

# ALLAN GRAY

QUARTERLY COMMENTARY

31 DECEMBER 2018





# COMMENTARY



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It has been a poor year for sharemarket returns in Australia. We've fared even worse. It is hard to pinpoint the exact reasons for our underperformance over short periods of time, but increased uncertainty surrounding global trade and economic growth appears to have weakened market sentiment. Volatility

has increased significantly (but most likely to more normal, rather than elevated, levels) and investors have sought refuge in companies with defensive earnings streams. We are not invested in these companies as they appear to be expensive relative to their long-term earnings prospects. We believe the more cyclically-exposed companies offer better value but these have suffered over the past year. We discuss one of these companies, Peet Limited, below.

## What does Peet do?

Peet is a residential land developer. It buys parcels of undeveloped land in population growth corridors around Australia, applies for the land to be reclassified as 'residential' (if not already zoned as such) and builds infrastructure and amenities necessary to support new communities. These include roads, bridges, sewerage works, pavements, parklands, schools, shopping centres and the like. Once developed, vacant land lots are sold to individuals and builders who in turn build homes, townhouses and apartments. Figure 1 shows Peet's Flagstone development in Queensland, where construction is already underway.

**Figure 1: Peet's Flagstone development is already underway**



Source: Peet Limited

Development activities are either funded using Peet's own balance sheet, or via syndicates and joint ventures through which external investors fund the land acquisition and development costs. Peet refers to their syndicates and joint ventures as their 'funds management' business. Where Peet uses its own balance sheet, all of the rewards and the risks associated with the development of land parcels accrue to its shareholders. For development activities undertaken by the funds management business, Peet earns development fees. These are usually a percentage of the sale proceeds, but can also include performance fees where syndicate returns exceed a given threshold. Peet typically co-invests in all syndicates and joint ventures (much like an investor might expect a fund manager to co-invest in a fund they manage).

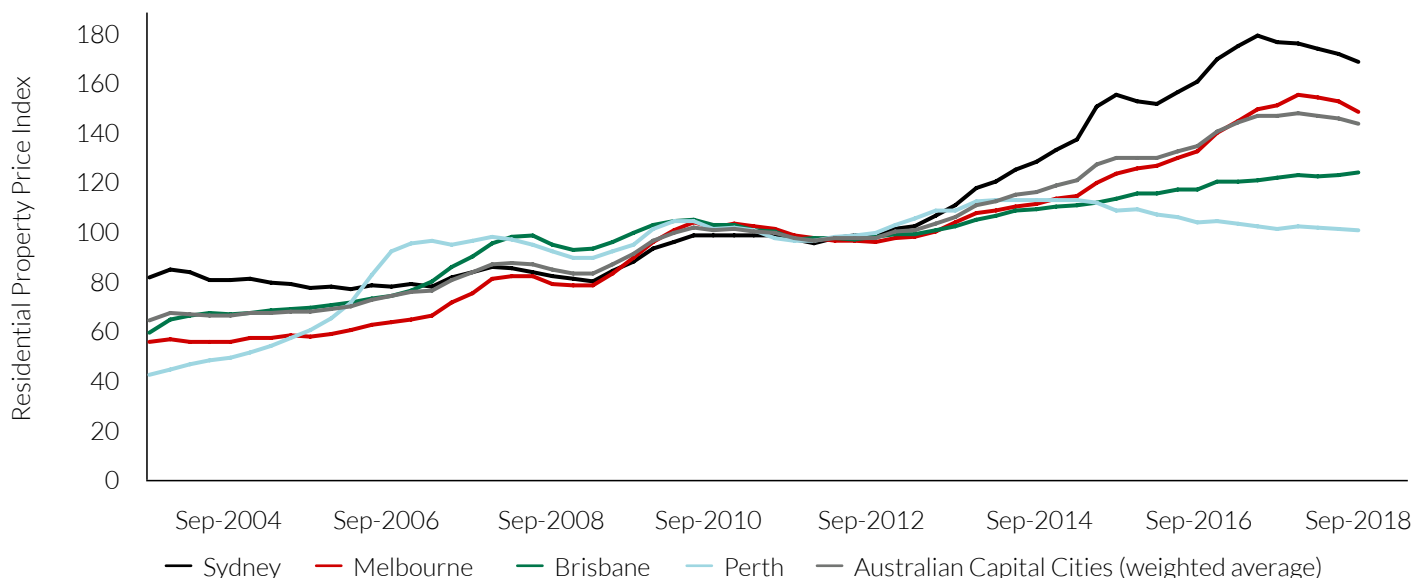
## What went wrong for Peet?

