2023 Annual General Meeting
Managing Director's Address

Delivered by Mr. Jason Beddow at the 77th Annual General Meeting of Argo Investments Limited (Argo or Company) held at the Adelaide Convention Centre on Monday 23 October 2023 at 10.00am (Adelaide time).

Market review

Only a short time ago, the prospect of a global recession seemed likely, as central banks aggressively raised interest rates to control rampant inflation. However, indicators are increasingly now pointing to an economic 'soft landing.' So far, economies are successfully navigating the narrow path of lowering inflation through tightening monetary policy, without causing a recession.

In the US, the Federal Reserve has raised rates more quickly than at any time since the 1980s. Australia has also followed suit, with twelve rate increases in quick succession totalling 4.0%. The official cash rate is now 4.1% and, while further increases are possible, we believe we are near the top for interest rates in the current cycle.

Like many other developed economies, Australia's economic resilience has been largely underpinned by fiscal stimulus and historically low unemployment. In addition, many Australians are benefiting from higher deposit rates, savings levels, and asset prices.

Over the financial year to 30 June 2023, Australia's share market defied most expectations to perform strongly in the face of this persistent inflation, a sombre global economic outlook and the steepest interest rate increases in recent history.

All industry sectors generated positive returns, although Technology was the standout performer, surging more than +30%. Companies leveraged to lithium and other battery minerals also generated particularly strong returns. Meanwhile, sectors with more defensive attributes, such as Utilities and Health Care, lagged the broader market.

Following this strong performance, Australian investors seem less certain as we entered the new financial year. For the first three months to 30 September 2023, the S&P/ASX 200 Accumulation Index fell -0.8%. Energy was the best performing sector for the quarter, up +11.2% in contrast to Healthcare which continues to be weak, down -8.6% and Consumer Staples down -5.9%.

Investment portfolio

We have been calling the investment environment "uncertain" for what feels like some time now. Reflecting these conditions, companies provided very little forward guidance during the recent August reporting season. I will elaborate on some of the key points from company profits results a little later.

We continue to see this uncertainty playing out in the underperformance of many smaller capitalised companies, as they are more likely to be impacted by higher costs, less scale, and a slowing consumer.

We diversify our portfolio to maintain balanced performance over longer time frames and deliver shareholders a relatively smooth dividend profile through market cycles.

We have largely been adding to existing holdings and reducing the overall number of holdings in the portfolio, although we have recently added one new stock to the portfolio, Resmed, which I will discuss shortly.

We have also exited two takeover targets: Liontown Resources at the Albemarle bid price of $3.00 per share and Estia Health following the final dividend payment which exhausted their franking credit balance. In addition, we have exited our holding in Insurance Australia Group and sold down positions in Brambles, Helia Group and Diversified United Investment.

Proceeds from these sales have been redeployed into several stocks including CSL, which we continue to believe is an excellent quality company and now trading at more attractive levels than previously, at a time when it is returning to double digit profit growth.

We also increased our holding in Viva Energy following major shareholder Vitol's selldown of 16% of the company. We think Viva's prospects remain strong. An ACCC ruling on its proposed purchase of the South Australian-based "On the Run" chain of petrol stations and convenience stores is pending.

We recently participated in a $750 million equity raising by APA Group to partly fund its acquisition of Alinta's Pilbara assets, which included a portfolio of conventional and renewable assets, including a development pipeline of wind, solar and battery generation.

Resmed (ASX code: RMD)
Resmed is the world leader in Continuous Positive Airway Pressure (CPAP) therapy, the recommended treatment for the majority of patients with obstructive sleep apnoea (OSA).

OSA is a sleep-related breathing disorder causing complete or partial obstruction of a person's airflow. The brain senses the impaired breathing, causing the individual to subconsciously rouse from sleep to reopen their airway. Resmed manufactures and distributes CPAP machines. These are ventilators which deliver a continuous stream of pressurised air through a mask while the patient sleeps.

Because obesity is a leading cause of sleep apnoea, the recent hype around GLP-1 'weight loss' drugs and speculation they are a 'cure all' for addressing obesity has led investors to conclude these medications will cannibalise or displace CPAP devices as a first line therapy for OSA.

This is reflected in Resmed's share price which is down more than 30% since 30 June. In our view, the potentially positive impacts of these weight loss drugs are overstated. We have listened to dozens of calls from medical experts, both positive and sceptical. The full impacts will not be known for many years.

Factoring in the possible negative impacts on Resmed's sales if obesity declines globally, we still believe that at these share price levels it represents a good buying opportunity.

August reporting season
Prior to the Covid-19 disruptions, a large percentage of listed companies provided guidance on forward earnings. Currently very few companies give guidance. More commonly they give trading updates at AGMs and investor days. Considering this, I wanted to give our insights from the most recent reporting season.

