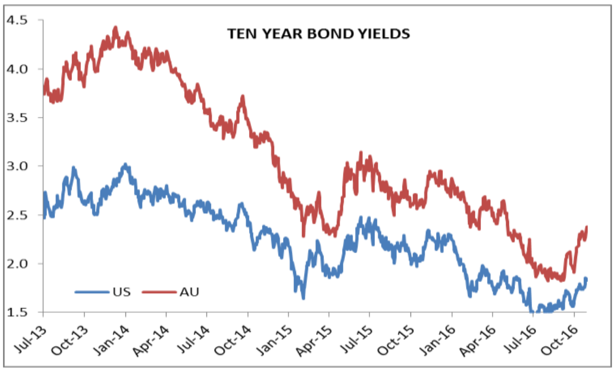
Monthly Comment – October 2016
Alphinity Wholesale Australian Share Fund

Trumped!

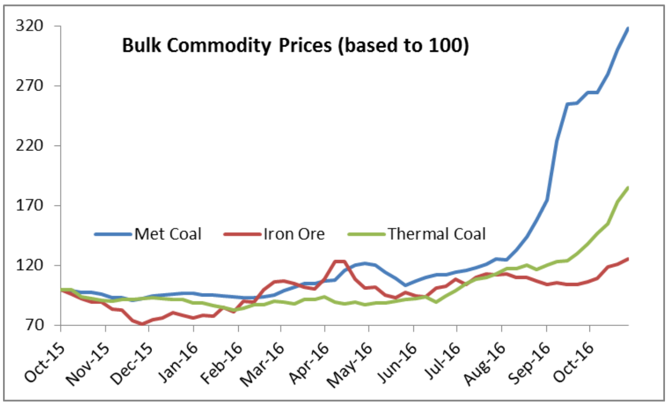
Market comment

The Australian share market (ASX300 including dividends) lost about 2% in October, putting us in the middle of the pack of stock market returns which were bounded by New Zealand at the low point (-6.5%) and Japan at the high (+3%). The UK lost 4% while US returned -1%. France and Germany just about broke even for the month. The $A was pretty much unchanged for the month at $US0.76.

Resource stocks held up well in October; only this sector and the Banks produced positive returns, albeit both less than 2%. More than offsetting that however was very poor performance from Healthcare and Property stocks: both sectors were down 8% in the month. One of the big features of the month was a sharp reversal of the recent strength in bond yields. Long bonds have backed up sharply from recent historic lows, causing so-called bond proxy stocks (these are generally in high-yielding sectors like Telecommunications, Property and Utilities) to underperform sharply. The chart below shows a noticeable move upwards in bond yields in Australia and the US. Notwithstanding this, yields remain very low even by the standards of recent history so if the bond sell-off were to continue those stock performance trends might as well.



Commodity prices were generally firm in October but the standouts were the bulks: Iron Ore, Thermal Coal and Metallurgical Coal. Iron Ore bottomed out in December 2015 below $US40 per tonne but recovered to $US65/tonne by the end of October. Metallurgical Coal, which is used to convert iron ore into steel, has been even stronger and is now more than triple its December 2015 low of $US75/tonne. Thermal Coal, which is used for power generation, troughed in March this year below $US50 and finished October just over $US100. Whether those prices can be maintained remains to be seen but, for now, many resource company share prices are very healthy indeed.



Base metals were generally stronger but much more subdued than the bulks: Aluminium and Zinc up 3-4% but Lead and Nickel fell slightly. Crude Oil and Gold both fell 3-4% as well.

And in late-breaking news, for what feels like the umpteenth time this year, the overwhelming consensus was overturned and Donald Trump became US President-elect.

Portfolio comment

The Fund performed better than the market during October although most stock movements were relatively small. The best contributors were not surprisingly in the commodity space: iron ore producer Fortescue Metals and diversified miner Rio Tinto while not owning toll road operator Transurban also helped. Against that, our positions in Goodman Group and Sydney Airport detracted modestly from returns.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	-1.9	-3.3	4.6	3.3	10.0	8.4
S&P/ASX 300 Accumulation Index	-2.2	-3.2	6.3	3.9	9.0	7.7

*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

October saw a continuation of the three market themes we explored last month: the outperformance of cyclicals, the underperformance of yield proxy stocks, and the rotation out of high Price-to-Equity stocks. There are a lot of interrelationships between these themes and they are really just different outcomes (or perhaps causes) of one overarching topic: the likely bottoming in global interest rates. How long has this theme left to run?

The answer is as usual, it depends. Many yield proxy stocks have already corrected by 10-15% in the relatively flat equity market so far in FY17 and bond yields, while off their lows, are likely to remain well below historical levels for some time. And it depends primarily on whether higher interest rates will stall the nascent improvement in global economic growth that currently appears to be underway. If that were to occur we may see a reversal of recent market moves, with cyclical stocks selling off again and the chase for yield and earnings growth in secular growth sectors return. However, we think that there are several factors that reduce the likelihood of this occurring.

