Australian equities market review

July 2021

frontier

Contents

Summary

FY21

- This is Frontier's annual review of Australian Equities, focusing on the 2021 Financial Year.
- The year was characterised by strong returns as the Australian equity market continued to recover from COVID-19 induced losses in 2020. Strong performance followed global markets as the economic outlook improved and vaccination rates improved. Locally, we have seen a V-shaped economic recovery which has led to a consensus view of a similar recovery in earnings and paved the way for the strong index returns we have seen this financial year.
- A feature of this year's index returns has been the strong performance of the Mid and Small-cap segment of the market. The S&P/ASX Mid Cap 50 and the S&P/ASX Small Ords outperformed the S&P/ASX 50 Accumulation by 9.2% and 6.8% respectively. This marks the 2nd year in a row of large cap underperformance versus mid and small cap companies.
- The Utilities sector was the worst performing sector of the S&P/ASX 300 in FY21 returning -18.6% and was the only sector to record a negative return over the 12 months. Other laggards included Health Care and Consumer Staples. Notably this is the first time the Health Care sector has unperformed the broader market in nearly a decade.
- The market performance can be characterised in two halves, with positive news on the COVID-19 vaccine front driving strong rotations at both a sector level and style level. We saw the return of value in an Australian equities context as investors rotated out of growth stocks and into more cyclically exposed stocks in anticipation of a strong economic rebound. Similarly, we saw COVID-19 beneficiaries such as IT stocks coming under pressure as investors looked to the Financial and Energy sectors for reopening plays.
- The outperformance of Mid and Small caps as well as the increased levels of volatility in markets ensured a rich environment for active managers to showcase their skills in stock picking. Active managers had a strong year with the median broad cap manager generating an excess return of 2.2% above the S&P/ASX300 Accumulation index.
- Small cap managers also enjoyed a similar environment for stock picking with the median small cap manager delivering a return 6.5% above the S&P/ASX Small Ords index.
- Factor returns for the 12 months to 30 June 2021 illustrated the changing fortunes of value investing over the year with value factors comfortably outperforming growth factors for the first time since 2016. Both growth and quality factors delivered negative excess returns over the financial year while volatility factors performed strongly.

Market performance over FY21

- The Australian equity market delivered a strong year of returns in FY21 with the S&P/ASX 300 Accumulation index returning 28.5%. This was the market's strongest year of returns since 1987, with 11 out of 12 calendar months recording gains (September 2020 -3.6%). Stocks enjoyed the positive tailwinds of significant monetary and fiscal stimulus during FY21, while concerns surrounding inflation were largely managed by central bank messaging.
- Australia has enjoyed a V-Shaped economic recovery due to its relative success in containing the spread of COVID-19. Led by an improving labour market which as of May 2021 saw employment +1.2% and hours worked +1.8% above pre-pandemic levels, economic data has generally surprised on the upside and been supportive of an improving outlook for company earnings.
- Performance varied along the cap spectrum, with Mid caps reporting the strongest performance over the year. The S&P/ASX Mid Cap 50 Accumulation and the S&P/ASX Small Ords Accumulation returned 35.6% and 33.2% respectively.

Index performance for periods to 30 June 2021

Index	1 Year (%)	2 Years (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)	10 Years (% p.a.)
S&P/ASX 300 Accumulation	28.5	9.0	9.8	11.3	9.2
Performance by Market Capitalisation					
S&P/ASX 50 Accumulation	26.4	7.1	9.4	10.8	9.1
S&P/ASX Mid Cap 50 Accumulation	35.6	16.8	12.2	13.9	11.7
S&P/ASX 100 Accumulation	27.9	8.6	9.9	11.3	9.5
S&P/ASX Small Ords Accumulation	33.2	12.1	8.6	11.2	6.0

