

# Clime Australian Value Fund



## Quarterly Report December 2019

The objective of the Fund is to provide consistent capital growth and a growing level of income over the medium term (3 - 5 years) by investing in securities listed on the Australian Securities Exchange.

Quarter Net Return (Retail)	1 - Year Net Return (Retail)	Inception p.a. Net Return (Retail)	Total Fund Size
<b>1.6%</b>	<b>27.7%</b>	<b>8.2%</b>	<b>\$9.2m</b>

	1 month	3 months	1-year	3-years*	5-years*	Inception*
<b>Retail (AUD Portfolio Return)</b>	-0.2%	1.6%	27.7%	9.7%	7.2%	6.9%
<b>Wholesale (AUD Portfolio Return)</b>	-0.2%	1.7%	27.9%	9.8%	7.3%	6.2%

Inception: Retail Units: 28 August 2006; Wholesale Units: 15 April 2011.

\*Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes. Performance figures compare unit price to unit price for the given period. The returns exclude the impact of imputation.

### Top 5 Holdings (Alphabetical)

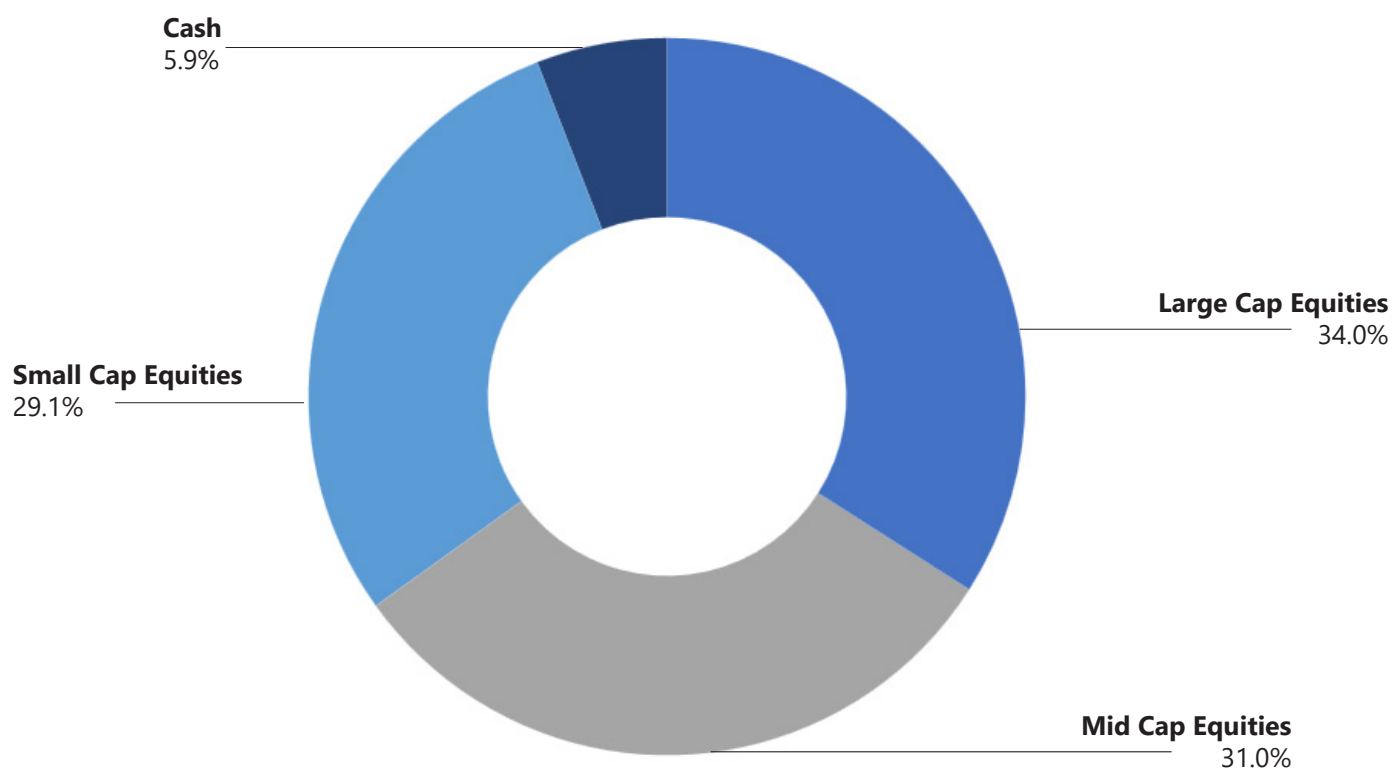
Company	ASX Code
<b>Ancor</b>	AMC
<b>BHP Group</b>	BHP
<b>Bravura Solutions</b>	BVS
<b>Webjet</b>	WEB
<b>Westpac Banking Corporation</b>	WBC

