D R U M M O N D

C A P I T A L   P A R T N E R S

DRUMMOND DYNAMIC PORTFOLIO

Quarterly Investment Review – December 2018

MARKET OVERVIEW

In an extraordinary reminder of the dynamic nature of markets after such a calm 2017, the 2018 calendar year ended with capitulation. December was the worst month for the S&P500 since 1931. In fact, some 90% of asset classes finished the year in the red, the worst year since 1901 (Deutsche Bank).

During the quarter, the US mid-term elections delivered a split congress with a democratic house majority win. This combined with fading stimulus from corporate tax cuts, Federal Reserve tightening and the US-China trade dispute pushed the S&P 500 13.5% lower. Australian markets struggled, falling 9% on continued credit tightening and Europe was weak as Theresa May faced a parliamentary showdown over her Brexit deal, whilst Italy's budget woes continued. Asia bore the brunt of the negativity from the US-China trade war. Japanese and Chinese equities lost 17.5% (Nikkei) and 12% (CSI 300) respectively.

Government bonds were buoyed by investors flight to safety and a resetting of growth and inflation expectations. Australian government bonds finished the year as one of the world's best performing assets, returning +5.1%. Aiding the bond rally was a 35% fall in the oil price due to increased supply and global growth concerns.

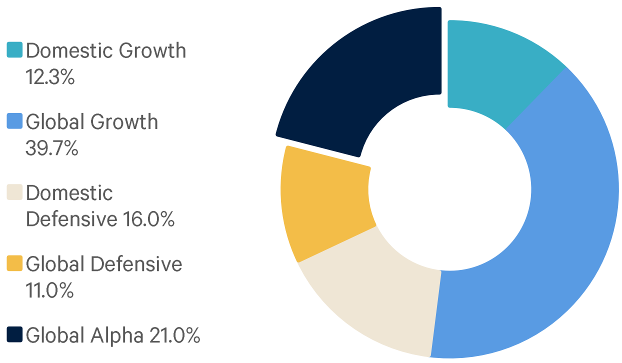
PORTFOLIO PERFORMANCE AND REVIEW

The Drummond Dynamic Portfolio (DDP), our core multi-asset solution, returned -3.8%* over the December quarter. The Morningstar Multi-Asset Balanced and Growth Indexes returned -4.2% and -6.0% respectively. Cash returned +0.5% and Australian residential property returned -2.9%

Since inception, the DDP has returned -1.0%* vs its cash benchmark returning +1.5%.

The following chart shows the asset allocation of the DDP split into geography and type (i.e. growth vs defensive) and the accompanying table details the changes made at the asset class level over the quarter.

DRUMMOND DYNAMIC PORTFOLIO DIVERSIFICATION



DRUMMOND DYNAMIC PORTFOLIO CHANGES (Q4 18)

Asset Class	Start	End	Change
Cash	21.8%	11.0%	-10.8%
Government Bonds	12.5%	13.0%	+0.5%
Corporate Debt	10.0%	3.0%	-7.0%
Australian Equities	13.0%	12.0%	-1.0%
International Equities	15.0%	40.0%	+25.0%
Private Equity	5.0%	0.0%	-5.0%
Real Estate	-	-	-
Infrastructure	-	-	-
Commodities	-	-	-
Global Alpha	22.7%	21.0%	-1.7%

After commencing the quarter in a very defensive position (see Due Diligence review for more detail), the changes made to clients' portfolios during the quarter consisted of using the volatility to gradually increase exposure to growth assets, namely international equities, that presented value after significant falls during the quarter (see Outlook).

As the US Federal Reserve continued to raise interest rates, the risk premium demanded by corporate debt investors continued to increase which resulted in widespread selling of the asset class. We discussed our concerns around liquidity in debt markets earlier in the year and decided it was time to reduce exposure to these risks despite the reasonably healthy fundamental backdrop.

Our sovereign bond managers performed well during the quarter as bond yields fell (prices increased). A combination of a more moderate growth and inflation outlook as well as a flight to safety increased the appeal of government bonds.

Australian credit availability continues to tighten which is impacting property prices (CoreLogic reported a national fall in Australian dwelling values of -4.8% for 2018) despite a broadly healthy economy. As the largest asset class in Australia, a crash in Australian property prices is a major concern for domestic consumption and overall growth. This was a major driver for our reduction in Australian equities exposure by 40% in the 3rd quarter.

