Monthly Comment – February 2016
Alphinity Wholesale Australian Share Fund

Ups and Downs

Market comment

The market in February repeated recent months' pattern: very weak at the start of the month followed by a sharp recovery to finish at more reasonable levels. In this case, it still made an overall loss but quite a modest one, only 1.7% It was looking a lot worse at one point. Global markets were roughly similar, with a few exceptions. Europe was a good place for $A investors to avoid with performances ranging from -2% (France) to -8% (Greece). HK was -4%, the US -2% and China -0.6%. There weren't many positive markets but NZ just scraped in at +1.3% and Canada relatively boomed at +4% but that's about it. It was a month in which resources shone: whether this is a fundamental shift in the outlook or just a temporary blip remains to be seen, but it certainly hurt those without much exposure to stuff you dig out of the ground and put on a ship.

Commodity prices were uncharacteristically strong in February. Even oil, which has been remarkably weak over the past year, bounced strongly with Brent crude rising 8% to $36/barrel. Iron ore was up an amazing 19% – also from quite depressed levels – despite Chinese New Year traditionally being a period of soft demand. Gold rose 11% as the scourge of negative interest rates seems to be spreading in developed markets. Base metals were mostly higher with tin and zinc both up more than 7%, aluminium up 5%, copper 3%, lead 2% although nickel was fractionally lower.

February was a month in which big macro movements had a significant impact on markets, share prices and portfolios. The banking system in Japan and Germany was rocked during the first part of the year by the imposition of negative interest rates, sending bank shares sharply lower in many markets around the world. This was a factor in the poor performance of Australian bank shares which, as a group, fell 9% in the month. Another factor was a story put about by a hedge fund on the front page of a leading financial newspaper suggesting that the Australian housing market is about to go through the same thing the US went through a decade ago. More about this in BTW.

Reporting season had some impact, although individual results were often swamped by the macro moves. Overall it didn't turn out too badly – in fact compared to sentiment going in, it was arguably one of the best reporting seasons for a few years. Net earnings revisions were still down (this is quite typical so not much of a concern in our view) but concentrated in Energy and Resources, while industrial revisions were benign.

It was pleasing to see that our biggest holdings were among the biggest positive contributors to returns this month – sadly though it was a month in which what you didn't own determined the outcome more than what you did.

Portfolio comment

The Fund underperformed the market in February. While there were obviously a number of stock specific effects, it was largely macro factors that impacted: primarily a bounce-back in some resource stocks that had been underperforming. The best positive contributors to portfolio returns were global industrial property developer Goodman Group, global logistics operator Brambles, and globally-operating winemaker Treasury Wine Estates. However, not owning gold-producer Newcrest or diversified commodity producer South32 detracted from performance, as did our holding in Super Retail Group which produced a disappointing result towards the end of the month.

Market outlook

The fears of global recession that prevailed only a few weeks ago have receded more recently. Some better (but still mixed) data out of the US, the Chinese RMB stabilising and a recovery in the oil price from very low levels have all combined to help calm investor nerves, and equity markets were staging a strong comeback in the first few days of March. As we wrote in the December monthly when markets appeared to be in full panic mode, avoiding some of the downside scenarios should be enough to provide a degree of upside for equities. While we happily echo the market's almost audible sigh of relief, we do wonder how much more markets can continue to recover over the next few months, as it appears to us that we are merely recovering back to the low growth, low interest rate world we have known for the last couple of years.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	-2.8	-5.6	-12.9	3.7	5.9	7.6
S&P/ASX 300 Accumulation Index	-1.7	-4.5	-13.4	2.9	4.6	6.4

*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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The equity market turnaround has been led by cyclical sectors in general and by Resources & Energy stocks in particular. While it's not surprising to see these stocks do well in a "risk on" market, some of the moves have been nothing short of spectacular with share price rises of more than 50% not uncommon. This appears to have more to do with investor positioning before the recovery, including those who engage in the short-selling of stocks, rather than any dramatic change in fundamentals.