### Fund Facts

<b>Portfolio Managers</b>	Adrian Ezquerro, Ronni Chalmers, Jonathan Wilson, Vincent Cook & David Walker
<b>Fund Inception</b>	August 2006
<b>Fund Size</b>	\$9.2m
<b>Cash Distributions</b>	Annually
<b>Eligibility</b>	Wholesale & Retail



## Asset Allocation



## Asset Allocation by Sector

Industry	Weighting
Financials	21.7%
Information Technology	20.2%
Materials	13.5%
Consumer Discretionary	13.1%
Industrials	7.5%
Health Care	6.6%
Cash	5.9%
Real Estate	3.4%
Consumer Staples	2.5%
Energy	2.5%
Utilities	2.0%
Communication Services	1.1%



## Portfolio Commentary

Clime's investment philosophy remains focused on quality with strong valuation discipline. The portfolio is constructed based on a "sub-portfolio" approach. This allows your investment manager to look right across the market cap spectrum to find the best investment opportunities available. This commentary presents the current positioning of each sub-portfolio by market capitalisation.

### Large Cap Sub-Portfolio

**CSL (CSL)** continued to rally strongly as annual growth in demand for its immunoglobulin therapy (IG) products accelerated to high single-digit (7-9%) rates. More doctors are recommending IG treatment for patients with immune system disorders and the number of indications for existing therapies like CSL's Privigen and Hizentra increases.

Management forecast IG demand growth will continue at current rates in coming years. CSL is also gaining market share in IG because it invested ahead of its competitors in plasma collection centres in the US, so it can now meet growing demand from its own supply of product. CSL's immunology, neurology and haemophilia businesses are proving strong enough to resist evolving competitive pressures.

The market is also correctly starting to price in earnings upside from CSL's deep and comprehensive R&D program, which is optimising and extending existing successful franchises, addressing competitive deficiencies where they exist and expanding into new medical and technological adjacencies.

**Amcor (AMC)** shares rallied this quarter as the company reported a strong first-quarter result, the market became more comfortable with the Bemis acquisition and concerns about the company's risks from waste plastic in the natural environment abated.

AMC is executing well and continues to demonstrate resilience in the face of a global economic slowdown. After a strong first (September) quarter, management reported momentum in the base business and reiterated guidance for 5-10% constant currency growth in earnings per share in FY20.

Initial synergies from Bemis are meeting expectations and longer-term targets for synergies and integration costs remain unchanged. Volumes and sales are growing in North America and Western Europe and costs are being controlled. The Euro's current rally against the US dollar increases the translation of Amcor's European earnings into US dollars, its reporting currency.

We see environmental concerns as more of an opportunity for the company than a risk. Amcor's customers, which are in the consumer and healthcare industries, face increasing consumer demand for sustainable packaging. Amcor, the world's largest manufacturer of packaging, has pledged all its products will be recyclable or reusable by 2025. In our view, AMC has the R&D budget and global reach to achieve this.

**BHP Group (BHP), Rio Tinto (RIO) and Woodside Petroleum (WPL)** rallied as US-China trade tensions eased, Chinese infrastructure stimulus buoyed steel production and steel margins, markets became more optimistic about the world economy in 2020, and iron ore, copper and oil prices rose. The three resource majors also reported improved operational performance in the September quarter.

Markets welcomed BHP's announcement that Mike Henry would succeed Andrew Mackenzie as CEO. WPL reported meaningful progress towards developing its Scarborough and Browse gas reserves and we expect a formal decision to proceed with Scarborough in 2020. We agree with forecasts for improved global growth in 2020 and see further potential upside in these stocks.

We had modest exposures to but remained significantly underweight **ANZ Banking Group (ANZ), National Australia Bank (NAB) and Westpac (WBC)** before their disappointing full-year results and went further

underweight after the results. Financial crime regulator Austrac launched legal proceedings against WBC, which at the time was in the middle of an equity raising, for its failure to report large numbers of international funds transfers. This subsequently led to the resignations of the Chair and CEO.

Growth in mortgage and business lending by banks continues to slow as households deleverage and businesses stay cautious. Interest margins remain under pressure from ultra-low interest rates and strong ongoing price competition. Fee income is falling as banks try to restore trust with customers while regulatory and compliance costs continue to rise.

Dividend yields in excess of 6.5%, and undervaluation on heavily written down consensus earnings forecasts, keep us interested in the sector but we expect to remain meaningfully underweight banks for some time yet.