Peet's share price has fallen 30% this year and has significantly

underperformed the broader sharemarket. Much of this weakness stems from poor sentiment towards Australia's residential property prices. According to the Australian Bureau of Statistics, Australian home prices increased 44% from 2013 to their 2017 peak, with Sydney up 74% and Melbourne up 52%. Since its peak, the national average is down 3% (to September 2018 and more since then), with Sydney and Melbourne leading the declines.

Property experts now appear unified in their forecasts for further weakness in residential property prices, with these experts and the popular press contributing to the current weak sentiment.

**Graph 1: Residential property prices (to 30 September 2018)**



Source: Australian Bureau of Statistics

There is little doubt that falling house prices create headwinds for property developers like Peet. First, declines are likely to be disproportionately reflected in land values (Peet's largest asset) as this was the source of most of the increases in property prices over the past five years. Secondly, Peet's profits are heavily linked to activity levels and lot sales. Funds management fees are only earned when lots are settled, contributing to significant operating leverage in the business. Falling lot sales and settlements will likely see profits of their on-balance-sheet development business fall too.

But it is important not to lose sight of the underlying fundamentals. Understanding what drives the profitability of a company is as important as knowing to what degree changes in

these drivers are already priced into a company's share price. Sharemarkets are forward looking and dire outlooks are often more than fully reflected in share prices, which can present great long-term buying opportunities.

## Four reasons for optimism

Peet's share price is approximately \$1/share today. This is just under 10 times last year's earnings and represents a 15% discount to its net tangible asset ('NTA' – calculated by taking a company's physical assets minus its total liabilities) value of \$1.18/share. Below are four reasons why we think this is compelling, even in this environment of falling house prices.

1. Peet's NTA is stated at historical cost. With the average age of its land bank being over five years old, and possibly as high as eight years old, its reported NTA does not capture any of the strong increases in Australia's residential property prices over the past five to eight years. Were one to restate Peet's NTA to market values today, Peet's share price is likely to factor in a much higher discount than the 15% referenced above.
2. Like other companies with a funds management business, using only NTA as a yardstick for valuation is likely to significantly understate the value of a company's future earnings streams. Over recent years Peet has been moving more and more of its activities into its capital-light funds management business. Today, less than 25% of Peet's land bank under development is on its own balance sheet. In 2018, Peet's funds management business contributed 30% (or \$30m) of the company's earnings before interest, tax, depreciation and amortisation (EBITDA). For the year to June 2018, 2,486 lots were settled in its funds management and joint venture business, a run rate the company could sustain for over 15 years before depleting its inventory. This future earnings stream has little tangible assets associated with it, but is likely to be valuable.
3. Peet has been reducing its exposure to the most overvalued states in Australia. It has accelerated the development and sale of its lots in Victoria and taken steps to sell two of its undeveloped Victorian land banks to other developers, using the proceeds to significantly reduce its debt outstanding. In 2018, 74% of its EBITDA came from lot

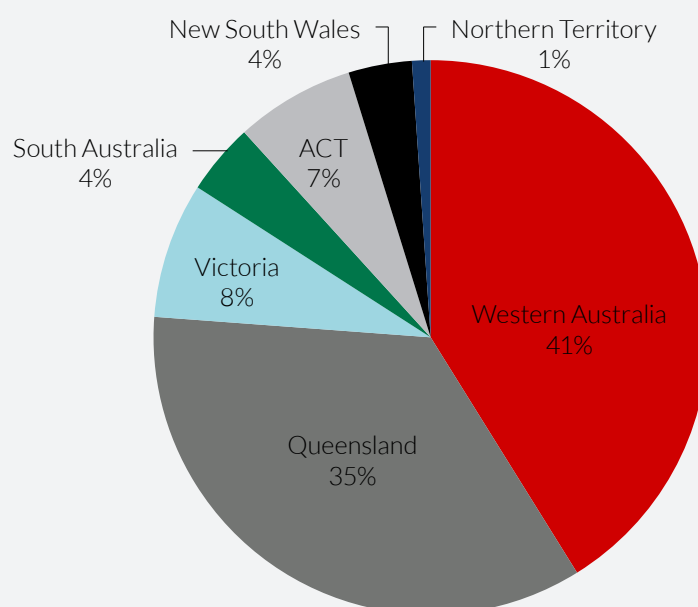
sales in Victoria – this illustrates the extent of its Victorian inventory drawdown (but admittedly also creates a challenge to replace in future years). It has not added to its New South Wales or Victorian land banks for over three years. As Chart 1 shows, Peet's exposure to these states is less than 15% of its development land bank.

