ACTIVE OUTLOOK

MARTIN CURRIE
A Legg Mason Company

MARTIN CURRIE AUSTRALIA VALUE EQUITY

JANUARY 2018 FOR WHOLESALE CLIENTS ONLY

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After the strong run for Australian equities and for the Martin Currie Australia Value Equity portfolio in 2017, Reece Birtles and Michael Slack look to the year ahead and explain how the Australia Value Equity strategy is well positioned to capture opportunities in 2018.

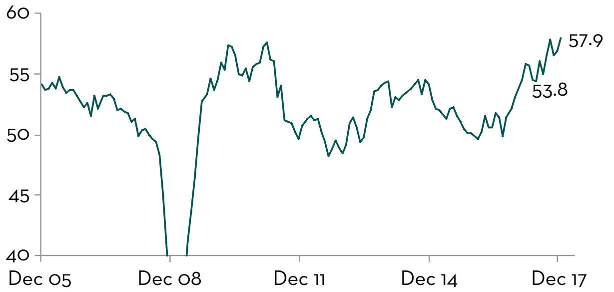
> **"Our multi-lensed investment approach of Valuation, Quality, Direction and Sustainable Dividend places us in a strong position to navigate the economic environment going forward."**

WHAT WERE THE KEY DRIVERS OF YOUR MARKETS LAST YEAR?

During 2017, a key market driver was the improvement in business and economic conditions, a precursor to improved GDP growth.

Improvement in the World Purchasing Managers' Index, or PMI[1], is a key economic indicator. In 2017 it went from low 50's at start of the year to high 50's by the end of the year[2].

World PMI indicates a recovering economy



Source: Martin Currie Australia, Factset; as at 31 December 2017.

We also saw commodity price improvement on the back of China stimulus, expanding from minerals in 2016 to also include oil during 2017. This rise in oil prices, in particular, is important to nominal growth in the US.

Such economic improvements confirmed that world growth is accelerating to more 'normal' conditions, rather than the tepid growth seen following the global financial crisis (GFC). As a result, central banks are also beginning to remove stimulus measures, and in the US's case, to raise its short-term rates.

These improved conditions have resulted in accelerating global earnings per share (EPS) forecast growth to over 15%[2] – the first time since the GFC. This has supported strong market performance in 2017, with the MSCI World ex AU Index returning 13.4%[2] for the year.

Given the hangover from the mining boom, Australian economic conditions have lagged the US improvement, but we did see a strong pickup in business conditions and employment growth over the year. The S&P/ASX 200 Accumulation index returned 11.8%[2] during 2017.

DID YOUR STRATEGY PERFORM AS YOU WOULD HAVE EXPECTED IN 2017?

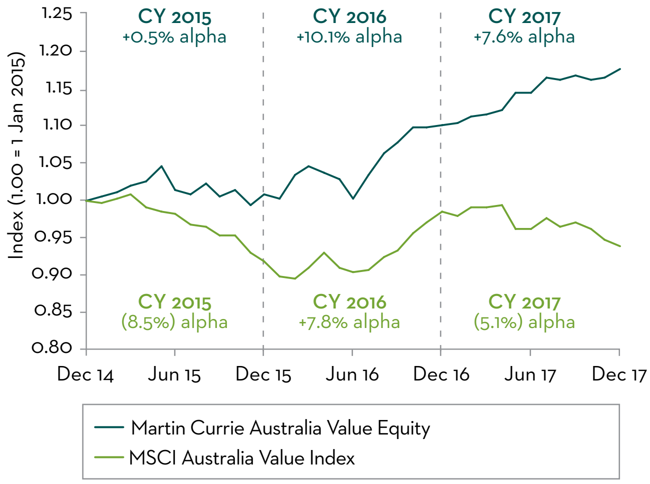
While market performance for the year was strong overall, factor style performance was quite mixed.

After a strong 2016, we witnessed a significant reduction in the market's valuation spread (i.e. the gap between the cheapest- and average-priced stocks), and the value style performed poorly in 2017. The improved growth environment also had an increasingly negative impact on low-volatility, high-quality and high yield styles over the year.

