Alphinity INVESTMENT MANAGEMENT

Monthly Comment – August 2016
Alphinity Wholesale Australian Share Fund

Gold! Gold! Gold!

Market comment

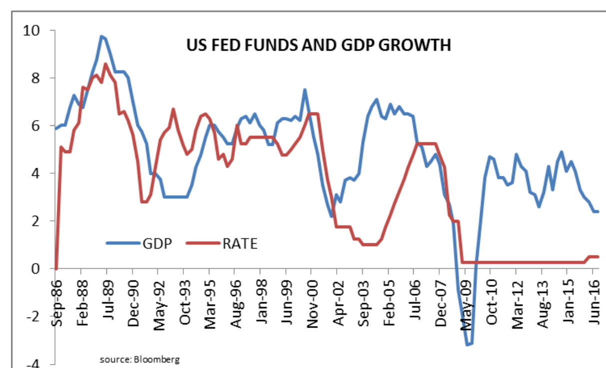
…as the late great Norman May might have said. Gold has been a great performer so far in 2016, starting the year at $A1450/oz and rising to $A1750 by the end of August, despite the headwind of a firming $A. But demand for that precious metal was not overly stretched by the Australian Olympic team in Brazil in August. Australia won eight gold medals, mostly in events involving water and firearms, and 29 medals in total. This was not its finest performance: that was at the Sydney Olympics in 2000 when the local team won twice the number of medals in total, 16 of which were gold.

The Olympics telecast provided a handy occasional distraction from what was at times quite a dour Reporting Season. While the ASX300 (including dividends) only fell a little in August there were, as always, some very significant individual stock movements as well as some large macro moves which often swamped fundamentals. The biggest active weights in the portfolio which reported (bearing in mind that some large holdings such as Aristocrat Leisure and Macquarie Group have out-of-synch financial years) overwhelmingly had pleasing results, and only one major holding detracted. Some of the biggest underweights in our portfolio, like Telstra and Transurban, also underperformed meaningfully. On the other hand, we did miss out on some stocks that produced strong reactions, like Woodside and JB Hi Fi.

Most global markets in $A did a little better than Australia in August, counter to July's trend. The US was up 1%, UK up 2% and most European markets 3-4% higher. Asian markets were similar, with Japan up 1% and China and HK up more than 4%. The $A itself fell fractionally after Glenn Stevens' farewell rate cut at the start of the month.

Base metals were mixed in August with nickel -8%, copper -6% and aluminium -2.5% although tin, lead and zinc were up between 3 and 6%. Iron ore, a very important commodity for Australia, was largely unchanged at a price that produces decent profits for most domestic players. The price of oil rose by 10% in the month, continuing its recent run of strength despite there being no shortage of supply.

There continues to be some big macro themes impacting on bourses worldwide. Top of mind is the state of monetary policy in the world's two biggest economic groupings, the US and Europe. With the US having stuck with short term rates so low for so many years, the tentative hike of 0.25% that took place just before last Christmas might soon be repeated – or so the market is starting to believe. This chart showing rates and GDP growth would suggest that the move is well overdue – in fact it may almost be time to start cutting rates again. In Europe there are signs of monetary fatigue with some senior figures suggesting the end of its easing program might be nigh.



And of course the US election draws ever closer. We are living in interesting times.

Portfolio comment

The Fund performed fractionally under the market in August despite some good individual efforts. Gold went to the Fund's position in Treasury Wine Estates, which finished with a Usain Bolt-style grin at the camera as it passed the finish line; silver went to Macquarie Group and bronze was taken out by Fortescue Metals. The only wooden spoon went to Adelaide Brighton Cement which tripped just before the finish line. Not owning Woodside Petroleum hurt a little.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	-1.8	2.0	7.6	6.1	10.6	8.9
S&P/ASX 300 Accumulation Index	-1.6	2.1	9.7	6.6	9.5	8.2

*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

Monthly Comment – August 2016
Alphinity Wholesale Australian Share Fund

Market outlook

Two steps forward, one step back. Having breathed a collective sigh of relief in July, after realising that Brexit would not lead to immediate economic chaos, the global equity market has turned its focus back to the potential for one or even two rate hikes by the US Federal Reserve Bank (Fed) over the balance of the year. Many of the concerns that caused the Fed to pause earlier in the year have one by one been assuaged: growth in the US and China has improved, global equity markets have strengthened and, while still early days, the Brexit vote has come and gone without too much of a negative impact.