### Mid Cap Sub-Portfolio

Earlier in 2019, wealth and funds management administration software provider **Bravura Solutions (BVS)** raised \$165 million for acquisitions, initially as part of a bid for competitor GBST. However, GBST was lost to a competing higher bid, and BVS finished FY19 with a balance sheet laden with net cash of \$195 million.

Some of this went to acquisitions during 1H20. In August, BVS completed a \$50 million acquisition of Australian financial planning back office software provider MidWinter. MidWinter's offering sits adjacent to BVS. It followed this in October with a \$25m purchase of FinoComp, a Wealth reporting and regulatory compliance software provider with some leading UK Wealth institutions as clients. This business will add functionality to Bravura's existing software.

At the November AGM, BVS reiterated previous guidance of mid-teens NPAT growth, but clarified that guidance excludes the impact of acquisitions of about \$3 million to NPAT. This was effectively an upgrade.

The AGM update was a pleasant surprise; however, our focus remains on the long term opportunity. Within the wealth and funds administration software market, BVS is a key beneficiary of increased out-sourcing by financial institutions in highly regulated financial markets across Australasia and Europe. BVS is well positioned to soak up what is a multi-year pipeline of demand from new and existing customers.

**Webjet (WEB)** presented at two investment conferences during the quarter and then provided an AGM update in November. Each of these presentations provided positive commentary on the long term growth outlook and the specific earnings guidance provided at the AGM was ahead of market expectations.

Management guided to EBITDA of \$157-167 million this financial year, compared to prior consensus expectations of \$159 million. The presentations focused on the WebBeds bed bank business, which provides distribution of hotel room inventory to travel agents globally. This segment accounted for 48% of group earnings last financial year and is WEB's fastest growing business.

Despite the growth of hotel booking industry behemoths such as Booking.com and direct booking with hotel websites, bed banks continue to be a critical alternative distribution channel for hotels. Moreover, this is a very large (over US\$50 billion per annum) and highly fragmented industry, providing a significant long term growth opportunity for WebBeds.

**Seek (SEK)** affirmed guidance at the AGM in late November, including revenue growth of 15-18% this financial year. Net profit is expected to be approximately in line with last year, given a step up in investment spending to ensure the business has the strongest possible market position and profitability in the future.

The affirmation of guidance was despite headwinds from the macro environment in ANZ, China and Asia, where job ad volumes have softened. SEK continues to have a significant opportunity to increasing pricing over the long term, which is more than offsetting the short term weakness in volumes.



**Afterpay (APT)** continued to demonstrate effective execution as the year progressed. As at 31 October, APT had 6.1 million active customers, up from 2.6 million in the prior year. Additionally, the final audit report on APT's AML/CTF compliance was submitted to AUSTRAC.

The report deemed APT to be a low risk business in this regard and that no money laundering or terrorism financing activity has been identified. While there was some historic non-compliance, APT's current AML/CTF program is aligned with the regulatory requirements.

A portfolio position was re-established in **Appen (APX)** during the quarter after a significant reduction in the share price despite a continued positive trajectory for earnings expectations. Following this, the company provided an earnings update on 18 November. Management upgraded EBITDA guidance for the year to 31 December 2019 by 10% at the top end of the range, plus another 1-2% from foreign exchange movements.

APX is a global leader in its area of the artificial intelligence industry. APX supports businesses to incorporate artificial intelligence by providing largely human sourced annotation of data – data that is used to train computer systems. For example, APX might employ a crowd of several thousand people to rank the relevance of search results, such as for the question – "Where are the 2020 Olympics being held?". This human input is then used to improve the algorithms that enable a search engine. APX has a market leading global crowd of over a million people and has market leading technology, following the acquisitions of Leapforce and Figure Eight.

**EML Payments (EML)** is also a new addition to portfolios. The company is a global provider of pre-paid cards and payment processing across a range of use cases, including cards used in shopping mall gift programs, sports betting and salary packaging. EML has significant offshore growth potential.

EML's core proprietary software enables its business clients to tailor 'open-loop' and 'closed-loop' card programs, by codifying controls on how loaded money is spent – by merchant type, store, transaction value, frequency, amongst many other features. These programs enhance loyalty and manage transactions across large customer bases. EML is thus entrenched in the user experience for customers of EML's clients. The risks of switching customer bases to alternate providers is high, which is partly why EML has retained all its clients to date.

EML typically targets specific industry verticals that are undergoing regulatory or structural change, and this has resulted in EML becoming the global leading card program provider across local gaming, salary packaging, gift and incentive verticals. Over the near to medium term EML is seeking to expand gift card operations in Europe and reloadable gaming cards in the US.