But it's not all sentiment driven. One noticeable change year to date has been how the relentless rise of the $US appears to have stalled against most currencies, including the $A which has risen from 69c in January to 74c at the time of writing. The strong $US, which was driven by the US economy outperforming the world and the US Federal Reserve preparing for higher cash rates, played a significant role in driving commodity prices lower: it lowered cash costs for major resource countries like Australia who were competing for market share and made imports more expensive for users such as China. With the partial reversal in the $US has come a rebound in most commodity prices. How sustainable these price increases will be remains to be seen but at current spot prices many resources companies are poised for earnings upgrades – the first for at least 18 months. Energy companies remain the exception as most forecasters were already anticipating a strong recovery in oil prices. And taking it back to basics, most commodities continue to be in oversupply, so it's difficult to see much of a continued price recovery from here.

The Australian banking sector was also caught in the global downdraft. Some signs that the Australian housing sector was cooling a little and global concerns over the banks' exposure to Resource & Energy companies with stretched balance sheets provided the perfect storm for Australian banks. While earnings growth for the banking sector has slowed over the last year, and dividend growth going forward will likely be more in line with earnings growth after a few years of increased payout ratios, bank shares should continue to recover with improved investor sentiment.

While the Australian reporting season was overshadowed by broader macro trends, results were broadly pleasing. Importantly, overall earnings growth outside of the Resources sector saw only minor negative revisions which should be enough to allow the market to generate mid-single earnings growth (excluding Resources) for the year.

In summary, while things are not as bad as investors seemed to believe at the beginning of the year, they are also probably not as strong as more recent share price moves would suggest.

Top 5 active overweight positions as at 29 February 2016	Index weight %	Active weight %
Goodman Group	0.8	2.5
Aristocrat Leisure Limited	0.5	2.1
Sydney Airport	1.1	2.0
Westpac Banking Corporation	7.4	2.0
GPT Group	0.7	1.8

Portfolio outlook

As discussed earlier, the Fund lagged the market in February. The rebound in commodity prices and a stable to slightly higher gold price helped the Energy & Resources sectors rally sharply during the month. This, in combination with a couple of disappointing results, overshadowed what was otherwise quite a solid reporting season for the Fund. Eight of our top ten active positions reported interim or full year results in February, and all eight beat market expectations; Westpac and Aristocrat have different half-year ends and will report their respective interim results in May. Some of the highlights were Brambles, Sydney Airport, Treasury Wine and Goodman Group. We believe that all of our top ten positions are well positioned to keep outperforming both earnings expectations and the equity market this financial year.

While we are mindful of not being complacent about the recent strength in commodity prices, and some of our holdings such as Fortescue, Rio Tinto, Oil Search and AWE have greatly benefited, we are finding few fundamentally-based reasons for the turnaround. The weaker $US, as discussed, has certainly been one factor but as many of our readers know, we prefer not to base our investments purely on a currency forecasts. We will continue to look out for further signs of any cyclical recovery, either in China or other parts of the world, but we typically find company-specific drivers more reliable, often due to management executing a particular strategy well.

One company that now fits this bill is South32 and we have recently added this company to the Fund. While the company would of course benefit greatly from any continued strength in the commodities to which it is exposed, more important is the fact that management has taken decisive action on costs which should see significant free cashflow generation from financial year 2017 and beyond. The Fund briefly held a small position in the company after it was spun out of BHP, at which point a weak earnings outlook prompted us to exit the stock at much higher prices. But with price expectations now largely reset and management showing it knows it can't rely on a cyclical recovery for better share price performance, we now see the risk reward balance as more favourable.

Whether January 2016 marks the low point for most commodity prices remain to be seen. However, it may be that the market volatility so far this year has made investors more aware of longer term valuation metrics for both cyclical companies whose earnings are under significant short to medium term pressure, and of companies that are delivering solid earnings growth but are also trading at significant valuation premiums.

The Alphinity process aims to identify companies that are both attractively priced and poised to deliver positive earnings surprises. We believe a market taking both of these factors into consideration should be beneficial for the Fund.