Over the last 12 months, the Value Equity portfolio delivered a strong return of 19.4%, outperforming the index return of 11.8% by 7.6%.[3]

The Value Equity strategy also performed well versus the MCSI Australia Value index, which had underperformed the broader market by 5.1%.[3]

Performance relative to S&P/ASX 200



Past performance is not a guide to future returns.

Source: Martin Currie Australia; as at 31 December 2017. Data shown for a representative Value Equity account in A$ gross of management fee.

Our outperformance over both the value style and the broader market reflects on how we manage the Value Equity portfolio. We believe that our proprietary investment approach focusing on a combination of four research lenses, (Valuation, Quality, Direction and Sustainable Dividends), enabled us to position the portfolio according to the 'reward' available for taking 'factor risk exposures', and the market's current valuation. Our market outlook at start of 2017 for strong growth and increasing bond yields went against consensus. We believed that the Chinese economy would not slow, and would in fact benefit from Government stimulus. We held the view of rising oil and base metal prices, and also expected Australian GDP growth to accelerate.

Based on this, and our bottom-up stock analysis, the Value Equity portfolio was positioned in more cyclical names such as resources, non-bank financials and consumer stocks. These stocks were well rewarded as our view has become more consensus going into 2018.

The following page describes the portfolio management techniques used to manage our out-performance in further detail:

Past performance is not a guide to future returns.

1PMI is derived from monthly surveys of private sector companies, provides a picture of business conditions. MCA combine regional PMIs based on GDP weights.

2Source: Factset. In Australian dollars.

3Source: Martin Currie Australia, as at 31 December 2017. Data for the representative Martin Currie Australia Value account in Australian dollars, gross of management fees. This data is presented without deducting investment advisory fees, broker commissions, or other expenses that reduce the return to investors. Relative calculation is arithmetic.

DEALING WITH REDUCED VALUE OPPORTUNITY

Our multi-lensed investment approach (Valuation, Quality, Direction, Sustainable Dividends) allows us to consider each stock from alternative points of view and understand the pros and cons for each name and factor. We can thus assess the risk versus reward on individual stocks under consideration in the portfolio.

The narrower valuation spreads for the market throughout 2017 have meant that we did not find potential reward for buying the 'cheap-but-risky' stocks in the market.

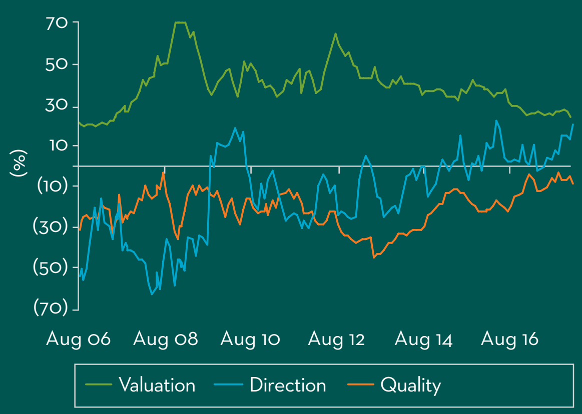
As such, with less reward on offer from stocks with the most attractive Valuation, we were not willing for the portfolio to take on as much 'risk' to buy these names.

For MCA, risk in this context means the negative characteristics, such as low Quality and poor Direction, that often (but not always) come with value-style names.

During the year, we instead focused on reducing the risk of the portfolio by choosing companies with better Quality and Direction characteristics.

Holistically, you can see in the chart below that as Valuation has narrowed for the portfolio, we have been able to improve the portfolio's Quality and Direction characteristics, ensuring strong expected return characteristics of the portfolio going forward.

Additional factor risk not taken unless rewarded



Source: Martin Currie; as at 31 December 2017. Data shown for a representative Value Equity account for illustrative purposes only.

DEALING WITH PRICE MOMENTUM

Another important aspect our multi-lensed investment approach is how to control for excess price momentum, especially when our alpha is strong like it has been in 2016 and 2017.