Source: Bloomberg

Market performance over FY21

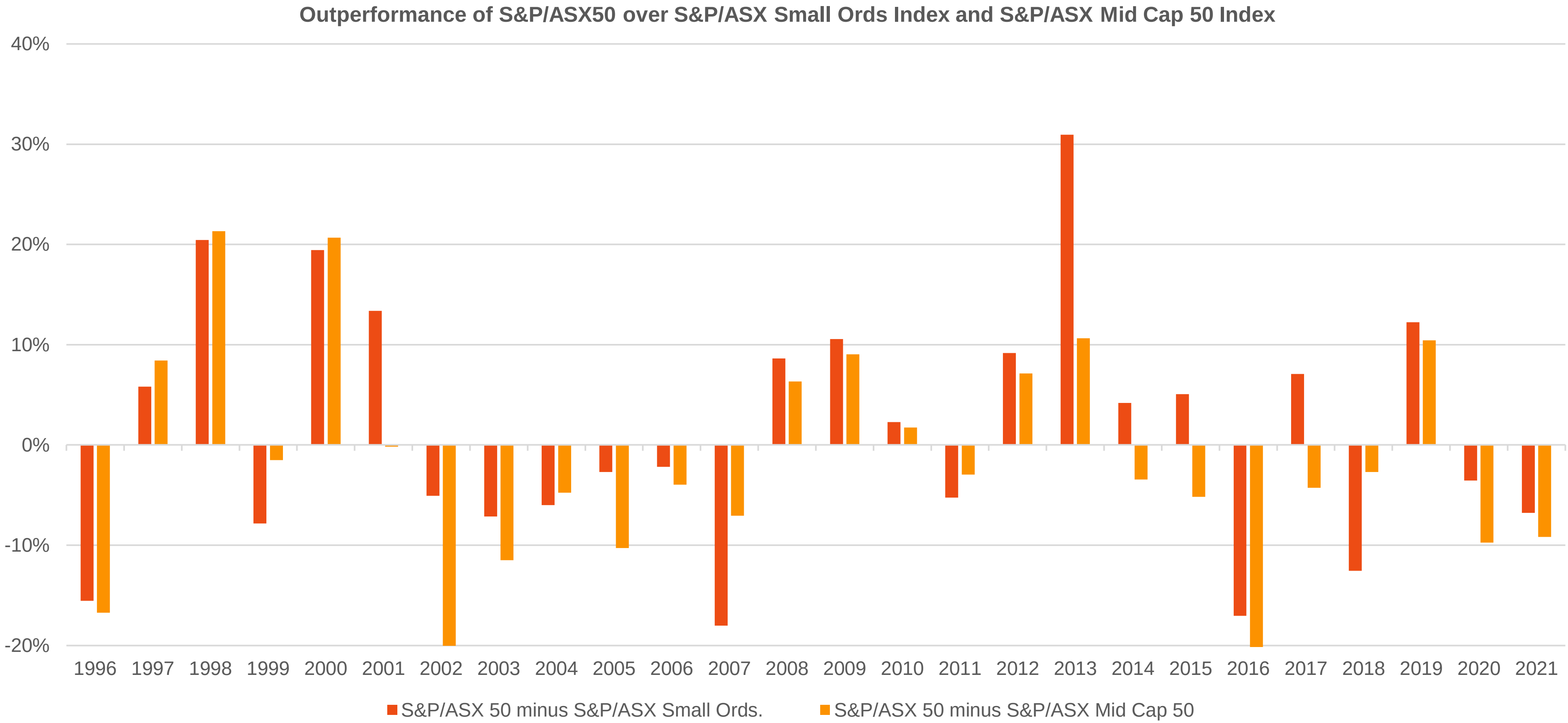
- Returns for the S&P/ASX300 Accumulation index were evenly split between the first half and second half of the financial year with returns of +13.7% and +13.0% reported respectively. Split into quarters however, the index was flat over the September quarter before rallying strongly in the December quarter due to positive vaccine news. The Australian equity market continued to rally through the March and June quarters, buoyed by improving economic data.
- The S&P/ASX Small Ords. and S&P/ASX Mid Cap 50 significantly outperformed the S&P/ASX 50 in the first half with the S&P/ASX Small Ords. generating returns of 20.3% and the S&P/ASX Mid Cap 50 index returning 22.9%. This trend was slightly reversed in the second half, with the S&P/ASX 50 outperforming the smaller indices.

Index performance for various periods

Index	Sep-20 (%)	Dec-20 (%)	Mar-21 (%)	Jun-21 (%)	1st half (%)	2nd half (%)
S&P/ASX 300 Accumulation	-0.1	13.8	4.2	8.5	13.7	13.0
Performance by Market Capitalisation						
S&P/ASX 50 Accumulation	-1.9	13.2	5.3	8.2	11.0	13.9
S&P/ASX Mid Cap 50 Accumulation	5.2	16.9	0.2	10.1	22.9	10.3
S&P/ASX 100 Accumulation	-0.8	13.8	4.5	8.5	12.9	13.3
S&P/ASX Small Ords Accumulation	5.7	13.8	2.1	8.5	20.3	10.8

