Lazard
Select Australian Equity Fund

Oct 2022
Factsheet

High Conviction
Benchmark unconstrained, with high active share and best ideas

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	32
Total Fund Size	$65.2m
Inception Date	22 August 2002
Total Management Costs	W Class: 1.15% p.a.
Index	S&P/ASX 200
Minimum Investment	$20,000
Buy/Sell Spread	0.20%/0.20%
Distributions	Quarterly[1]
APIR Code	LAZ0013AU

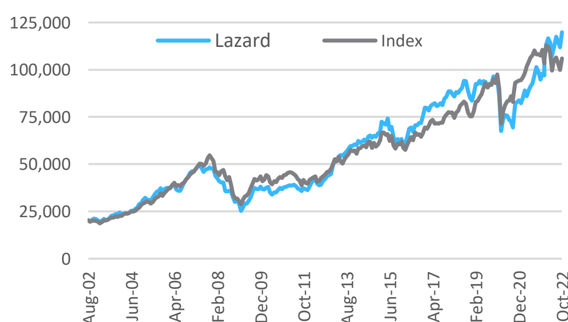
Investment Characteristics

	Lazard	Index
Price/Cash Flow	6.1	8.4
Price/Book Value	1.5	2.0
Dividend Yield (%)	4.8	4.6
Forward Price/Earnings	10.3	13.6
Active Share (%)	74.7	-
3 Year Turnover (%pa)	74.2	-

Performance[2] (%)

	Lazard	Index	Excess Return
1 Month	7.1	6.0	1.0
3 Months	7.1	0.7	6.4
1 Year	21.5	-2.0	23.5
3 Years (pa)	9.1	4.8	4.3
5 Years (pa)	7.2	7.2	0.0
10 Years (pa)	10.6	8.7	1.9
Since Inception (pa)	9.3	8.5	0.8

Growth of $20,000[2]



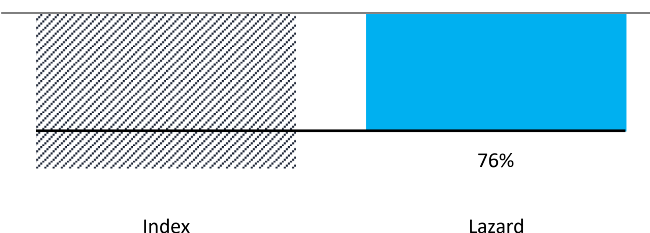
Allocations (%)

Sector	Lazard	Index	Overweight/ Underweight
Communication Services	1.6	3.9	-2.3
Consumer Discretionary	10.3	6.5	3.8
Consumer Staples	10.3	4.8	5.5
Energy	17.3	6.5	10.8
Financials	31.9	30.1	1.8
Health Care	0.9	10.0	-9.1
Industrials	7.0	5.8	1.2
Information Technology	1.9	2.8	-0.9
Materials	14.9	22.1	-7.2
Real Estate	2.6	6.2	-3.6
Utilities	0.0	1.3	-1.3
Cash	1.3	0.0	1.3

Top 5 Holdings (%)

	Lazard	Index
QBE Insurance Group Limited	10.1	0.9
Woodside Energy Group Ltd	9.0	3.4
AMP Limited	7.9	0.2
Rio Tinto Limited	7.0	1.6
South32 Ltd.	4.5	0.8

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 Down Market Capture ratio (or percentage) of less than 100 (or 100%) reflects that the manager, on average, 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.

LAZARD
ASSET MANAGEMENT

Commentary

Equities had a strong month during October 2022 on the speculation that central banks are nearing the peak of policy tightening which lifted sentiment in share markets. The MSCI Developed Markets (DM) Index rose 7.5%, and the S&P 500 gained 8.1% in local currency terms. The S&P/ASX 200 gained 6.0% during the month as investors responded to a more dovish than expected RBA's 25bps hike in the cash rate to 2.60%. This was reflected in Australian bond markets, as the Australian 10-year yield moved down by 13bps to 3.76%. Meanwhile US yields continued their upward trend, rising 28bps to 4.07%, however speculation of a potential pivot in the Fed's policy path supported risk sentiment. On a sector basis, Financials was the strongest performer, while REITs and Energy sectors also outperformed in Australia. The Consumer, Materials and Health Care sectors were the worst performers.

During the month ended October 2022, the Lazard Select Australian Equity Fund returned 7.1% (net of W Class fees), outperforming the S&P/ASX 200 Accumulation Index which returned 6.0%.

