Quarterly Comment – December 2016

Alphinity Wholesale Australian Equity Fund

Santa Delivers Again

Market comment

A fairly reliable phenomenon in equity markets is the Santa Clause Rally, the positive run in the market in the lead-up to the end of a calendar year. Despite all that was wrong in the world in 2016, the year-end rally in global equity markets, which started with the election success of Trump in November, was unstoppable. Santa didn’t disappoint. Whether or not his largesse extends far into the New Year remains to be seen but we will accept what has been given so far and be satisfied with the solid double-digit returns realised by Australian equities over the year.

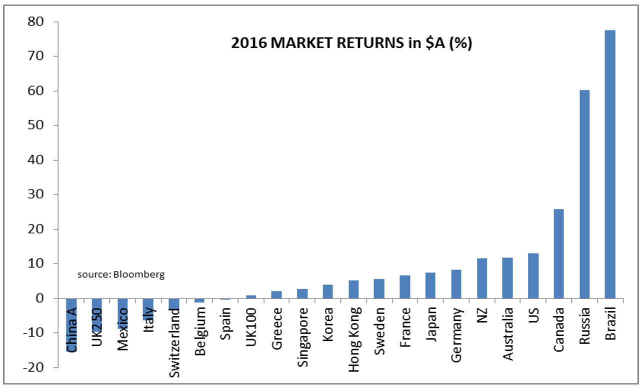
To recap, 2016 started poorly with a sharp global market slump in January and the early part of February as the world adjusted to the US rate cycle entering tightening mode in December 2015. The reality was quite benign: there were no more moves all year until the 0.25% increase in December 2016. The Australian market suffered a nasty 15% fall between January 1 and mid-February, bottoming during the rather tepid interim reporting season, but recovered that fall and more in the lead-up to the federal budget in May. Of course that budget coincided with the announcement of a double dissolution election which was cause for some market softness, compounded in June by the surprise Brexit vote in the UK which caused our shares to fall again. A resurgence in the prices of commodities important to Australia, which had been building all year, set resource company shares running in the second half pushing the market to new highs, essentially ignoring the local election result which was not a good outcome for anyone. Markets softened into the US election, falling back to post-Brexit levels, but after the new seemingly pro-business US President’s surprise election in November it took off again, rallying sharply in November and December to record a decent total return of 11.8% (ASX300 including dividends).

In other parts of the world, commodity-exposed markets did the best in $A terms in 2016 (see chart), the best being Brazil which returned more than 70% (for context it fell sharply in 2015 so on a two-year basis it is up a more reasonable 20%). Russia and Canada were also strong. The US pipped Australia with 13% but other markets did less well: Japan +8%, European markets ranged from -6% to +8%, Mexico -9% and China (Shanghai) -15%. The UK did poorly post-Brexit reflecting the devaluation of the Pound: the FTSE 100 was flat for the year in $A terms but the domestically-focused FTSE250 fell 10%. There were some big currency moves in 2016, the most dramatic being the Pound Sterling, which lost a fifth of its value post-Brexit. The Euro was also soft. The $A traded between $US0.69 and $US0.78 but finished the year pretty much where it started, a little above $US0.72.

Despite a little year-end softness $A commodity prices were impressive over the year, the best rises being in the bulks with Metallurgical Coal (+192%), Iron Ore (+84%) and Thermal Coal (+76%). Base Metals were also quite strong: Zinc +62%, Tin +47%, Copper +18% and Lead +12%. Aluminium was up 13% and Gold +10%. Oil (Brent) rose 24% but Uranium fell 40% over the year.

Portfolio comment

The Fund outperformed in the December quarter, over and above the strong market return. The best contributions came from Resource or resource-related companies: steel recycler Sims Metal, iron ore producer Fortescue Metals and diversified resource giant Rio Tinto provided material positives, while not owning toll road operator Transurban also helped. On the negative side were drug-maker Mayne Pharma; not owning global insurance company QBE also hurt somewhat.



Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	4.0	5.3	8.8	5.6	12.5	11.0
S&P/ASX 300 Accumulation Index	4.3	4.9	11.8	6.6	11.6	10.0

*Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance.

^The Fund changed investment manager and investment methodology on 12 July 2010, at which time Alphinity Investment Management commenced managing the Fund and started the transitioning of the portfolios to a structure consistent with Alphinity’s investment views. The transition was completed on 31 August 2010. The inception date for the returns for the Fund is 1 September 2010. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 during Sydney business hours.

Alphinity INVESTMENT MANAGEMENT

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Market outlook

2016 again showed how difficult it is to predict equity market returns over time periods as short as 12 months. After a dramatic fall at the start of the year, the Australian equity market went on to produce its best annual return since 2013 and its fifth consecutive year of positive returns. A steady, if only modest, improvement in global economic growth, which was led by the US but also evident in large emerging countries like China, and the rally in commodity prices explains some of the advance but the reality is that about half of the market's gains for the year happened after the election of Donald Trump as the next US president. That's a lot of optimism for someone with a fairly untested policy agenda who is yet to actually take office.