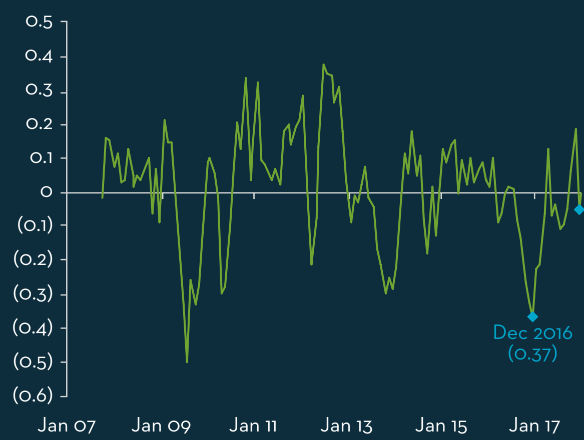
This is an issue because:

- Firstly, we need to ensure we don't hold stocks beyond their fair value, and for this we look at our in-house Valuations.
- Secondly, we don't want to sell our winners too early as Good Value with Good Momentum can be a winning combination.

To assess if our winners are being under-rewarded by the market and should not yet be sold, we can look at our exposure to Earnings Revisions relative to Price Momentum.

At the end of 2016 our portfolio faced the situation of stock prices running well ahead of earnings, as can be seen in the chart below:

Earnings revisions vs. price momentum



Source: Martin Currie; as at 31 December 2017. Data shown for a representative Value Equity account for illustrative purposes only.

As active managers, we can add some control for this by managing portfolio turnover. During the periods of strong performance, we increased our portfolio turnover to ensure we were recycling winners into new Value names at the right time.

HOW HAVE YOU POSITIONED THE PORTFOLIO TO TAKE ADVANTAGE OF THESE THEMES?

Our portfolios are currently overweight stocks in consumer, non-bank financials and energy sectors, holding higher-than-average quality exposures.

Below, we highlight some of the key holdings in the portfolio that we believe are being undervalued by the market and demonstrate our process and outlook:

Jim Power
Research Analyst

JB Hi-Fi[4] is a world-leading retailer with high sales productivity and low cost-of-doing-business ratios. The retailer is well-positioned against Amazon's arrival with its improved online and delivery options. It is producing strong above-market EPS growth, yet is trading at a 20%[5] discount to the market price/earnings (P/E) multiple.

Fonterra is a world-leading dairy products company with a strong position in the China Food services market. While sales are growing at 40%[5] p.a. in a diverse range of products, it is trading at a 55% discount[5] to the far-more speculative **A2 Milk**[4].

Michael Slack
Head of Research

Energy stocks have underperformed the market for 10 years, impacted by deflationary forces, lower bond yields, falling oil prices, and the perception that there is a glut of liquified natural gas (LNG). With oil prices now regaining ground towards incentive cost, as well as strong demand growth and a likely shortage of LNG beyond 2020, energy companies such as **Oilsearch** and **Woodside**[4] are well-positioned with new projects to deliver growth into this demand window.

Matthew Davidson
Senior Research Analyst

Financial services company **IOOF**[4] has demonstrated itself as a preferred home for financial planners and has significant opportunities from platform optimisation including the integration synergies of the ANZ Wealth business. We think there will continue to be growing demand for financial advice and IOOF continues to prove its worth as an efficient, cash-generative company exposed to the trend.

WHAT SUSTAINABILITY THEMES DO YOU SEE YOURSELF ENGAGING WITH COMPANIES ON MOST IN 2018?

As ever, we consider governance is key to a company's sustainability and we will continue to focus on that in our engagement.

In terms of wider sustainability themes, over the long term, we see cybersecurity as an important focus in our research and company engagement.

The PRI has assembled an advisory committee of investors to build a collaborative engagement project on cybersecurity that began in the first half of 2017. As part of this committee, we are leading engagement with JB Hi-Fi, Telstra, ASX, Commonwealth Bank and Medibank[4].

WHAT DO YOU THINK WILL BE THE KEY DRIVERS FOR THE MARKET AND YOUR STRATEGY IN 2018, AND WHAT ARE THE RISKS?