Source: MSCI, eVestment

Market performance over FY21



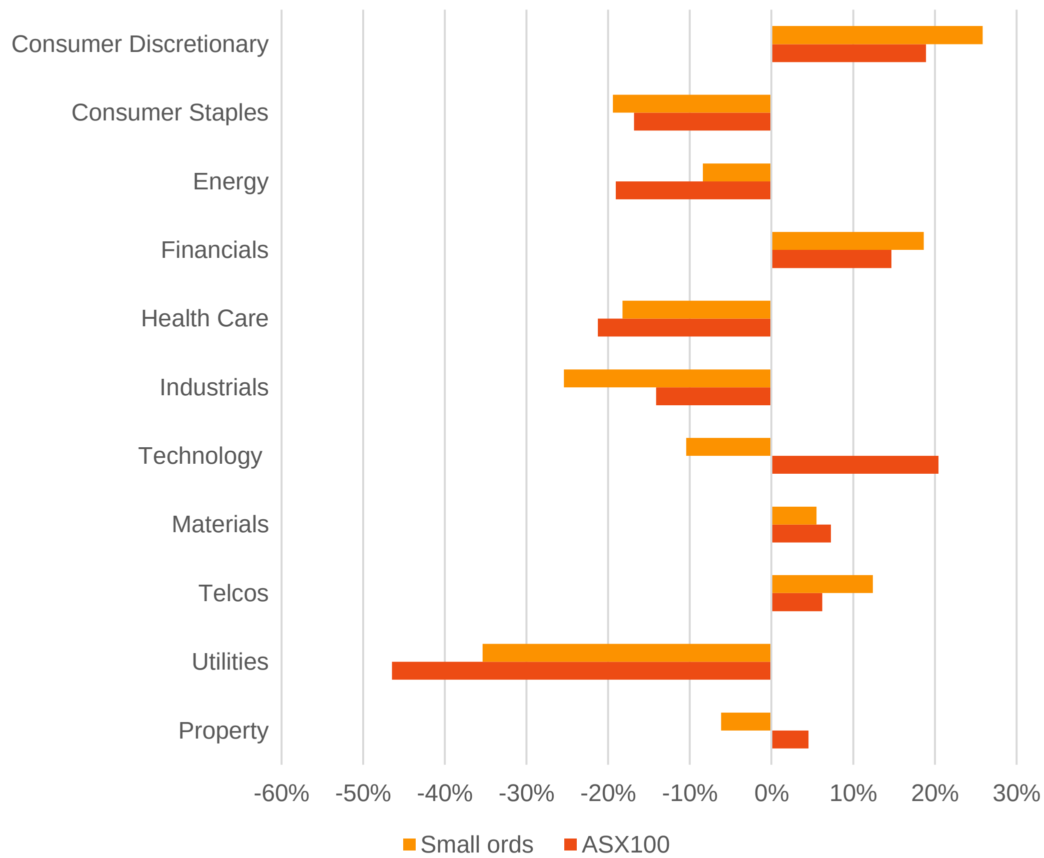
- FY21 marked the second consecutive year in which S&P/ASX 50 underperformed S&P/ASX Mid-Cap 50 and S&P/ASX Small Ords. The mid cap index outperformed the large cap index by 7.7% in FY21 following on from 8.4% in FY20. Likewise, for the small caps which outperformed the large cap index by 5.3% in FY21 following on from 2.2% in FY20.

Sector performance

COVID-19 dominates sector performance

- Nearly all sectors posted gains of >25% in FY21, with the laggards being Health Care, Consumer Staples, Energy and Industrials. The Utilities sector (led down by Origin and AGL) was the poorest performing sector in FY21 with a return of -18.6%.
- For the S&P/ASX100 index, on a relative basis, Consumer Discretionary (18.9%), Financials (14.7%) and IT (20.4%) outperformed the broader market, with many stocks within these sectors benefitting from the structural changes occurring in the economy due to COVID-19.
- For the S&P/ASX Small Ords index, it was a similar story with Consumer Discretionary (25.9%) and Financials (18.4%) being the strongest outperformers.
- The Health Care sector (across the cap spectrum) underperformed the market for the first time in nearly a decade as investors were attracted to reopening plays such as travel and retail stocks.
- The materials sector and in particular iron ore miners have enjoyed a solid FY21. This is due to the very strong demand for iron ore as the Chinese government looked to stimulate their economy through increasing the levels of steel production for infrastructure and construction purposes.
- Interestingly, the S&P/ASX Small Ords IT sector underperformed the broader market where the S&P/ASX100 IT sector outperformed. This is likely attributable to the concentrated nature of the S&P/ ASX100 IT sector with two stocks (Afterpay and Xero) accounting for over c60% of sector weight.

