MARKET MATTERS

INVEST

MONTHLY REPORT | SEPTEMBER 2023 | ACTIVE INCOME

PORTFOLIO DETAILS

Portfolio Name	Active Income
Structure	Separately Managed Account
Benchmark	RBA Cash +4%
Management Fee	0.85% incl GST
Platform	Open Wealth | Praemium
Included Assets	Equities, Hybrids, Trusts, ETFs
Portfolio Manager	James Gerrish
Annual Performance	9.04%*

OBJECTIVE

The objective of the Market Matters Active Income Portfolio is to provide a high level of regular tax-effective income with lower volatility than the underlying share market. This is achieved by actively managing a portfolio of high-yielding equities combined with ASX listed income securities that offer diversification benefits to both Australian equities and cash or term deposits.

**Inception Date 05.07.2017*

MARKETS & PERFORMANCE

The Market Matters Active Income Portfolio advanced +0.09% in September, underperforming its RBA Cash +4% benchmark which increased +0.65%, however, the return compared favourably against the broader ASX (-2.84%). The portfolio has returned +17.33% for the rolling 12 months, against the benchmark return of +7.51% and +13.81% per annum for 3 years, 8.51% per annum above its benchmark.

PERIOD	1 MONTH	3 MONTH	6 MONTH	1 YEAR	2 YEAR PA	3 YEAR PA
PORTFOLIO %	0.09	2.43	4.70	17.33	7.16	13.81
BENCHMARK %	0.65	2.01	3.95	7.51	5.97	5.30
RELATIVE %	-0.56	0.42	0.75	9.82	1.19	8.51

Benchmark: RBA Cash Rate +4%

More broadly, the MSCI Developed Markets Index fell during September (-3.7%), while the S&P 500 also declined (-4.8%) in local currency terms. Australian 10-year bond yields finished the month at 4.49%, up a significant 46bps despite the RBA leaving the cash rate unchanged.

In the US, the Federal Reserve delivered a ‘hawkish pause’, keeping their target rate unchanged but implied higher rates were a distinct possibility, 10-Year US Treasury yields increased 49bps to 4.57%, having a significant influence on stocks.

Commodity prices were mixed over Sept. Brent Oil rose by US$8.45 to US$95.31/bbl, on a resilient US economy and bullish demand sentiment around China over Golden Week holidays. Iron Ore prices held, rising by US$2.00 to US$119.50/Mt, however depressed rebar prices and spreads signal softening steel demand by China. Gold prices fell on a strong dollar, falling by US$71.80 to US$1,871.

Energy (+1.6%) was the only sector to make gains while Financials (-1.6%), Consumer Staples (-1.8%), Materials (-1.8%) and Utilities (-1.9%) outperformed the benchmark.

Property (-8.6%) struggled most while IT (-7.9%), Healthcare (-6.2%) Consumer Discretionary (-3.7%), Communication Services (-3.5%) and Industrials (-3.2%) all dipped more than the market.

WHAT'S OUR TAKE ON THE MACRO?

Markets have become decidedly more anxious over the past month, but it's important to realise that while the ASX 200 did hit multi-month lows in September and there are legitimate risks to the outlook, underlying fundamentals remain generally robust.

First, while there are reasonable concerns about a future economic slowdown, the latest economic data remains solid. Employment, consumer spending and business investment were all resilient in the first quarter and there simply isn't much actual economic data that points to an imminent economic slowdown. So, while a future economic slowdown is certainly possible given higher interest rates, the actual economic data is clear: It isn't happening yet.

Second, fears that inflation may bounce back are also legitimate, given the rally in oil prices. But the Reserve Bank of Australia, The US Federal Reserve and other central banks typically look past commodity-driven inflation and instead focus on "core" inflation and that metric continued to decline throughout the period. Additionally, declines in housing prices from the recent peak are only now beginning to work into the official inflation statistics, and that should see core inflation continue to move lower in the months and quarters ahead.

Finally, regarding monetary policy, the US Federal Reserve's historic rate hike campaign is nearing an end. And while we should expect the Fed to keep rates "higher for longer," high interest rates do not automatically result in an economic slowdown. Interest rates have merely returned to levels that were typical in the 1990s and early 2000s, before the financial crisis, and the economy performed well during those periods. Yes, the risk of higher rates causing an economic slowdown is one that must be monitored closely, but for now, higher rates are not causing a material loss of economic momentum.

To be clear, there are real risks to both the markets and the economy as we move deeper into FY24. But these are largely the same risks that markets have faced throughout FY23 and over that period the economy and markets have remained impressively resilient. So, while these risks and others must be monitored closely, they don't present any new significant headwinds on stocks that haven't existed for much of the year.

We intend to remain invested, holding stocks and fixed income securities that we believe offer good risk/reward dynamics, that align with our broader macro views. We don't believe now is the right time to significantly increase cash, or turn aggressively defensive, outside of our currently balanced approach in this portfolio.

PORTFOLIO POSITIONING

The portfolio held 19 positions at the end of September with a forecast yield of 5.70% plus franking. The portfolio is weighted 50% in Equities, 40% in Hybrids/Fixed Income, 6% in property and 4% cash.

New Hope Corp (NHC) was the top performing position in the portfolio during September after reporting a solid FY23 result, headlined by a 15% increase in underlying earnings to $1.63bn and a 30cps fully franked dividend for the 2H.