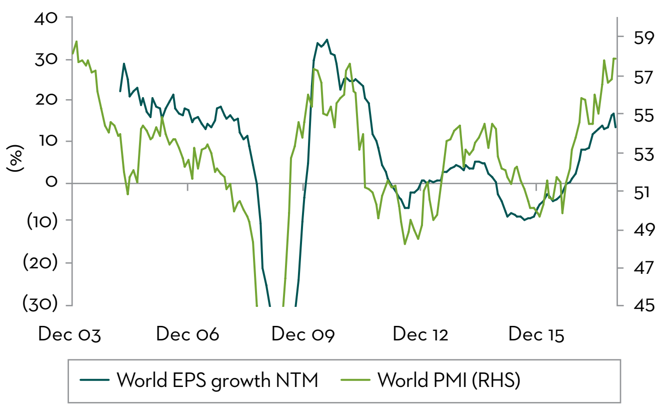
As discussed earlier, lead indicators of global economic growth such as PMI are pointing to an accelerating level of growth, the strongest in more than a decade.

These conditions could persist for a while given the current low base of post-GFC world growth and hence current conditions are more akin to an early cycle pick-up than late expansion.

We are now 18 months into the expansion. Capacity utilisation and employment are tightening which is increasing pricing power and ultimately inflation.

We believe that this economic environment indicates the potential for double digit EPS growth for global equities.

Economic growth indicating stronger EPS growth



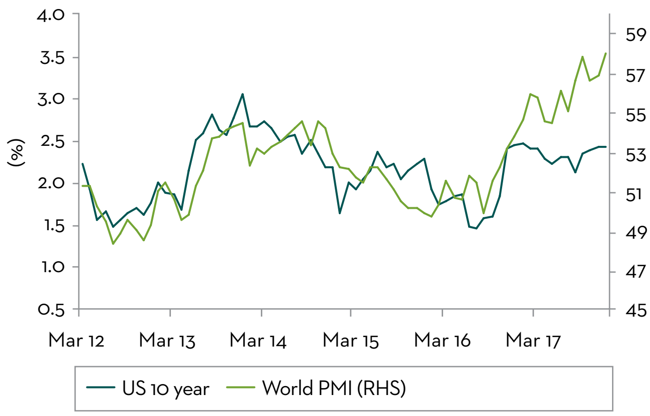
Source: Martin Currie Australia, Factset; as at 31 December 2017.

[4]The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

[5]Source: Factset, company reports. As at 31 December 2017.

As evidenced in the chart below, World PMI has shown very strong growth since March 2016, whereas the US bond rate has stagnated. We expect bond rates to eventually rise globally given their strong relationship with PMI, as well as a result of the Fed reducing its balance sheet and quantitative easing being scaled back elsewhere.

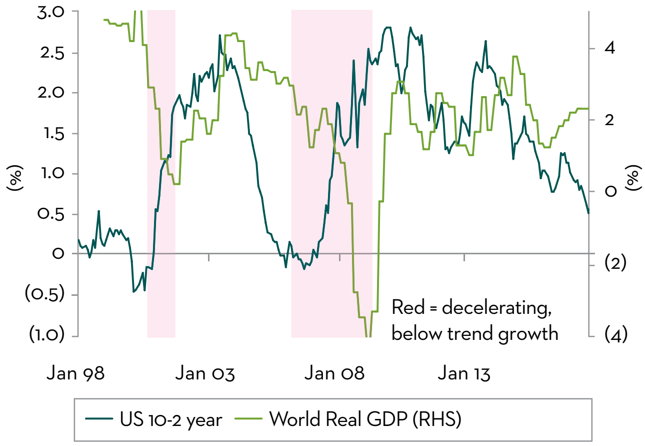
US 10 year bonds should rise to meet PMI



Source: Martin Currie Australia, Factset; as at 31 December 2017.

On a longer view, this stronger growth, increasing inflation and less accommodative central banks will result in higher interest rates which will ultimately then lead to a deceleration of the economic expansion.

A flat yield curve can signal a deceleration of economic growth



Source: Martin Currie Australia, Factset; as at 31 December 2017.