The Drummond Australian Equity Portfolio lost -11.1%* for the quarter as the portfolio was impacted by several stock specific issues, a weak market overall, and not owning enough of the interest rate sensitive sectors (REITS + Infrastructure) that outperformed. We were reasonably active at the stock level, adding defensive companies and reducing positions in cyclicals. These changes are detailed below.

QUARTERLY AUSTRALIAN EQUITY PORTFOLIO CHANGES

MAJOR ADDITIONS / REMOVALS	
NEWCREST	+
APA	+
WESFARMERS	+
RELIANCE WORLDWIDE	+
NAB	+
SEEK	–
TREASURY WINE ESTATES	–
INCREASES / DECREASES	
MACQUARIE	↑
BORAL	↓
NUFARM	↓
LENDLEASE	↓
OIL SEARCH	↓
WOODSIDE	↓
LINK	↓

Stocks in Focus

SEEK Limited (SEK) – Removed

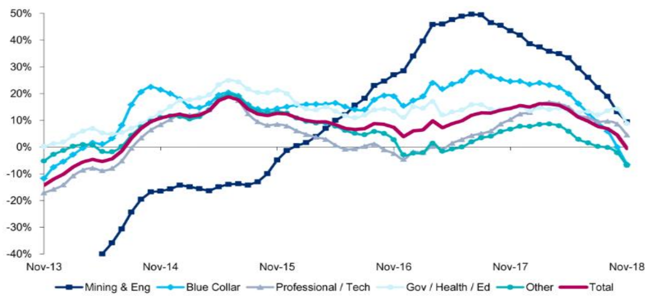
Seek Limited is the country's preeminent job advertising website and an early pioneer in successfully utilising the efficiencies of the internet to disrupt the use of the news-paper as an advertising medium.

We invested in Seek at a time of global synchronised growth and a relatively positive macro-economic backdrop. Growth in job ads within Australia has been positive since 2013, helping to drive their continued revenue growth over this period. Given the cyclical nature of job advertisements, it's not surprising to see the strong correlation to supportive economic environments.

To supplement this, management's strategy has been to expand in developing countries with a large population and a growing online presence. Significant capital has been invested in China, Brazil and Mexico with the focus being China's number two job platform, Zhaopin. Combined, this growth strategy has seen management's expected market opportunity grow from ~$500m at inception of the business, to over ~$60bn today. It has also driven the valuation of the company higher based on these future expectations.

As the macro-economic backdrop became increasingly volatile both domestically (slowing housing and consumer confidence) and internationally (trade wars, strong US dollar troubling developing nations), we started to question investors reliance on forecasts of future revenue growth and the translation of capital expenditure to earnings growth.

JOBS GROWTH NOW TURNING NEGATIVE



Source: Citigroup

After providing a disappointing FY19 outlook in October, highlighting further cost increases, we sold the position. Total job ads growth has now turned negative for the first time since 2014 and since our exit the stock has fallen a further 15%.

Newcrest Mining (NCM) – Added

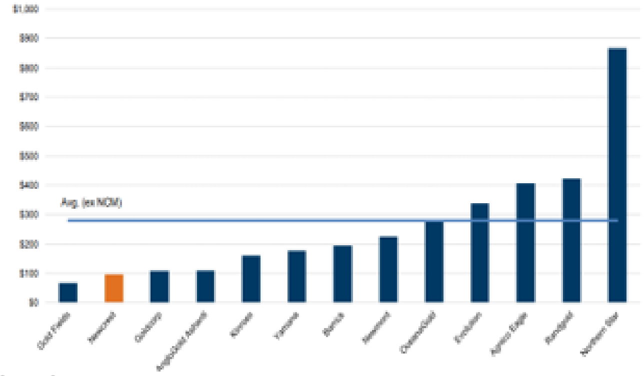
After selling Seek Limited due to elevated earnings risk we rotated into Newcrest Mining in October.

Newcrest is one of the world's largest gold miners operating 4 major assets producing approximately 2.3 million ounces per annum. Newcrest has a long mine life of over 25 years from its 2 major assets, Lihir and Cadia Valley. Cadia Valley production is recovering from a seismic event earlier last year but at full production has one of the lowest mining costs globally.

