ALLANGRAY

QUARTERLY COMMENTARY

30 SEPTEMBER 2018

COMMENTARY

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We have not had much luck in choosing the companies we write up in our Quarterly Commentaries recently. Last quarter we wrote about Asaleo Care on the eve of an unexpected profit downgrade and a 35% collapse in the company's share price. In December 2017's report we wrote about Sigma Healthcare and the risks surrounding its largest customer, Chemist Warehouse, terminating their relationship with Sigma. Unfortunately this is exactly what has happened. Its share price has fallen by over 20% since we wrote about it.

It is not unusual for us to invest in companies that go on to significantly underperform the broader sharemarket. In fact, this happens to us 40% of the time. It is the other 60% of the time and what we do on the back of a significant fall in the price of an investment that really counts. Investing is risky and it comes with both hits and misses. Wayne Gretzky, the famous Canadian ice hockey player once said "you miss 100% of the shots you don't take" and this is equally true in investing. This report covers a third shot of ours, Sims Metal Management. Hopefully this one finds the goal mouth.

Who is Sims?

Sims Metal Management Limited (Sims) is a metals recycling company with operations in the United States, Australasia and the United Kingdom. Sims buys 'feedstock' – ferrous metals (materials containing iron) from metals dealers, peddlers, auto wreckers, demolition firms and various manufacturers who have metal offcuts which can be recycled. This scrap is processed and separated into product streams that are capable of being reused and converted into everyday products. Much of Sims' processing is initially performed by mega shredders shown in Figure 1.

Once shredded, the metals are separated using particle size screening, eddy current separators, magnetic separation techniques and various sensors. Once the metal feedstock is fully processed, Sims is left with a ferrous product stream and various non-ferrous product streams.

Figure 1: Mega shredder used by Sims

Source: Sims

The ferrous product is an internationally traded commodity and is sold to electric arc furnace steel manufacturers around the world who use scrap steel as their primary raw material input. This method of steel production accounts for about 30% of the world total (with the remaining 70% coming from blast furnaces which use iron ore as their primary raw material input).

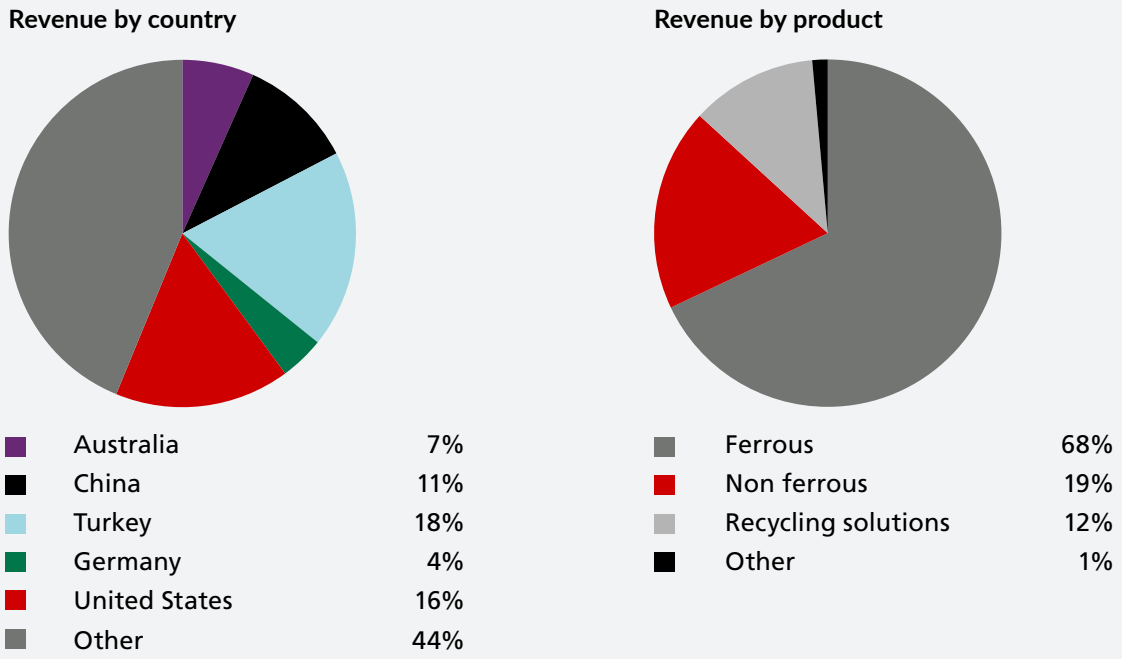
The US and EU are the largest exporters of ferrous scrap but they are also large consumers of it for their own steel mills. Turkey's steel manufacturing industry is the world's largest importer of ferrous scrap.