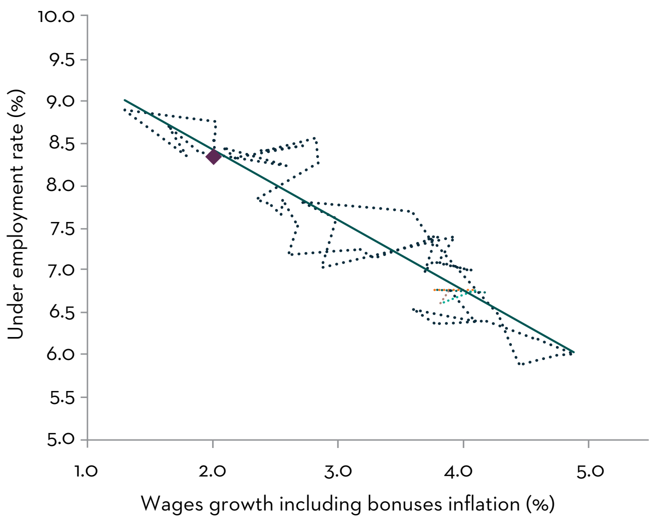
AUSTRALIAN OUTLOOK

Given the backdrop of steadily improving global growth, the outlook for the Australian economy is looking more positive for the medium term, as the Australian economic cycle is running behind that of the US recovery.

We also believe that given the current narrow spread between Australian and US bond yields, Australian bond yields will either need to rise in step with the stronger GDP growth and higher commodity prices, or the value of the Australian dollar will likely fall. Currently, growth is outpacing bond spreads.

The Phillips Curve[6] is an important indicator of the progress between economic recovery, wage inflation and future interest rates. We don't believe that this relationship has broken down (as much speculated on recently), it just needs an even-lower unemployment rate (~5%) to find the inflection point for inflation and wage increases to kick in.

Phillips Curve (modified): high underemployment needs to be reduced before wage inflation kicks in

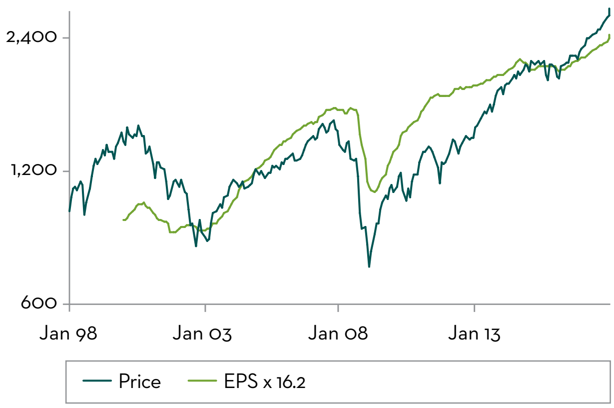


Source: Martin Currie Australia, Factset; as at 31 December 2017.

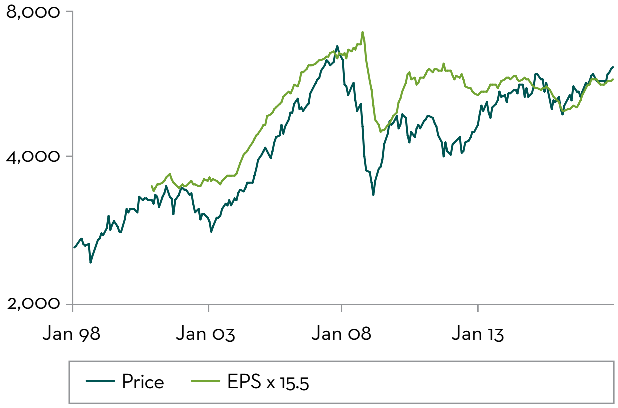
[6]The Phillips Curve shows the inverse relationship between rates of unemployment and corresponding rates of inflation.

Given the lagged start in the rebound relative to the US, Australian equities are thus at an earlier stage of EPS acceleration and carry less valuation risk than global or US equities.

USA (S&P 500) EPS expansion already underway



Australia (S&P/ASX 200) has further space for EPS growth



Source: Martin Currie Australia, Factset; as at 31 December 2017.

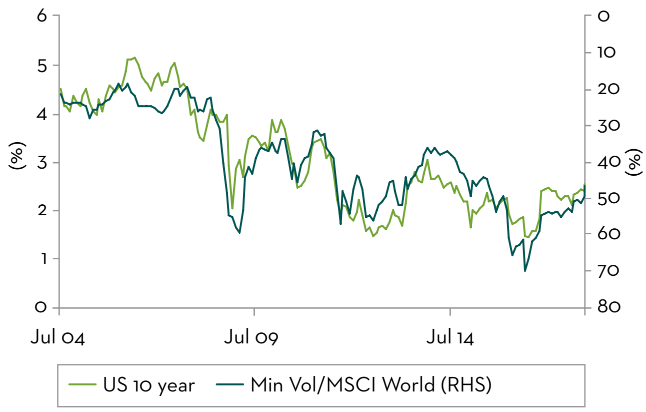
Whilst equities are no longer cheap on long run measures, valuation is not yet a barrier to equity market returns in the 'double digit EPS growth world' discussed above.