Newcrest has a group average production cost of ~USD 790 per ounce which is 38% lower than the current gold price of ~USD 1280 per ounce. This healthy margin continues to deliver the company significant free cash flow which has been used to strengthen the balance sheet and will now provide capital for future growth as well as growing dividends for shareholders.

There has been an increase in corporate activity in the global gold sector including Newmont's recent USD 10bn offer to buy Goldcorp to create the world's largest gold miner. Newcrest trades on an enterprise value to resource valuation discount similar to Goldcorp given its long mine life.

ENTERPRISE VALUE PER OUNCE OF GOLD RESERVE



Source: Company reports

During the first half of 2018 a strong USD contributed to the gold price falling ~14% to below USD 1200 an ounce, however with growing geo-political instability and a now moderating USD the gold price has begun to rebound. This combined with the company stabilising production at Cadia Valley and relative valuation appeal provided an opportunity to purchase the stock within our Australian equity portfolio.

Since we purchased shares in October, the stock has performed very well, rising 15% against a severely negative equity market.

MANAGER RESEARCH & DUE DILIGENCE

True diversification is the holy grail of investing, and investments when combined in a portfolio that can both improve returns whilst at the same time reduce risk are what we continually apply ourselves to find. The team continue to undertake significant manager due diligence as we seek out the best combination of asset mix and manager capability. Our December quarter research activity is summarised as follows:

QUARTERLY RESEARCH MEETINGS SUMMARY

FUND MANAGER MEETINGS	49
No. FUNDS ADDED	5
UNLISTED INVESTMENTS REVIEWED	6
No. UNLISTED INVESTMENTS APPROVED	1

This quarter we provide readers with greater insight into the active investment philosophy behind Drummond Capital Partners and how this has helped our portfolio to better navigate the exceptional volatility over the last quarter of 2018.

Yesterday's solution

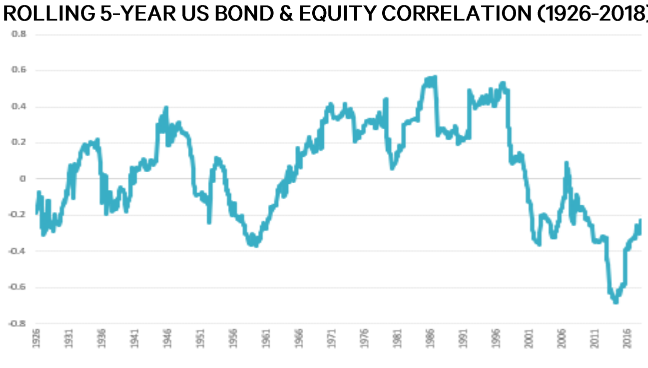
We started Drummond Capital Partners with a view to providing private clients with a better wealth management and investment solution. The annual returns of investment markets are clearly positive over a long period of time, and when markets go through bad periods often the advice is to effectively stand pat. This advice may be appropriate for a young professional with 30 years of earnings and accumulation ahead of them, but for investors who are approaching retirement or have just sold a business and invested their life's work, this is the last thing they need.

It is difficult for advisors to actively manage for this risk under the operating model adopted by most wealth management businesses today. Advisors providing quality technical advice to their clients often lack the time, resources or experience to implement a dynamic tactical asset allocation strategy. Even if an advisory firm has the internal expertise to manage a dynamic strategy, it requires a lot of client contact and administration to implement effectively across a diverse client base. The cumbersome nature of the operating model and the risks involved in making an error means advisory firms are averse to making changes. This is the reason why advisory firms are inclined to rely on long term return assumptions and stick to a mainly static asset allocation strategy.

Do you really want to set and forget?

While relying on the long-term average return of asset classes to decipher optimal portfolios is fine, it doesn't really account for the variation that can occur in the medium term nor the changing relationships between assets over time. Diversified asset allocation typically refers to having a combination of growth assets (equities) and defensive assets (bonds). Bonds did exceptionally well during the financial crisis in 2008 while equities did poorly. So, by owning bonds your overall portfolio performance was better than just owning equities. Yet even this relationship changes dramatically over time (see below) and didn't help investors in 2018 either as both assets fell.

