AUDUCO

Q4 FY20 STATUS REPORT

"Our focus, trust"

"Accounting for every trade"

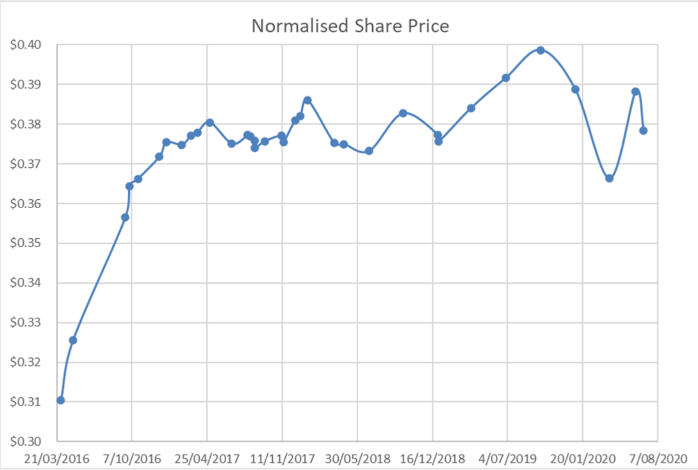
Investment Performance of Deployed Capital

Auduco Pty Ltd's current investment position and normalised share price are summarised in the table and figure below.

30/06/20 Snapshot		
Top 5 Equity Holdings	**Ave Entry Price**	**Market Price**
ANZ	$23.43	$18.64 (Q3 perf: $1.68)
BOQ	$8.13	$6.17 (Q3 perf: $1.17)
NAB	$19.01 (reduced $1.36)	$18.22 (Q4 perf: $1.54)
WBC	$16.18	17.95 (Q4 perf: $1.77)
WPL	$23.28	21.65 (Q4 perf: -$1.63)
	Current Market Value	

FY20 Dividends to-date	
FY20 Interest to-date[1]	
Cash Holdings	

Note 1: Does not include interest currently being accrued in term deposit accounts.



Strategy working. Albeit, pace slow. We picked up some more blue chips at good prices and their market values are now higher. We were able to bring the average buy-in on key banking stocks to level that reflect what we see as excellent long-term purchase points.

Our normalised share price continues to hold up well.

We have taken a hit in the dividends department. This is something telegraphed as possible. NAB cut their interim payment by 63%. BOQ declined to pay with no notice to shareholders except a letter indicating they were assessing but provided no follow up. How temporary this is, we do not know yet.

It has been a strange few years. As the warning signs that we have bubble-like conditions re-appear, it again sends a reminder of the need to maintain our path of positioning into defensive instruments that exhibit recovery value. i.e. whether we can liquidate at decent levels if we have to liquidate. There has long been intent to diversify stock purchases, selecting from a watchlist we continue to build. However, despite the euphoria that now exists so soon after the fear of the crash, it is very difficult to determine intrinsic value at the moment. As share prices have gone back up, the attractiveness of stocks has been fleeting. Further, as we have seen with banks, which are generally a surer bet when it comes to dividends, risk to cashflow is calls for restraint. Nonetheless, we now have all the banking equity we would like for the size of the available capital pool. So, the next purchases will be from different sectors.

Synopsis

Welcome to the first massive financial bubble inside a recession. The precedents keep coming. They continue to be whoppers. It has become a very difficult market to judge. Macro and fundamental metrics are screaming that everything is too expensive, but markets keep charging up.

The warning signs alluded to above? We have documented a couple of them repeatedly before:

- Rapid increases in prices beyond growth that can be expected from underlying businesses.
- Significant wave of profitless companies hitting the technology bourses in the west as IPOs.

A third warning sign is the huge increase in retail trading in these stocks. It has finally hit in a way that was not present prior to the Covid-19 crash.

We are reading many headlines of the rise of RobinHood accounts. Our look into this has been high level, but have already learnt of one novice suiciding over $730,000 in losses and another losing his $1 million account[1] Bare in mind, people are experiencing these losses in a surging market.