Sims sells the non-ferrous product streams (aluminium, copper, magnesium, etc.) to metal smelters and processors around the world. China is a large importer of these products.

Sims also has a Recycling Solutions business that provides global electronics recycling and technology asset disposal.

Chart 1 shows Sims' 2018 revenue split by country and product.

Chart 1: Sims' 2018 revenue



Source: Sims' Company Financials

Competitive advantages

About two-thirds of Sims' cost base is made up of raw materials costs – the amount it pays peddlers and dealers to supply the metal scrap feedstock. If well managed, these costs flex with the market prices of Sims' end products. When ferrous scrap prices fall, Sims pays peddlers less for obsolete scrap so as to protect its processing margins. This relationship is not unique to Sims.

The technologies used to process scrap metals are also widely adopted and don't provide a source of competitive advantage. But they are capital intensive and are expensive to run. Good recyclers have a ready and constant access to metal feedstock supplies, enabling them to run their processing plants near full utilisation rates and benefit from the ensuing operating efficiencies. To achieve this, proximity to metal peddlers and aggregators is important and is one source of competitive advantage.

Logistics and freight costs are also a significant cost for metal recyclers. Easy and cheap access to end markets is a second source of competitive advantage. This either involves being strategically located near processed scrap metal consumers (mainly steel mini mills), or near port and rail infrastructure so as to minimise logistics costs.

Sims' facilities are world class. They are close to both the originators of obsolete metal feedstocks and have competitive access to end markets for its products, primarily via its deep water ports which service export markets.

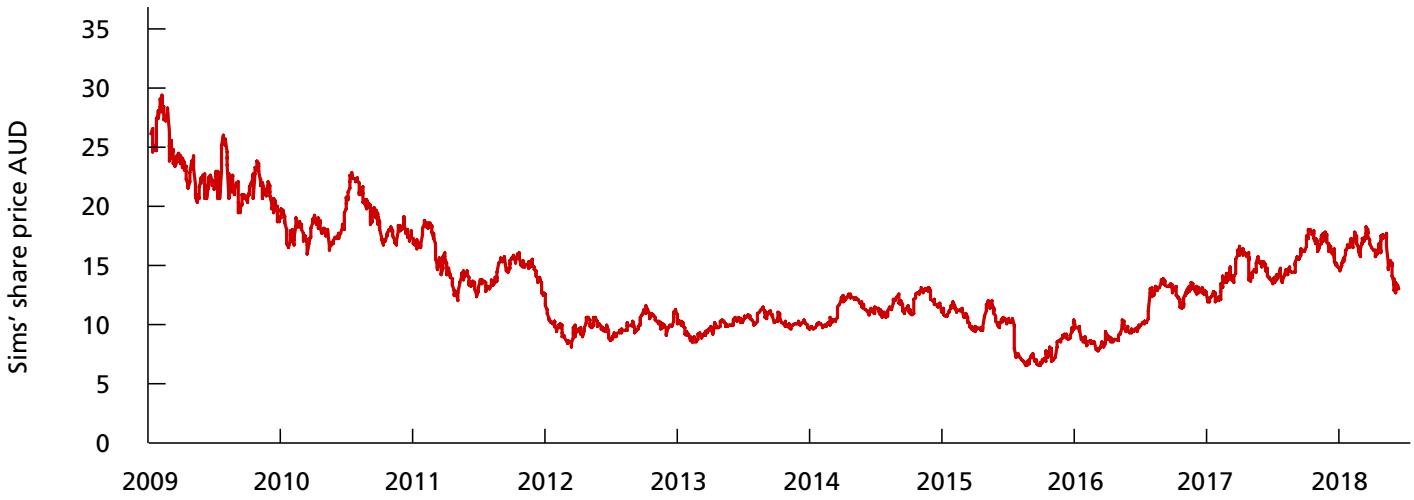
Trying times

Sims' share price has fallen almost 30% from its recent highs on the back of two developments and their potential future implications for Sims. This is shown in Graph 1.