Having said that, given that sentiment plays a tangible role in economic cycles, it is worth noting that US consumer confidence hit a 15-year high in December. Perhaps now that unemployment is back well below 5%, and with some signs of better wage growth and a pickup in inflation, Trump may have added the missing confidence boost to solidify economic growth prospects. His proposed tax cuts seem to have widespread support amongst his Republican party colleagues so should be relatively straightforward to implement. Corporate tax rate cuts should have the effect of increasing company valuations as the amount of profits available to equity holders will increase, although arguably some of that might already have been reflected in the rally so far. As always, however, much commentary in this matter remains speculation until the final detail is revealed.

What about interest rates? Monetary conditions and liquidity are after all key drivers of equity markets and, while the pace of tightening can be debated, the upward trajectory seems clear. It should thus be an interesting balancing act for the market in 2017, with the prospects for better growth potentially (and maybe more than) offset by higher interest rates and reduced liquidity. Either way, after such a strong finish to 2016 some consolidation could be expected in the near term.

Top 5 active overweight positions as at 31 December 2016	Index weight %	Active weight %
Goodman Group	0.7	2.1
Rio Tinto	1.7	2.1
Macquarie Group	1.9	1.8
Aristocrat Leisure	0.6	1.8
Treasury Wine Estates	0.5	1.7

Portfolio Outlook

We enter 2017 with a portfolio firmly positioned for higher bond yields (underweight Property, Telcos and other bond proxy stocks) and continued strength in commodity prices (overweight Resources). While the performance trends supporting these positions have been in place for 8-10 months now, we think bonds yields are likely to continue to grind higher in 2017 and commodity prices will be more sustainable than what is currently reflected in earnings estimates and share prices, especially for FY18 forecasts and beyond.

At the same time, we believe we are now well into the second phase of the change in market leadership, where a stock just being in the right or wrong sector is not sufficient reason for continued out- or under-performance. Individual company factors such as management's operational performance and investment decisions, cost out opportunities, balance sheet etc. will increasingly determine relative stock performance. In other words, stock picking should become increasingly important.

Alphinity is first and foremost a stock-picking manager and we believe this should assist us in generating competitive returns in 2017. As an example of such opportunities, Origin and Santos have been two of the biggest beneficiaries of a combination of investors' increased risk appetite and the recovery in the oil price. Both companies overextended themselves during the oil price boom and their respective share prices suffered from both project cost overruns and overly optimistic Liquefied Natural Gas (LNG) price assumptions. Both companies have newly appointed CEOs charged with restoring their respective company's balance sheets and then positioning those companies for growth.

Alphinity added Origin to the Fund's portfolio during the December quarter. We believe Origin has significant potential to reduce financial risk by deleveraging its balance sheet from asset sales and cash generated by its utility business, which is benefiting from increasing electricity wholesale prices. It has a superior gas resource position which underpins the full utilisation of its two-train LNG development at Gladstone, as well as the ability to arbitrage between the LNG export market and the domestic gas market. This should set the company up for an earnings upgrade cycle that has, in our experience, been the beginning of outperformance.

Asset allocation	31 December 2016 %	Range %
Securities	98.2	90-100
Cash	1.8	0-10

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BTW

Much is being made of that bastion of the US equity market, the Dow Jones Industrial Average, potentially reaching 20,000 for the first time, as it almost did in December. What does it mean though? Does Alphinity get excited by this milestone? Not at all. The Dow, as it is known, is just an index and not a particularly well-composed one at that.

Australia's main local benchmark, the ASX300, is made up of the 300 largest stocks listed on the ASX and the prominence given to each company varies according to its market capitalisation (i.e. share price x number of shares available to be investors). Most indices around the world are constructed this way. It means that price movements in a large company like say Commonwealth Bank make much more of an impact on the level of the index than a small company, like say Bendigo & Adelaide Bank. CBA is around 20 times BEN's size so it would take a much bigger move in BEN's share price to move the index as much as a small move in CBA. This makes intuitive sense.

The Dow, however, consists of only 30 stocks and is share price weighted. This means that a company with a high share price, such as Goldman Sachs' $240/share, makes up a much bigger proportion of the Dow than one with a low price, like General Electric at $30 a share. According to Bloomberg GS makes up 8.4% of the Dow versus only 1.1% for GE, despite GE having a $US280 billion market cap, almost three times that of GS. The biggest US company, Apple with its >$600 billion market cap, is only 4% of the Dow. This does not make intuitive sense.

And 30 stocks can hardly be representative of the thousands of listed companies in the USA which is why most in the market look instead at the S&P500, the 500 biggest stocks, or the even broader Russell 3000 which takes in 98% of US companies by market cap.