Relative sector performance for FY21

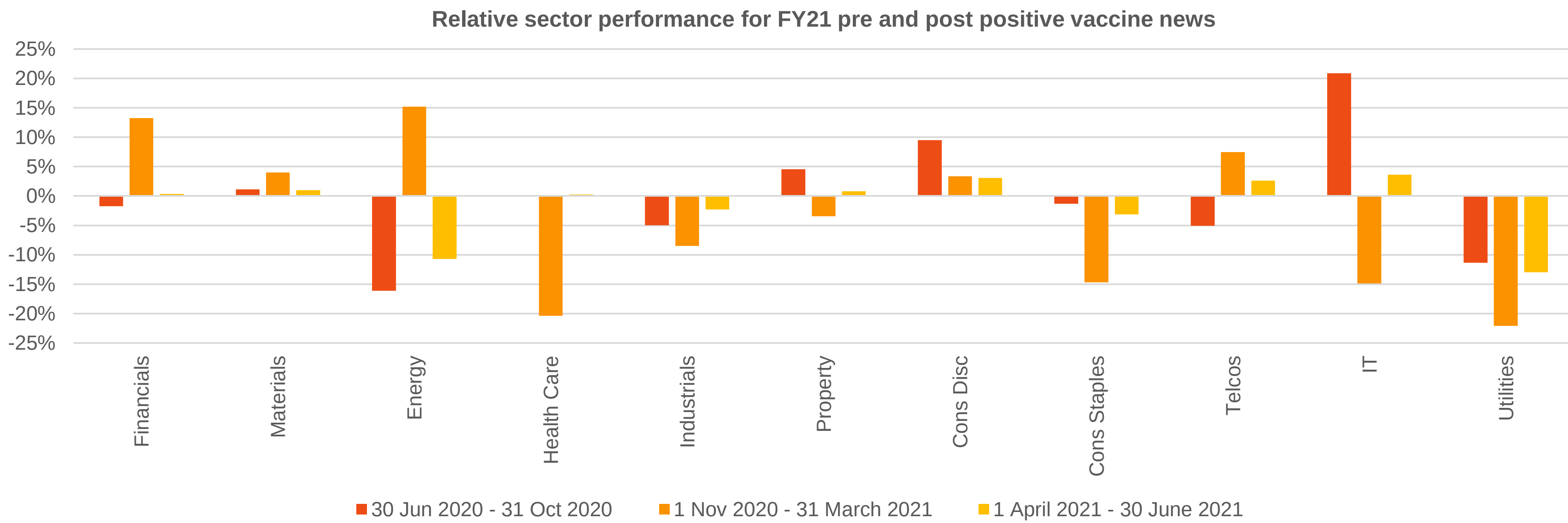


Source: GBST

Sector performance

Vaccine news causing a sectorial rotation

- Positive news regarding a COVID-19 vaccine in the 2nd half of the year triggered a rotation towards cyclical stocks that are well-positioned to benefit from the reopening of the economy.
- Technology stocks which had generally been classified as COVID-19 winners, being beneficiaries of the Work from Home model and the accelerated growth of digitisation and e-commerce trends, were sold as investors took profits following a strong period of returns.
- Investors rotated into the Financial and Energy sectors as bets were placed on reopening plays following the vaccine news.
- Interestingly, Consumer Discretionary stocks delivered a positive performance throughout as a lack of international travel increased the wallet share of domestic consumption of many Australian retailers.
- In the last quarter of FY21, declining bond yields have seen yet another rotation in the Australian equity market. Energy stocks underperformed despite strong oil prices while IT and Real Estate sectors once again delivered excess returns to the market.



Source: Bloomberg

Index contributors and detractors

Banks and resource stocks lead market returns

S&P/ASX200

- The S&P/ASX 200 returns were driven largely by the big 4 banks and iron ore miners. With a 12-month total return of 50.4% Commonwealth Bank of Australia was the largest contributor to index returns.
- Of the top 10 index contributors, 7 were either iron ore miners or banks.
- A2 Milk was the index's largest detractor with a total return of -67.8% for FY21 with gold miners Newcrest and Norther Star Resources also holding spots in the bottom 5.

S&P/ASX Small Ords

- The Small Ords 12-month returns were again led by resource companies. Rare-earths mining company, Lynas led the way with a total return of c200% while battery minerals miner, Pilbara Minerals and diversified miner, Mineral Resources posted strong returns.
- Gold miners, Regis Resources, St Barbara and Resolute Group were the index's top detractors due to a slightly weaker gold price in Australian dollars over FY21.

