

Kauri Communiqué

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What does war in Ukraine mean for the stock market?

History sheds some important insights on how the market fares during times of war, but are the risks different this time?

Monthly Portfolio Reports

Our portfolio managers take you through the main contributors and cover any changes across both the Australian and US markets.

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What does war in Ukraine mean for the stock market?

History sheds some important insights on how the market fares during times of war, but are the risks different this time?

As the world looks on at the devastating scenes unfolding in Ukraine, many of our worst fears of a war have come to light after recent months where conflict loomed as a distinct possibility.

For all the likelihood of a war breaking out based on surveillance intelligence, recent events have still been a shock for the global community.

In the wake of the recent crisis, there is now a significantly heightened element of uncertainty on a number of fronts.

This ranges from the outcome of the conflict and peace talks, Russian control of nuclear facilities in Ukraine, the global economic impact of sanctions introduced by countries around the world against Russia, how inflation might respond as commodity prices soar, and whether more countries find themselves directly involved as participants in a wider war.

The initial reaction for markets pointed to grave concerns across these areas, with stocks falling sharply. Since then, however, global indexes have been recording volatile swings, with markets staging a relief rally, but large negative sessions are still a common sight.

What does history suggest occurs during times of war? Let's take a closer look at what this might mean for the market.

How does the stock market perform during times of war?

History tells us that beyond an initial 'shock', wars tend to have little sustained impact on the stock market, nor growth in corporate earnings for that matter.

There are caveats of course. First, past performance is no indicator of future performance, especially when things appear to be sitting more on a knife-edge at the moment in terms of the conflict escalating into a broader international war involving NATO nations.

There has also been an unprecedented level of cooperation and implementation of sanctions directed towards Russia in response, and its status as a major commodities player is a curveball given the inflationary impact.

Nonetheless, if we consider the current conflict to be among the biggest, if not the biggest threat to global peace since the Second World War, it is worth noting that the Dow Jones actually increased 50% during World War II.

In this respect, it is incorrect to assume that geopolitical crises will inevitably result in market crashes. In our view, that shouldn't exclude the need to act with prudence, which is one reason why we are currently holding higher cash balances across all of our Portfolios at this time.

There are also other strategic reasons for this caution. This includes: flexibility to deploy funds into more attractive opportunities that have been sold down; and to ensure we have appropriate exposure to the sectors that we see outperforming.

If World War II is considered perhaps an anomaly in terms of stock market performance, what about other results? Well, research from the Swiss Finance Institute shows a surprising phenomenon when it comes to military conflicts involving the US since that date.

During 'pre-war' phases, the increasing prospect of a war breaking out has weighed on sentiment and typically yielded negative returns. But stocks have often rallied once a war does break out, with the exception where wars were started by surprise.

Another piece of research comes from Armbruster Capital Management. It looked at data spanning 1926 right through to 2013, and it came to the view that, with the exception of the Gulf War, volatility in the stock market was lower during periods where a war was active.

Why might stocks continue to rally during times of war?

It seems almost incomprehensible that a war could have little impact on the stock market. After all, there is untold chaos, destruction and grief, let alone the economic fallout and the hit to sentiment.

However, as we have learnt from various other black swan-like events, the market is not necessarily an indicator of the real world. It is only a reflection of the constituents that make up the key indexes.

And on that point, over the years, our markets have shifted in terms of their composition and the way the economy is also built on these names.

Reflecting on the current war, alongside the impact on exports out of Ukraine itself, the role of sanctions on Russia has sparked a sharp increase in a number of commodities, including oil, coal, gas, precious metals, base metals, and even agricultural staples as well.

This is because Russia is a global supplier of: 8-10% of oil supply; approximately 30% of natural gas; about 20% of palladium and 12% of platinum; about 8% of aluminium; and with the inclusion of Ukraine, roughly 27% of wheat and 15% of corn. Furthermore, supply constraints in the shipping waters around the region could also play a role.

