

Jacinta King (00:00):

Welcome to the Ideas Exchange by ASX, connecting you with investment experts, market updates and ideas. I am Jacinta King, business development manager, investment products at ASX and this is our regular podcast covering everything from investment trends through to different ways to invest using a variety of products.

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Jacinta King (00:48):

Welcome to the Ideas Exchange. I'm your host, Jacinta King from ASX. Founded in 2003 and based in Auckland, New Zealand, Milford managed investments of over \$16 billion and they entered the Australian market in 2014 when they established a Sydney office. They initially offered products to the institutional market, but in recent years, their products have been made available to retail. Will Curtayne is a portfolio manager at Milford and one of the lead portfolio managers of the Milford Australian Absolute Growth Fund. It's quoted on the ASX under ticker code MFOA. And today we're going to discuss Milford's investment position against the backdrop of high interest rates and sticky inflation. Welcome to the Ideas Exchange, Will.

William Curtayne (01:36):

Hi Jacinta, and thanks for having me on.

Jacinta King (01:37):

You are most welcome. I've been looking forward to this conversation. We've got a lot to get through. I've got a lot of questions for you so let's get into it. But before we begin, can you provide our listeners a bit about your background and the work that you do at Milford?

William Curtayne (01:50):

Sure. So yeah, I got on this industry just at the back end of the great financial crisis in 2009. So before that, I was actually a professional triathlete for a couple of seasons. That was after finishing up my education and so on. I pursued my triathlon career and had a bit of fun competing around the world but then decided that I wanted to put my study and apply my passion for investing in a professional sense. So I joined Milford Asset Management originally in Auckland at that point in time and quickly got put to work doing New Zealand and Australian equities. And it wasn't too long, I think it was about 2014, Milford sent me over to Sydney to set up the Australian business. So we went over there first just to get closer to the companies we were researching and to be able to hire good Australian investment personnel to help us do Australian equities.

The second phase of the plan was once we'd built up our team and research better, we began to launch products in Australia about five years ago and recently obviously MFOA listed on the ASX. So these days my role is I'm the head of Australian equities so I manage the Australian equities team and I also am one of the lead portfolio managers on the Milford Australian Absolute Growth Fund, which is our flagship product in Australia.

Jacinta King (03:13):

That's so interesting. I didn't know that background that you were a professional triathlete. And I'm curious there in that, do you find that some of the skills and discipline it took to be an athlete you transfer across to some of the ways that you approach work now?

William Curtayne (03:30):

Oh yeah, absolutely. It's the general hate of failure or the learning in both...

Jacinta King (03:37):

You must achieve at all costs.

William Curtayne (03:39):

Yeah, that's right. And for all but very few sports people, you fail a loss and often and you've got to learn to deal with that. You tend to have competitive people get into sports and also funds management so they tend to be people who like to do well and don't like to fail. But part of it's learning to deal with those setbacks and use that as a motivation. Not getting too caught up in the failures and taking the lessons. So there's actually plenty that applies, I believe.

Jacinta King (04:08):

I think we'll have to have you back and we'll focus, we'll start from that side of it because yeah, I think you're right. We do see quite a lot of athletes who enter the finance industry and there's resilience and all sorts of things come into play there. So I don't want to digress because we want to stick to what we planned for today. So look, firstly what everybody's still the ever present thing is interest rates and cost of living, inflation. So the US Federal Reserve pause rate heights at the beginning of November and in Australia, the RBA announced another rate rise last week. So we've gone from 4.1% to 4.35%. We're up another 25 basis points this month. So this potentially will continue the knock on effect to decrease consumer spending as people feeling that pinch and combined with low wages growth. Looking at some of Milford's recent commentary, you lead with caution at the moment and you have a measured approach. Can you share some of Milford's thinking around how to find value in companies with this backdrop of persistent inflation and interest rate rises?

