

Investors Mutual Private Portfolio Fund: A Defensive Absolute Return Share Fund

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17 November 2020

Investment Approach and Strategy

The Investors Mutual Private Portfolio Fund uses a combination of investment strategies underpinned by IML's core philosophy and fundamental research, with the goal of achieving a consistent absolute return profile with significantly lower volatility than that of the Australian sharemarket. The stated target is to provide a return of three percent above the Reserve Bank of Australia cash rate on a rolling four-year basis after fees and expenses and before taxes.

The Private Portfolio Fund's focus is on providing investors with a consistent return profile through the cycle, but importantly also on generating absolute returns in various market conditions, providing a return from the equities asset class which is significantly less dependent on market beta. The aim is to provide investors with relative capital stability in volatile and fully valued markets and a conservative approach to income generation in a continuing record low interest rate environment. The Fund shares IML's core quality and value investment philosophy. Launched in 2018, the Private Portfolio Fund is managed jointly by and draws on the complementary skills and expertise of Portfolio Manager Tuan Luu and Investment Director Anton Tagliaferro.

Portfolio Construction

The Private Portfolio Fund is designed to complement an investor's existing exposure to Australian equities, by providing a strategy which delivers a consistent, conservative return profile and income generation from equities. The Fund is also intended to act as a defensive strategy in fully valued, volatile bear markets, providing additional portfolio defensiveness for investors.

The investment universe is Australian and New Zealand listed companies. Portfolio construction parameters are broad, giving the portfolio managers increased potential to deliver consistent returns with lower volatility than the sharemarket over time. The portfolio managers undertake opportunistic short-selling of stocks they consider to be challenged or over-priced to contribute to achievement of the target consistent return profile. As candidates for short-selling, the portfolio managers look for companies which they consider to be over-valued as a result of short-term momentum and investor sentiment; companies which have structural challenges stemming from changing underlying industry or company dynamics; and companies where the business is affected by systemic, fundamental, technological, and environmental shifts in underlying supply and demand for commodities and services.

Prudent derivatives strategies are also employed for risk management to protect the portfolio against market risk, and as an additional source of return generation. There is no financial gearing.

Tuan Luu and Anton Tagliaferro adopt a dynamic approach to investing, leveraging IML's stock research and selection, events trading, and income generation capabilities. The portfolio managers use three strategies – **relative value**, **events**, and **income**. In bullish market conditions, high-conviction stock calls, merger and acquisition, and demerger trades are expected to be key drivers of alpha generation. In neutral market conditions, the portfolio managers utilise buy-write strategies to supplement income generated from stock positions. In bearish market conditions, the portfolio managers deploy shorting capabilities to protect capital, while taking advantage of corporate restructuring and recapitalisation trades to provide sources of return.

The **relative value strategy** accounts for about 30% of the portfolio at the time of writing, drawing on fundamental research ideas from IML's large-cap and small-cap portfolio managers and investment analysts. This strategy invests in the same core stocks as the major IML funds, with leading positions including **Ancor**, **Brambles**, **Coles** and **Orica**. The portfolio managers also identify and implement pairs trades (such as **National Australia Bank** versus **Commonwealth Bank of Australia** on the basis of relative valuation, or **Charter Hall Retail** versus **Scentre Group** on the basis of different tenant profiles), as well as undertaking opportunistic short positions.

The **events strategy** accounts for about 40% of the portfolio, targeting merger and acquisition transactions (such as when packaging manufacturer **Orora** sold its Australasian fibre business to Nippon Paper Industries in 2019), and select share buybacks and discounted capital issues.

The **income strategy** involves identifying stocks which can provide a sustainable income yield, drawing on the fundamental research and analysis undertaken for the Investors Mutual Equity Income Fund, including the prudent use of option strategies to supplement dividend income.

Risk Management

In common with IML's other funds and house philosophy, risk management is a significant element in the management of the Private Portfolio Fund. Net market exposure is dynamically managed and maintained from zero to 70%, with an average of 35% beta over the long term to maintain relative capital stability. Individual stock position sizes are typically around two percent, enabling the portfolio managers to control downside exposure in the case of an adverse or surprise event. The portfolio maintains effective diversification of 30 – 100 positions across sectors and market-cap bands. The strategy does not use financial leverage, in line with the goal of delivering a consistent, conservative return profile and income generation.

Recent Investment Activity and Performance

Investment markets experienced extremely high levels of volatility in February and March 2020, as markets began to have serious concerns about the likely effects of the COVID-19 pandemic on global growth. The Fund shared in the sharp initial selloff as panicky investors sold off "the good, the bad, and the ugly" indiscriminately.

The portfolio managers responded quickly, focusing on risk management. They increased the shorting limit capacity to 100% to enable them to reduce market exposure more effectively if required and reduced the sizes of stock positions that they considered most likely to underperform during an extended period of lockdown in economic activity.

Tuan Luu and Anton Tagliaferro then drew on the wider IML investment team's systematic, in-depth company assessments to actively revisit their understanding of where the risks were in the portfolio, and to identify companies they considered likely to be relative winners and losers in the changed environment. The goal was to strengthen portfolio resilience in a more challenging economic and business environment, by identifying companies which IML's investment team believed would be well-positioned to ride out the event. Conversely, the portfolio managers also closely scrutinised companies that they assessed as being challenged and overpriced, and opportunistically increased short-selling of these.

Many companies have undertaken capital raisings to strengthen their balance sheets, facilitated by regulatory relief. The portfolio managers have participated selectively in a number of these capital raisings. The portfolio managers have also been able to use elevated volatility levels to earn good option income over core holdings including **Metcash, Sonic Healthcare, Tabcorp, and Woolworths**.

This investment activity had at the time of writing enabled the portfolio managers to recover approximately 85% of the Private Portfolio Fund's initial February/March drawdown. The Fund returned +2.0% per annum over the 28 months since inception, and has been much less volatile than the sharemarket (as measured by the S&P/ASX300 Accumulation Index).

Current Positioning

In a likely environment of prolonged uncertain economic growth, the Private Portfolio Fund is positioned to focus on IML's core quality and value industrial companies while looking to short-sell overvalued or challenged companies. The Fund is targeting companies with sound balance sheets and sustainable income streams. The prudent writing of ASX listed options based on researched target prices remains an important strategy for incremental income generation in an environment where many companies are reducing or deferring dividend payments.

At the time of writing, 64% of the portfolio was in stock positions, -15% in buy-write options, and -20% shorting index futures to manage market risk, leaving a net market exposure of around 30%. The Fund is overweight quality industrials companies, underweight real estate investment trusts and underweight the Resources sector. The portfolio also remains comparatively liquid, with 88% of stock positions in the top 100 stocks. The portfolio managers are investing the Fund's cash into the market dynamically, taking advantage of short-term opportunities such as select capital raisings, while preserving a healthy cash balance as a vital tool for managing the overall net market exposure and as a defensive buffer for downside risk management.

Summary

The Investors Mutual Private Portfolio Fund offers risk-conscious investors a conservatively managed vehicle for investing in Australian shares, focused on generating consistent absolute returns and above cash rate income with significantly lower volatility. The strategy enables the portfolio managers to deploy multiple drivers of returns generation through the cycle, and provides the flexibility to adapt nimbly to changing market conditions. The Private Portfolio Fund should therefore continue to achieve its goal of generating a consistent absolute return profile with relative capital stability.

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