Turkey, the world's largest importer of ferrous scrap, is experiencing significant economic difficulties with rampant inflation and loose monetary policy contributing to a depreciation in the Turkish Lira. It is unclear what impact this will have on domestic steel demand and therefore Turkey's continued demand for ferrous scrap. Turkish steel mills are a large customer of Sims' and account for 18% of Sims' ferrous sales volumes. To make matters worse, political tensions between Turkey and the United States have resulted in Donald Trump doubling steel and aluminium tariffs on Turkish imported steel.

The second development relates to China, a large importer of non-ferrous scrap products. In recent environmental clampdowns, China has banned the import of a number of scrap and waste products and strengthened the quality requirements for other products. This has impacted demand for scrap paper, plastics and high impurity non-ferrous scrap products which metal recyclers had previously come to rely on as income streams.

Graph 1: Sims' share price



Source: FactSet

How does this impact Sims?

Turkey's economic situation, whilst a near-term headwind, is unlikely to be permanent. Steel is an internationally traded commodity (as is the ferrous scrap used to make it). It is quite possible that any domestic demand declines could see a greater proportion of Turkey's steel exported without a significant reduction in the country's demand for ferrous scrap or its domestic steel production.

The changes in China are likely to be more permanent and, with a bit of luck, increasingly adopted by other developing nations. Sims appears to have foreseen this trend and has already invested over $100m in its metal recovery processing plants in order to improve the quality of its non-ferrous product streams.

In 2018, 15% of Sims' non-ferrous volumes were comprised of a low-grade aluminium product (85-96% metal grade) which can no longer be sold in China and instead has needed to find alternative end markets. By the end of 2019, Sims' product quality investments will see more than half of this volume upgraded further into a 98-99% grade product, which is highly sought after and can not only be sold into China, but even markets like the United States where demand for these product streams is strong. This investment by Sims has further enhanced their competitive advantage, as other recyclers have not followed suit and are stockpiling their low-grade non-ferrous products. This advantage, however, is unlikely to last long, as its peers will also invest in these new technologies in order to remain competitive.

The ability of metal recyclers to sell their non-ferrous product streams drives the price they in turn are able to pay for metal feedstocks. Should China and other countries shut its doors to metal imports, with all this recovered metal finding its way to landfill, recyclers will be forced to pay peddlers and aggregators of obsolete metal less for the same raw material feedstock it supplies today. Under this scenario, Sims' profits may not be impacted at all.

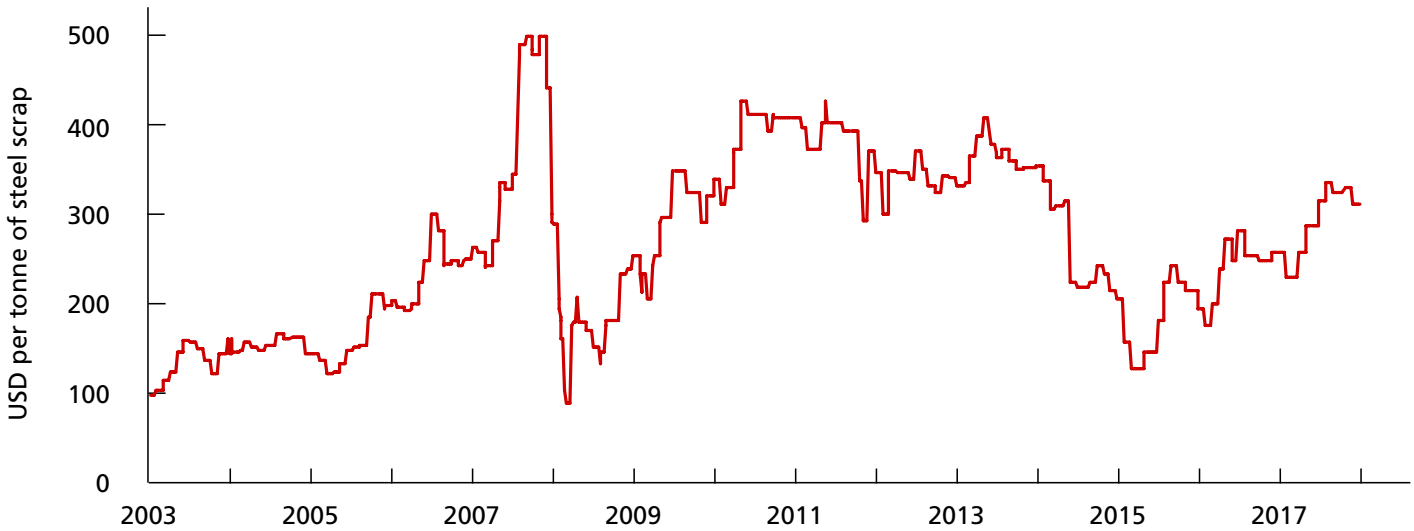
This Utopian view of the future won't always hold though and Sims' profits may well be negatively impacted. As prices for obsolete metal feedstock fall, the economic benefits of collecting this feedstock will fall too. A tipping point exists where prices are so low that it is not worthwhile for peddlers to collect the metal feedstock in the first place. Sims' supply will dry up, its processing yards will operate well below capacity and profitability will collapse given the high fixed costs in the business. This happened in 2015 when Sims' share price bottomed below $7 per share, well below its current share price of $12.65 per share. Whilst possible, current metal prices are well above the levels which would result in feedstock supply concerns, with Graph 2 showing the price of Heavy Melting Steel, the benchmark ferrous scrap price. At over US$300 per tonne, it is more than double its 2015 levels.