4. While the selling prices and therefore profits from Peet's land bank may well fall, it is possible that development and performance fees from its maturing funds management business offset or at least cushion earnings falls from here. Given this, the 10 times earnings multiple that investors pay for Peet today provides a reasonable margin of safety.

We are not alone in our attraction to the company at these levels. At the time of writing this, the company itself has bought back 1.3% of its issued share capital at an average price of \$1.06/share. Also, the chairman owns close to 20% of the company's issued shares and has done for some time. Share buybacks at times like this (prevailing large discounts to intrinsic value) and the alignment of interests between management and shareholders (having 'skin in the game') can contribute to outsized benefits for shareholders.

With today's volatile markets and skittish investor base, it is impossible to know how much further Peet's share price could fall (our recent experience with Asaleo Care was an all too sobering reminder of this – please refer to the June 2018 Quarterly Commentary). But it is in times of trouble and negative sentiment that shares are priced for the greatest returns. We believe Peet is a great example.

**Chart 1: Peet's development land bank exposure to each state**



Source: Peet Limited FY18 Results Presentation, 23 August 2018

# EQUITY FUND PERFORMANCE

## Allan Gray Australia Equity Fund – Class A units

	Allan Gray Australia Equity Fund	S&P/ASX 300 Accumulation Index	Relative Performance
<b>ANNUALISED (%)</b>			
Since Public Launch on 4 May 2006	7.5	5.1	2.4
10 Years	12.9	8.9	4.0
5 Years	9.2	5.6	3.6
3 Years	14.2	6.6	7.6
1 Year	(7.3)	(3.1)	(4.2)
<b>NOT ANNUALISED (%)</b>			
Latest Quarter	(11.0)	(8.4)	(2.6)

## Allan Gray Australia Equity Fund – Class B units

	Allan Gray Australia Equity Fund	S&P/ASX 300 Accumulation Index	Relative Performance
<b>ANNUALISED (%)</b>			
Since Class Launch on 26 October 2012	11.1	8.4	2.7
5 Years	8.9	5.6	3.3
3 Years	13.6	6.6	7.0
1 Year	(7.0)	(3.1)	(3.9)
<b>NOT ANNUALISED (%)</b>			
Latest Quarter	(11.0)	(8.4)	(2.6)

## Highest and lowest annual return since launch

Allan Gray Australia Equity Fund - Class A units	Return %	Calendar year
Highest	55.1	2009
Lowest	(45.9)	2008

Allan Gray Australia Equity Fund - Class B units	Return %	Calendar year
Highest	33.4	2016
Lowest	(7.0)	2018

Returns shown are net of fees and assume reinvestment of distributions. Returns are annualised for periods of one year and over. Annualised returns show the average amount earned on an investment in the relevant Class each year over the given time period. Actual investor performance may differ as a result of the investment date, the date of reinvestment of income distributions, and withholding tax applied to income distributions.

The highest and lowest returns earned during any calendar year since the launch of each Class are shown to demonstrate the variability of returns. The complete return history for each Class can be obtained by contacting our Client Services team.

# EQUITY FUND HOLDINGS

(CLASS A AND CLASS B)