William Curtayne (05:12):

Yes. So the first thing I think to appreciate is that this backdrop of rising interest rates after a period of low rates for so long that push valuations on equities to quite high levels is a backdrop that is just going to depress returns for a while. So from that point, we don't need to force returns. We don't need to shoot for 15 or 20% years at the moment. We start from the, certainly if we're looking for 12 or 18 months view was that most likely the Australian market remains in a big trading range without breaking out to the upside and beginning another 20% bull market run. So we are not trying to be greedy and shoot for high returns but we've just got to let these high interest rates filter through to valuation inequities and positioning inequities. And that filtering process takes quite a lot of time because a lot of the money in the world is controlled by big super funds and big pension funds and they're not the little speedboat hedge funds who will change their asset allocation from one week to the next in quite significant ways.

These are super funds and pension funds are big, big boats and they just take a long time to turn. So we've just got to let that process work its way through which we do think still takes another 12 months. And then our job is to try protect capital if there's a large downturn on the way and not lose much of that hard-earned capital. And if we can do that, when we do work through this process into another bull market, we can capture that bull run with our capital intact. And try hit the ones and twos to pick up a few returns along the way but not swing for the fences. So how do we do that? It's all very well. We've tended to be weighted more to value stocks than gross stocks over the last 12 months. Milford is stalling [inaudible 00:06:58] so we're happy to be very overweight gross stocks or very overweight value. We've got a top-down process we use to decide when and how we want to do that.

But higher interest rates and the starting point of high valuations on a lot of gross stocks and technology stocks meant that that was a fairly easy place to avoid and we weighted a lot more to energy companies and resources and insurers and companies that given that they're trading on cash for yields of 10% or so or in some cases higher, that means that yeah, they tend to not be knocked around as much when interest rates go because you can collect those strong cash earnings very, very immediately. So that was one way that we are seeking to get better returns and we still have a bit of a value bent today, by the way. So it remains not as drastic as what it was last year, but it's still there. And from this view that markets are really in a large trading range, we have the ability to raise cash a bit when markets are high. So the ASX is 7,300, 7,400, 7,500.

We've tend to be raising a bit of cash in the fund and taking some profits and then we are putting that money back to work when the market falls down to towards 7,000 or below. So you can pick up a few little gains just by moving your cash in and out. We do rotate between sectors fairly heavily if those sectors have become particularly oversold or under or overbought and the value's there. So we can dollar our bank's exposure down to zero or we might take it up to 12 or 14% of the sector's completely beaten up. So I'll leave it at that. We could go on for another 10 minutes on that question, but I better leave it there.

Jacinta King (08:33):

Yeah, because you're already touching on some of the other questions I had for you so we'll go through those as well. But I thought just as we're talking about the stocks that you cover, we've just gone through earning season. So what did my husband say to me the other day? He said, you're a realist, a practicing optimist. So I'm realistic, I look at things and then I go, but let's try and see what the good news story is. So was there anything there from the companies that you analyzed in reporting season?

William Curtayne (09:01):

There was far more bad news stories than good ones unfortunately, and that's just the nature of where we are in the earnings cycle. Earnings in the ASX 200 has fallen 10, 11% since the peak last year. But that's a great thing about stock picking, isn't it? There's always something in someone going, even in the greatest bear markets of all time, there's some stocks that still go up in the face of wider markets going down. So a couple of the ones that we've liked recently. So at the moment of course we've got annual general meetings going through and a lot of companies are updating earnings. We like Viva Energy who had an investor day just last week and they painted a picture of their

medium-term earnings targets, which were quite significant and quite far above expectations. And that's based in the spec drop as Viva's been taking on the Coles stores and the OTR stores from South Australia and they've got a lot of upside in their retail business. So just optimizing the procurement, the pricing strategies, that should generate large sustainable gains in the earnings from their stores and the petrol stations.

And we already have a very favourable view on their refining of business, which is just globally, there's a shortage of refining given that no one wants to build new refineries in the context of peak oil around the corner. Other updates where insurers are going well, where competition's very benign and they're making good margins. Chrysol which is a small [inaudible 00:10:26] company that only listed last year. It's got this product that goes on mine sites, to do the gold assay studying the assays that come out of the drilling cores and it's picking up a lot of demand. So it's a shining light in a tough spot at the moment doing very well and there's a little biotech company we own called Neuren Pharma, which has just started sales of its first ever drug that it's commercialized and those sales are beating expectations. So there are companies out there doing well still. So it's good to know.