ASX200 contributors and detractors

Contributors	Contr-ibution (bps)	TR (%)	Detractors	CTR (bps)	TR (%)
Commonwealth Bank	353	50.4	A2 Milk	-59	-67.8
BHP Billiton	265	44.8	AGL Energy	-31	-47.6
Westpac	190	52.0	Newcrest Mining	-29	-21.1
ANZ	189	57.9	Northern Star Resources	-19	-30.4
NAB	183	46.6	Appen	-14	-59.7

Small Ords contributors and detractors

Contributors	Contr-ibution (bps)	TR (%)	Detractors	CTR (bps)	TR (%)
Lynas Corporation	159	200.5	Regis Resources	-71	-54.1
Pilbara Minerals	119	522.6	St Barbara Ltd	-45	-46.3
Mineral Resources	113	167.8	Resolute Group	-35	-58.4
ARB Corporation	113	148.0	Chorus Ltd	-30	-11.8
Virgin Money	99	117.1	Mesoblast Ltd	-28	-40.4

Source: Bloomberg, Morgan Stanley

Active management in FY21

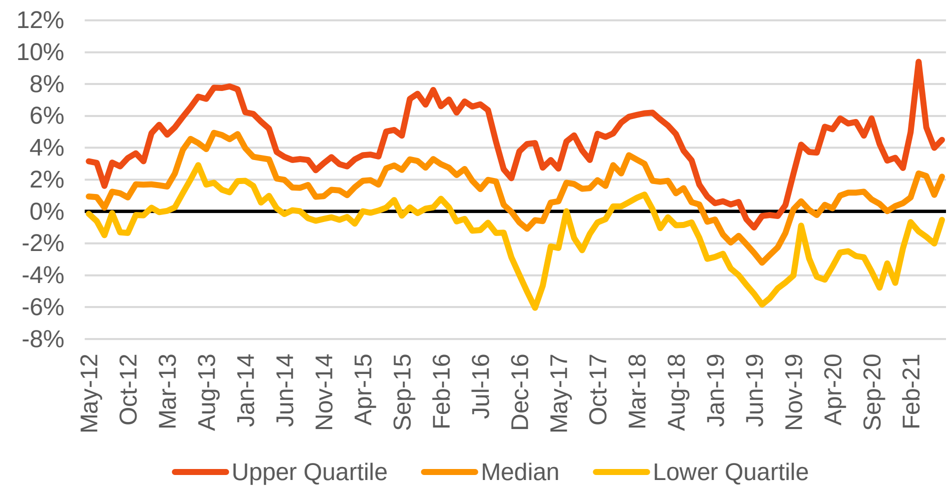
Broad Caps

Australian broad caps manager excess returns for periods to 30 June 2021

	1 Year (%)	2 Years (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)	10 Years (% p.a.)
Upper Quartile	4.5	4.2	1.7	1.7	2.9
Median	***2.2***	***0.9***	***-0.2***	***0.6***	***1.1***
Lower Quartile	-0.5	-1.4	-2.8	-0.7	0.1
Observations	48	48	48	47	44
S&P/ASX 300	28.5	9.0	9.8	11.3	9.2

Source: eVestment, Frontier cleansed universe, gross of fees, AUD

Australian broad cap manager rolling 12 month excess returns to 30 June 2021



Source: eVestment, Frontier cleansed universe, gross of fees, AUD

- The past 12 month period has witnessed strong results from active management in Australian equities with the median broad cap active manager in Australia delivering excess returns of 2.2%.
- This outcome was largely driven by the outperformance of S&P/ASX Mid-Cap 50 and S&P/ASX Small Ordinaires, given that active managers readily invest with more exposure down the cap spectrum than the market cap weighted S&P/ASX 300 index.
- Cross-sectional volatility, which is used as a proxy for the potential to add value from active management, was high.

