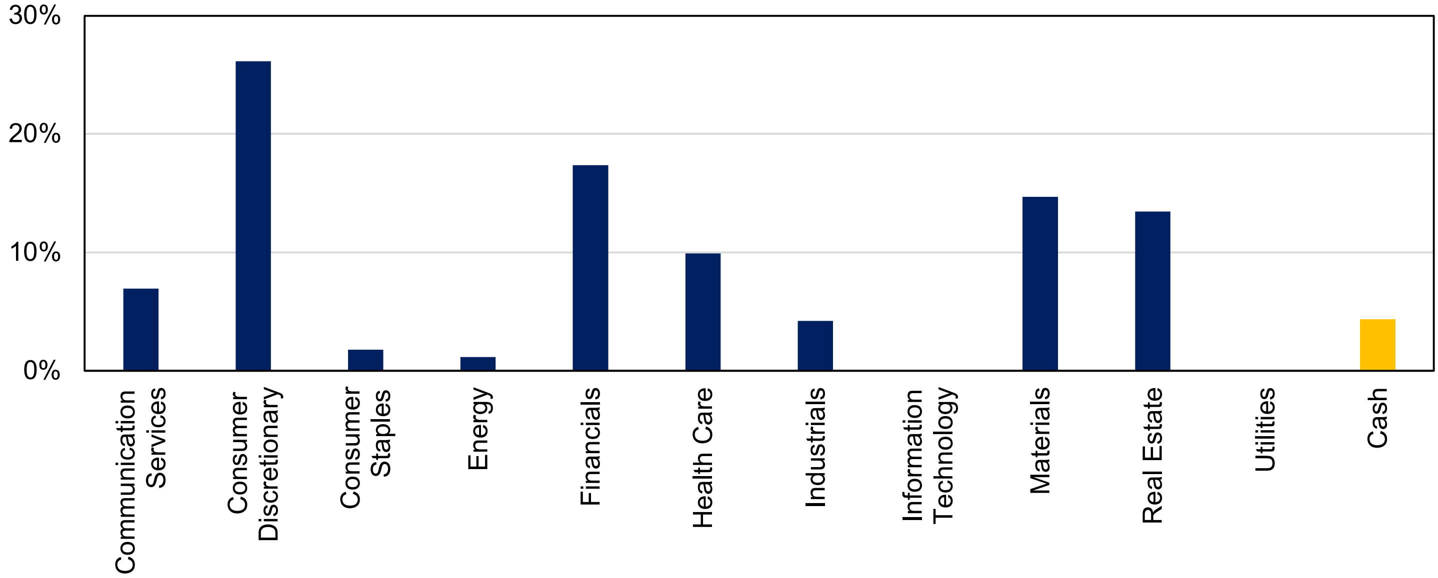
During June, the financials, communication services, consumer staples, energy and consumer discretionary sectors contributed positively to returns, while the materials, health care, real estate and industrials sectors detracted.

Over the month, Macquarie Group was the largest positive contributor to performance. Mineral Resources, Pilbara Minerals and ResMed were the most significant detractors from returns.

## Top 20 Investments^

| | |
|---|---|
| ARB Corp | Mineral Resources |
| Breville Group | Netwealth Group |
| CAR Group | NIB Holdings |
| Charter Hall Retail REIT | Nick Scali |
| Eagers Automotive | PWR Holdings |
| HMC Capital | REA Group |
| HomeCo Daily Needs REIT | Reece |
| HUB24 | ResMed |
| James Hardie Industries | Sigma Healthcare |
| Macquarie Group | Sonic Healthcare |

## Sector Exposure - June 2024#




* *Performance figures are calculated for the Monthly Class net of all fees and expenses and assuming the reinvestment of all distributions. Note, as at 1 January 2021, the Series Class was consolidated into the Monthly Class. Past performance is not a reliable indicator of future performance.*

\+ *Beta adjusted net adjusts the portfolio for the beta, or share price volatility, of the stocks relative to the All Ordinaries Accumulation Index.*

^ *Top 20 long investments in alphabetical order as at 30 June 2024.*

\# *Average sector exposure during June 2024.*

Auscap Asset Management

# Auscap Ex-20 Australian Equities Fund

## Fund Performance*

| Period | Auscap | Index** |
|---|---|---|
| June 2024 | (2.0%) | (0.8%) |
| Financial Year To Date | 12.7% | 10.5% |
| Since Inception (Dec 2023) | 12.7% | 10.5% |
| Annualised Returns | NA | NA |

## Fund Exposures

| June 2024 Average | % NAV | Index |
|---|---|---|
| Equities | 96% | 100% |
| Cash | 4% | 0% |
| Beta Adjusted Exposure+ | 105% | 104% |
| Positions | 51 | |

## Portfolio Commentary*

The Fund returned negative 2.0% net of fees during June 2024. This compares with the S&P/ASX 300 Ex S&P/ASX 20 Index return of negative 0.8%.