Fund holdings as at 31 December 2018  
**Statement of net assets (unaudited)**

Security	Market Value AUD 000's	% of Fund
Newcrest Mining	165,805	11
Woodside Petroleum	146,324	9
Origin Energy	112,451	7
Alumina	108,688	7
QBE Insurance Group	106,866	7
Telstra	97,870	6
Metcash	82,693	5
Sims Metal Management	74,313	5
National Australia Bank	60,200	4
Oil Search	42,889	3
Navitas	41,286	3
AMP	40,939	3
Austal	36,503	2
AusNet Services	35,749	2
Southern Cross Media Group	35,286	2
HT&E	27,489	2
Aust. and NZ Banking Group	25,455	2
Peet	24,068	2
Asaleo Care	22,793	1
Chorus	22,112	1
Woolworths Group	21,928	1
Aurizon Holdings	21,291	1
Sigma Healthcare	16,069	1
WorleyParsons	15,723	1
Positions less than 1%	131,505	8
<b>Total Security Exposure</b>	<b>1,516,292</b>	<b>97</b>
ASX SPI 200™ Futures Contract (03/2019)†	41,290	3
Net Current Assets	10,633	<1
<b>Net Assets</b>	<b>1,568,215</b>	<b>100</b>
Price per unit - Class A (cum distribution)	AUD 1.5403	
Price per unit - Class B (cum distribution)	AUD 1.5546	
Total Assets Under Management for the Australian equity strategy (AUD 000's)‡	AUD 5,279,109	

† Futures contracts are fully backed by cash holdings.

‡ Allan Gray Australia Pty Ltd also manages segregated accounts that have substantially the same investment goals and restrictions as the Fund.



# BALANCED FUND PERFORMANCE

## Allan Gray Australia Balanced Fund

	Allan Gray Australia Balanced Fund	Custom Benchmark*	Relative Performance
<b>ANNUALISED (%)</b>			
Since Public Launch on 1 March 2017	4.8	5.8	(1.0)
1 Year	(4.1)	2.2	(6.3)
<b>NOT ANNUALISED (%)</b>			
Latest Quarter	(7.7)	(4.3)	(3.4)

\* The Custom Benchmark for the Fund comprises 36% S&P/ASX 300 Accumulation Index; 24% S&P/ASX Australian Government Bond Index; 24% MSCI World Index (net dividends reinvested) expressed in AUD; and 16% JPMorgan Global Government Bond Index expressed in AUD.

Returns shown are net of fees and assume reinvestment of distributions. Returns are annualised for periods of one year and over. Annualised returns show the average amount earned on an investment in the relevant Fund each year over the given time period. Actual investor performance may differ as a result of the investment date, the date of reinvestment of income distributions, and withholding tax applied to income distributions.

# BALANCED FUND HOLDINGS

Fund holdings as at 31 December 2018  
**Statement of net assets (unaudited)**

Security	Market Value AUD 000's	% of Fund
Equity		
Domestic Equity		
Newcrest Mining	3,046	4
Woodside Petroleum	2,799	3
Origin Energy	2,107	3
Telstra	2,026	2
QBE Insurance Group	1,982	2
Alumina	1,880	2
Metcash	1,590	2
National Australia Bank	1,367	2
Sims Metal Management	1,288	2
Oil Search	925	1
Domestic Equity Positions less than 1%	8,536	11
Global Equity		
AbbVie	1,844	2
BP	1,384	2
Taiwan Semiconductor Mfg.	1,334	2
NetEase	1,216	2
Bristol-Myers Squibb	1,204	1
Royal Dutch Shell	1,163	1
Celgene	934	1
Mitsubishi	814	1
Global Equity Positions less than 1 %	15,620	19
Total Equity^	53,059	65

^ The Fund holds derivative contracts which reduces the effective net equity exposure to 57%.



# BALANCED FUND HOLDINGS

Security	Market Value AUD 000's	% of Fund
Fixed Income		
Domestic Fixed Income		
Australian Government Bonds	15,620	19
Global Fixed Income		
Treasury Note 1.75% 30 Sep 2019 (USD)	1,299	2
Global Fixed Income Positions less than 1 %	5,050	6
Total Fixed Income	21,969	27
Commodity Linked Investments		
SPDR Gold Trust	3,667	5
Total Commodity Linked Investments	3,667	5
Total Security Exposure	78,695	97
Term Deposits and Cash	2,174	3
Net Current Assets	198	<1
Net Assets	81,066	100
Price per unit (cum distribution)	AUD 1.0618	

# STABLE FUND PERFORMANCE

## Allan Gray Australia Stable Fund

	Allan Gray Australia Stable Fund	RBA Cash	Relative Performance	Distribution
<b>ANNUALISED (%)</b>				
Since Public Launch on 1 July 2011	6.5	2.4	4.1	4.2
5 Years	5.8	1.9	3.9	3.6
3 Years	6.9	1.6	5.3	3.5
1 Year	(0.5)	1.5	(2.0)	3.9
<b>NOT ANNUALISED (%)</b>				
Latest Quarter	(2.6)	0.4	(3.0)	0.4

## Highest and lowest annual return since public launch

Allan Gray Australia Stable Fund	Return %	Calendar year
Highest	14.4	2016
Lowest	(0.5)	2018

Returns shown are net of fees and assume reinvestment of distributions. Returns are annualised for periods of one year and over. Annualised returns show the average amount earned on an investment in the relevant Fund each year over the given time period. Actual investor performance may differ as a result of the investment date, the date of reinvestment of income distributions, and withholding tax applied to income distributions.