While historically these commodity sectors have had an influence over US markets - it is easier to say they hold a bigger influence over the ASX - there has been a seismic shift in what other companies have contributed to the market in that time.

So while rallying commodity prices, and other sectors like defence become more prominent amid expected government spending, this is more of a catalyst for individual stocks. The reality is that the overall market will still be subject to the biggest drivers, which are the mega-tech stocks.

This is another reason why we have exercised some caution and sold down our holdings in some growth names during February, as these assets are more likely to face challenges in the current environment.

But that doesn't mean other sectors from energy to food and defence are not poised to rise during the current circumstances. In fact, that is principally why we have freed some capital across our Portfolios.

The other consideration at hand is the impact to global growth, with the potential for a domino effect. Soaring commodity prices are expected to feed through to inflation, and this is a barrier that central banks will need to contend with at a time when preparing to lift rates. That timing may sound aligned, but it raises further question marks and uncertainty over the pace at which rates increase.

Do central banks risk raising rates as quickly as they were preparing to, noting the uncertainty stemming from the war in Ukraine? On the contrary, do central banks risk raising rates slower than anticipated, and failing to quash inflation?

In our view, there is no doubt the current war has become a point of concern for the stock market in the near-term. However, if the war is somewhat contained and does not spiral into a broader conflict dragging in other countries, we would expect stock prices to resume their upwards trend. The historical data also suggests this is more likely than not.

The unprecedented nature and juncture of several themes at the moment is something that necessitates flexibility when it comes to decision-making.

Our lesson here is that you can never be too rigid with your investment thesis, you must be prepared to adapt and take into account new information and risks.

At the same time, uncertainty and fear is also the catalyst for opportunities, so being prepared and tailoring one's investments to the current climate is far more important than worrying about the day-to-day movements in the market.



Mike Smith
Managing Partner



MICHAEL SMITH
Head of Research and
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George Wong
Senior Financial Advisor

Performance:

Index	February Performance	2022 Performance
Dow Jones	-3.5%	-6.7%
NASDAQ	-3.4%	-12.1%
S&P 500	-3.1%	-8.2%
Global Growth Portfolio	-8.7%	-13.7%

Top 10 Holdings:

Code	Company Name	Weighting %
COST	Costco	7.3%
BRKB	Berkshire	6.1%
MSFT	Microsoft	6.1%
GOOGL	Google	5.9%
TGT	Target	4.0%
V	Visa	3.9%
PFE	Pfizer	3.6%
PG	P & G	3.5%
ISRG	Intuit	3.5%
CME	CME Group	3.1%

International

International Growth Portfolio

It was another difficult month for the Global Growth Portfolio in February as growth assets fell out of favour amid the outbreak of war in Ukraine, and momentum also swung against the US dollar.

In total, Growth Portfolio NAV decreased by 8.7%, trailing the likes of the Dow Jones, S&P 500 and Nasdaq. Each of these benchmark indexes declined in the vicinity of 3% to 3.5%, albeit those results are somewhat flattering given a modest relief rally in the last days of the month, while the timing of some of our exits from certain stocks was on the day the war broke out and the market tumbled sharply.

As alluded to earlier, the weaker greenback also had a prominent role in terms of the underperformance of the Portfolio. More specifically, our USD exposure resulted in a 3% decline in NAV in its own right, before taking into account the underlying movement in our holdings. Despite the fall in the USD/AUD from 1.4147 to 1.3770, we expect the US dollar will strengthen as the war intensifies. It's also worth noting the exchange rate has resulted in a 7% decline in our portfolio YTD.

The majority of our holdings were 'out-of-the-money' last month, with our exposure to underperforming stocks like Meta (FB) and PayPal (PY) hurting us. Both companies handed down disappointing earnings updates, however, we feel the sell-off may have been overdone here.