Firstly, the improvement in economic growth has been fairly broad-based with developing countries benefiting from the recovery in commodity prices. Secondly, higher commodity prices have already markedly improved the balance sheets of many Resource companies, which has not only reduced their vulnerability from potential price setbacks but also lessened the credit risk for banks and other lenders to the industry, thereby reducing the risk of a downward spiral. Thirdly, inflation has gradually been ticking up, which should reduce the scope for interest rates to fall significantly again.

A more likely scenario in our view is that bond yields will continue to grind higher putting further pressure on yield proxy stocks, while Resource company earnings upgrades will persist if coal and iron ore prices keep proving more resilient than the market expects. This should provide support for continued relative outperformance by the Resource sector and reduce the overall earning scarcity which pushed up the valuation of more defensive sectors.

In addition, moves in financial markets in the final weeks of the US presidential election, both before and after the result was known, have been interesting to observe. The late resurgence of Republican candidate Trump ahead of election day saw equity investors hit the “risk-off” button. However the reaction in the bond market and the performance of yield proxy stocks was noticeably muted compared to other risk-off events over the last few years. This may be an indication that investors are increasingly reluctant to back this part of the market which had, until recently, appeared to be almost bullet proof. Initial reactions to Trump’s surprise victory have seen bond yields rise further as his policies of infrastructure spending and tax cuts are seen as potentially positive for US growth and certainly inflationary. If correct, as unexpected as Trump’s victory was, this could add further strength to our thinking.

Portfolio Outlook

The relative sector performances discussed above have benefited the portfolio so far in FY17, and should keep doing so if they continue. However within these sectors the outperformance generated from stock selection has been the greatest contributor. This is encouraging. Our experience is that as sector rotation matures, relative performance becomes even more stock specific as only those companies that can take advantage of the improved industry fundamentals and deliver better than expected earnings will continue to outperform.

Recent stock selection has been particularly successful in the Resource sector. Since Fortescue Metals was added to the portfolio in October last year, it has been one of our strongest contributors to performance. This has been through a combination of better-than-anticipated cost performance and of course the stronger iron ore price. These have not only delivered earnings dramatically ahead of market expectations but also transformed the company’s balance sheet, leaving it with much more manageable debt levels than in the past. If current pricing trends persist, that debt will even look conservative in a year or so.

Two more recent additions to our Resource exposure are South32 and Sims Metal. South32 has significant earnings upside from the rally in commodity prices with its key exposures manganese, coking coal and alumina all trading well above market expectations. The company also has a major cost reduction program underway. In combination, these factors will generate significant free cashflow that is likely to be used for capital management as well as smaller acquisitions. Sims Metal exposure is primarily to the export of scrap metal collected in the US. This has been a challenging market for several years which has masked an impressive efficiency drive by management. We expect this will deliver strong earnings growth once volumes stabilise, as they currently appear to be doing.

Asset allocation	31 October 2016 %	Range %
Securities	97.6	90-100
Cash	2.4	0-10

Top 5 active overweight positions as at 31 October 2016	Index weight %	Active weight %
Goodman Group	0.8	2.2
Macquarie Group	1.9	1.9
Aristocrat Leisure	0.6	1.8
Rio Tinto	1.6	1.8
Treasury Wine Estates	0.6	1.8

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BTW

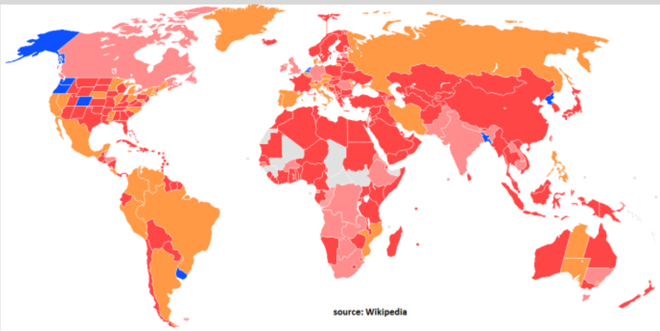
We now know the result of the US Presidential election. And it hasn't come soon enough – it feels like this race has been going on for years, ever since the second inauguration of Barack Obama almost four years ago.

But amidst the hoopla it is often forgotten that there are issues at stake in this election other than "just" who becomes President: voting for Congress (the House of Representatives and the Senate) takes place at the same time and is probably just as important, after all the Speaker of the House is effectively the equivalent of our Prime Minister. While the President gets all the glamour and attention, it is Congress that largely determines what the President can achieve. Which party actually controls either or both the House and the Senate also feeds into the legislation that is passed and the direction of the country. When all three are controlled by the same party there is the prospect of coordinated policy to address some of the issues facing the country and produce wholesale change. The end of policy gridlock may not be such a bad thing.