STYLE OUTLOOK

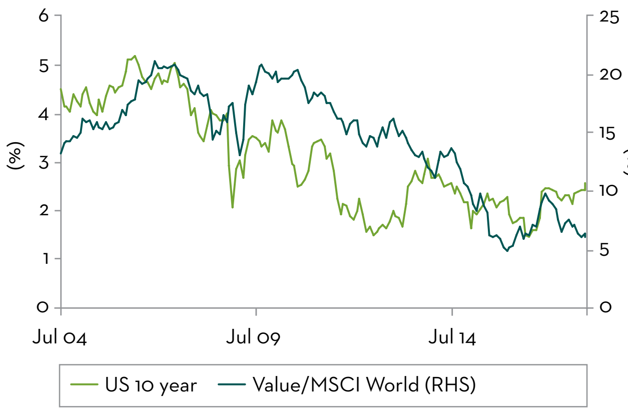
Cyclicals and value stocks that have been more economically sensitive in the post-GFC environment are likely to perform well in 2018, but as discussed earlier, we no longer believe high-risk value offers an attractive reward versus risk.

By contrast, low-volatility, high-quality and high-growth style stocks are likely to suffer in this environment, as growth is less scarce, and they are more impacted by increasing discount rates from higher bond yields. We think value will now start to perform well relative to high-growth and low-volatility (given their factor performance correlation shown below).

Low volatility underperformance to accelerate



Value has reached an inflection point



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Source: Martin Currie Australia, Factset; as at 31 December 2017.

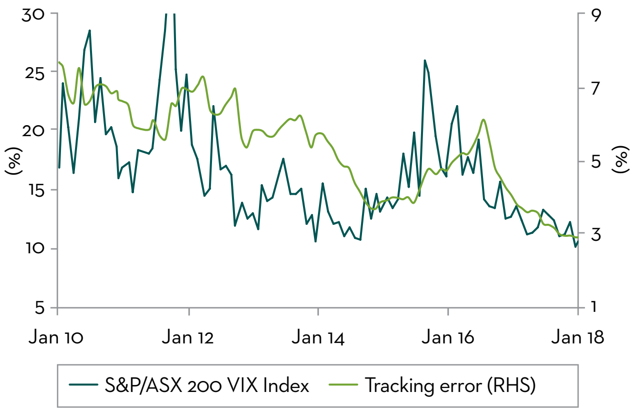
This is a good equation for our markets in the short term, but the canary in the coal mine is an excessive rise in bond yields or inverse yield curves (and/or a major geopolitical caveat).

PORTFOLIO OUTLOOK

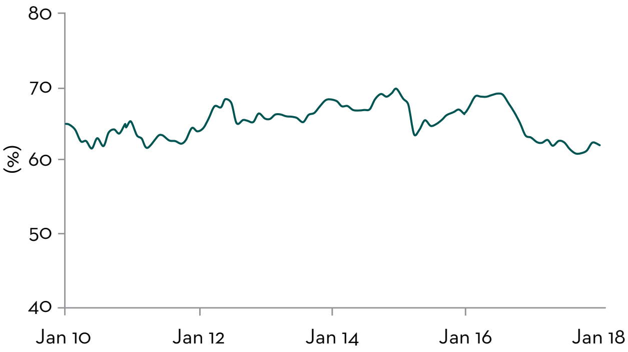
As we get further in the economic cycle with higher interest rates and an inverted yield curve, the investment environment will become more difficult and require rotation away from current winners.

Extreme low levels of volatility and the reversal of 10 years of falling bond yields could play havoc with backward looking risk models that focus on risk measures such as tracking error. In this environment, we believe it is important to focus on longer-term measures such as active share.

Lower market volatility lowers portfolio tracking error



Despite little change in active share



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ACTIVE OUTLOOK is just one part of our range of investment materials. To access further perspectives on our strategies and key investment themes, visit: www.martincurrie.com

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