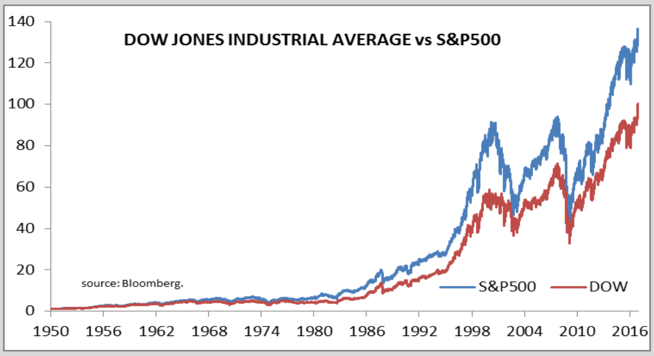
The Dow does however have longevity in its favour. It was founded by Charles Dow in New York in 1884 and was no doubt state of the art for its time; the S&P500 has been around only since the Second World War. "The Dow" also sounds a bit cooler than Standard & Poor's (although incidentally that company owns the Dow Jones Indices as well as the S&P500: it bought the Dow from News Corporation after News acquired it along with the Wall Street Journal in 2006).

So why does the Dow have so much resonance? As for most things, we blame the media. Everyone knows the Dow, it is quoted ad nauseum on the news, including the notion that it is "just short of the 20,000 barrier". 20,000 is no barrier, it is merely a round number which is the outcome of a mathematical equation. Having said that, legions of people around the world engage in technical analysis – looking for share price patterns which may or may not exist and trading on the back of them – so sometimes these notions can become self-fulfilling.

The Dow is the highest it's ever been, but so it should be. As most companies aim to produce higher earnings over time, their shares should be worth progressively more too. In a perfect world a share market index would just display a slow and steady march upwards as the constituent share prices factor in gradually higher earnings. The market should be hitting all-time highs regularly, so the fact the Dow (and S&P500 for that matter) is doing that now shouldn't really be much of a surprise.

Of course the reality is quite different. The nature of markets is to try to anticipate what will happen in the future and get ahead of the trend. You think a company might be going to have a particularly good year next year so you want to buy the shares at today's price in the expectation that you'll get a boost when/if your expectation becomes reality. Or, conversely, you think a company will have a terrible year so you sell before everyone else realises. That's why share prices wax and wane as they do, as the normal market forces of supply and demand swamp what should ideally be a calm, steady progression of earnings. In addition there are many and varied macro forces at play in the world influencing stock prices. And each company has a different earnings cycle, which is why Alphinity can generally find companies in an upgrade cycle regardless of what is happening in the economic cycle or even the market cycle. From period to period individual stocks that make up the portfolio might be overcome by those macro forces, but over time the performance of the Fund has been very consistent.

So which has provided a better outcome, the price-weighted benchmark of 30 stocks or the cap-weighted one of 500? As always with these things it depends on the timeframe, you will always be able to find a period that suits your case. But as the chart below shows, over the very long term – i.e. since 1950 – the S&P has won by quite a margin: DJIA is up 100 times; the S&P500 136 times. It is interesting to note the Crash of '87 which is now just a blip, and just how bad were both the Tech Wreck and the GFC. But when it comes to US stock market indices our advice is to do what we do: just don't think about the Dow!



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Traveller's Tale

Stephane went to South Africa in December to see South 32's manganese (see photo), aluminium and coal assets there as well as a number of iron ore mining companies like Kumba, Assmang, Exxaro and African Rainbow Minerals, and state-owned service providers Eskom and Transnet.

Stephane lived in South Africa for some years in the period just after Mandela came to power and still loves the country and its people. He moved to Sydney around the turn of the century and had not been back there for some years. It was very sad for him to see that governance in that country has gone backwards since Mandela gave up leadership in 1999. The current government is causing significant unrest and there have been numerous corruption claims and several attempts to impeach the president.

While cruising along the highway in Kwazulu Natal with his driver the car was stopped by a policeman jumping into the middle of the highway in front of them. The policeman alleged that the speed limit had been slightly exceeded, which may or may not have been the case. He engaged in an intense discussion with the driver, insisting that they go to the closest police station to pay a 1000 Rand fine (~$A100). The driver argued that this would really not be possible as Stephane was already late to catch his flight. In any case he only had 200 Rand on him.

The officer started to smile and, looking at the cash, suggested "maybe we can find a solution that will work for us all". Perhaps he could take the cash to the police station, or even just cancel the ticket altogether? The driver however argued that he would rather pay the full fine and that it should be posted to his home.

It was startling to see through this little event how wide-spread and petty is the attempt at corruption. There were obviously no hard feelings though, as the policeman waved us off he warned us to slow down at a bridge a few kilometres on as another police patrol was stationed there!

Alphinity Investment Management

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