Lazard
Australian Equity Fund

Jun 2022
Factsheet

Risk Aware
Focus on benchmark and absolute risk

Disciplined 'Value' Investment Approach
Longer-term independent thinking

Stability and Experience
Team together at Lazard for more than 20 Years

Fund Facts

Number of stocks	37
Total Fund Size	$132.3m
Inception Date	16 December 2002
Total Management Costs	W Class: 0.90% p.a.
Index	S&P/ASX 200
Minimum Investment	$20,000
Buy/Sell Spread	0.20%/0.20%
Distributions	Quarterly[1]
APIR Code	LAZ0010AU

Investment Characteristics

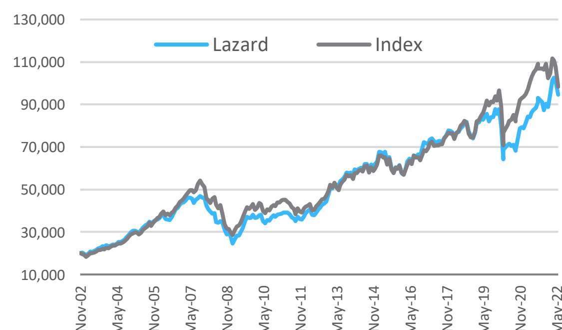
	Lazard	Index
Price/Cash Flow	7.6	9.2
Price/Book Value	1.6	2.0
Dividend Yield (%)	5.0	4.8
Forward Price/Earnings	10.1	13.0
Active Share (%)	62.0	-
3 Year Turnover (%pa)	36.5	-

Performance (%)

	Lazard (W Class)	Lazard (I Class)	Index
1 Month	-6.1	-6.1	-8.8
3 Months	-6.7	-6.7	-11.9
1 Year	8.2	8.4	-6.5
3 Years (pa)	3.7	3.9	3.3
5 Years (pa)	5.6	5.8	6.8
10 Years (pa)	9.6	9.7	9.3
Since Inception (pa)	8.3		8.6
Since Inception (pa)		8.9	7.7

Inception Date (W Class): 16 December 2002
Inception Date (I Class): 17 October 2000

Growth of $20,000[2]



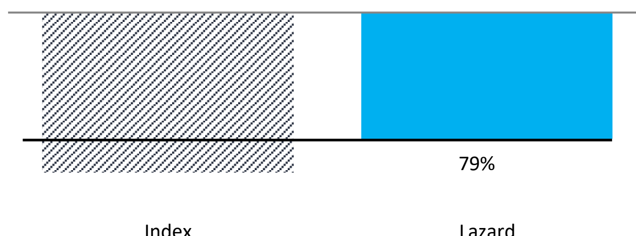
Allocations (%)

Sector	Lazard	Index	Overweight/ Underweight
Communication Services	0.9	4.1	-3.2
Consumer Discretionary	8.3	6.4	1.9
Consumer Staples	13.2	5.3	7.9
Energy	14.1	5.9	8.2
Financials	30.8	27.9	2.9
Health Care	3.5	10.2	-6.7
Industrials	5.7	6.0	-0.3
Information Technology	2.7	2.7	0.0
Materials	17.8	23.7	-5.9
Real Estate	1.7	6.3	-4.6
Utilities	-	1.5	-1.5
Cash	1.4	-	1.4

Top 5 Holdings (%)

	Lazard	Index
BHP Group	7.4	10.8
Woodside Energy	6.1	3.1
Rio Tinto	4.7	2.0
QBE Insurance	4.6	0.9
Commonwealth Bank of Australia	4.4	8.0

Down Market Capture Ratio



Down Market Capture Ratio is calculated since inception and based on performance gross of all fees. Down Market Capture is a statistical measure of an investment manager's overall performance in down markets, being calendar months where the Index experiences negative performance. A drawdown ratio (or percentage) of less than 100 (or 100%) reflects that the manager has outperformed the Index during such down markets.

1 Distributions are made quarterly if of an economic size.
2 Performance is presented net of W Class fees, please refer to www.lazardassetmanagement.com for performance of the I Class.
Investments can go up and down. Past performance is not necessarily indicative of future performance. Net returns are quoted after the deduction of Management Costs. Performance assumes reinvestment of all distributions.

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ASSET MANAGEMENT

Commentary

Following a brief rally in May 2022, global equity markets continued to fall in June as concerns over rising inflation levels, fuelled by higher oil and commodity prices, labour shortages, and ongoing supply chain disruptions weighed on investor sentiment. Australian shares also lost ground in June, with the S&P/ASX 200 falling -8.8% over the month and finishing the 2022 financial year at a loss for only the third time in the last ten years. Central banks have broadly acted in a coordinated fashion to fight inflation, with 45 banks raising rates thus far in 2022, including a 50 basis point rate hike to 0.85% by the Reserve Bank of Australia (RBA). This tightening of monetary policy saw Australian 10-year yields selling off to 3.66%. Against this backdrop, the Utilities and Energy sectors were the strongest performers in Australia over the quarter, whilst the IT, Real Estate and Materials sectors were the worst performers.