Jacinta King (10:51):

You touched on just earlier that how you can shift and rotate through sectors. So are there specific sectors that you're finding favourable in the Australian market at the moment?

William Curtayne (11:00):

Yeah, so just to finish off insurance, which I touched on where we've been overweight there for over a year and probably 18 months really and remain overweight. So the mature sectors, whether it's Telco's supermarkets, banks, or insurance, you typically find that you only do well when competition's benign and then these sectors go through cycles. One competitor is trying to pick up market share and for years every company in that sector will do poorly. I think Telstra has been doing poorly For years and years when Optus furiously tried to win market share and didn't focus on profitability. Insurance had been a terrible sector for a long time but then what's basically happened is as inflation came in and drove up the costs of claims for insurers and it also drove the cost of reinsurance, it's really hurt the smaller competitors, the small minnows in the sector that we're chipping away at the market share of the big guys like IG and Suncorp. These small companies were completely on reliant on reinsurance funding where Suncorp and IG self-insured some of their own books. So the 50% increases in reinsurance prices really hurt the small competitors.

And small competitors also don't have as much negotiating power with suppliers in terms of managing their claims costs. So it's basically meant that these small competitors that for most of the last decade were driving prices down, are now driving prices up and IG and Suncorp can just sit there and follow the prices up and collect the margin along the way. So not something that people want to hear when we're paying huge insurance bills but our jobs as investors are to find the companies in a good position and we think insurance is still in a good position. More recently we've really dialled up our iron ore exposure. Now we've always had a core holding and resources in iron ore over the last couple of years, but we've dialled it up to a higher level now. That was basically on the back of a few things. President Xi did about three weeks ago as he did. He did three new things that we hadn't seen in a long time. The first is he binned the finance minister and put a new one in. Then they did a mid-budget, federal budget, government change.

So they changed the budget mid-cycle, so out of cycle, which hasn't been done in 22 years. And he also went in and visited the PBOC, the central bank in China. Went into their offices, which he hasn't done in his 12, 13 years in power. So three big moves that signals to us that President Xi's probably had a guts full of the economy where it is and they're going to try and get things humming along. And this is a backdrop where the iron ore price had already been pretty good, at 115, 120 US dollars. The iron ore prices since moved up to about 131 US dollars. BHP and Rio are spitting off cash. They're on eight, nine times [inaudible 00:13:43] multiples. If we're right that China is now going to take more significant steps to accelerate the economy, the iron ore price should at least be, it may go much higher than 130 or at least stay reasonably elevated. It means that there's just great earnings and cash flow to be had from these major miners.

Jacinta King (13:59):

One more question on sectors is what about materials? Are you bullish there and how are you positioned?

William Curtayne (14:04):

Yeah, so it is very much through the iron ore ones which I've just [crosstalk 00:14:07] So outside of iron ore, we don't have huge amounts. Lithium, we've got a little bit in IGO but we're a little bit cautious that we haven't seen a bottom in the lithium cycle yet. We're not seeing the signs of the mine closures and there's still inventory elevated on finished batteries in China. So we like lithium long run but we're just a bit waiting a little bit yet before firing all our bullets into the sector. We want to see signs of inventories coming down. We want to see the headlines of lithium mines closing to give us a bit of a signal that this washout has run its course. But yeah, energy, not so much

materials, but we do, yeah, we maintain a fairly decent core energy weight through Santos and the refiners and beach energy, actually.

Jacinta King (14:51):

Now I note that you're sometimes cautious on banks. What's your thinking behind that? Some love it and will always keep it primarily.

William Curtayne (14:58):

Your classic Australian equity large-cap fund will always be within four or 5% of the market to banks. If you're 25% weight, most of them will have somewhere between 18 and 22% that they run just small underweight. Most of the time we run an absolute return equity fund, so we are much more benchmark unaware. So we will go down and have gone to 0% in banks as a starting point. If we like banks, we're more likely to have 10 or 12% in banks rather than 25% because from an absolute point of view, we don't think you need 25% in one sector or one banking sector, prudent diversification. So from that point we'll differ a lot to other fund managers and the market on banks exposure. At the moment, we bought banks during the Silicon Valley bank crisis and when their earnings were weak back in May and the sector got beaten up, so we're picking up CBA at 90 and we've picked up a lot of nab and then now later in the years, they had a bit of a run-up and over the third quarter, we let most of our banks go.