Active management in FY21

Broad Caps

Active manager performance (financial years)

	FY15 (%p.a.)	FY16 (%p.a.)	FY17 (%p.a.)	FY18 (%p.a.)	FY19 (%p.a.)	FY20 (%p.a.)	FY21 (%p.a.)
Upper Quartile	9.2	8.8	18.2	17.8	10.5	-2.7	33.0
Median	7.4	2.8	15.2	14.9	8.8	-7.0	30.7
Lower Quartile	5.9	-0.3	12.6	12.7	6.1	-10.1	28.0
S&P/ASX 300 Accum	5.6	0.9	13.8	13.2	11.4	-7.6	28.5
Median Excess	**1.8**	**2.0**	**1.3**	**1.6**	**-2.6**	**0.6**	**2.2**
Top Quartile minus Lower Quartile	3.4	9.1	5.6	5.1	4.3	7.4	5.0

Source: eVestment, Frontier cleansed universe, gross of fees

- The table above illustrates that active management, as measured by the median manager has been able to outperform the benchmark in 6 of the past 7 years in Australian Broad Caps. This demonstrates the continued ability of active managers to add value in the Australian equities market over time.
- FY21 was the strongest year for active management in the past 7, with the median manager outperforming the S&P/ASX300 Accumulation Index by (2.2%). This follows on from a couple of poor years for active managers in FY19 and FY20 where the median manager delivered excess returns of -2.6% and 0.6%.
- Despite the volatile market conditions and exceptionally strong returns, we saw a relatively average dispersion of returns between the upper and lower quartile managers at 5.0% in FY21.

Active management in FY21

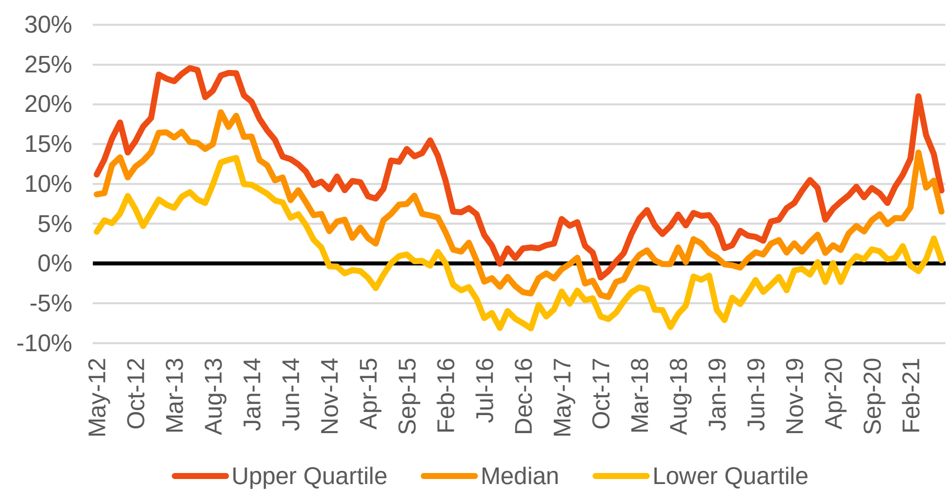
Small Caps

Australian small cap manager excess returns for periods to 30 June 2021

	1 Year (%)	2 Years (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)	10 Years (% p.a.)
Upper Quartile	9.2	8.8	5.5	5.0	7.8
Median	6.5	6.0	3.7	2.3	5.5
Lower Quartile	0.4	1.4	0.1	0.5	4.7
Observations	23	23	23	22	16
S&P/ASX Small Ords	33.2	12.1	8.6	11.2	6.0

Source: eVestment, Frontier cleansed universe, gross of fees

Australian small cap manager rolling 12-month excess returns



Source: eVestment, Frontier cleansed universe, gross of fees, AUD

- Active management in Australian Small Caps was exceptionally strong in FY21, with the median manager delivering excess returns of 6.5% above the S&P/ASX Small Ords index.
- The vast majority of the outperformance by small cap managers occurred in the six months from 1 July to 31 December 2020.
  - This was in part a rebound. Small caps managers underperformed in the March 2020 negative market environment, but then recovered this (and much more) in the following six months as markets reversed.
  - Frontier observed strong stock picking from managers, particularly in Consumer Discretionary, Financial and Telecommunications sectors which contributed to excess returns.

Active management in FY21

Small Caps

Active manager performance (financial years)

	FY15 (%p.a.)	FY16 (%p.a.)	FY17 (%p.a.)	FY18 (%p.a.)	FY19 (%p.a.)	FY20 (%p.a.)	FY21 (%p.a.)
Upper Quartile	12.1	21.0	12.3	28.9	6.2	2.9	42.4
Median	7.1	17.1	8.2	25.6	3.7	-1.9	39.7
Lower Quartile	2.3	11.8	0.7	19.7	0.2	-5.7	33.6
S&P/ASX Small Ords Accum.	0.4	14.4	7.0	24.3	1.9	-5.7	33.2
Median Excess	**6.7**	**2.7**	**1.2**	**1.4**	**1.8**	**3.8**	**6.5**
Top Quartile minus Lower Quartile	9.8	9.1	11.6	11.6	6.0	8.5	9.2