In November 2019 EML made a \$423 million acquisition of Ireland-based Banking-as-a-Service software provider Prepaid Financial Services (PFS). PFS positions EML to participate in the growth of digital neobanks in Europe and US. EML partially funded the acquisition via a \$67 million placement, which allowed us to initiate a position in portfolios. EML was subsequently included in the ASX200 index in early December. A key attraction of EML is its operating leverage. The business is able to add new business clients with little extra investment in its operations. Gross margins are over 75%. Organic annual revenue growth over last two financial years was 20%. With successful execution offshore we forecast strong earnings growth over the medium term.

During the quarter we exited the position in **G.U.D. Holdings (GUD +6.6%)**. The share price had rallied from the lows of August, while headwinds from currency and the consumer environment have remained or intensified. We also note that key customers such as Bapcor (BAP) are continuing to rationalise their distribution footprints, which can have the effect of reducing required inventory over time. A known headwind for GUD has been that Bapcor is growing its penetration of in-house brands, while a soft consumer environment is unlikely to be helpful for GUD's more premium ranges.

## **Small Cap Sub-Portfolio**

Healthcare imaging data management software provider **Mach7 Technologies (M7T)** was added to portfolios during the quarter and remains on a strong inflection path, with a raft of initiatives adding to the investment thesis in recent months. Early in 2019 management committed to delivering a maiden 12 months of positive cash flow.

True to its word, M7T had strong start to FY20 with operating cash flow of \$1.7 million for the September quarter. Positively, this result was delivered without any contribution from the A\$15 million Enterprise Imaging contract with the Hospital Authority of Hong Kong (HAHK) signed in December 2018, M7T's largest deal to date. With HAHK to contribute from 2H20, we expect cash generation to remain healthy from here.

On the contracting front, M7T started FY20 by adding a top 10 US public health system, Aurora Healthcare (contract value of A\$5.7 million over 5 years), and a leading Hong Kong private hospital, St. Teresa's (A\$0.95 million over 5 years). Typically, contracts are split evenly between upfront licence and implementation fees and recurring maintenance revenues. Contracts are typically renewed at the end of the initial term. M7T hasn't lost a customer to date and Contracted Annualised Recurring Revenue has increased by 70% to \$8.5 million over the last 18 months.

M7T raised \$20 million via a placement in December, which was well-oversubscribed. Management highlighted that the funds were "not raised for working capital purposes", implying no change to its cash flow positive outlook. Rather, the funds were raised to "provide financial security well into the future".

This is notable because hospital customers are anxious to ensure providers of mission-critical systems will be partners over long periods. The placement signals there are potentially large contracts in the near-term pipeline. For context, there are several hospital systems in the US that outsize HAHK's network of 43 hospitals.

In the new year, the Imaging Innovations Lab at key client Sentara Healthcare will be ready to receive visitors, allowing potential hospital customers to review a fully functional demonstration of M7T's novel PACS and Enterprise Imaging systems.

With \$24 million in cash, no debt, an advanced reference site in Sentara, and a healthy contract pipeline, the future is bright for this emerging leader.

The portfolio has held property focused asset manager, **APN Property Group (APD)** for some time now. Our initial investment thesis centred on APD's significant scope for growth, a strong net cash balance sheet, aligned management and an enticing entry price.

In retrospect, our initial position was built at a price that only reflected net tangible asset backing, with a profitable funds management business encompassing more than \$2 billion of Funds Under Management (FUM) priced at next to nothing. While outsized returns can be generated by a focus on emerging quality, they are often augmented by a sharp entry price.

Since that time, APD management have executed well. Group FUM has continued to grow at a steady rate and now approximates \$3.0 billion, with APD's listed funds leading the way. Both APN Industria REIT (ASX: ADI) and the APN Convenience Retail REIT (ASX: AQR) have delivered strong investment outcomes for their investor bases and remain well capitalised with attractive future growth pipelines. Concurrently, APD's property securities funds, the APN AREIT Fund and Asian REIT Fund, have continued on their respective growth paths.

While APD has since rerated, having delivered a total shareholder return of 28.2% p.a. since early 2017, we still see several positive attributes. The strong net cash balance sheet remains, as does the significant opportunity set for long term growth. Management continue to demonstrate execution, albeit in a measured, thoughtful way. All of this is still available for a sensible price, while the yield of 5.0% also remains attractive in this low interest rate environment.