Elsewhere, some of our other big-tech holdings weighed on the Portfolio, including Apple (AAPL), Amazon (AMZN) and Alibaba (BABA). In light of the market conditions it has prompted us to take capital out of these names and rethink our sector exposure.

With that in mind, we have raised our cash holdings, but we intend to deploy these funds into compelling or attractive opportunities as they arise.

One of the particular areas we plan to increase our exposure to is the defence sector, namely Northrop Grumman (NOC), Lockheed Martin (LMT) and Raytheon (RTX). In our view, given the current crisis unfolding in Ukraine, security concerns will remain a present focus for many other countries, and defence expenditure in global budgets will inevitably increase.

We have also kept an open mind about the prospect of adding other stocks at the centre of the commodity and inflation boom. The war is driving prices sharply higher across energy and food commodities, so we may look closer at related stocks.

Following our selling activity, the Portfolio realised a minor loss of 0.5% of NAV from the end of January, while our unrealised gains were pared to 10.5% of February's closing NAV.



George Wong
Senior Financial Advisor

Hub 24 - Conservative



MICHAEL SMITH
Head of Research and
Senior Investment Advisor

Conservative Portfolio

NAV for the Conservative Portfolio declined by 0.6% last month, which was significantly ahead of global markets, albeit the result represented an underperformance compared with the ASX 200, which gained 1.1% during February.

More specifically, our holdings in ASX companies fared reasonably well, but the Portfolio was let down by a number of disappointing results from funds with high exposure to global equities and bonds.

The biggest drags on the Conservative Portfolio were the NB Global Corporate Income Trust (NBI), Hearts and Minds Investments (HM1), KKR Credit Income Fund (KKC), MFF Capital Investments (MFF) and the VanEck MSCI International Quality ETF (QUAL).

Performance:

Index	February Performance	2022 Performance
ASX 200	1.1%	-5.3%
ALLORDS	0.8%	-5.9%
Conservative Portfolio	-0.6%	-3.5%

In light of their underperformance, we have reduced some of our exposure to these funds given the risks and uncertainty for markets associated with the war in Ukraine. Furthermore, we feel the market pull-back provides us with the opportunity to be more selective in where we invest our capital, and with buying opportunities emerging, we would prefer having the flexibility as opposed to relying on fund managers.

There were some positive signs last month, however, with gold hitting a multi-month high and sparking a rally in Newcrest Mining (NCM) shares. It has taken a little longer for gold to rally than we might have expected, and in rather unfortunate circumstances given the war, but we always view gold as an integral part of a defensive Portfolio to act as a hedge as it has here.

Our iron ore miners in BHP (BHP) and Rio Tinto (RIO) also posted robust gains, up 5.2% and 5.9% respectively as iron ore prices firmed on expectations China's appetite for the commodity may pick up.

In light of the circumstances at this time, and with the Fed poised to lift rates imminently, we are currently holding a higher cash balance than normal. For the Conservative Portfolio, capital preservation and income generation is a key requirement, so it is imperative we exercise caution during these moments, and we will be looking to take up more exposure to hybrids to generate fixed income.

That doesn't necessarily mean we have turned away from our conviction in the market's mid-to-long-term outlook, but we do need to be prudent in our decision-making for the time being.



George Wong
Senior Financial Advisor



Samuel Waldron
Financial Analyst

Hub 24 - Balanced

Balanced Portfolio

NAV for the Balanced Portfolio decreased 3.2% in February, trailing the ASX 200, which advanced 1.1%. We have a greater bias towards growth assets in the Balanced Portfolio, particularly international stocks, which goes some way towards explaining the Portfolio's underperformance and the discrepancy when compared with the Conservative Portfolio.

On that note, we saw our biggest drag on the Balanced Portfolio come from the likes of the T. Rowe Price Global Equity Fund, Betashares Nasdaq 100 ETF (NDQ), ETFS FANG+ ETF (FANG), Hyperion Global (HYGG), as well as the VanEck MSCI International Quality ETF (QUAL) and Vanguard US Total Market (VTS).

