Monash
ABSOLUTE INVESTMENT COMPANY

Monash Absolute Investment Company Limited

Monash Absolute Investment Company Limited (ASX: MA1) **2 March 2020**
February 2020 End of Month Update

In the interests of keeping the market fully informed of performance on a timely basis, we release a preliminary estimate of the Pre-Tax Net Tangible Asset Backing per share. It is only a guide, the official NTA will be released later in the month. All return calculations include dividends paid.

We estimate that at 29 February the NTA Pre-Tax was $1.0487.

Company Strategy

The Company is benchmark unaware, style and stock size agnostic, both long and short, and only invests in compelling opportunities. In keeping with the Company's absolute return objectives, if the investment manager cannot find stocks that meet the very high return hurdle requirements, the Company will preserve that capital in cash at bank.

Monthly Commentary

For the month of February the Pre-Tax NTA was down -11.00% (after fees) compared to the S&P/ASX200 down -7.69%, and the Small Ords, which was down by -8.68%.

Pre-Tax NTA is still in positive territory for the financial year. For the eight months since 30 June, the Pre-Tax NTA is up 0.79% (after fees). This compares to the S&P/ASX200 down -0.12%, and the Small Ords which was down -1.92%.

February 2020 will be remembered as the month that Coronavirus Disease 2019 (COVID-19) went global.

As the outbreak progressed over the month, the implications began to be anticipated by the markets leading to steep falls in the last week.

For example, the USA's S&P500 posted its worst weekly performance since the GFC and was down nearly -14% in seven straight declines.

February was also a results season month. In this up-date we outline how the portfolio went, COVID-19, what action we took, and how we are positioned.

Company at a Glance 29 February 2020

ASX Code	MA1, MA1O
Portfolio Size	$46.6m
Share Price	$0.91
Shares on Issue	44.3m

Estimated NTA (unaudited) 29 February 2020

Estimated NTA Pre Tax	$1.0487

Return Estimate to 29 February 2020

	NTA Pre Tax
1 Month	-11.00%
3 Months	-7.61%
CYTD	-7.44%
FYTD	0.79%
1 Year	12.08%
2 Years p.a.	4.05%
3 Years p.a.	7.01%
Since Inception p.a. (April 2016)	2.96%

Portfolio Structure 29 February 2020

Outlook[i] Stocks (Long)	17 Positions	61%
Outlook Stocks (Short)	1 Position	-2%
Event, Pair and Group (Long)	3 Positions	9%
Event, Pair and Group (Short)	1 Position	-11%
Cash		42%
TOTAL		**100%**
Gross Exposure		83%
Net Exposure		58%

For more information about the Company and the strategy, please refer to the Monash Investors website at www.monashinvestors.com. You can also follow us on Livewire here or subscribe to our updates here.

Before February

The portfolio began February with a net exposure of about 80%. That is to say, it had a cash weight of about 20%. It was an increase over the prior month from around 8%. To get there we had sold a few stocks that were near our price targets in January (Infomedia, Nearmap and Temple & Webster) and we had generally been taking profits in stocks that had performed well, in order to control their weight in the portfolio (Afterpay, Electro Optic Systems and EML Payments).

February Reporting Season

We keep track of how each of our stocks report relative to consensus forecasts. Typically out of our top 10 stocks we will have 1 or 2 that disappoint and 2 to 4 that do better than expected.

This time almost everything reported in line; there were no misses and one stock had a small beat (Electro Optic Systems). It was somewhat surprising we didn't have at least one bad result, but we had been quite ruthless over the last 12 months in exiting any stock in the portfolio that had a reasonable risk of missing its growth expectations.

Stock price responses to results have become more extreme over the years. It is probably due to the rise of automated trading by quant fund managers and high frequency traders. Unfortunately, we tended to be on the wrong end of it this reporting season, with our Outlook stocks suffering on average a price fall of -3.6% on the day each reported.

The biggest contributor to the fall was EML Payments (ASX: EML), which was down -13.5% on the day. EML had reported a result that was in line with expectations for strong growth in the 1H, without lifting full year guidance[ii]. The market responded like this was a downgrade, rather than the management setting themselves up for a strong beat for 2H. A few days later it also became apparent that during the week, there had a been a negative research note from Ownership Matters published. Their clients had been responding to this note during the week. As it turns out, Ownership Matters subsequently retracted their major critique within that note (EML's treatment of currency) because it was factually incorrect.

COVID-19

The news from China about COVID-19 got worse over the first half of the month. In the first instance, factories in Wuhan were temporarily closed. Ultimately, restrictions progressed to other regions and the movement of goods by ships from China. This was a problem for any company that relies on Chinese factories to manufacture part or all of their product. The concern was that sales would be lost if inventories were emptied prior to the reestablishment of supply.

For Australia, supply chains are not the only concern. Businesses that sell to the Chinese would be effected too. Resources, tourism and education are obvious examples. But, by how much? If COVID-19 was a problem restricted to a small set of businesses, and it would only impact their earnings for at most a year, it would not be such a big deal.

As investors, we are always trying to sensibly incorporate what we know into our decision making. If we were overly cautious we wouldn't invest much in anything at all.[1] As evidence grows for any developing situation that can effect a company's business outlook or stock price, there comes a point that it becomes solid enough to act on.