Whether this is a continuation of the 11 year bull, or a new bull, is anyone's guess. Well, our guess is it's a continuation of the bull following a couple of steep breaks. After all, the corrections were not sustained for periods synonymous with bear markets. Only now are we seeing massive numbers of retail investors jumping in, with professionals scratching their heads regarding what is going on. Retail investors being left holding the potato is typical of busts. They usually happens following periods of euphoria in the markets with extreme prices and reduced overall breadth as the indices continue to surge, but not so soon after the market panics we have seen over the past couple of years.

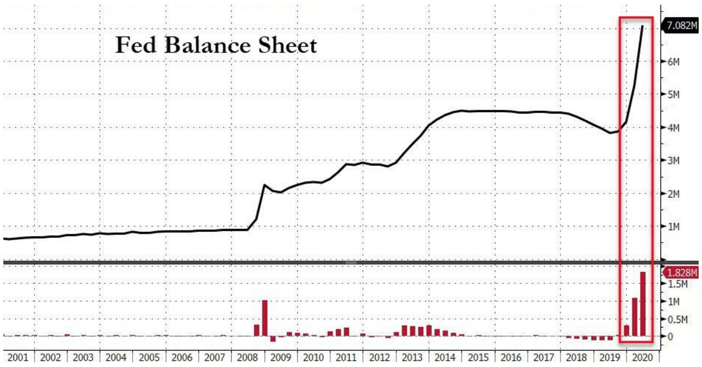
[1] Robin Hood traders examples – commits suicide after realising his account was $730,000, the other saw his account go from $1m to ~$7,000. Robinhood makes money by enticing retailers to trade more. Free brokerage? Not a problem for this company as their revenue comes from deal flow. Statistically, the more retail "investors" trade, the more they lose. https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html; https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html

Markets being out of touch with economic reality is all down to the central banks. Here is the breakdown of the US Fed injections into markets:

- 2008-2017 – increase liquidity from $0.8 to $4.2 trillion;
- 2018 – "autopilot" roll-off, reduce by $400 billion;
- 2019 – 3 rate cuts, $400 billion balance sheet expansion, $500 billion in bond repurchases;
- 2020 – cuts rates to zero, $3 trillion balance sheet expansion, buys junk bonds, corporate bonds and US debt.

Key point: 6 years were taken to increase the balance sheet by ~$3.4 trillion following the GFC. A similar magnitude, ~$3 trillion+, was added in only 3 months this year.

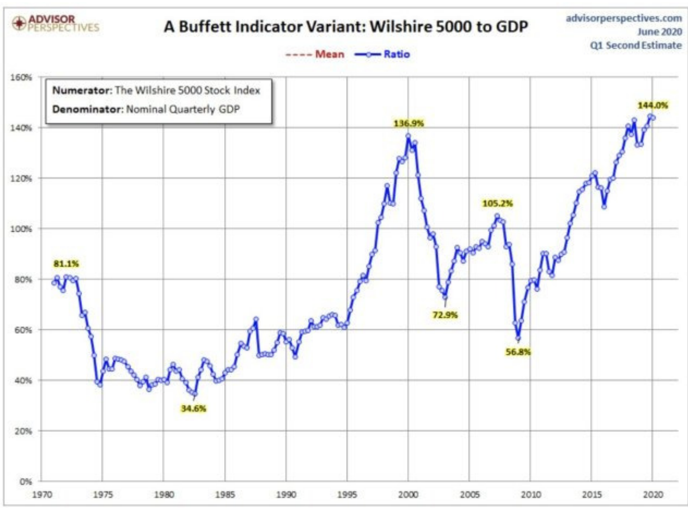
Here is a visual:



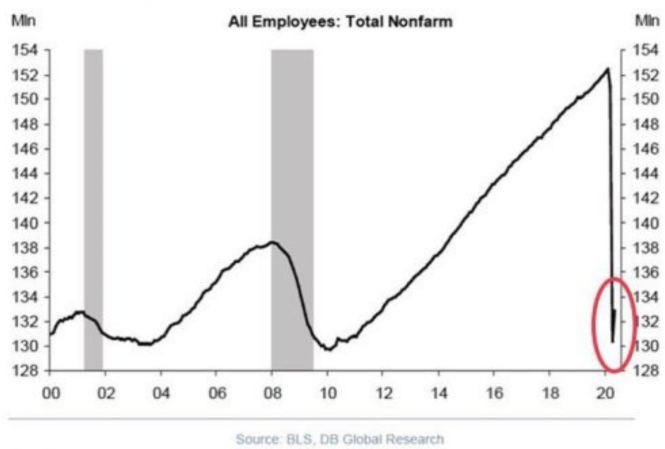
Arguments that the efficacy of central bank injections will diminish are technically true, but currently just a side note. We have our answer as to how it will be dealt with; ramp up the scale of it.