Source: eVestment, Frontier cleansed universe, gross of fees

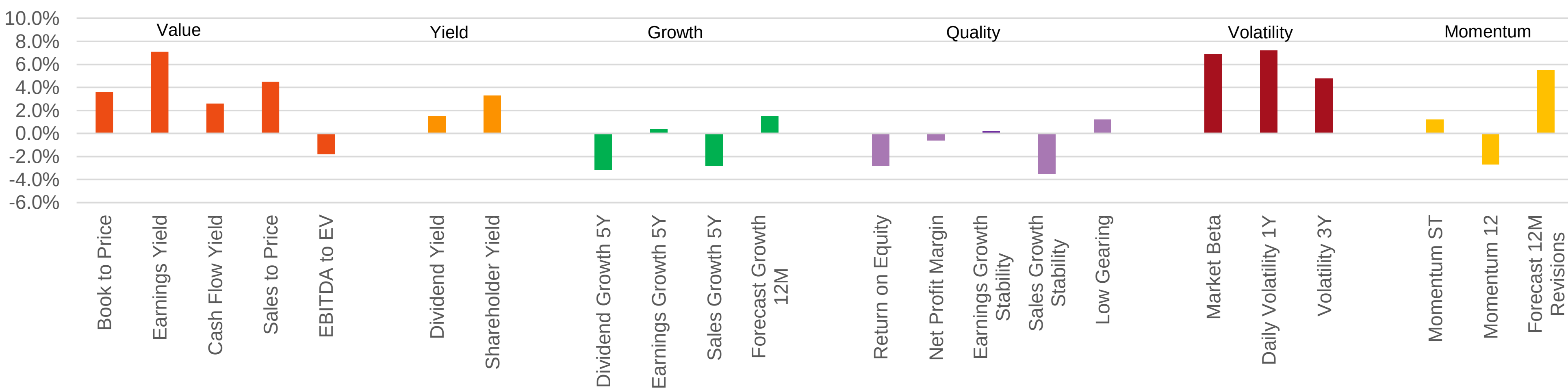
- The table above illustrates that active management, as measured by the median manager has been able to outperform the benchmark in all of the past 7 years in Australian Small Caps. FY21 was a particularly strong year as previously mentioned, with the median manager outperforming the S&P/ASXSmall Ords index index by (6.5%).
- The dispersion between the upper and lower quartile managers was again high and is typically much higher than for large cap managers, providing evidence that there is greater volatility in small caps alpha and opportunities for adding value.

Style/factor returns in Australian equities

The return of value factors

- FY21 saw the return of value factors in the Australian equities market. All value factors except EBITDA to EV were positive over the period, with the earnings yield factor proving particularly strong.
- While the value factor outperformed over the period, we have observed varied results between the Australian equities value peer group. Over the year, the median moderate value manager* has outperformed its deeper value manager* equivalent. After an initial strong turn in performance in November 2020 where deeper value managers generally outperformed moderate value managers, a turn in market sentiment in Q1 2021 saw many deeper managers underperform over this quarter, to finish the year behind their moderate value peers. Further, the underperformance of energy (despite rises in oil prices) has been a factor, as deeper value managers have tended to have higher weights towards stocks in this sector. (Please refer to slide 7).
- Growth and Quality factors were mostly negative over the period with dividend growth and sales growth particularly negative for growth factors while return on equity and sales growth stability dragging down the overall quality factor.
- Volatility factors accompanied value factors as providing positive returns, with all three factors illustrating strong factor performance over the 12-month period.
- In the final quarter of FY21 however, we saw a reversal of this trend. Growth and quality factors outperformed value in the Australian equities market.