During the quarter ended June 2022, the Lazard Australian Equity Fund returned -6.7% (net of W Class fees), outperforming the S&P/ASX 200 Accumulation Index which declined -11.9%.

Contributors to Performance

- QBE's share price rose 5.3% over the June quarter. The share price benefitted from three factors. First, interest rate rises across the curve and in various geographies raised the yield on QBE's technical reserves, the pool of provisions set aside for future claims, with every 100bps rise, this increases QBE's forward earnings by about 20%. Another factor is the rise in global premium rates, and importantly US rates, which continue to rise strongly. MarketScout reported an approximately 25% year-over-year rise in commercial catastrophe and liability class premium rates in the US to the end of June 2022. Crop premiums are also up strongly due to higher commodity prices. Finally, the US dollar strengthened against the AUD, increasing the value of QBE through FX translation. We own QBE for the on-going hard market in premium rates, which continues to surprise by its longevity. It is important to note, though, that while higher interest rates boost the P&L, on-going rates of high inflation would require reserve strengthening by QBE and other insurance companies. QBE trades on 13x current year consensus EPS and only 8.2x 2023 consensus EPS, a 37% discount to the ASX200. This is well below the usual 16% discount, particularly for an economically defensive company in the present market.

- Whitehaven Coal's (WHC) share price continued to outperform the market in the June quarter, underpinned by further increases in global coal prices. Benchmark Newcastle (NEWC NAR 6,000 kcal/kg) coal finished at US$385/t, up 50% from the start of the quarter as the backdrop for the global coal market continues to be very supportive. Supply from the two largest seaborne exporters, Australia and Indonesia, remains very tight. as 'La Nina' brought an extended period of rainfall, impacting coal production and logistics. The conflict between Russia and Ukraine is encouraging Western and some Asian buyers to look for an alternate source of coal outside of Russia, the third largest exporter of coal. Australia is one of the few alternative suppliers of higher quality coal than that produced in Russia, further boosting demand. At the current spot coal prices, the stock is trading at 100% FCF yield and is sitting on a net cash position. Our valuation captures the near-term strength in coal prices, but we continue to normalise our long-term coal price assumptions to US$72/t for NEWC 6,000kcal/kg. On this basis WHC is still looking relatively attractive. We believe shareholders are going to be increasingly rewarded with higher dividend payments and share buybacks in the near term.

- Aurizon (AZJ) was broadly flat for the June quarter, outperforming the ASX200 which declined by about 10%. AZJ benefitted as it a defensive asset with a high proportion of revenues contracted or guaranteed via regulation revenues and a high dividend yield. AZJ also benefits from higher interest rates through the profit reset on the Central Queensland Coal Network in June 2023. These features make AZJ attractive in an environment of higher interest rates and deteriorating economic conditions.

Detractors from Performance

- Alumina's (AWC) share price underperformed the market in the June quarter. The seaborne alumina price has come down following a strong start to the year, averaging over US$400/t in the first quarter of 2022 to finish at US$360/t by the end of June. Chinese smelters, who are the balancing buyers of seaborne alumina, are sourcing more from their domestic refineries, which have resumed production following the end of curtailment over the Beijing Winter Olympics period. We believe the price has stabilised at the current level for the near term as it is getting close to the marginal cost of Chinese refineries and the ex-China market is relatively balanced for now. In the company's last quarterly update, it is evident that they are facing significant energy cost pressure at its Spanish refinery, San Ciprian, giving a much higher cost guidance compared to market estimates. San Ciprian is making losses at the current alumina prices, as they are more exposed to the European spot gas market following the expiration of their contract late last year. San Ciprian accounts for about 13% of production volume of the Alcoa World Alumina and Chemicals (AWAC)partnership, of which Alumina owns 40% equity. The rest of AWAC's refineries are mostly located in Western Australia, where they are at the bottom of the global costs curve as a result of low gas prices due to the area's lack of exposure to the international market. We believe the pull back in share price already reflects the higher cost at the San Ciprian refinery to the group in the near term, and we believe the stock is looking relatively attractive at the current share price.

Commentary

- Eagers Automotive (APE) underperformed substantially during the second quarter of 2022, falling 32%. As a car retailer, APE is highly leveraged to the economic cycle. Through the quarter expectations for interest rates rose on the back on high inflation numbers and RBA commentary. This led to a commensurate reduction in earnings estimates for consumer related sectors of the market, APE included. This headwind was exacerbated on the 18th of May 2022, when the company issued a profit downgrade stating that H1'22 before-tax profits will be A$183 mil, about 12-15% below the PCP. The frustrating reality with the downgrade is that new car demand is very strong. APE's order book has increased by 25% since the beginning of the year, however, constrained car supply means that deliveries and therefore recognised profits will be lower in the near term. The timing of when supply recovers will dictate how strong second half and full year profits will be. Estimates suggest that APE has 6-9 months of 'excess' profits stored in the order book that will be realised over time. Longer term we believe there are three material value drivers for APE that are not reflected in the share price. These include the successful scaling of the fixed price used car business EasyAuto123, increasing share of franchised automotive through value enhancing M&A and the potential for margins to be supported through a lower cost base. Any one of these three options being realised justifies holding APE today. That said, we are mindful that APE is a cyclical business that is highly leveraged to consumption. While the balance sheet is in great shape and the business can comfortably manage a down cycle, it is likely we will keep APE at a modest weight in the portfolio despite the large potential upside due to these cyclical considerations.