Overall, profit results defied the gloomy expectations from earlier in the year, given headwinds from the slowing economy and rising costs, especially labour, insurance and interest costs. While revenues showed strength, this often came from price increases rather than volume expansion. Declines in other input costs, such as commodity prices and freight costs, also helped to ease margin pressures.

Companies generally provided conservative guidance, if at all. This often disappointed the market and saw consensus earnings downgrades for companies.

For the broader market, consensus earnings expectations were revised down by -2.4% during the month and now sit at -6.6% for the 2024 financial year.

Australian equities were soft in August and September, as lacklustre outlooks from companies weighed on investors' minds. Interestingly, August was one of the most volatile earnings seasons in the past 15 years, with one in eight stocks moving more than 10% up or down on the day of their result.

The escalating cost of debt is emerging as an issue, with higher interest payments a growing challenge for companies with stretched balance sheets or large refinancing needs. We believe this issue is being underestimated and could result in further earnings downgrades over the next couple of years as companies need to refinance cheaper debt.

August dividends were slightly disappointing, particularly from the large, diversified miners, though not unexpected with lower commodity prices and higher capital expenditure. On average, payout ratios are still well below the pre-pandemic average. However, we see a risk that payouts edge lower as companies brace against a tougher economy, service higher interest costs and potentially de-leverage their balance sheets.

Turning now to commentary from some of the bigger companies during reporting season.

The Commonwealth Bank of Australia result was solid, despite Net Interest Margin and cost pressures. Bad debts remain low in the banking sector but have started to creep up in some non-bank lenders. There was evidence that competitive pressures may be easing and, while there was an air of caution, there was certainly no panic in the outlook comments from CBA.

Wesfarmers indicated no signs of weakness in their Bunnings or Kmart businesses. Woolworths noted that demand remains solid, although there are signs of customers switching to cheaper items. Fuel retailers Viva Energy and Ampol reported seeing strong commercial demand for fuel and Domino's noted 'signs of life' in demand for pizza.

Resource companies disappointed with operating cost pressures and labour remaining a challenge. We are seeing further delays in project execution. We also saw over $5 billion in impairments due to cost overruns across the industry, including Rio's Australian aluminium assets, South32, Alumina and Fortescue's iron ore business.

Global cyclicals benefited from the weak Australian Dollar. This group of stocks was the only category that reported positive profit surprises in the June half. It also had the lowest share of negative revisions for financial year 2024 earnings, due to a combination of the higher quality of global cyclicals and the translation benefit of the lower Australian Dollar.

Health Care had a mixed reporting season, as the sector continued to deal with cost pressures, labour absenteeism and weaker utilisation of their services. Some companies in the sector, such as Ramsay Health Care, are relatively highly geared and saw a significant increase in interest costs.

REITs had a decent reporting season, although rising interest rates and the expiration of interest hedges meant earnings declined for many Australian REITs.

Outlook

In comparison to most other countries, Australia's economy is faring relatively well. However, as we look ahead to next year, interest rate rises will likely have a slowing impact on the economy.

It appears the first half of 2024 will be particularly weak, with economists expecting the global economy to eke out GDP growth of just +1.7%. This compares to this year's predicted growth of +2.3%.

Geopolitical risks remain elevated. As we approach the two-year anniversary of Russia's invasion of Ukraine, there are few signs there will be a resolution to the conflict. More recently, a significant increase in hostilities in the Middle East has added to geopolitical tensions around the world.

Current investor sentiment indicates that Australia and the global economies should be able to avoid recession. In our view, further share market volatility is likely and evidence of the economy slowing will likely emerge, leading to pressure on earnings.

High population growth, driven by immigration, should be a major economic tailwind for Australia in the coming years. However, on a per capita basis the growth does not look so impressive, which highlights the lack of productivity and the challenges with migration exacerbating the housing shortage issue. Residential housing availability and affordability are now key areas of community concern.

With no debt, cash available and a diversified portfolio, Argo is well-positioned to navigate these conditions, applying our conservative, long-term investment approach.

Thank you

I would like to acknowledge the efforts of the whole Argo team this year. Our staff continue to be fully committed to the success of the Company across both our Adelaide and Sydney offices.

I also acknowledge the contribution from the Chairman and Non-executive Directors. I welcome the new Directors to Argo, and I look forward to working with them all as we best navigate Argo through this next period for you, our shareholders. I would also like to personally thank Roger Davis for his contribution to the Company.

I wish all our shareholders well for the remainder of the year. We thank you for your continued support and I look forward to continuing the conversation with you in 2024.