Alphinity INVESTMENT MANAGEMENT

Monthly comment – August 2015
Alphinity Wholesale Australian Share Fund

Seeing Red

Market comment

Global markets were hit hard in August and ours was no different. The ASX300 (including dividends) fell by 7.7%, and looked a bit worse than that at one point in the month. Our share market merged into the sea of red that included most Asian markets (down between 8 and 15%); most European markets (down 5 to 10%) and most in the Americas (down 5 to 15%). The falling $A cushioned some offshore market returns but there was little joy anywhere. The only markets we could find that were up in their own currencies in August were Iceland, Russia, Slovakia and Macedonia. And Cyprus. There are only two companies in the Cyprus Stock Exchange General Index, and one of them looks not to have traded in the past year. Fair to say it was a poor month for stocks.

Why were equity markets so soft? There were plenty of factors contributing to the falls. China was probably the biggest (falling share market, despite government intervention and despite a decent proportion of the market being suspended, and their first currency devaluation in memory) but there were plenty of others besides: shots across the border between the two Koreas; the resignation of the Greek PM who had orchestrated the latest bail-out raising the prospect of further turmoil there; the burgeoning refugee crisis in Europe; the likely imminent end of ZIRP (the zero interest rate policy in the US) and prospect of Donald Trump as US president.

Domestic factors provided less compelling reasons to sell: yes the resource sector was under pressure but that's been situation normal for a while; banks similarly. Reporting season was reasonably benign for the most part, although which a much greater than normal degree of share price volatility.

There were obviously plenty of reasons to be bearish: who would buy stocks in such an environment? Well, these are often the best conditions for those with cool heads to either put fresh money into the market or to re-jig their existing portfolioto either enhance its quality or increase its exposure to the upside once markets settle a bit. That's what Alphinity has been doing on your behalf.

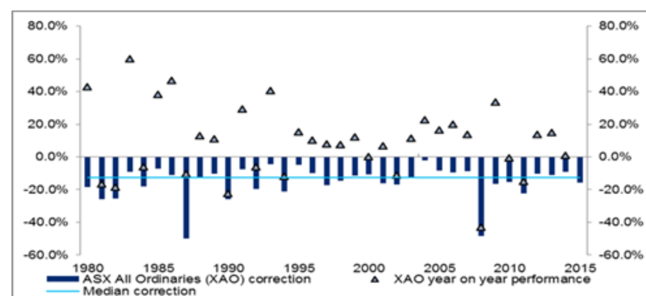
Portfolio comment

The portfolio performed in line with the overall market in August. TV network Nine Entertainment, services company Spotless, health insurer Medibank Private and gaming machine Aristocrat Leisure were the best contributors to the portfolio's performance in August, as were not owning gas producers Origin Entergy or Santos. Being underweight defensive companies like diversified conglomerate Wesfarmers, shopping centre owner Scentre Group and airport owner Sydney Airports Corporation all detracted however.

We are pleased to report that this month represents the fifth anniversary of Alphinity taking over management of the Fund, and particularly pleased to have been able to generate solid above-market returns with a low degree of volatility despite the varied and at times quite challenging market conditions that have prevailed at various times since August 2010.

Market outlook

A correction or the end of the bull market? The market has now declined 14% from its peak in April, and a more modest 4% since the beginning of 2015. As can be seen in the chart below, intra-year corrections of 5-10% are quite normal in markets that still deliver positive full year returns. Nonetheless, after annual returns averaging 16% for each of 2012, 2013 and 2014, this poses the question: is this the beginning of something more sinister than the usual correction? The answer is (as always): it depends. In this case it depends primarily on whether or not the Australian economy is heading for a recession.



Source: Datastream, Citi Research

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (Net)	-7.8	-8.5	-2.9	5.4	12.4	9.2	9.2
S&P/ASX 300 Accumulation Index	-7.7	-8.8	-3.2	5.1	10.9	7.9	7.9

*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.

^ Figures for the Inception Date for the Fund are taken from 1 September 2010, once Alphinity assumed formal investment management responsibilities. 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 logo]

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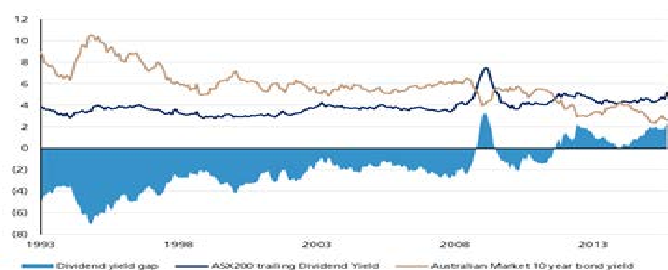
Higher interest rates are often the cause of equity market downturns, but that is not presently the case and the risk of higher cash rates in the foreseeable future appears very low. And while longer term bond yields may move up a bit with US bond yields, this is unlikely to have too much impact on the broader economy or even the equity market. The dramatic drop off in capital expenditure (largely due to the end of the resources boom), and deteriorating terms of trade (due to the fall in commodity prices) are putting GDP numbers under some pressure, but while economic growth is likely to be well below trend, other parts of the economy – predominantly housing with some flow-on effects into consumer spending – should allow Australia to avoid an outright recession in the period leading up to the point that east coast gas exports improves our terms of trade next year.