So here we are again. Macro conditions that cause pause in thoughts to take large positions, even in the best value stocks.

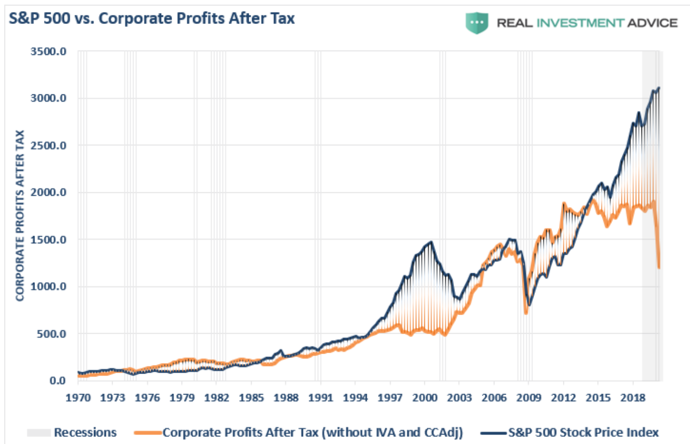
Case in point, the chart be below showing total representative US stock market capitalisation to GDP ratio. Its back to all-time highs in some indices, and like the last time we mentioned it, the recent crash was just a blip. This is a bit surprising considering economic disruption from Covid-19.



During the quarter there was a non-farm payroll result showing 2.8% growth, which resulted in a massive jump in the US market indices that day and continued upwards momentum, in general. There was also a self-congratulatory Trump tweet associated with the event. Well, this is what the US employment pictured looks like (the red circle emphasises the what the 2.8% signifies in the bigger picture):



And here is how corporate profits a tracking relative to the S&P 500 as of June:



Something is clearly amiss.

Below is an excerpt from the article the above chart is from, which sums it up:[2]

As Michael Lebowitz, CFA previously noted:

"As a result of these behaviours, we have witnessed a divergence in what has historically spelled success for investors. Stronger companies with predictable income generation and solid balance sheets have grossly underperformed companies with unreliable earnings and over-burdened balance sheets. The prospect of majestic future growth has trumped dependable growth. Companies with little to no income and massive debts have been the winners."

Such also occurred in late 1999 as companies with no earnings, no revenue, and no real growth strategy exploded higher in a speculative fuelled buying frenzy.

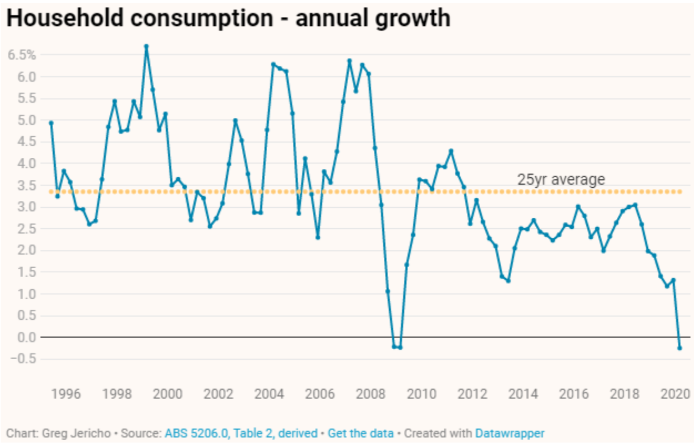
This underperformance of "value relative to "growth" is not unique. What is unusual is the current duration and magnitude of that underperformance. To say unprecedented is almost an understatement.