And that's because the sector started to rally again but the earnings outlook would just kept getting worse. And that's basically the margin outlook continues to deteriorate. So the pressures that banks are facing are on a number of fronts. The first is the costs are going up. There's significant wage inflation. So the driving up in a lot of cases, the underlying cost inflation is 5, 6, 7% before they try to remove some cost to keep that at bay. But it's really just a competition of mortgages. When the mortgage market isn't growing fast like it is at the moment, the banks are all competing furiously amongst each other to try and maintain the size of their books. They don't want their book going down in a backdrop of their cost basis going up 6, 7% because that's a very quick way to destroy your earnings. So they're competing away the profitability on mortgages. And on the funding side, they're also competing furiously on deposits.

Some of the cheap funding from the RBA given how the COVID rolls off. And customers are also able to get decent interest rates on deposits now, are shopping around a lot more. It's making the banks have to pay a lot more for those deposit funding. This is all fairly known. It's nothing new. I'm not saying anything that anyone in close to that market doesn't know but for us it just means that they're not particularly cheap in the background. We don't think they're expensive, we think they're of fair value, they're fine, but we would rather see returns elsewhere

where we think that industry isn't competitive like insurance, for example.

Jacinta King (17:20):

Thanks for going through that because that's something I picked up on in my readings about what Milford do. My next question is, what's your view on tech and does it make it into the portfolio or do you just keep an eye on it at the moment?

William Curtayne (17:31):

Yeah, we've started to add some of that recently actually. So most of last year we generally avoided the technology stocks as they were very expensive, very crowded and higher interest rates were always going to be headwind. That played out. The sector had a bit of a pretty good run earlier this year. Some of them are coming back now. It's creating interesting opportunities. Xero was very weak after its result with a slower subgrowth in the UK and the US and costs not quite as good as hoped. We believe the company's worth a hundred dollars even if the US doesn't work and if the US works, it could be worth \$200 closer, \$200 a share. So as it pulled back to a hundred, we're happy to start accumulating some of that business because we think the cost out program ultimately will deliver them and they'll have some success in the US in time. And the other one that some of the strategies have been picking up at Milford over the last month or two has been WiseTech, which got knocked around pretty heavily on its result, but it's an exceptional business with very good competitive position.

It's just so dominant and there's almost no one within anywhere near them. So there's a pretty good certain long-term growth path there. Yes, WiseTech's been expensive for long time so you've got to pay up a little bit to get it, but at least you can buy it now after it's pulled back, 30 odd percent since the recent highs. But yeah, tech we will own more if the valuations are still generally the thing that holds us back on buying too many of them. If those normalize more then yeah, we'll certainly be looking to dial up more technology exposure.

Jacinta King (19:00):

Now, you touched on it earlier that you can move to elevated cash and I see that you did through September. So what indicators are you looking for before you deploy some of that cash?

William Curtayne (19:10):

Yeah, here we are talking on the 15th of November and that cash is mostly gone, so it's been deployed. So it's a pretty easy question to answer because I can now say in hindsight why we did it. Yeah, in Australian Absolute Growth Fund, we can take cash all the way up to 50% if we want to and we have done so over the last, we did it before

COVID and we've done so various times last year. And we would take it all the way down to zero for a particularly bullish in the market. Generally why that cash was high is because monetary policy we thought had more to [inaudible 00:19:41] them. We didn't think investors were particularly underweight equities yet. This is going back to August, September. We thought valuations were getting increasingly expensive versus bonds equity whereas bond yields went higher in equities didn't derate. The [inaudible 00:19:55] was six and a half and the ASX was pretty expensive. And we thought that just incremental quantitative tightening and monetary policy flows would be a headwind for liquidity in the markets.