The global economy is facing similar challenges but again we think a further period of below-trend growth, rather than a recession, looks the most likely outcome. The US recovery appears strong enough to withstand the negative impact of slowing emerging market growth in general and Chinese growth in particular. While risks have increased, and it needs to be recognised that the equity cycle is maturing, we see the present correction as more a buying opportunity rather than the first phase of a more significant downturn.

The domestic reporting season was consistent with our thinking. Reported earnings growth was slightly on the negative side and outlook statement were underwhelming, but if we look beyond the impact of falling commodity prices earnings grew by 8% in FY15 and are forecast to grow around 5% in FY16: hardly stellar but also no disaster. The gap between bond yields and dividend yields is close to record levels, another sign that further downside looks limited and that a rebound looks more likely.



Source: UBS

Portfolio outlook

Notwithstanding the market decline during the month, the Fund had a pleasing reporting season. A number of our stocks received further positive earnings revisions with Adelaide Brighton Cement, Medibank, Spotless and Qantas among the highlights. In what has been quite a difficult earnings environment it was also comforting that most of our other holdings at least held earnings estimates while we were underweight the more disappointing results such as Woolworths, BHP Billiton, CBA, Origin and Santos. While our sector positioning remains largely unchanged with its underweight to Resources and overweight to Diversified Financials companies Macquarie Group and IOOF and Insurers AMP, QBE and Covermore, a reporting season typically provides new insights and investment opportunities.

Our most significant recent portfolio change has been to add Sydney Airport to our portfolios and reduce our holding in Telstra. Sydney Airport achieved a number of important outcomes in the first half of 2015, including a new 5-year aeronautical agreement, the acquisition of Terminal 3 from Qantas and a new duty free retail contract. Together with continued investment in airport infrastructure such as parking and additional carrier capacity mainly by Chinese airlines, Sydney Airport looks set to be able to achieve solid double digit growth in cash flows and dividends over the next few years, which is not adequately reflected in earnings estimates.

Telstra has been a strong contributor to the fund's performance over the last few years. During that time earnings have consistently surprised to the upside and the stock re-rated significantly as well. It had its first downgrade for operational reasons with its FY15 result, and we expect that the potential for upside surprise may be more limited from here. Competition may require Telstra to invest in increased marketing spend and network infrastructure to retain its current leadership. In addition, the company's Asian growth ambition may increase the its risk profile somewhat.

Asset allocation	As at 31 August 2015 (%)	Range (%)
Securities	98.6	90-100
Cash	1.4	0-10

Top five active overweight positions as at 31 August 2015	Index weight (%)	Active weight (%)
Macquarie Group Ltd	1.9	2.3
Goodman Group	0.7	2.0
AMP Limited	1.3	1.7
APA Group	0.7	1.7
Aristocrat Leisure Limited	0.4	1.6

Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size ($A)	112.6M
APIR code	PAM0001AU

Fees	
2013/14 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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INVESTMENT MANAGEMENT

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BTW

Technology has come a long way in the automotive industry, and each model that is released bringing with it another impressive essential feature that we didn't know we needed but that the industry had somehow survived a hundred years or more without. In a time in which the most basic iPhone apparently has more computing power than was in Apollo 11 that took man to the moon, most cars have the equivalent of a supercomputer under the bonnet. Stories about the driverless car are commonplace and although the reality is yet to feature on Australian roads, technology is now available here even in affordable cars that will turn the steering wheel for you when parking, or even drive itself in heavy traffic for you, accelerating and braking with the car in front.

Incorporating IT into cars: what could possibly go wrong? Well a pair of hackers in the US demonstrated what could in July. According to *Wired* magazine, security researchers Charlie Miller and Chris Valasek recently used the car's mobile phone connection to hack into the entertainment system of a friend's Jeep that was travelling down the freeway. From several kilometres away they took control of the display, steering, transmission and brakes. Then proceeded to drive it gently into a ditch as pictured. The best place for a Jeep some might say.

What did Jeep (or its owner, Fiat Chrysler Automobiles) do? The only thing it could really: issue a recall for 1.4 million cars so they could install a software update to prevent such a thing happening. Australian cars are apparently immune from this as the entertainment system used in Jeeps here is different.