Sims has a market capitalisation of A$2.6 billion and has $300m of net cash. In the 2018 financial year, it made an operating profit of $280m and it has guided to operating earnings for the September 2018 quarter of $58-63m. Annualised, this $242m in operating profit at the mid-point would result in Sims trading at less than 10 times operating profit. This compares to the broader share market, which trades at 14 times operating profits. The market appears to be pricing in a significant (and permanent) decrease in processing volumes from today's levels.

While the Chinese developments appear to have had some impact this quarter and the Turkey developments do not appear to have had an impact as yet, that is not to say they will not cause greater issues in the future. But it is impossible to know how difficult operating conditions for Sims and its peers will become, or whether scrap flows are destined to dry up.

Despite these risks, it is investing during times of uncertainty like this that many of our best investments have been made. We think that today is a case in point for Sims and that the sharemarket reaction has created what we perceive to be a long-term buying opportunity.

Graph 2: Ferrous scrap price



Source: FactSet

EQUITY FUND PERFORMANCE

Allan Gray Australia Equity Fund — Class A units

	Allan Gray Australia Equity Fund	S&P/ASX 300 Accumulation Index	Relative Performance
ANNUALISED (%)			
Since Public Launch on 4 May 2006	8.7	6.0	2.7
10 Years	10.7	7.7	3.0
5 Years	12.2	8.2	4.0
3 Years	21.7	12.2	9.5
1 Year	15.8	14.0	1.8
NOT ANNUALISED (%)			
Latest Quarter	2.2	1.5	0.7

Allan Gray Australia Equity Fund — Class B units

	Allan Gray Australia Equity Fund	S&P/ASX 300 Accumulation Index	Relative Performance
ANNUALISED (%)			
Since Class Launch on 26 October 2012	13.9	10.4	3.5
5 Years	12.0	8.2	3.8
3 Years	21.2	12.2	9.0
1 Year	16.0	14.0	2.0
NOT ANNUALISED (%)			
Latest Quarter	2.4	1.5	0.9

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	(4.7)	2015

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 30 September 2018

Statement of net assets (unaudited)

Security	Market Value AUD 000's	% of Fund
Woodside Petroleum	173,549.01	10
Newcrest Mining	149,817.85	9
Origin Energy	124,740.88	7
Alumina	117,521.78	7
QBE Insurance Group	107,106.98	6
Telstra	106,146.48	6
Metcash	98,228.42	6
Sims Metal Management	64,084.96	4
HT&E	52,144.72	3
AusNet Services	46,143.68	3
Woolworths Group	43,260.13	3
Oil Search	41,599.45	2
Southern Cross Media Group	40,094.40	2
Chorus	37,568.92	2
National Australia Bank	37,485.18	2
Austal	36,083	2
Navitas	35,268.11	2
Sigma Healthcare	32,139.20	2
Aust. and NZ Banking Group	24,615.48	1
Peet	24,098.72	1
AMP	22,004.61	1
Starpharma Holdings	20,602.78	1
Aurizon Holdings	20,463.15	1
Positions less than 1%	150,230	9
Total Security Exposure	1,604,998	95
ASX SPI 200 ™ Futures Contract (12/2018)†	72,625	4
Net Current Assets	17,122	1
Net Assets	1,694,745	100
Price per unit - Class A (cum distribution)	AUD 1.731	
Price per unit - Class B (cum distribution)	AUD 1.746	
Total Assets Under Management for the Australian equity strategy (AUD 000's)‡	AUD 5,718,517	