The highest and lowest returns earned during any calendar year since the public launch of each Fund are shown to demonstrate the variability of returns. The complete return history for each Fund can be obtained by contacting our Client Services team.

# STABLE FUND HOLDINGS

## Fund holdings as at 31 December 2018 Statement of net assets (unaudited)

Security	Market Value AUD 000's	% of Fund
Newcrest Mining	11,384	4
Woodside Petroleum	11,012	4
Origin Energy	8,083	3
Alumina	7,979	3
QBE Insurance Group	6,730	2
Metcash	6,485	2
Telstra	6,370	2
Sims Metal Management	5,066	2
National Australia Bank	3,784	1
Oil Search	3,414	1
Positions less than 1%	18,640	6
<b>Total Security Exposure</b>	<b>88,949</b>	<b>29</b>
Term Deposits and Cash	217,517	70
Net Current Assets	2,616	1
<b>Net Assets</b>	<b>309,081</b>	<b>100</b>
Price per unit (cum distribution)	AUD 1.1699	

# INFORMATION ABOUT THE FUNDS

	Allan Gray Australia Equity Fund	Allan Gray Australia Balanced Fund	Allan Gray Australia Stable Fund
Investment objective	The Fund seeks long-term returns that are higher than the S&P/ASX 300 Accumulation Index (Benchmark).	To seek long-term returns that are higher than the Custom Benchmark. In doing so, the Fund aims to balance capital growth, income generation and risk of loss using a diversified portfolio.	The Fund aims to provide a long-term return that exceeds the Reserve Bank of Australia cash rate (Benchmark), with less volatility than the Australia sharemarket.
Who should invest?	Investors looking for contrarian investment style exposure to the Australian sharemarket and who are able to take a long-term view and endure performance fluctuations.	Investors with an investment horizon of at least three years who want to easily diversify their portfolio within a single fund and are looking for less ups and downs than investing solely in shares. The Fund invests in shares, fixed income, cash and commodity investments sourced locally and globally.	Investors with a two-year or longer investment horizon who are looking for an alternative to traditional money market and income generating investments. The Fund's portfolio can hold a combination of cash and money market instruments (100% to 50%) and ASX securities (up to 50%) in pursuit of stable long-term returns.
Dealing	Daily (cut-off at 2pm Sydney time. A different cut-off applies if investing via mFund, where applicable).		
Buy/sell spread	+0.2%/-0.2%	+0.2%/-0.2%	+0.1%/-0.1%
Fees and expenses (excluding GST)	<p><b>Class A</b> Management fee comprises:</p> <ul style="list-style-type: none"> <li>Fixed (Base) fee – 0.75% per annum of the Fund's NAV.</li> <li>Performance fee – 20% of the Class' outperformance, net of the base fee, in comparison to the Benchmark. A performance fee is only payable where the Class' outperformance exceeds the high watermark, which represents the highest level of outperformance, net of base fees, since the Class' inception.</li> </ul> <p><b>Class B</b> Management fee comprises:</p> <ul style="list-style-type: none"> <li>Fixed (Base) fee – Nil.</li> <li>Performance fee – 35% of the Class' outperformance in comparison to the Benchmark. A performance fee is only payable where the Class' outperformance exceeds the high watermark, which represents the highest level of outperformance, since the Class' inception.</li> </ul>	<p>Management fee comprises:</p> <ul style="list-style-type: none"> <li>Fixed (Base) fee – 0.75% per annum of the Fund's NAV.</li> <li>Performance fee – 20% of the Fund's outperformance, net of the base fee, in comparison to the Custom Benchmark. A performance fee is only payable where the Fund's outperformance exceeds the high watermark, which represents the highest level of outperformance, net of base fees, since the Fund's inception.</li> </ul>	<p>Management fee comprises:</p> <ul style="list-style-type: none"> <li>Fixed (Base) fee – 0.25% per annum of the Fund's NAV.</li> <li>Performance fee – 20% of the Fund's outperformance, net of the base fee, in comparison to the Benchmark. A performance fee is only payable where the Fund's outperformance exceeds the high watermark, which represents the highest level of outperformance, net of base fees, since the Fund's inception.</li> </ul>
Minimum initial investment	AUD 10,000/AUD 500 per month on a regular savings plan.		
Additional investment	AUD 1,000/AUD 500 per month on a regular savings plan.		
Redemption	No minimum applies for ad hoc redemptions. A minimum of AUD 500 per month applies on a regular redemption plan. Investors must maintain a minimum account balance of AUD 10,000.		