Information management solutions provider **Citadel Group (CGL)** had a busy December quarter, with a positive AGM update in October, a new CEO announced in November, and a 10-year contract extension with Queensland Health in December.

CGL had a tough calendar year 2019 for a couple of reasons. The first is that the business is pivoting from Managed Services to Software. Software is growing but still only contributes a third of revenues. There's a lot of potential with its cloud software products, particularly Citadel IX, however it's not yet showing in the financials.

The second was that contracting within CGL's Managed Services segment during the June quarter was disrupted by the Federal Election. This dented FY19 revenues and earnings and triggered a heavy sell-off. Despite CGL reporting at its AGM that these contracts had been finalised, confidence is yet to fully return. CGL has pedigree in information management in highly sensitive environments, and they've never lost a managed services contract. We marginally increased our position during the sell-off.

Software is the growth engine, and our channel checks found that early adopters of Citadel-IX are very happy with the product. Citadel-IX is a global opportunity. The new management team led by co-founder and now CEO Mark McConnell have solid experience in enterprise software.

The investment thesis for **IMF Bentham (IMF)** centres on the company's multi-year transition from investing in legal disputes via its own balance sheet to investing as manager of partly owned (generally 20%) fund structures with much larger capacity.

The transition should facilitate global expansion and increase the breadth and potential value of case investments. As a future player of global scale, IMF should also enjoy reduced competition for very large case investments, and therefore protect healthy unit economics – historically IMF has averaged Returns on Invested Capital of about 140%.

However, most of its US\$1.5 billion of fund vehicle capacity was added in the last 12 months or so with the launch of two US\$500 million funds, each respectively focused on the US and Rest of World markets. This capital will be fully deployed in coming years, and both vehicles include an option to increase capacity to US\$1 billion.

We believe successful execution on this strategy will result in IMF becoming much a larger business. The \$141 million October acquisition of European litigation funder Omni Bridgeway will help accelerate the process. We participated in the associated equity raising at \$3.40 per share.

In the near-term IMF is benefiting from a series of financial windfalls as balance sheet investments roll-off. Most notably, in December the Supreme Court of NSW ruled in favour of the plaintiff in the Brisbane Floods Class Action. As funder, IMF expects to generate \$100 - \$130 million in revenue. Total expected income for 1H20 of \$304 million already dwarfs the \$35 million generated for the whole of FY19.

In November defence and space technologies developer, **Electro Optic Systems (EOS)**, announced upgraded guidance alongside a capital raising to fund growth and working capital. FY20 EBIT guidance was increased to 70% growth (previously 45%). Including a \$68 million placement and a \$17 million share purchase plan (increased from \$10 million due to investor demand), EOS increased equity by \$85 million and remains debt-free. The Fund participated in the placement at \$6.66 per share.

Demand for EOS's leading remote weapon system technology is reflected in a \$680 million order backlog. Additional demand from 2020 will be met in by new plants in USA, the UAE and Singapore, to complement Australian operations. The technology has applications in the emergent counter drone market, which as per the guidance update, EOS expects to exceed the \$12 billion defence systems market by 2022.

EOS is a niche leader in remote defence systems, supplying to Australian defence allies. Whilst we're pleased with progress in this field, we look forward to potential opportunities in the Space sector, where EOS has leading and highly coveted Space object monitoring technology. We

believe potential value of the Space business is not reflected in the current market valuation.

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Potfolio Manager

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## Market Commentary

The S&P/ASX 200 Accumulation Index delivered a strong 23.4% return in 2019, while the S&P/ASX Small Ordinaries Accumulation Index delivered a return of +21.4% for the year. Though impressive, the ASX actually lagged most other developed countries sharemarkets. The healthcare and technology sectors performed particularly well, but the large banking sector was relatively weak.

A point made on Clime's end of year roadshows was the bifurcation in domestic earnings trends. Earnings revisions were in aggregate negative for the year, with initial projections for large capitalisation company earnings growth receding from 8.8% to just 1.7% for FY2020. Smaller company earnings expectations remain significantly more robust, reinforcing our positive stance on an 'All Cap' approach to Australian equity investing, one focused on quality with strong valuation discipline.

Central bank policy and interest rate settings were significant drivers of risk asset returns during 2019. The Federal Reserve's dovish 'pivot' in early 2019, whereby the trajectory of US interest rates pivoted from higher to lower, calmed markets after a tumultuous December 2018 quarter and set investors up for a productive year.

It is however notable that much of these returns were generated in the first half of the calendar year, with mediocre domestic earnings trends and somewhat stretched valuations combining to halt the advance of Australian shares as the year progressed. The S&P/ASX 200 Accumulation Index delivered returns of 0.7% and 3.1% for the December quarter and six-month period respectively.