ROLLING 5-YEAR US BOND & EQUITY CORRELATION (1926-2018)



Source: Drummond Capital Partners, R. Shiller

Clearly there are times in capital markets when you want exposure to risk premia and times when you don't. For this reason, active capital management is a core tenet for Drummond Capital Partners. We base our strategic asset allocation on 40 years of data given some 90% of returns are derived from long term asset allocation decisions rather than individual security or manager selection. Yet we know, and expect, that the future will be very different from the past.

Importantly, we recognise that each client's investment experience can differ wildly depending on when they began their investment journey. A 20% drawdown today can equate to a large dollar value for investors that have already accumulated a large pool of assets that may not be so concerning to those at the start of that journey. Our primary obligation (and our obsession) is to manage this risk for our clients. No one knows the sequence they will get into the future. It is not acceptable to just assume that future returns will resemble the long-term average return without active management.

To help put into perspective the necessity for active asset allocation, consider the forward 10-year total return from the ASX All Ordinaries Accumulation Index.

ASX FORWARD 10-YEAR RETURN vs. AVERAGE RETURN

Source : Drummond Capital Partners, Reuters

As you can see, the average annual return from 1979 to 2018 has been 11% p.a. However, someone beginning their investment journey in 2007 on the premise of the long term 11% p.a. return but then only achieving 3% pa over the next 10 years, may indeed wish they had opted for a different asset mix given the coming volatility in equities. The severely negative returns through the financial crisis in 2008 get completely swallowed by average returns over long periods. While this supports the argument to stick with it in fear of making the wrong decision at the wrong time, it doesn't make the person in question feel any better about their actual experience.

Of course, we cannot predict the future of markets any better than the next person and we don't try to. We do however know that recommending to our clients a static asset mix based on long term average returns simply doesn't reflect what their actual experience will be like. Instead of being put in a static box of defensive, balanced or growth for example, most clients we speak to want to take risk when it's going up, and take chips off the table when it's not. It's common sense.

Fundamentally we believe in winning by not losing

Realistically, severe negative periods are typically felt in equity markets every decade. So not being able to significantly reduce risk when fundamental market conditions change just doesn't make sense. The problem is that there is no single set of rules that works, no single event or indicator that works across time in all markets. And of course, markets often go down faster than the time afforded to investors on the way up. That's why investors must be nimble and have conviction.

Using a set of fact-based inputs along with significant experience as active portfolio managers to drive the tactical asset allocation framework over the medium term (i.e. moving the portfolio between a growth and balanced or conservative position) a dramatically better outcome can be achieved. By adopting this approach, we do miss some of the peaks but our clients avoid the worst of the significant market drawdowns. Over time this preservation of capital and active participation in the good times creates a significantly better investment journey.

Ultimately, we believe a considered, experienced and rational approach is required with a capital preservation mindset always at the fore.

What you say and what you do

There was no one reason for the sudden risk off environment that began in October. Perhaps the hawkish fed and rising rates were the trigger but underlying that was a culmination of other factors (emerging markets weakness, trade wars, credit concerns, peaking global growth, rising rates, quantitative tightening and full valuations) that finally saw the buyers stand back. It's not a trivial list.

We wrote about the risks in our Q2 and Q3 quarterly and of course lots of commentary has surfaced in reaction to the drawdown, exploring the reasons for the weakness and what to do - or not do - now.

We acted to significantly reduce risk in the third quarter, taking our clients' portfolios exposure to growth assets from our neutral position of 50% to a defensive level just below 30%. The typical diversified portfolio (60% growth / 40% defensive) has now experienced their worst drawdown since the financial crisis during Q4 2018.

The below chart shows the Australian equity market and the actual 2 periods where we took steps to reduce our Australian equity exposure by 40% (red circles).

40% REDUCTION IN AUSTRALIAN EQUITIES IN Q3

This action was mirrored in our international equity exposure and other parts of the portfolio. Neither of these were knee jerk reactions to weak markets but rather were a considered approach to reducing portfolio risk in an ongoing assessment of the underlying market conditions.

Being in a defensive position during this period afforded us the time to assess the value emerging in the equity markets driven by the ongoing risks already touched on rather than worry about large falls in the value of our portfolios. We discuss the portfolio activity in the outlook below.