FCA also worked with the mobile phone network its cars use in the US to prevent the hack from happening. A subsequent test by the same hackers showed that even without making the software update the network changes were effective enough to stop it happening again. It had taken the pair more than a year to work out how to execute the hack, suggesting it is not an easy thing to do, so maybe we don't need to be too worried about it happening to us. But it was a reminder to car makers that connecting a car to the internet magnifies the risk of something going wrong, and that in the future employing cyber-security experts will be almost as essential as engineers.

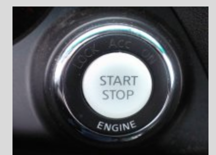
Which reminded us of an old story which may provide a bit of levity after a what was a tough month. It has dated a little but much of it still rings true.

Bill Gates was supposedly addressing an IT conference and compared the dynamism inherent in the computer industry with the staid old auto manufacturing industry: "If carmakers had kept up with the technology like the computer industry has, we would all be driving $25 cars that got 1000 miles to the gallon."

In response to these comments, a manufacturer issued a press release that said: "If we had developed technology like Microsoft, we would all be driving cars like this:

- For no reason whatsoever, your car would crash twice a day
- Every time they repainted the lines in the road, you would have to buy a new car
- Occasionally your car would die for no reason. You would have to pull over to the side of the road, close all of the windows, shut off the car, restart it, and reopen the windows before you could continue
- Sometimes, executing a manoeuvre such as a left turn would cause your car to shut down and refuse to restart, in which case you would have to reinstall the engine
- Apple would make a car that was powered by the sun, was reliable, five times as fast and twice as easy to drive, but would run on only five percent of the roads
- The oil, water temperature, and alternator warning lights would all be replaced by a single "General Protection Fault" warning light
- The airbag system would ask "Are you sure?" before deploying
- Occasionally, for no reason whatsoever, your car would lock you out and refuse to let you in until you simultaneously lifted the door handle, turned the key and grabbed hold of the radio antenna
- Every time we introduced a new car, car buyers would have to learn to drive all over again because none of the controls would operate in the same manner as the old car
- You'd have to press the "Start" button to turn the engine off

While operating systems have become more reliable since those days and Apple computers are now positively mainstream, many cars do now have "start" buttons so at least the final point seems to have come to pass.



Monthly comment – April 2015
Alphinity Wholesale Australian Share Fund

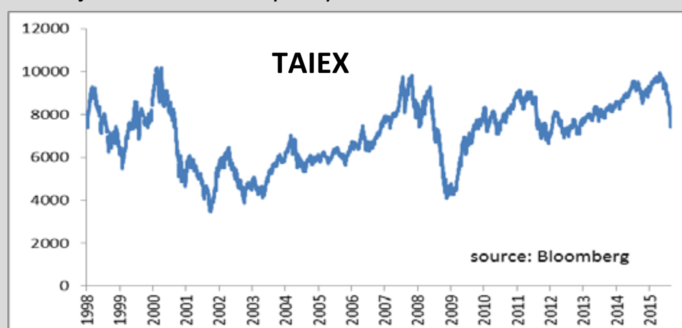
BTW$_2$

RUOK? I mean, really? After a month of hefty losses in the global share markets we thought it might be timely to consider a piece of research by three Taiwanese psychologists that was recently reported in the Health and Policy Planning section of the *Oxford Journal*. These psychologists for some reason chose to study the correlation of fluctuations in the Taiwanese stock market index TAIEX with mental disorders, comparing observations from 4000 days of trading between 1998 and 2009 with admissions to hospitals for mental health reasons.

You may need some context around TAIEX. As the chart shows, Taiwan's index is presently 7700 which is roughly the same level it was in 1998. It finished 2009 at 6700. During 1998, in the aftermath of the Asian debt crisis, TAIEX fluctuated between 6200 and 9400. In subsequent years it has reached as high as 10400 (in 2000, 2007 and again this year) and fell as low as 3400 (in 2001). As the chart shows, with that much volatility there is ample opportunity for this research: no wonder people were stressed! Australia was a safe haven of calm by comparison and almost doubled over the same period (and trebled including dividends).

They concluded that a 1000 point fall in the TAIEX (this would represent 10-25%, so a significant move) would increase hospitalisation by a very precise 4.71%, and that a 1% fall in the TAIEX in a single day increased admissions by 0.36%. Should the TAIEX fall on consecutive days hospitalisations for mental disorders would increase by a further 0.32%. As the age cohort rises the effect is magnified, especially for men and those in the 45-64 age bracket.

The conclusion in the abstract of their research was that "stock price movements can drive you crazy". We would be cautious about reading that much into it: after all correlation is very different to causation. Come to think about it, we'd be cautious about any psychologist who used the term "crazy". But if you do get that stressed about market movements maybe you shouldn't be dabbling in stocks in the first place. Better just to let us worry on your behalf.



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