While financial markets are strong, economic fundamentals remain relatively soft. Since the start of 2019, Australian consumers have benefited from three interest rate cuts, tax cuts, strong commodity prices and a bottoming in the housing market. Nevertheless, wages growth has been absent, consumer confidence weak, and retail spending flat. Drought, bushfires and "eco-anxiety" have certainly not helped, and further revelations about banks behaving badly coupled with recent soft profit results have soured the mood of bank shareholders.

### Downturn ending, but recovery weak

Financial markets experienced an upbeat year end, signalling rising optimism; this was somewhat surprising, coming only a few weeks after the IMF described the global economy as "precarious". Indeed, 2019 looks likely to post the weakest global economic performance for a decade. This reflects rising US-China trade tensions, their dampening impact on exports, industrial production, and a global manufacturing recession; yet investors are appearing to see green shoots of recovery next year.

The IMF and other forecasters expect to see an improvement in 2020, but mixed data in recent weeks raise the question whether the outlook is much improved. It is possible that investors' enthusiasm may be overblown. So far, the evidence of a robust recovery in the global economy is unconvincing; while most data suggest the slide in the global economy is coming to an end, the pace of recovery in the new year is expected to be weak.

Financial markets are forward-looking, generally catching on to trends before they become obvious in the economic data. Markets have been pointing towards a broad recovery, and many are close to all-time highs. There are two broad explanations for this: firstly, there are few alternative investments available, with rates so low; and secondly, investors expect that prospects for corporate profitability have improved in recent months.

Government bond yields, usually a good indicator of economic momentum, have risen slightly across advanced economies. Global trade is showing signs of stabilisation. Much of the nervousness regarding the global economy in the last quarter of 2019 stemmed from the fear that global trade wars would intensify. Yet during the last couple of months, the news has been mostly positive.

A disruptive no-deal Brexit now looks less likely, and while tensions

between the US and China ebb and flow on a daily basis, the most recent news suggests a deal will be signed in coming weeks. We expect ultimately it will be in both sides' interests to agree to a deal. A recent uptick in Middle East tensions following the US assassination in early January of a leading Iranian general may however create further market volatility: we noted spikes in the oil and gold prices following this development.

More positive trends have become visible in global trade data, with volumes growing in recent months. In November, investment bank JP Morgan noted that its index of global purchasing managers' orders improved by the largest amount in four years — albeit from a low base.

### Australian Economy

Going into the new year, the Reserve Bank of Australia continued to provide an upbeat refrain: the Australian economy is benefiting from low levels of interest rates, tax cuts, spending on infrastructure, the upswing in housing prices, and a brighter outlook for resources. Given the significant reductions in interest rates over the past six months and long lags, the RBA made its intention clear to hold the cash rate steady as it assesses the growth momentum both here and elsewhere around the world.

The RBA is "committed to maintaining interest rates at low levels until it is confident that inflation is sustainably within the 2 to 3 per cent target range". It sees the central scenario for the Australian economy for economic growth to pick up and reach around 3% in 2021. This pick-up in growth should see a reduction in the unemployment rate and a lift in inflation. However, we point out that the RBA has consistently been too optimistic in its growth forecasts.

Nevertheless, the important statement for the markets remains the following: "Interest rates will remain low for an extended period – certainly, much lower, on average, than before the global financial crisis", as stated by Governor Lowe.

Australia's service and manufactured exports have continued to grow steadily, supported by a depreciation of the Australian dollar over the past year, reasonable growth in our trading partners and, in the case of service exports, an increase in student and tourist arrivals. However the support provided by a declining currency may be coming to an end – the AUD looks like it bottomed at around US\$0.67.

One downside risk to the Australian economy is housing construction activity. A larger-than-expected contraction in investment could delay the gradual improvement in GDP growth. In the year to the end of September, the economy managed to grow at just 1.7% - well below the long-run average of around 3.3%. Looking forward, the outlook is more balanced. Mining activity has some upside risk. That said, the overall outlook for the Australian economy is unexciting, and the devastating bushfires around the country coupled with a general lack of rain will probably have a depressing effect on consumer spending.

### Mixed picture overseas - trade war cools

Somewhat against expectations for an early resolution, the trade war between the US and China intensified during the course of 2019, although recent announcements suggest at least a partial "Phase One" resolution. Yet it remains possible that trade disputes could flare once again, and in such circumstances, many companies may be forced to make disruptive adjustments which threaten to spill over into the broader economy.