Meanwhile the US economy has steadily marched towards full employment. The only missing ingredient there has been inflation but it's probably close enough for the Fed to take a least one more step towards 'normalisation'. How markets will react to a rate hike is difficult to be certain about but, given valuation metrics that sit well above historical averages, it could be that markets take a step backwards while assessing the impact of those higher rates on the economy and equity valuations.

The domestic reporting season did little to allow the Australian equity market to decouple from global macro factors. Aggregate earnings for FY17 have been lowered by around 2% and consensus earnings growth forecasts are now around 8%. This would be much better than FY16's -8% but almost entirely due to a sharp turnaround in the fortunes of Resource companies. Resource sector earnings declined by more than 40% in FY16 but are now expected to grow by at least that much in the new financial year. And based on the current positive gap between spot commodity prices and analysts' expectations, there is room for the earnings rebound to be considerably stronger.

This brighter outlook is somewhat offset by the Banks which, in aggregate, are forecast to deliver minimal earnings growth. This sector's trend in earnings revisions has been consistently negative for much of the year so it's difficult to be certain that even flat earnings can be achieved.

Outside the Resources and Bank sectors, earnings surprises – both positive and negative – were largely company-specific rather than driven by broader factors such as industry conditions, currency etc. Based on stock reactions it appears that investors' willingness to pay ever increasing multiples for high growth companies may be beginning to wane. And so-called "yield proxy" sectors, while delivering in-line results, underperformed for the month, building on a trend that started to establish itself in mid-July when US bond yields bottomed. While it is probably too early to call the end of ultra-low bond yields, it may be that with increased confidence in the industrial cycle, equity markets are starting to build in some normalisation of interest rates.

Portfolio Outlook

The August FY16 reporting season as usual provided winners and losers. Treasury Wine Estates, Fortescue Mining, Lend Lease and Goodman Group were some of the highlights for the Fund whilst Brambles (CEO change), Medibank (cautious outlook) and Adelaide Brighton Cement (volumes a bit weaker) fell a little short even though these stocks made strong contributions over last 12 months. While we are likely to do some portfolio adjustments as a result of the new information released with company results, the most important question in coming months will most likely be how to position for a potentially changing macro environment.

As discussed in last month's report we have been steadily increasing our weighting to the Resources sector, and have been overweight since June. We continue to see potential for further positive earnings revisions and are likely to keep adding to this sector. The fund has so far balanced the Resources overweight with only a modest underweight to the yield proxy sectors of the equity market, although this underweight is more significant when positions in the Banks and Telstra are taken into consideration.

We have over the last couple of months been taking yield exposure down further, primarily by exiting property company GPT and trimming our position in Sydney Airports, although this has to some extent been offset by building the Fund's position in better-valued Spark Infrastructure. We believe that a market environment in which sector and stock performance is less dominated by bond yields and unusually high multiples being paid for earnings growth should benefit the Fund's performance given Alphinity's more balanced investment approach.

Asset allocation	31 August 2016 %	Range %
Securities	97.7	90-100
Cash	2.3	0-10

Top 5 active overweight positions as at 31 August 2016	Index weight %	Active weight %
Goodman Group	0.8	2.5
Aristocrat Leisure	0.6	2.3
Treasury Wine Estates	0.6	1.7
Macquarie Group	1.9	1.7
Sydney Airport	1.1	1.6

Alphinity INVESTMENT MANAGEMENT

Monthly Comment – August 2016
Alphinity Wholesale Australian Share Fund

BTW

A lot of people in our industry like to liken themselves to the Oracle of Omaha, Warren Buffett. It is wise to be suspicious of anyone like this as such self-boosters invariably won't have his degree of experience, insight or mandate flexibility, let alone an investment timeframe untroubled by the pressures short- or even medium-term returns. We don't dispute that Buffett is a wise and experienced investor but what we like most is his ability to simply express deep truths. Things like *"never ask a barber if you need a haircut"*; or to those who thought you could automate the process of investing he said *"If calculus or algebra were required to be a great investor, I'd have to go back to delivering newspapers."* At his annual shareholder meeting a couple of years ago he really skewered those investors – as opposed to athletes – who are obsessed with gold. He said:

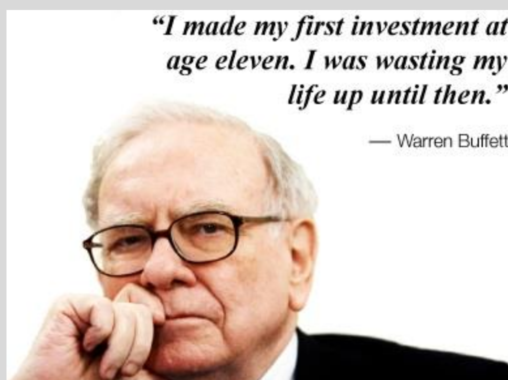
Today the world's gold stock is about 170,000 metric tons. If all of this gold were melded together, it would form a cube of about 68 feet [20 metres] per side. At $US1,750 per ounce – gold's price as I write this – its value would be $9.6 trillion. Call this cube pile A.

Let's now create a pile B costing an equal amount. For that, we could buy all U.S. cropland (400 million acres with output of about $200 billion annually), plus 16 Exxon Mobils ([then]the world's most profitable company, one earning more than $40 billion annually). After these purchases, we would have about $1 trillion left over for walking-around money… Can you imagine an investor with $9.6 trillion selecting pile A over pile B? Beyond the staggering valuation given the existing stock of gold, current prices make today's annual production of gold command about $160 billion. Buyers – whether jewellery and industrial users, frightened individuals, or speculators – must continually absorb this additional supply to merely maintain an equilibrium at present prices.

A century from now the 400 million acres of farmland will have produced staggering amounts of corn, wheat, cotton, and other crops – and will continue to produce that valuable bounty, whatever the currency may be. Exxon Mobil will probably have delivered trillions of dollars in dividends to its owners and will also hold assets worth many more trillions (and, remember, you get 16 Exxons). The 170,000 tons of gold will be unchanged in size and still incapable of producing anything. You can fondle the cube, but it will not respond.

While the numbers have changed a bit in the meantime (for instance the $US price of gold is 20% lower today), the general principle remains. The lower oil price prevailing now means that Exxon Mobil is earning around half what it at the time – $US20 billion instead of $40 – but that just proves his point: it is still earning, whereas your lump of gold would just be sitting there, probably costing you for storage or to hire guards so that it wasn't stolen. But dissing gold lovers obviously has some dangers. He subsequently said in an interview:

"Why do you think gold bugs get so irate? ... If you go on CNBC and say that bonds are kind of a poor investment, people don't get mad at you. You don't hear from the Treasury. You can knock almost any investment and nothing happens. But when you talk about gold it's different. Of course that says something about their motivation for ownership. They want people to agree with them. They want everybody to get so scared they run to a cave with gold. Caves might be a better investment than gold. At least they're not producing more caves all the time. So they want people to be as afraid as they are. Incidentally, they're right to be afraid of paper money. Their basic premise that paper money around the world is going to be worth less and less over time is absolutely correct. They have the correct basic premise. They should run from paper money. But where they run to is the mistake."



We too like investing in productive companies which will generate wealth on your behalf. While one of those in the portfolio at present is a gold stock, Newcrest Mining, this is a company which earns hundreds of millions of dollars a year and pays a dividend, unlike the commodity it produces. Our view is that the best long-term returns will come from good quality domestic and global equities, which history suggests will reap rich rewards over time.

Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size	$135.0M
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%

Monthly Comment – August 2016
Alphinity Wholesale Australian Share Fund

Traveller's Tale

Bruce has just come back from a quick two day trip to a very humid Macau to check on developments in the biggest gambling market in the world, surpassing even Las Vegas by a large margin. It is a very important market for Australian stocks Aristocrat and Crown Resorts.