# NOTICES



## Sources

The source for the S&P/ASX 300 Accumulation Index and the S&P/ASX Australian Government Bond Index is Standard & Poor's. "S&P" is a trademark of S&P Global, Inc.; "ASX" and "ASX 300" are trademarks of ASX Operations Pty Limited ("ASXO"); and "S&P/ASX300" exists pursuant to an arrangement between ASXO and Standard & Poor's.

The source for the MSCI World Index is MSCI Inc. "MSCI" is a trademark of MSCI Inc.

The source for the JP Morgan Global Government Bond Index is J.P. Morgan Securities LLC. "JP Morgan" is a trademark of JPMorgan Chase & Co.

The third party information providers do not guarantee the accuracy, adequacy or completeness of this information, and no further distribution or dissemination of the index data is permitted without express written consent of the providers. None of those parties shall have any liability for any damages (whether direct or otherwise).

## Returns

Fund returns are gross of all income, net of all expenses and fees, assume reinvestment of distributions and exclude any applicable spreads.

## Risk Warnings

Managed investment schemes are generally medium to long-term investments. Past performance is not indicative of future performance. Each Fund's unit price will fluctuate and the Fund's performance is not guaranteed. Returns may decrease or increase as a result of currency fluctuations. When making an investment in a Fund, an investor's capital is at risk. Subject to the disclosure documents, managed investment schemes are traded at prevailing prices and can engage in borrowing and securities lending.

## Fees

The base fee and the performance fee (if applicable) are calculated and accrued daily, and paid monthly. A schedule of fees and charges is available in the relevant Fund's disclosure documents.

## US and European Persons

The Funds do not accept US persons as investors and are not marketed in the European Economic Area (EEA). Investors resident in the EEA can only invest in the Fund under certain circumstances as determined by, and in compliance with, applicable law.

## Other

Equity Trustees Limited, AFSL No. 240975 is the issuer of units in the Allan Gray Australia Equity Fund, the Allan Gray Australia Balanced Fund and the Allan Gray Australia Stable Fund and has full responsibility for each Fund. Equity Trustees Limited is a subsidiary of EQT Holdings Limited, a publicly listed company on the Australian Stock Exchange (ASX:EQT). Allan Gray Australia Pty Limited, AFSL No. 298487 is the Funds' investment manager. Each Fund's Product Disclosure Statement and Information Booklet (together, PDS) are available from [www.allangray.com.au](http://www.allangray.com.au) or by contacting Client Services on 1300 604 604 (within Australia) or +61 2 8224 8604 (outside Australia). You should consider the relevant Fund's PDS in deciding whether to acquire, or continue to hold, units in the fund.

This report provides general information or advice and is not an offer to sell, or a solicitation to buy, units in the relevant Fund. Where the report provides commentary on a particular security, it is done to demonstrate the reasons why we have or have not dealt in the particular security for a Fund. It is not intended to be, or should be construed as, financial product advice. This report is current as at its date of publication, is given in good faith and has been derived from sources believed to be reliable and accurate. It does not take into account your objectives, financial situation or needs. Any implied figures or estimates are subject to assumptions, risks and uncertainties. Actual figures may differ materially and you are cautioned not to place undue reliance on such information. Subject to applicable law, neither Allan Gray, Equity Trustees Limited nor any of its related parties, their employees or directors, provide any warranty of accuracy or reliability in relation to such information or accepts any liability to any person who relies on it. Fees are exclusive of GST. Totals presented in this document may not sum due to rounding.





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