† 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
ANNUALISED (%)			
Since Public Launch on 1 March 2017	11.1	9.7	1.4
1 Year	10.4	12.0	(1.6)
NOT ANNUALISED (%)			
Latest Quarter	1.8	2.4	(0.6)

** 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 30 September 2018

Statement of net assets (unaudited)

Security	Market Value AUD 000'S	% of Fund
Equity		
Domestic Equity		
Woodside Petroleum	2,984	4
Newcrest Mining	2,855	4
QBE Insurance Group	2,331	3
Telstra	2,283	3
Origin Energy	2,079	3
Metcash	1,809	2
Alumina	1,787	2
HT&E	1,208	1
Sims Metal Management	1,128	1
Oil Search	987	1
Sigma Healthcare	847	1
Southern Cross Media Group	826	1
Domestic Equity Positions less than 1%	6,659	8
Global Equity		
AbbVie	1,672	2
BP	1,642	2
Taiwan Semiconductor Mfg.	1,376	2
Royal Dutch Shell	1,282	2
PG&E	1,250	2
XPO Logistics	1,104	1
Bristol-Myers Squibb	1,058	1
NetEase	907	1
Mitsubishi	888	1
Alphabet	857	1
Samsung Electronics	841	1
Global Equity Positions less than 1 %	13,812	17
Total Equity^	54,472	67

^ The Fund holds derivative contracts which reduces the effective net equity exposure to 60%.

BALANCED FUND HOLDINGS

Security	Market Value AUD 000'S	% of Fund
Fixed Income		
Domestic Fixed Income		
Australian Government Bonds	15,210	19
Global Fixed Income		
Treasury Note 1.125% 28 Feb 2019 (USD)	851	1
Global Fixed Income Positions less than 1 %	5,469	7
Total Fixed Income	21,529	27
Commodity Linked Investments		
SPDR Gold Trust	2,998	4
Total Commodity Linked Investments	2,998	4
Total Security Exposure	78,999	97
Term Deposits and Cash	1,741	3
Net Current Assets	431	<1%
Net Assets	81,171	100
Price per unit (cum distribution)	AUD 1.1499	

STABLE FUND PERFORMANCE

Allan Gray Australia Stable Fund

	Allan Gray Australia Stable Fund	RBA Cash	Relative Performance	Distribution
ANNUALISED (%)				
Since Public Launch on 1 July 2011	7.1	2.5	4.6	4.3
5 Years	6.5	1.9	4.6	3.8
3 Years	8.9	1.6	7.3	3.7
1 Year	5.5	1.5	4.0	4.2
NOT ANNUALISED (%)				
Latest Quarter	0.7	0.4	0.3	0.5

Highest and lowest annual return since public launch

Allan Gray Australia Stable Fund	Return %	Calendar year
Highest	14.4	2016
Lowest	2.1	2015

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 30 September 2018

Statement of net assets (unaudited)

Security	Market Value AUD 000's	% of Fund
Newcrest Mining	10,015	3
Woodside Petroleum	9,392	3
Metcash	6,700	2
Telstra	6,479	2
Origin Energy	6,213	2
Alumina	5,522	2
QBE Insurance Group	5,459	2
Sims Metal Management	3,463	1
HT&E	3,022	1
Positions less than 1%	14,194	5
Total Security Exposure	70,457	24
Term Deposits and Cash	220,955	75
Net Current Assets	2,551	1
Net Assets	293,963	100
Price per unit (cum distribution)	AUD 1.2077	

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)	**Class A** Management fee comprises: • Fixed (Base) fee – 0.75% per annum of the Fund's NAV. • 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. **Class B** Management fee comprises: • Fixed (Base) fee – Nil. • 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.	Management fee comprises: • Fixed (Base) fee – 0.75% per annum of the Fund's NAV. • 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.	Management fee comprises: • Fixed (Base) fee – 0.25% per annum of the Fund's NAV. • 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.
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 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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