12-month style factor performance in the Australian equity market

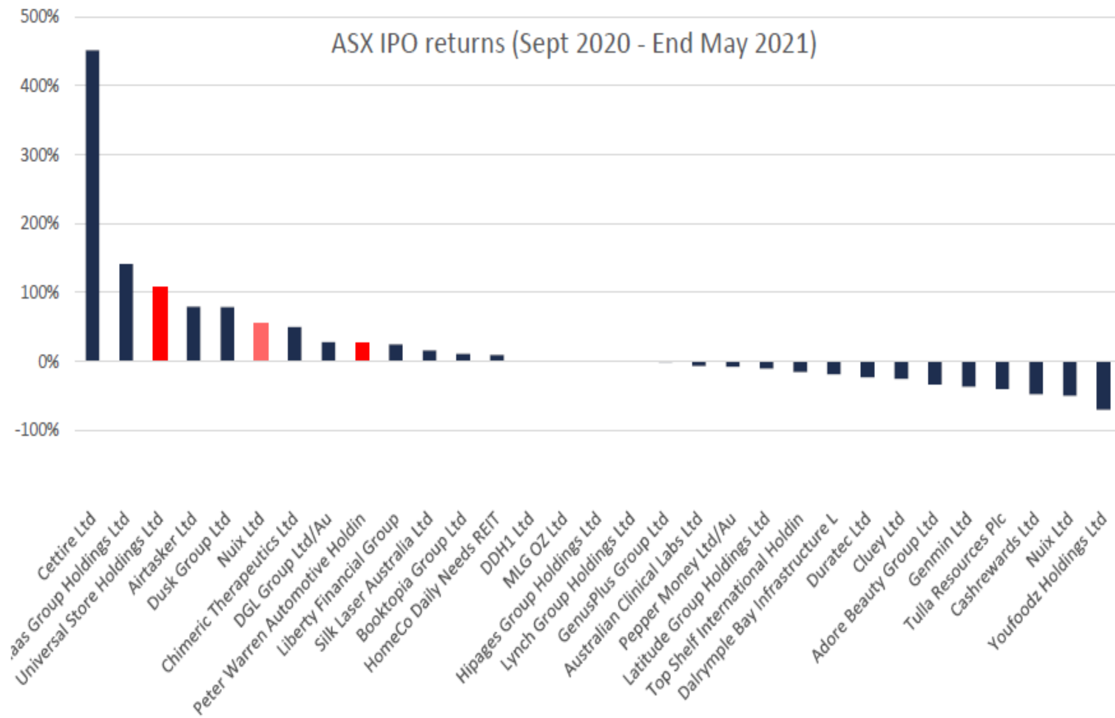


Source: Style Analytics. * Deeper" style value managers are characterised by a greater focus on valuation and lower focus on quality compared to "moderate" value peers.

Initial public offerings and capital markets

Rebound in new stock issuance activity

- Following the strong rebound in the Australian equities market, the market witnessed an increase in new listings.
- In FY21 there was a total of $40.7 billion of initial capital raised, a 50% increase on FY20. There was a total of 176 new listings on the ASX boards, more than double the 83 listings in FY20.
- The weighted average return of the IPO market from September 2020 to May 2021 was 7%.
- It was a different story when looking at secondary capital raised in FY21. Following an elevated period of capital raisings in FY20 due to the COVID-19 pandemic, there was a 12% fall in secondary capital raised to $61.9 billion.
- While FY21 did see a reduction in secondary capital raised, the $61.9 billion is still materially above the $48.6 billion in FY19.



Source: Spheria Asset Management, ASX Limited

Fees and ESG

Observations over FY21

Fees

- Industry dynamics such as increased passive management, internalisation of industry super funds and the underperformance of active management have continued to create an environment that is conducive to lower fees for active management in FY21.
- In general, we note that high alpha seeking portfolios are associated with higher fee structures given higher excess return objectives necessitating higher tracking error budgets
- We have observed, in several cases, a willingness on behalf of managers to negotiate lower fees throughout the year. That said, there are still a small number of notable outliers within Australian Equities where managers have been reluctant to lower fees to meet the market

ESG

- Climate change and decarbonisation has come into sharp focus in FY21, after a lawsuit brought against Retail Employees Superannuation Trust (REST) highlighted the obligations as well as potential legal consequences of trustees not adequately considering these risks in setting investment strategy. We have also seen many Superannuation funds pledge to become net zero emissions by 2050 or sooner.
- As a result, decarbonisation has been a strong focus from Australian-based investors, which has seen accelerated development in low carbon offerings by fund managers wishing to better serve this market.
- The S&P/ ASX 200 Carbon Price Risk 2030 adjusted index (S&P/ ASX 200 CPRA) delivered an excess return over the S&P/ ASX200 benchmark by ~80bps. We have observed over the course of FY21 an outperformance of many passive strategies with low carbon overlays, in no small part due to the underperformance of carbon intensive sectors such as Utilities and Energy.
- Frontier has observed a continuous evolution in Australian equities managers' approach towards ESG, with many fund managers now viewing ESG as a core part of the due diligence process, being assessed both from a risk and opportunity perspectives, regardless of whether a client is investing in a sustainable or a more traditional mandate. Climate change, modern slavery and diversity were also raised as key front of mind ESG topics being considered across our managers universe.
- Finally, we continue to expand our coverage of ESG oriented strategies and in particular, low carbon offerings.

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