Macau is a series of tiny islands just off mainland China, near Hong Kong, and a former colony of Portugal. The idea that land is a scarce commodity has been challenged by its government in recent years as it has expanded the territory considerably by filling in the sea to create more. Macau was only 15km^2 in the 1970s but is now just over 30km^2. An area between two of the islands, Taipa and Coloane, has been filled in to create "Cotai", and it is this area in which the last decade of casino development has been concentrated.

Nothing Succeeds Like Excess might be a good motto for Macau. In order to attract Chinese punters to their properties, the six operators of the 40-odd casinos keep outbidding each other to come up with "must-see" sights. The first major attraction was the enormous Venetian casino which opened in 2007, an expanded version of the Las Vegas property. It has since been surrounded by other properties including its sister casino, the Parisian, which is opening in September with a half-scale replica of the Eiffel Tower as its main draw card. So the Chinese can now see the best of Europe without really leaving home.

But the cake will soon be taken by a new casino to be known as The 13, to open early 2017. This 200 room property is costing $US1.6 billion to build – that works out to be $US8 million ($A10 million) per room. For context, the current record holder of expensiveness is the "7-star" Burj Khalifa Hotel in Dubai which cost $US3.5million per room. This is a point of pride for the owners of The 13, but would not be for any other company we can think of.

The biggest suite at The 13 is about 600m^2 - that's around twice the size of the average Australian McMansion - and will cost the lucky sheik/plutocrat/princeling $HK1 million per night. That's $A170,000. Guests will need to be in the top 0.1% of the world's wealthiest to be welcome at this hotel.

Bruce, wearing a gold hard hat of course, had a tour of The 13 construction site and was blown away by the extravagance already evident. The exterior is ultra-modern and red but inside is faux baroque, with square kilometres of genuine gold leaf applied to surfaces to produce an opulent finish. There is no reception area at the property as guests will be driven into the basement and take a private lift to their room where check-in will take place. Famous chefs have been contracted to operate the five restaurants. The pool is stunning and features the largest planted wall in the world. Even though the building isn't quite finished, The 13 has already taken delivery of its fleet of 22 customised Rolls Royce cars (red with gold trim), which cost more than $A1 million each, to ferry guests around the islands in style.

One slight hitch is that its casino doesn't yet have a gambling licence or the official approval to install any baccarat tables, potentially making The 13 just a really expensive hotel. This isn't unusual in that market where investments are routinely made with little certainty, as the authorities usually come though at the last minute. The Macau market is always an interesting one to watch but will be following the fortunes of The 13 with particular fascination.

Alphinity Investment Management

Level 12, 179 Elizabeth Street
Sydney NSW 2000
T 02 9994 7200
F 02 9994 6692
W www.alphinity.com.au

Unless otherwise specified, any information contained in this publication is current as at the date of this report and is provided by Fidante Partners Limited (ABN 94 002 835 592, AFSL 234668) the issuer of the Alphinity Australian Share Fund (ARSN 092 999 301) and the Alphinity Concentrated Australian Share Fund (ARSN 089 715 659) (Fund). References to Alphinity Wholesale Australian Share Fund and the Alphinity Wholesale Concentrated Australian Share Fund are to the wholesale class unit in the relevant fund and references to the Alphinity Australian Share Fund and the Alphinity Concentrated Australian Share Fund are to the retail class unit in the relevant fund. Alphinity Investment Management Limited (ABN 12 140 833 709, AFSL 356895) is the investment manager of the Fund. It should be regarded as general information only rather than advice. It has been prepared without taking account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on any such information, consider its appropriateness, having regard to their objectives, financial situation and needs. Each person should obtain the relevant Product Disclosure Statement (PDS) relating to the Fund and consider that PDS before making any decision about the Fund. A copy of the PDS can be obtained from your financial adviser, our Investor Services team on 13 51 53, or on our website www.fidante.com.au. If you acquire or hold the product, we and/or a Fidante Partners related company will receive fees and other benefits which are generally disclosed in the PDS or other disclosure document for the product. Neither Fidante Partners nor a Fidante Partners related company and our respective employees receive any specific remuneration for any advice provided to you. However, financial advisers (including some Fidante Partners related companies) may receive fees or commissions if they provide advice to you or arrange for you to invest in the Fund. Alphinity Investment Management, some or all Fidante Partners related companies and directors of those companies may benefit from fees, commissions and other benefits received by another group company.