Overseas stocks are currently facing a number of headwinds, and investors are responding to global concerns including the crisis taking place in Ukraine at the moment.

This has also made us pause for thought, and we have taken the opportunity to exit some of our underperforming growth stocks like Xero (XRO), Pointsbet (PBH) and Square (SQ2) - formerly Afterpay.

As a result, we are currently holding more cash in the Balanced Portfolio than we normally would, but we feel as though this will allow us to be more nimble entering new positions once we identify risk-adjusted investment opportunities.

In terms of specific opportunities, we may look to increase our fixed income exposure via hybrids and similar securities. In our view, this would be an appropriate option given the volatility and negative sentiment that is weighing on unprofitable companies and stocks trading at higher multiples.

Rio Tinto (RIO) and BHP (BHP) were two of the positive names last month, rallying in line with broader support for commodity markets. However, as the Balanced Portfolio holds a large number of holdings, there was relatively limited upside for the broader Portfolio despite the strong performances of these heavyweight stocks.

We expect volatility to remain a prominent fixture in the near-term, and with global economic growth concerns now a live issue, plus the Federal Reserve also poised to lift rates, we believe it is appropriate to have some cash at our disposal to ride out this uncertain period.

Performance:

Index	February Performance	2022 Performance
ASX 200	1.1%	-5.3%
ALLORDS	0.8%	-5.9%
Balanced Portfolio	-3.2%	-8.4%



George Wong
Senior Financial Advisor



Samuel Waldron
Financial Analyst

Hub 24 - Growth

Growth Portfolio

Last month saw NAV for the Hub24 Growth Portfolio decline by 3.4%, with the Portfolio trailing both the Conservative and Balanced Portfolios for the second month in a row. This time around, however, the Portfolio also lagged the ASX 200, which rose 1.1% thanks to the performance of the energy and materials sectors.

While our Growth Portfolio provides some exposure to materials by way of holdings in BHP (BHP), Rio Tinto (RIO) and Fortescue Metals (FMG), it was the limited exposure to gold, and the absence of any oil stocks that partly explained last month's underperformance. Both of these sectors rallied strongly as the war broke out in Ukraine and commodity prices soared to fresh highs.

Nonetheless, Lynas Rare Earths (LYC) and OZ Minerals (OZL) offered some support for the Portfolio, up 13.9% and 6.2% respectively. Lynas, as the standout of the two, posted record first-half profits amid surging demand for its rare earths. Meanwhile, OZ Minerals has been leveraged to copper prices hitting all-time highs, and to a lesser extent, surging gold prices as well.

The other factor behind last month's underperformance was our large weighting towards international stocks. The ASX was largely shielded from the full extent of February's sell-off due to its high concentration of resources companies, but US markets fared much worse due to the number of growth names that prop up the market.

As a result, we took a big hit across many of the funds that also weighed on the performance of the Balanced Portfolio, including the T. Rowe Price Global Equity Fund, Betashares Nasdaq 100 ETF (NDQ), ETFS FANG+ ETF (FANG), Hearts and Minds Investments (HM1), Hyperion Global (HYGG), VanEck MSCI International Quality ETF (QUAL), plus the Vanguard US Total Market (VTS).

As we have made the decision to do in our other Hub24 Portfolios, last month provided us an opportunity to recalibrate the Portfolio and increase our cash position by selling out of companies trading on lofty valuations, and reducing the weight of our exposure in other areas.

While we still maintain a positive stock market outlook for the mid-term, we are also cognisant that we need to manage through the current volatile conditions. In this respect, our near-term priority is freeing cash partly for deployment into hybrids for fixed interest, and monitoring other opportunities in beaten-down stocks.

Performance:

Index	February Performance	2022 Performance
ASX 200	1.1%	-5.3%
ALLORDS	0.8%	-5.9%
Growth Portfolio	-3.4%	-9.2%



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