- Virgin Money's (VUK) share price fell 28% over quarter, due to increasing concerns about a UK recession arising from the inflationary impacts in Europe of the Russian-Ukraine conflict. While we are aware of the economic leverage inherent in banks, we are reassured by the fact that VUK's loan book comprises 82% residential mortgages, in a country with housing prices which equate to approximately half of Australia's, and with much lower household debt levels. History also suggests that credit cycles tend to be less costly when there is a history of recent downturns (which tend to eliminate weak business models and excessive gearing). At A$2.21, Virgin trades on 3.2x actual trailing and 4.0x expected 2022 earnings and 0.40x NTA. We believe the capital position is very sound, as illustrated by the fact the UK regulator gave permission for VUK to commence a buyback in June, despite the present economic uncertainties in Europe.

Outlook

In retrospect we can now identify 9th November 2020 as an important turning point of internal stock market dynamics in Australia, even if speculative activity only reached its peak in the first quarter of 2021. Value style started to outperform from November 2020, although to end 2021, better returns were driven entirely by superior EPS growth, partly offset by continuing increases in the dispersion of valuations due to ever increasing multiples for the high multiple stocks of the ASX. This widening dispersion finally started to reverse over January and February of 2022, resulting in dramatic relative gains for our portfolios. As of end of March 2022, about 40% to 50% of the gap that had opened up had mean-reverted, when measured against the benchmarks of the last 25 low inflation years and dispersion measures tracked mostly sideways over the June quarter. Even after the 1H22 unwind of the 2020/21 excesses, absolute forward earnings multiples for the high quintile multiple stocks remain near the levels of March 2000, however, and the majority of the relative mean-reversion and thus of the associated out-performance is yet to unfold. History suggests that a distortion of this magnitude, which has built up over several years of boom, will similarly correct over a multi-year period, but so far, the mean reversion has been more rapid than in the tech wreck years of 2000-2003 or post the China boom of 2007. This may be due to the greater extremes reached and/or the current inflation risks that were not present in these prior post-bubble normalisations. Historical experiences suggests, however, that the rapid unwind of the bubble over the last seven months is unlikely to continue in such a straight-line fashion, as even during the March 2000 to March 2003 "tech wreck", there were several explosively rapid ~30% rallies in the NASDAQ, even as the overall index declined 80%. We should experience similar market volatility over the current normalisation period as well.

A significant contributor to outperformance over 1H22 were our Energy positions. Even following the gains in 2022 to date, the sector remains very attractively priced as the sector price index continues to be below end 2019 levels, for example, despite dramatic increases in coal, gas and oil prices since that time and we have only lowered the fund's exposure modestly through the period. The increased likelihood of a US recession presents risks to energy commodity prices, but there is considerable structural support from accumulated under-investment.

In prior quarterly commentary we have focused on the inflation risks arising from the MMT-driven increases in broad money across the western world and the US in particular, where a wage-price feedback dynamic has developed. Exogenous shocks on Western inflation have come from the Russian-Ukraine conflict placing upward pressure on food and energy prices, off-set by China's economic problems arising from its adherence to a COVID-19 elimination strategy in the face of increasingly infectious omicron sub-variants.

Commentary

We outline our market expectations in low or high inflation scenarios below.

1. If inflation subsides, rates remain in the low range that has prevailed over the last 30 years and market multiples remain supported by the "fed put", we expect outcomes similar to those following 2001 – an extended period of normalisation of relative multiples driving value out-performance, in the context of overall negative US and subdued Australian equity returns.

2. If inflation rates remain significantly higher than central bank targets, a global or at least developed world recession is almost certain within the next 18 months. Returns across all asset classes – bonds, property, equities – would likely be negative, some significantly so, but the relative gains by value equities would probably be even greater than those that seem likely from multiple normalisation in any case. The combination of extreme distortions as the starting point and a rise in inflation could result in the most dramatic relative gains by value stocks since the early 1970s.

For very different reasons, namely a property downturn, the risk of a Chinese recession is thus also much greater than usual. Such a recession would alleviate food, commodity and energy inflation pressures globally and thus may even be of some net benefit for western commodity-importing manufacturing nations, although it would clearly be a significant negative for Australia.

Domestically, the rise in interest rates once more raises the risks associated with extended home prices and the high level of household debt, and we are watching house price developments in New Zealand closely, as rates rose earlier in that market. As of the end of June, CoreLogic report that Auckland prices had declined by 10.5% from the 2021 peak, which by itself this decline is not concerning, and national prices have declined by less, but the rate of decline is rapid for residential property and the rate of decline has accelerated. We see a ~15% national decline as approaching a "danger zone" beyond which internal market dynamics and self-fulfilling sentiment changes could lead to a recession and yet further falls beyond the ability of monetary policy to prevent.

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or visit www.lazardassetmanagement.com

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