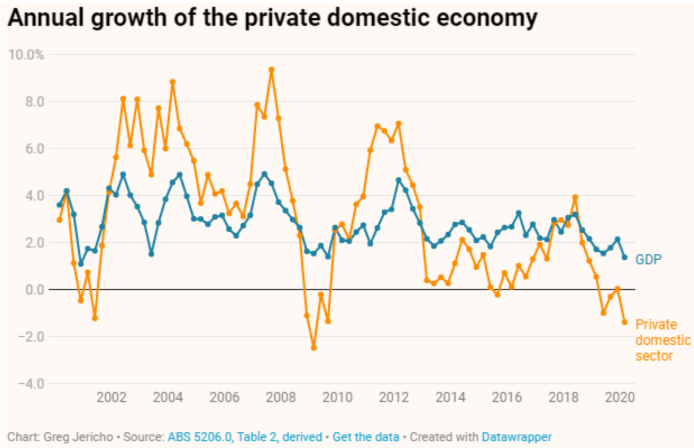
[2]#MacroView: Value Is Dead. Long Live Value Investing, https://realinvestmentadvice.com/macroview-value-is-dead-long-live-value-investing/

Once upon a time, waiting was a good strategy. Owing to our strategy, we have not touched what have proved to be zingers, like Afterpay.[3] As mentioned in the referenced article, fund managers who have not taken a stake in it have struggled to perform. It says something anecdotally about the limited breadth of the currently rally. Afterpay fell from a pre-crash high of ~$40 to a low of $8, then subsequently sored to over $70. It is inconceivable to think that anyone looking at this logically would have expected Afterpay to be at new highs. It might be the most overpriced tech stock on the planet right now. Analysts who downgraded it recently, with a target of $27.10 by Citi, for example, now find themselves more their doubling their valuations in order to keep up and their institutions clambering to underwrite capital raisings. As Michael Pascoe put it:

"Unsurprisingly, some greybeards hear echoes of the Dot Bomb era, but there are plenty of boosters thinking Afterpay is the best thing since tulips."[4]

Articles that present nice summary charts of our local conditions are rare, but here are a few that confirm how it has 'felt' for some of us over the past decade[5]:





We will leave it at that. Caution remains the theme.

News

We have some news that was eight years in the making. Despite all that time, it is still early days, but significant. The key conditions of the trading system we aim to implement are now coded and (re-)verified.

We were at this point way back in 2012, but realised two things:

1. The capital available was insufficient.
2. The level of code developed at the time required more work to filter out "noise" / improve the reliability that the alerts generated from scanning than were routinely workable and tradable with minimal fuss.

The system's raw criteria had been coded but the specific trend filter's had not been satisfactorily completed. (There was also the issue of preferred software environment we developed in having undergone language and architecture overhauls, while other selections were being bought out and made unavailable.)

It was possible to work with the level of coding at that point, but only if one could undertake the work full time. This would have required sufficient capital..... a chicken and egg problem.

So, from that point we continued to live test the system in semi-automated and manual fashion. Other aspects were also worked on, such as setting up for automated trading, which required working out how to get scanning software to pull live data and talk to brokers, plus determining implementing fail-safes,

We also worked on teaming up with coders to develop the trend filter aspects of the system. Six coders had a look and tried to work on the problem. All were talented, but they ultimately had little sustained interest in the challenges of trading systems. Seventh time lucky and 6 months later and we are close to the end point. So, it is coded (on different software to the original development environment), QA'd, re-backtested, and a sensible scanning/monitoring routine is presently being worked on. From there, we trade light to optimise the feel for it, while the remaining conditions are also worked on.

Website

A basic website has been constructed: www.auduco.com. The site displays the normalised share price on the performance page. If you wish to get an update on the share price prior to these reports being available, you can obtain it there. The share price its updated once a quarter at a minimum and is posted to the website within 5 days.

[3] Brutal for Australian Fund Managers that have Eschewed Afterpay, https://www.smh.com.au/business/companies/it-s-been-brutal-for-australian-funds-managers-who-eschewed-afterpay-20200708-p55a82.html

[4] Michael Pascoe: Afterpay market mania is tempting fate, https://thenewdaily.com.au/finance/finance-news/2020/07/13/afterpay-share-price-bubble-pascoe/

[5] Yes, Australia is in a Recession – but Worse is Yet to 2Come, https://www.theguardian.com/business/grogonomics/2020/jun/03/yes-australia-is-in-a-recession-but-worse-is-yet-to-come