A serious and protracted trade-war could cause a global recession, but most forecasters and economic indicators still suggest this is improbable. Tariffs, like other disruptions (such as an oil shock) could become inflationary, a dangerous accompaniment to a slow global economy. To date, the most obvious effects of the trade war have been declining business confidence, a global manufacturing slump and lacklustre investment trends. Inflation expectations have been steadily falling, as have long-term interest rates.

International trade tends to be a good barometer of how the world economy is doing and where it is headed. This is why twists and turns in the US-China trade war, and other developments in world trade, receive so much attention.



## What do recent trade data portend?

Much will depend on US trade policy and the political cycle, and whether the Trump administration chooses to settle or further escalate its trade disputes, not just with China, but with other major US trading partners.

International trade volumes tend to grow in line with or slightly faster than global GDP growth. The World Trade Organization late last year slashed its forecast for global trade growth in 2019 from 2.6% to just 1.2%. For 2020, the forecast has been cut from 3.0% to 2.7%. The Baltic Dry Index, a closely-watched indicator based on bulk commodities shipping that serves as a reliable indicator of future trade activity, has fallen by nearly 50% since August (after doubling in the first eight months of the year), suggesting hopes for a rebound in global trade may be unduly optimistic.

The level of uncertainty about macroeconomic growth prospects, exacerbated by trade tensions, has driven down business investment around the world. This has had adverse effects on cross-border trade of machinery and equipment. While household consumption has remained strong in most major economies, due to high levels of employment, the stagnation of trade portends a weakening in this key driver of GDP growth.

Slow global growth means that economies need ongoing stimulus. The US Federal Reserve has already cut interest rates aggressively, the European Central Bank has re-started quantitative easing, and Chinese and Japanese policymakers have eased both monetary and fiscal policy. Yet developed world central banks are running up against limits on monetary policy: rates in many places are already negative or close to zero, central banks cannot buy bonds for ever, and the Fed has little room to cut rates further.

## The USA

In the US, the seasonally adjusted manufacturing Purchasing Managers' Index posted 52.6 in November, up from 51.3 in October, to signal the strongest improvement in the health of the manufacturing sector in 6 months. US manufacturers have been under pressure amid slower economic growth globally, while prolonged trade negotiations between the US and China have weighed on business confidence.

November & December data indicated a slightly faster rate of improvement in operating conditions across the US manufacturing sector. Overall growth was supported by expansions in production and new orders, with both domestic and foreign client demand strengthening. Manufacturers also increased their workforce numbers. Yet business confidence remained muted as global economic uncertainty continued to weigh on expectations.

The manufacturing sector's struggles contrast with the larger services sector, whose growth accelerated in October versus the prior month, and upbeat consumer spending signals, creating a mixed bag of US economic data. Overall the US economy grew at an annualised rate of 2.1% in the third quarter, compared with 2.0% in the previous quarter.

## China

Factory activity in China unexpectedly returned to growth in November for the first time in seven months, as domestic demand picked up on Beijing's accelerated stimulus measures. But gains were slight, and export demand remained sluggish. More US tariffs loom while Beijing and Washington are still haggling over a trade deal. With China's economic growth cooling to near 30-year lows and industrial profits shrinking, speculation has been mounting that Beijing needs to roll out stimulus more aggressively, even if it risks adding to high debt levels.

On New Year's Day, Beijing announced that the People's Bank of China would inject about US\$115 billion into the economy by freeing up banks to lend more money. This stimulus is relatively modest given the overall size of the Chinese economy, but the timing suggests that the Beijing leadership is on high alert for any signs of further slowdown.

Recent developments in China underscore rising uncertainties in the trade

conflict, which bodes ill for the outlook for external demand. New export orders fell for an 18th straight month in November, albeit at a slower pace. China's GDP growth in the year to end September was 6.0%, the slowest rate since 1992. China's gross domestic product growth is expected to slow further in 2020 – albeit off a much larger base.

## Europe

Eurozone economic growth has been barely positive for the last 6 months; it was 0.2% in the third quarter of 2019, the same as in the previous quarter. Among the Euro bloc's largest economies, Germany narrowly avoided entering recession in the third quarter, largely driven by public and private consumption, while GDP growth rates were unchanged in France, Italy and Spain. The GDP growth rate in the Euro area has been moribund for 25 years: it has averaged just 0.4% pa from 1995 to 2019.

Christine Lagarde, the new president of the European Central Bank (ECB), speaking before members of the European Parliament's Economic and Monetary Affairs Committee, tried to explain why. The problem, she explained, is that "the world economy outlook remains sluggish and uncertain. This lowers demand for euro area goods and services and also affects business sentiment and investment."