And then as the market came down below 7,000, a couple of things happened that signalled to us it was time to put cash to work because one just bottomed up. A number of companies became better value. So ignore everything macro, ignore the bigger world as some companies start to look good value because they pull back. We deployed some cash into those. But particularly a bit of a positioning flushed out. It's clear to us to see some data that we show that a lot of certain strategies and cohorts of investors have got very bearish and very short the market. And that's always a contrary indicator that the returns and markets might improve going forward. Valuations finally improved a little bit as the ASX 200 came down overall. And then you had the Federal Reserve Jerome Powell blink in his most recent monetary policy statement. And the RBA has continued to be a bit confusing. One moment hawkish, one moment the dovish. But certainly a blink from Jerome Powell on how resolute he was to continue tightening is what opened up the market to have a relief rally to allow bond prices to cool down.

And then that relief rally tends to then force in these hedge funds who are particularly short or any fund managers sitting on too much cash. Most fund managers don't want to fight the pain of being under invested as markets rally too long so they get forced in. So we got all the way up to reduced cash levels from nearly 40% down to 10%. So we're 90% invested in equities at the moment, obviously helping out the market's doing well this month. We'd still consider that to be more of a tactical bullish positioning for us in the fund. We aren't hugely optimistic about next year. We're not particularly bearish on next year but we just think that if we're going to have a continued bull market in equities, we need to see long run bond yields get back down to something like 2% to [inaudible 00:21:53] equities.

Again, we don't see that happening because we think inflation has strong structural elements that will keep rates elevated above the level or you need a big earnings cycle, bullish earnings cycle, play out. Again, we'd think nearing the end of the earnings downgrade cycle in

Australia, but we don't see a big bull cycle in earnings early next year so that if the market keeps running up to Christmas and we hope we get to Christmas early, we'll likely be taking profits and raising cash levels again.

Jacinta King (22:20):

For those who are new to Milford and wanting to understand a bit more about how you think about your portfolio, so can you just elaborate, you've touched on a lot of it, but elaborate on some of the fundamentals that you consider and maybe a bit on the investment process that you and your team, how you approach your assessment of those stocks?

William Curtayne (22:40):

So yeah, Milford does top-down and bottom-up. So we do with stock pickers like most other firm managers you would meet and talk to have got a process for identifying good stock picks and that's what we call the bottom-up work. Where we're a bit different as most firm managers don't really have much of a top-down process, they don't raise cash in their funds or do a huge incorporation of the macro world. So Milford's always done that as part of our process. So quickly to just finish off the top-down macro process, so we look at five factors called the five P's that we think can explain a lot of the market returns. Those factors are the outlook for profits, the outlook for policy, monetary and fiscal policy, the price of markets which is valuation so are they expensive, more cheap. Positioning, which is whether investors are particularly overweight or underweight equities and the potential risks. So those are the five factors. We do a rating score of those and a lot of those factors are contrarian.

When everyone's super positive in equities, it becomes a negative factor in our process and we incorporate that into our view on that market that will drive our decision to raise cash and reduce it. Now I won't labour that too much because we could spend 30 minutes just on that. But the bottom-up process, we look at six factors, that's the quality of the management team, the outlook for the industry whether it's got good growth or not, where that company sits, is it a winner within the industry or is it just average Joe Bloggs who if the industry does well, that company might get dragged along? In a favourable sense financials is where we do our and look at the gearing and the cash flow conversion, the valuation of the business, and then sustainability, which is our ESG process. So we look at those six factors, form a view and then that'll go into a conclusion what we think of that business.

Jacinta King (24:27):

Excellent, thank you. And lastly, before we wrap up, two stocks that you're most excited about if you want to share that with us?

William Curtayne (24:35):

I'm going to go on a limb here and do two stocks, have a couple of catalysts that could cause the businesses to go up 50%, but if those catalysts go wrong, they could also go down 50%. So bear that in mind.

Jacinta King (24:53):

It's not advice, this is just ideas shared.