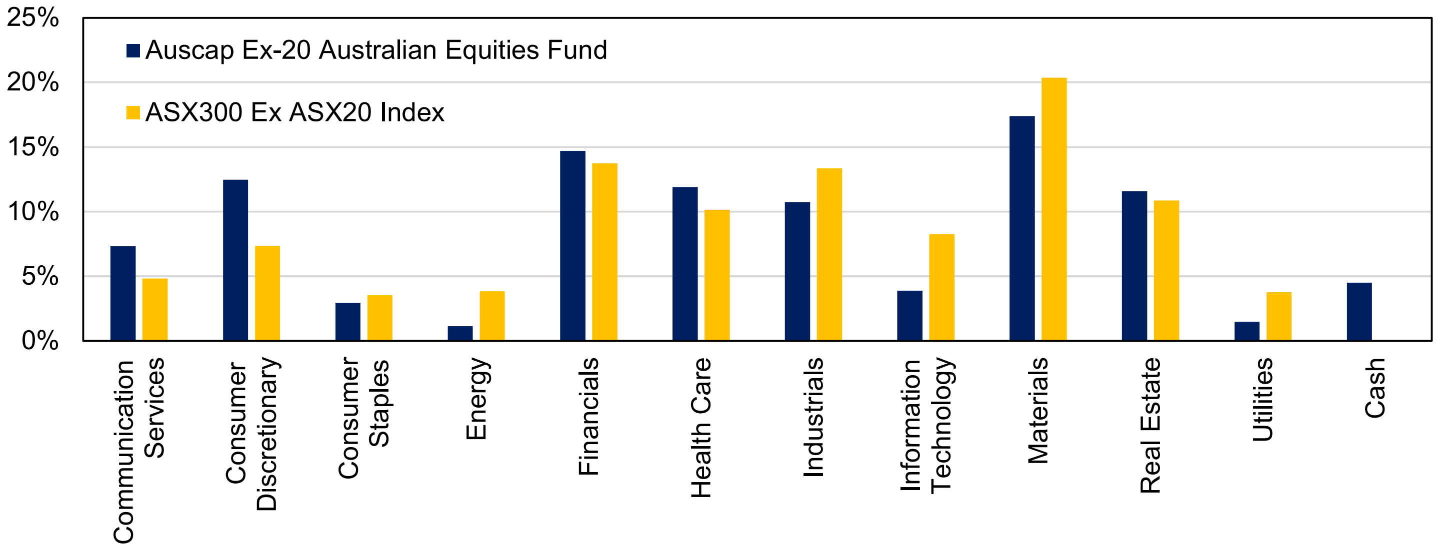
During June, the Fund's exposure to the financials, communication services, information technology and utilities sectors contributed positively to returns. The Fund's exposure to the materials, industrials, communication services, health care, consumer discretionary, consumer staples and energy sectors detracted from returns.

The Fund's holding in Hub24 was the largest contributor to returns. Mineral Resources, Pilbara Minerals and ResMed were the most significant detractors from performance.

## Top 20 Investments^

| | |
|---|---|
| AUB Group | Nick Scali |
| CAR Group | PWR Holdings |
| Charter Hall Retail REIT | Qube Holdings |
| Cochlear | REA Group |
| HMC Capital | Reece |
| HomeCo Daily Needs REIT | ResMed |
| HUB24 | Sigma Healthcare |
| James Hardie Industries | Sonic Healthcare |
| Mineral Resources | Wisetech Global |
| NIB Holdings | Xero |

## Sector Exposure - June 2024#




* Performance figures are calculated for the General Class net of all fees and expenses and assuming the reinvestment of all distributions. Past performance is not a reliable indicator of future performance.
** Index used is the Benchmark for the Auscap Ex-20 Australian Equities Fund, being the S&P/ASX 300 Ex S&P/ASX 20 Index.
+ Beta adjusted exposure adjusts the portfolio of the Fund and of the Benchmark (being the S&P/ASX 300 Ex S&P/ASX 20 Index) for the beta, or share price volatility, of the stocks relative to the All Ordinaries Accumulation Index.
^ Top 20 investments in alphabetical order as at 30 June 2024.
# Average sector exposure during June 2024.

# Newsletter – July 2024



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Tax & Audit: EY