PORTFOLIO STOCKS	
NO. OF HOLDINGS	19
ESTIMATED YIELD (%)	5.70
TOP 5 POSITIONS (% OF AUM)	32.24
TOP 10 POSITIONS (% OF AUM)	60.4

STOCK	CONTRIBUTION (%)
NEW HOPE CORP (NHC)	0.54
NAB HYBRID (NABPF)	0.19
BHP GROUP (BHP)	0.15
ANZ HYBRID (AN3PI)	0.15
NAB HYBRID (NABPI)	0.14

STOCK	DETRACTION (%)
APA GROUP (APA)	-0.36
CENTURIA CAPITAL (CNI)	-0.26
DEXUS (DXS)	-0.22
TELSTRA (TLS)	-0.20
COMMONWEALTH BANK (CBA)	-0.15

%	JUL	AUG	SEP	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY	JUN	YTD
FY24	2.79	-0.44	0.09										**2.44**
FY23	4.22	0.30	-3.64	3.31	4.82	-0.07	3.49	-1.61	0.06	2.16	-2.01	2.07	**13.10**
FY22	0.10	3.04	0.58	-1.58	-1.31	3.01	-2.45	4.05	4.25	-0.09	-1.80	-6.54	**1.26**
FY21	1.16	2.22	-1.21	-0.17	9.29	1.46	0.47	0.96	2.73	2.79	1.91	2.39	**24.00**
FY20	1.54	-0.57	2.90	-4.54	1.16	-0.51	1.78	-3.97	-15.53	7.33	6.24	1.94	**-2.23**
FY19	1.35	0.76	-0.62	-3.09	-0.61	-0.40	2.42	3.92	-0.21	1.17	3.13	1.37	**9.19**
CUMULATIVE													**47.76**

PORTFOLIO POSITIONING CONTINUED

This means they will pay 70cps for the full year (including 19c worth of special dividends), equating to a yield of 12.4% on our original entry.

Grossed for franking, this equates to 17.7% – and they say don't buy resources for income!

New Hope is ultimately delivering for investors, generating significant cash flow and passing those back to investors in the form of dividends, which is pushing the shares higher. However, it's important to recognise that FY23 is likely to be an anomaly in terms of income, that earnings and therefore, dividends will be lower in FY24-25, putting it on an expected yield of around 6.5% fully franked from here.

Telstra (TLS) hit a 6-year high on the 21st of June at $4.46 and has since pulled back ~15%. While they traded ex-dividend for 8.5c fully franked during the period, the share price has clearly underperformed, prompting the question of why, and what should we be doing, if anything.

Their FY23 results were solid, particularly in Mobile which makes up ~60% of their earnings. They confirmed the turnaround towards growth is ongoing, with earnings up 9.6% on the same time last year and the highest for a decade. This is underpinning growth in dividends, which at 17cps for the FY was up from 16.5c in FY22 and the first lift in 6 years, with another increase expected in FY24 which should see it on a yield of ~4.6%.

We suspect there are four main reasons for the recent sell-off, that will ultimately subside, and TLS can re-capture its mojo:

Market positioning: The market was universally bullish, leaving a dearth of new buyers. Of the 13 analysts that feed into the Market Matters website, there are 11 buys with a consensus price target of $4.58, 18% above the current price. We've observed over recent years a complete 'about turn' from the analyst community, transitioning from an outright bearish view to a more balanced one, to now, a very universally bullish stance. Positioning is important and it seems to MM that such positioning predicated on the points above, has left an air pocket of new buyers.

Infrastructure divestment: At their August results, TLS said it is now likely to keep the current ownership of infrastructure (i.e. no spin out InfraCo) for the medium term. Some in the market would have been disappointed by this, however, we view this as a positive and don't believe the value of their infrastructure is being truly reflected in the TLS share price.

Mobile improvement will be fleeting: Strength in mobile is driving much of the improvement at Telstra. Higher Average Revenue Per User (ARPU) helps margins which underpins earnings. Lower discounting and a more rational market are the reasons, however, bears suggest this will not last, and that it is a lull rather than a trend. TLS recently announced a FY24 postpaid ARPU average increase of +7% across all of its mobile plans which is clearly a positive for this year at least. As companies push price increases through, we find it highly unlikely that these will be cut in the future, in any meaningful way.

Finally, valuations relative to history were on the high side, with the TLS P/E now back to more 'normal' levels. We see value in TLS ~$3.80.

The Active Income Portfolio holds a 13% weighting to bank equity via **Commonwealth Bank (CBA)** and **National Bank (NAB)** along with a 23% weighting to major bank hybrids, implying we are underweight bank equity offset by exposure to their floating rate debt.

From a sector perspective, positives include better economic conditions driving a better credit cycle. In other words, bad debts are still very low even with the significant increase in interest rates, while capital levels are incredibly strong, and this opens the door for higher dividend payouts and other forms of supportive capital management. Put simply, banks are in incredible shape from a capital position which makes them safer, but they do have some headwinds around earnings.

There remains some pressure on margins, a result of irrational pricing on mortgages (to win market share), and pressure to attract deposits (both are good for the consumer), although there is evidence that this has subsided more recently. Funding costs are also going up while cost pressures have been obvious.

Overall, consensus expectations have major bank earnings contracting ~6.5% in FY24 and only returning to the levels seen in FY23 by FY27, which is a pessimistic outlook. While we don't expect significant capital growth in the banks, which is why we remain underweight bank equity, their strong capital positions will support yields, and any share price weakness could create an opportunity to add to the sector.

In terms of Hybrids, APRA released a discussion paper late in the month looking at the current structure of **AT1 Hybrid securities**, with a specific focus on how they absorb losses in times of stress. There are multiple parts to this and a lot of water to go under the bridge until something might change, however, Importantly, if any changes are ultimately made to the structure of hybrids to be issued in the future, existing hybrids on issue cannot have their terms altered. We wrote an article here on the topic.

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