William Curtayne (24:54):

These aren't companies that beat the house on the companies that it's worthwhile having some of these ones because often the companies that do well, you've got to take a bit of a risk. One's Neuren Pharmaceutical, which is a small biotech company out of Melbourne [inaudible 00:25:05] NEU. They recently commercialized their first drug in the US this year and start sales of it. That's a drug treating Rett Syndrome, which is a genetic disorder in children. So this drug gives them an enzyme in the brain that helps remove some waste which is causing some awful issues with these young girls. They have an upcoming trial result in December for the second drug. It's a phase two trial for another drug that will, there's actually four phase two trials coming in the next six to 12 months but the first result will be in December. These are all for other rare genetic disorders. So if one of these drugs is successful, would see a strong run into the end of the year [inaudible 00:25:47] And if some of the other phase two results go well next year, then this stock's got plenty of upside.

It's about fair value based on the value of the one drug they have proved today. So success in these other drugs will make this business worth significantly more. But failure, I could see the stock price down 30% in December if it doesn't go well. Maybe even more. So be that in my second one is a newly listed company in Australia, which is an old Australian business now and that's Newmont, the gold miner, which now of course has taken over Newcrest and we now have Newmont listed in Australia through a CDI.

Jacinta King (26:24):

Listed just this month. Yeah,

William Curtayne (26:26):

It hasn't done so well until today. As we speak today, it's 15th in November. Again, it's up a few percent. But why Newmont? Step back a bit. Why gold? We think that in the future years, gold will increasingly be sought out and as [inaudible 00:26:44] now the first part of essential

banks are buying gold in massive gain. And that's larger because many central banks around the world who do not feel particularly allied with the West or the US or Europe are looking to diversify their treasury and their FX reserves away from the US dollar and the US Treasury's two alternatives and gold forms a big part of that alternative. So this is all in reaction to what happened when Russia invaded Ukraine and the West and US basically made Russia's FX reserves held in US dollars and euros worth nothing overnight.

So if you're any country, and there's a number of them that I won't go through, but if you're any country around the world who thinks that it may fall foul of the West in the geopolitical world and there's some sizeable ones that do, then it's a bit of a no-brainer to be at least moving some of your FX reserves from US treasuries to gold. On the flip side, we think geopolitics continues to get worse over the next couple of years and that's likely to drive gold as a safe haven, even for other investors. Newmont's trading at its cheapest value versus gold for about eight years. It's nearly not far of its all-time lows of how it's valued versus gold. Company's down 60% since its highs a couple years ago. As of the other day, I was trading its two-year lows. Why is this when gold price is nearly at its highs? A couple of reasons, is the company had to cut its dividend last year as cost inflation issues sort of hampered a little bit their earnings.

They've had a few production problems in some mines, processing in mines that have meant that their production guidance is cut. It's likely they have to cut their production guidance one more time before these issues are resolved. And that's been probably weighing on the share price and just the technical companies that make a big acquisition are like Newmont buying tend to be depressed for a while as it's just typically technical elements of the ownership of the company have just depressed the share price. So these things have all meant that this company's been a big underperformer versus our local gold miners like Evolution or Northern Star but it's actually very cheap. We think these production problems will be solved in the next six months. The company's very good value. And if you happen to get a decent gold price next year, you could see this type of business regrade 50, 60 or 70%.

But for that to happen, you probably need some of the US investors to want to own it. Again, at the moment, the only thing US investors want to own is the magnificent seven tech stocks and they're not in anything else but we think that'll change at some point. You'll see money rotate out of those big tech stocks into other companies and that'll tend to be a catalyst to re-rate other stocks.

Jacinta King (29:19):

Yeah, because we have seen that at times, the geopolitical issues where people will look to gold. I'm already seeing in some of our asset flows with our listed products, a little bit of a shift to cash as well. So we do see those behaviors kick in at times. Look, Will, thank you for joining us today. You've been generous of your time and of your insights and I think what I've learned, reinforced in my understanding about Milford is you really have that value bent. You've got that top-down, bottom-up approach and you've explained that really well for our listeners. So thank you. So just to recap, for all of those people joining us today, listening in, the Milford Australian Absolute Growth Fund is quoted on the ASX under ticker MFOA. So you can head to the ASX and look under that ticker to find out more information. And of course, head to Milford's website, make sure you click on your country New Zealand or Australia, and you can find a wealth of information there. Thank you, Will.

William Curtayne (30:18):

Thank you and a pleasure to be on.

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