Contributors to Performance

- Following a 16% rise in AMP's share price over the September quarter, October saw a further 15% gain in the share price to $1.26. The company released a quarterly trading statement late in the month, which showed 2.6% mortgage growth in the September quarter and a reduction in funds under management outflows compared to the previous corresponding period. The stock also benefitted from positive sentiment towards improving net interest margins across banking businesses. At the closing price the discount to NTA per share had narrowed to ~8%. Following the 33% rise in the shares since mid-year, AMP remains attractively priced, but no longer within the top 30 most attractive stocks on our value rank. We continue to expect further buybacks and debt repayment over 2023.

- Costa (CGC) outperformed in October with the shares rising 13%. After a disappointing year and a weak share price, investment firm Paine Schwartz bid for up to 15% of CGC's shares on issue at $2.60 per share, a 16.6% premium to the pre-bid price. This corporate interest led to share price gains and speculation about other interest in the CGS's assets. We believe Paine's interest confirms our view that the share price does not reflect the future earnings power of the assets and we continue to hold the stock.

Detractors from Performance

- South 32 (S32) underperformed the market during the month due to weakening aluminum prices. Recession fears continues to drive down broader demand for metals, leading to softness in commodity prices. Aluminum prices have dropped from over US$3,500/t in March 2022 to around $2,200/t today and is the only metal that is trading well into the global cost curve. Large producers Alcoa and Norsk Hydro believe that at current prices 50-60% of global aluminum smelters are loss making. This is not sustainable in the medium to long term, and we believe it will force higher cost smelters to curtail their productions in order to balance the market. S32 is still making a small cash profit from its aluminum business at current prices. S32 is a mining conglomerate with more than 95% of its portfolio leveraged to the green energy transition. More than 50% of the commodity exposure is aluminum and alumina (where S32 is a 2nd tier producer on the global cost curve), 25% to manganese (a key ingredient in steel making process and S32 is one of the lowest cost producers in the world) with the rest of the business in nickel, zinc and met coal (with a combined exposure less than 5%). During Q4 2021, S32 announced an acquisition of a 45% interest in the Sierra Gorda Copper mine in Chile for US$1.5bn. This mine has 20 years of reserve life and annual production of 210kt. This transaction adds another future facing commodity to the portfolio. Copper is estimated to account for 20% of underlying earnings on an annualized basis for FY21. The Sierra Gorda deal was attractively priced at 3.3x EV/EBITDA or 2x EV/EBITDA at spot copper prices. Our value for Sierra Gorda is lower than the markets due to a conservative copper price but this doesn't include the option value for mine life extension or a phase 2 concentrator expansion. In addition, S32 bought an additional 25% interest in the Mozal aluminum smelter, which is backed by hydro power, at an attractive acquisition multiple of 3.6x. The deal will increase S32's ownership in this smelter to 72%, adding another 145kt pa of green aluminum production. Overall, we continue to see S32 as attractively priced despite some short-erm earnings headwinds in its aluminum business.

- Bank shares rallied over the month of October following the announcement by Bank of Queensland of better-than-expected net interest margin (NIM) improvements following the rises in cash rates since April. Of the major banks, WBC rose most (by close to 17%), while NAB lagged with a 12.5% rise. We expect a 24bps rise in NIMs across the major banks from the f22 low-point to f24 driven by better deposit margins, higher earning on equity and the roll-over of fixed rate residential loans written in 2021 into better margin SVR mortgages. Higher wholesale funding costs, the need to refinance the 10bps TFF funds and a lagged move by households from at call to term deposits will we believe offset the gross benefits, however. Our above consensus of NIM gains is offset by an expectation of rising credit costs. Somewhat surprisingly, as of late October, the market had average bad and doubtful debt cost at only 10bps in f24 for the major banks. Given the dramatic actions by the RBA, home price falls and the risks of a coordinated global recession, this remains a very benign expectation relative to the 38bps 42-year average in Australia and the greater than 60bps long-term credit loss averages in the US, Ireland and the UK. The f24 consensus credit loss estimate would represent the 3rd best outcome

over 42 years and the equal lowest pre-COVID. While we do not know how severe the economic slowdown due to the RBA's monetary tightening will be, we see considerable risks around even our normalised mid-30s credit charge for f24. While our normalised credit cost estimate has fallen due to mix shifts over time, the proportion of mortgages in the books have not risen due to lower corporate debt, but due to very much higher household leverage and it is thus not clear how much of a positive this shift is to expected system credit costs.

Outlook

In retrospect we can now identify 9 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 the 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 benchmark 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, 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 suggest, 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.

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, we believe, 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 potentially 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 greater than usual. Such a recession could alleviate food, commodity and energy inflation pressures globally and thus may even be of some net benefit for western commodity-importing manufacturing nations, although we consider it would 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 2022, 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 an approximately 15% national decline as approaching a "danger zone" beyond which internal market dynamics and self-fulfilling sentiment changes could potentially lead to a recession and yet further falls beyond the ability of monetary policy to prevent.

For more information, call us on 1800 825 287
or visit www.lazardassetmanagement.com.au

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