Other than the House, Senate and President, individual States usually take the opportunity to put other issues to the people, leading to situations where the range of items to be voted on is immense: no wonder so many people choose not to vote! California residents for instance have 17 propositions on which to vote, in addition to deciding on the politicians. 14 of these are citizen-initiated. The issues are diverse, ranging from Finance (bond issuance for various purposes) through Income Taxes (the US states impose income tax additional to federal income tax, and the proposition would increase tax on individuals with incomes over $US250,000 or couples over $536,000 – who wouldn't vote for that?) and Gun Control (requiring background checks and prohibiting large-capacity ammunition magazines) to the Death Penalty (one to repeal it and another to modify appeals procedures). The strangest may be one that would require actors in porn movies produced in the state to use condoms. The most banal is one that relates to shopping bags.

But possibly the most socially significant is Proposition 64. This involves the legalisation of marijuana for recreational purposes for persons aged 21 or over. While marijuana has been allowed there for some years for medicinal purposes, it has still been against the law to grow and sell marijuana for any other use.

The map below shows regions of the world in which marijuana is totally legal in blue. Other regions have differing levels of legitimacy but in the red bits it is illegal. Most legal places are in the US (Alaska, Washington, Oregon and Colorado) but there are some surprisingly dispersed spots of blue. Uruguay. Bangladesh. Even North Korea. In North Korea it is known as 'yoksam' and, as *Huffington Post* reported a few years ago, it is freely purchasable in markets and openly consumed there.



source: Wikipedia

Bringing this sector of the black economy under government sanction will undoubtedly have a big impact on Californian society. Marijuana could become a major cultivatable crop, and the state would take tax of $US9.25 per ounce on cannabis flowers and $2.75 on leaves, as well as a 15% sales tax on the final product. The first $25m will be spread between medical and social research, funding the highway patrol to develop impairment detection devices, and health departments and non-profit organisations for drug abuse and mental health programs. Of the balance 60% will be spent on youth programs around drug education, treatment and prevention, 20% on environmental causes and the balance to programs to mitigate any negative impacts on health or safety which might result from the proposition.

This could end up being quite a lot of money. Colorado did the same thing in 2013. Last year, from its population of 5 million, it collected $US135m in tax from marijuana sales. California's 40 million people, one would think, are at least as likely to indulge as Coloradans so even just pro-rata-ing that number comes to more than a billion dollars. There will also be an immense amount of time freed up for police to concentrate on things other than enforcing marijuana laws.

Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size	$131.8M
APIR code	PAM0001AU

Fees	
2015/16 ICR	0.90%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	Nil
Buy/sell spread	+0.20%/-0.20%

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Traveller's Tale

One of the joys and trials of investing in stocks is the need to get on the road and see companies, both locally and overseas. This can bring with it risks: not just the normal risk involved in air travel but also risk on the ground. Our intrepid resource guru Stephane in particular spends a lot of time in what some might consider unsafe parts of the world checking out mines in places like Mongolia, China, South America and various parts of Africa, or seeking information in places like Iran as he did earlier this year. He's heading back to Africa in November for more excitement.

But it isn't all danger and hardship. Bruce was in the USA in October primarily for property reasons, spending time with management and seeing the operations of two companies in the portfolio (Goodman Group, Lendlease) and one that might be one day (Westfield). When he was done with that he headed to the Napa Valley, just north of San Francisco, for a couple of days catching up with some wine company contacts. Treasury Wine Estates is the only investable wine company on the ASX, one that has been a good contributor to returns since it entered the portfolio a bit over a year ago.

Companies often only tell you what they want you to hear (not that we would ever accuse TWE of that!), so it's important to have a variety of outside contacts in order to cross-check what you hear with people without a barrow to push. One pleasing thing about the wine industry is that the participants tend to be friendly and gregarious, and are usually happy to share their insights. This might have something to do with qualities of the product involved.

Napa in early autumn is idyllic, and one thing evident from the trip is that Treasury has some magnificent assets there, vineyards and properties, some with heritage back to the 1800s.

It also has a burgeoning tourism business with substantial wine sales through the cellar door and significant revenue just from visitation. At one property 200,000 people a year pay up to $US40 each for the cable car trip up a small mountain and a tasting at the Stirling winery, which Treasury acquired in 2015 from global spirits company Diageo. It is beautifully set up for tourism with a self-guided tour around viewing platforms with various wine tasting bays, finishing off on a deck with a place to sit down for lunch and lovely views down the vine-filled valley.

One phenomenon incidental to the wine industry is that of "Google Kids". Silicon Valley is less than two hours away by Tesla, so Napa and its surrounding towns have become an attractive place for cashed-up techies to get away to after a hard week in the bean bags. This means that very modest houses now cost quite a lot of money, which is increasingly crowding out the modestly-paid workers in the wine industry who make the Valley so attractive in the first place. You might expect that to happen in big cities but not out in the countryside.

Alphinity Investment Management

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