OUTLOOK

Only 3 months ago, the world was concerned about growth being too good and monetary policy so loose inflation was set to be the evil genie in the bottle for world equity markets. The Federal Reserve's desire to keep raising interest rates was destined to see a recession looming in the next 2 years.

In one fowl swoop, oil prices have crashed, equity markets have had their worst months since the GFC, safe haven bonds have rallied, global politics is in disarray, credit markets panicked, and volatility returned. There is no expectation of rate hikes in 2019 anymore and the recession that was certainly 2 years away was now so imminent that you must hold cash under the mattress it seems.

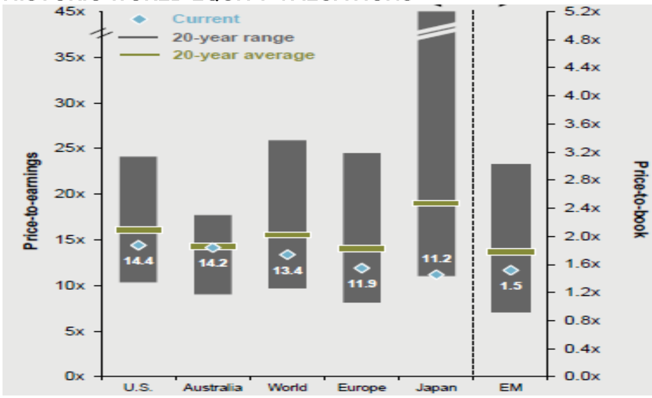
That's the funny thing about investing. Markets can be very dynamic, and prices and news flow reinforce the behavioural bias common among investors. As famed global fund manager Seth Klarman quotes – "investing is the intersection between economics and psychology".

The economic cycle is certainly long in the tooth, but the much talked about near inversion of the yield curve – a leading indicator of recessionary conditions – is exactly that. A leading indicator, and a good one at that. Yet CLSA note that on average the last four times the yield curve has inverted, it took 19 months for the market to peak and on average equity markets rose 25% in that timeframe.

We think that credit markets would have to completely fall apart for a recession to loom in the next year, which doesn't seem the most likely scenario for now. On the recent Citigroup earnings call, CEO Mike Corbat noted that "the biggest risk in the global economy is one of talking ourselves into the next recession as opposed to the underlying fundamentals taking us there".

The investment opportunity posed by equities became attractive again late in the quarter, with most global equity markets trading below their 20-year averages while many of the markets worries prior to the fall were in some way being addressed.

HISTORIC WORLD EQUITY VALUATIONS



Source: JPMorgan

Growth has slowed but still presents expansionary economic conditions; steps have been taken towards a more positive trade war outcome; the Federal Reserve has become less aggressive in its tone towards rising rates which has been helped by falling oil prices; expectations have become more realistic for 2019 and bond yields have fallen making equities relatively more attractive.

While these positive catalysts began to emerge, over Christmas we noted a common measure of investor sentiment was showing that investors were as bearish as they have ever been. That was surprising considering the current state of affairs compared to the global financial crisis, the bursting of the technology bubble or the Asian crisis. After adding to our growth exposure in November, we used this opportunity to add over 10% more to our growth exposure, taking the portfolio back towards a more neutral stance.

We remain cognisant of the many risks that exist in the global economy and the potential for corporate earnings disappointment given recent economic slowing and bellwether disappointments from the likes of Apple and FedEx. Consequently, our clients' portfolios remain in a relatively balanced position with a defensive tilt. The volatility is here to stay.

We have refrained from increasing exposure to large capitalisation Australian equities given the structural headwinds facing many of Australia's largest corporates on top of the freeze in Australian property and the negative consequences that could have for the economy. For now, Australia is cheap for a reason and we view other parts of Asia offer greater value.

Our clients have been successful building their wealth by making a lot of good decisions over a long period of time. We take this same active approach with our clients' portfolios. Vigilance is rewarded over time.

Best regards,

The Drummond Capital Partners team

* As at 31st December 2018. Inception date is 31/3/2018. Source: BT Panorama. The returns shown are net of fund manager fees but gross of Advisory fees. They are calculated from the DDP model portfolio within BT Panorama and as such may vary over time and vary by individual client