The media is generally not very helpful in trying to keep what was happening in perspective, because it tends towards sensationalism. Fortunately there were also government websites we could use, such as for the World Health Organisation (WHO) and the Centers for Disease Control and Prevention (CDC) to balance the media reportage.

On Friday the 21st of February, the ASX200 closed up 2% for the month to date, and was very close to its peak, but the news over the weekend was bad and it continued to worsen. The ASX200 then tumbled about 10% over the subsequent 5 days to month end.

It was on the morning of the Wednesday 26th February that week (the market had "only" fallen -2.5% by then) that we felt if we had enough information to act without jumping at shadows and getting whipsawed.

The final straw for us was the just updated situation summary from the CDC of 25th February (time in the USA being a day behind us), where it assessed the immediate health risk to the general American public as low but went on to state:

"However, it's important to note that current global circumstances suggest ***it is likely that this virus will cause a pandemic. In that case, the risk assessment would be different****."* (my emphasis in bold)

We saw that as a clear signal of likely developments, and we acted on it.

<u>Our Current View</u>

COVID-19 in its early forms appears to have a mortality of around 2-3%. However, it likely has a much lower mortality than that, because many cases go undetected. People most likely to die are the elderly and those with pre-existing conditions. There have been no reported instances of child deaths at the time of writing. The development of a vaccine for the illness appears well under way.

We have formed the view that the pandemic will be widespread across Asia, the middle East, Africa and continental Europe, as they are connected. The following already have detected hotspots:

- Asia: Korea, Japan, Singapore, Thailand
- Europe: Italy, Germany, France, Spain
- Middle East: Iran, Kuwait

On the other hand, we expect that more isolated countries with developed health systems and adequate regulation will be able to have a much milder experience. These being islands or continents making it easier to screen entrants.

- Australia / New Zealand
- USA / Canada
- United Kingdom

[1] You may have heard the joke that economists have predicted 7 of the last 1 recessions.

We expect that within the isolated countries consumer behaviour will change minimally, the exception being for travel. We expect that businesses that rely on supply chains through affected countries, or tourists from those countries, will be impacted.

Within the group of impacted companies, the ones that will be impacted most will be those with high operational leverage (high fixed costs and low margins) and/or high financial leverage. These companies may need to raise equity.

If a vaccine is developed quickly, it may be that at most we are seeing a one year's earnings impact.

Portfolio Activity

On Wednesday 26th February, we decided to sell/short businesses exposed to travel and tourism or that have logistics chains into China. Overall, we reduced our exposure to the market so that our cash weight, which had been about 20%, finished at about 40%.

We have taken a group trade (basket) approach to shorting stocks. For travel stocks, we have shorted Corporate Travel, Flight Centre and Qantas, about 2.5% each. We also shorted the casino stocks (Crown, Sky City and Star City) about 1% each. Overall, this shorting is about 11%, all in liquid stocks to enable us a rapid response to market outcomes amid COVID-19 developments.

There is considerable anecdotal evidence that businesses are pulling back on airplane travel, among them major accounting firms, investment banks and global companies like Amazon.com. Anecdotally, plans for travel overseas by holidaymakers are also being scrapped. We therefore expect that we will see further guidance downgrades from the travel companies. The casino businesses have related exposures for all three aspects of their businesses: conventions, grind and high rollers.

We have also sold down or exited some companies that we held. Having exited for logistics exposure Kogan and McPherson's; and halved our weight in Lovisa. We have also exited the travel company software provider, Serko. This selling of our holdings amounted to about another 10%.

Performance Impact and Outlook

We all expect corrections of this type to happen regularly. The definition of a correction is down -10% from a high point. The definition of a crash is down -20%. In recent times we have seen corrections in 1994, 2011 and 2015, and crashes in 1987, 2000 and 2008. So, that's about once every 5 or 6 years.

The impact of the market pull back on our portfolio has been quite severe so far, given that our 1H reporting outcomes were unequivocally on track, and we started with a 20% cash weight. About half of the negative return came from 3 of our larger positions: Electro Optic Systems, EML Payments and Afterpay.

These three companies are all in great shape: growing strongly, with good gross margins and strong balance sheets. They have little or no material exposure to COVID-19. But what they have in common is high near-term valuation multiples, which fall away dramatically in future years. Although we have taken profits in them regularly to keep their weightings reasonable, we have been loath to sell them into this weakness. We expect to purchase more of these stocks once the market has settled.

At 40% cash, we are at our highest cash weighting in two and a half years. The portfolio is well placed to weather further bad news. We will be in a position to buy back into the market at great prices when things settle down. We have done so before. The last time we had 0% cash (fully invested) was in December of 2018 just as the market was beginning the great run that it had in 2019.

In the past we have had large draw-downs like this associated with "risk off" events and every time we have seen the portfolio rebound strongly. The advantage of Monash Investors' approach is to be able to react when needed, but also to be able to be patient investors that can take advantage of opportunities in high quality companies.

This announcement has been authorised for release by the Board of Monash Absolute Investment Company Limited.

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[i] Glossary of terms can be found on the Company's website at www.monashinvestors.com/glossary/
[ii] https://www.asx.com.au/asxpdf/20200219/pdf/44f6r5j0sslcr3.pdf