As a solution, Lagarde offered that the ECB could "respond effectively even when growth is being dampened by external factors... by ensuring favourable financing conditions for all sectors of the economy and providing visibility on those conditions into the future." Presumably, this means that she wants to help banks get credit flowing strongly. One wonders, however, if this is anything different from her predecessors.

## Conclusion & Outlook

### What will 2020 bring?

What are our expectations for next year? We will have more to say in due course, but for now, we highlight in abridged and point form our thoughts.

The developed world has entered a period of Japan-style low growth. Thus, we expect the following:

- Periods of low growth to remain followed by mild downturns
- Bond yields stay low, the yield on quality assets is bid lower, followed by yields falling for inferior quality assets
- Equities are bid up (PE expansion) as required returns decline, albeit to a smaller extent than CY2019, and the time horizon is extended to value high growth opportunities, and
- Volatility increases but quality stands out and will generate superior returns.

A recession in 2020 is not probable. In many countries, especially America, healthy labour markets and confident consumers are bulwarks against a recession occurring. Yet these defences are beginning to show some vulnerabilities. In a worst-case scenario, the trade war intensifies, and becomes inflationary even as growth slows. The world economy in such circumstances could be subject to an unfamiliar type of downturn, with central banks out of ammunition.

The recent modest uptick in data does not yet provide convincing evidence for a broad-based global recovery. While we expect global growth to edge up over the course of 2020, the pace of recovery will probably be weak, and monetary and fiscal policies will have to remain accommodative. There needs to be a lot more movement in the data before economists will join financial markets in believing the worst of the global economic slowdown is over.

With this noted, investor sentiment is far from exuberant. As John Templeton said, "Bull markets ... die on euphoria". Currently, although markets are somewhat fully priced on various earnings multiples, and many are near all-time highs, we remain far away from euphoria. Cash positions of global fund managers remain well above average, and in general, investor positioning is defensive. Credit spreads are also within



normal ranges. If anything, exuberance seems to have skipped equities and moved to less liquid, alternative investments like residential property, leveraged loans and private equity.

Indeed, equities do not look extravagantly expensive in a multi-asset world. While equity pricing remains elevated, this largely reflects record low global bond yields.

In the shorter term, a focus on rational asset allocation and on yield is essential. Compounding of returns will reward patience, but will also require active management across and inside asset classes to ensure that capital is neither lost nor devalued. As always, a watchful eye must be diligently maintained, but we perceive that the risk of a major market retraction is fairly low because interest rates are low and unlikely to rise. The offset is that returns will be lower than the historical norm.

Thank you for your ongoing support.

**Adrian Ezquerro**  
Head of Investments





## Fund Information

### Investment Objective

The objective of the Fund is to provide consistent capital growth and a growing level of income over the medium term (3 - 5 years) by investing in securities listed on the Australian Securities Exchange. The Fund may not achieve its investment objective. Returns are not guaranteed.

### Investment Methodology

Clime seeks to identify high quality securities issued by businesses which contain most if not all of the following characteristics:

- A competitive advantage, leadership within a specific niche and a sound track record
- Financial strength, high levels of profitability and margin
- Low financial leverage
- Relatively low capital requirements allowing a business to generate cash while growing
- Highly capable management team aligned with creating shareholder value
- Companies that can deliver genuine sustainable long-term growth
- Investments that can be purchased at appropriate prices

## Portfolio Managers



**Adrian Ezquerro**  
Head of Investments



**Ronni Chalmers**  
Investment Director



**Jonathan Wilson**  
Portfolio Manager - Small Caps



**Vincent Cook**  
Portfolio Manager - Mid Caps



**David Walker**  
Portfolio Manager - Large Caps

### Fund Information

<b>Name</b>	Clime Australian Value Fund	<b>Investor Eligibility</b>	Retail & Wholesale
<b>Structure</b>	Managed Investment Scheme	<b>Minimum Investment</b>	Retail: \$10,000 Wholesale: \$100,000
<b>Investment Universe</b>	ASX Listed Securities	<b>Liquidity</b>	Daily Unit Pricing Applications and Redemptions
<b>Benchmark</b>	12% pa return after Investment Management Fees and usual expenses but before any Performance Related Fee.	<b>Fees</b>	Retail: 1.03% management and 15.38% of performance Wholesale: 0.87% management and 15.38% performance
<b>Stock Holdings</b>	25-40	<b>Admin</b>	Mainstream Fund Services Pty Ltd
<b>Fund Size</b>	\$9.2m	<b>APIR Code</b>	Retail: CRE0001AU Wholesale: CRE0005AU

### Contact Information

#### Investor information

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