Asset allocation	29 February 2016 %	Range %
Securities	96.6	90-100
Cash	3.4	0-10

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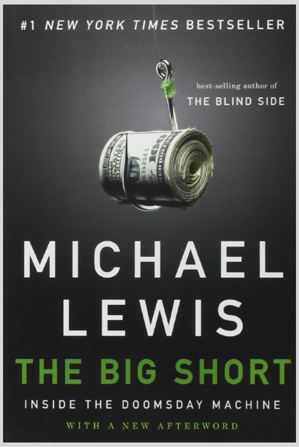
BTW

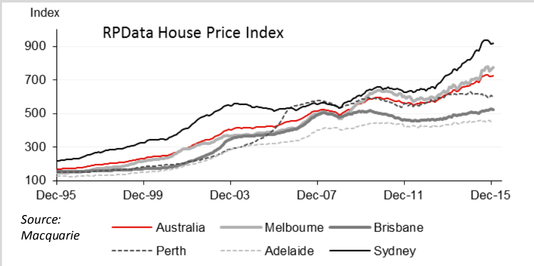


Some readers may have seen the blockbuster movie "The Big Short" in recent weeks, with its star-studded cast and outrageous story-line. Or will have read the 2010 book on which it was based, by superstar financial novelist Michael Lewis. It recounts behaviour that allegedly took place in various US investment banks, trading houses and funds management firms in the mid-2000s that was almost too bad to believe – gross incompetence, venality and massive breaches of fiduciary duty – that were major factors in almost bringing down the US and global banking and financial systems in 2008-2009. Those of us who went through it have many of the events seared into our memories, and never want to go anywhere close to that place again.

So when a story appeared on the front page of our premier financial daily newspaper in February headlined *The Aussie Big Short*, shudders naturally arose. A local hedge fund manager and a UK "contrarian economist" claimed to have blown the lid off an equivalent scandal in Australia that would send the Sydney property market down by 50%, the $A to $US0.40 and the share prices of local banks – heavily exposed to property prices through their books of mortgages – down by 80%. They did this by trawling around housing estates in far western Sydney and pretending to apply for loans through mortgage brokers, concluding that there are dodgy practices going on and a housing bubble that is about to burst. Presumably the hedge fund had already put its shorts on the banks before publicising this story, and was rewarded by the market on the day.

Australian bank stocks have been magnificent investments over the years – in fact the number of times people have lost big shorting banks over the years has led to this trade being known in our industry as "the Widowmaker" – not an appealing prospect, and one not quickly repeated. It is likely a different subset of hedge funds that loses on that trade each time. And the number of people who have been waiting for Sydney property prices just to "correct" (i.e. fall back to reasonable levels), let alone crash, is much greater. Alphinity takes a view of the fundamentals of each company – bank or not – and comes to an assessment of its appeal from a bottom-up basis and we feel that at current prices some banks still stack up reasonably well.

It would be easy to dismiss the Aussie Big Short as a cynical (and thus far probably successful) attempt to make money by the protagonists, but it's still worth asking the question: is Australian property in a bubble? It certainly feels like that in some places, although there might be a few bargains around in coal or iron ore mining towns a long way from the big city. Major city property is certainly expensive compared to some countries but it always has been. There are many reasons behind this, including our high levels of urbanisation, large block sizes, large house sizes, quality of construction, high incomes, the tax shield of negative gearing, the old "store of wealth" argument resulting from the home's Capital Gains Tax-free status, the low vacancy rates, demand from growing populations and so on. Prices have come down a little recently, but you still may need to take a long-term view if you're buying a new apartment off the plan, or buying a house on the outskirts of a major city.



But this is real estate we're talking about, you should be taking a long term view in any case. The amounts are too large and transaction costs too high to make it worthwhile buying and selling quickly, as you might with shares. Could something go wrong and cause the outcome predicted by the article: 50% house price falls, $A at 40c and bank shares down 80%? Nothing is impossible but we wouldn't want to make it our base case. Chances are it won't, and if it did we'd all have bigger things to be worried about than bank shares! There are many such disaster scenarios posited by self-interested financial markets types, but very few end up being well-founded.

Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size	$126.3M
APIR code	PAM0001AU

Fees	
2014/15 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

It is not all beer and skittles managing funds. While our work does occasionally takes us to ostensibly glamorous places like London, Paris or New York, just as often there is the need to go a bit further off the beaten track to seek out insights about how the big picture will unfold, to help us pick the right stocks for the portfolio.

The plummeting oil price over the past couple of years inevitably has had an impact on Australian energy companies, as will its recovery as and when it occurs. And when it comes to oil, you really need to go to the Middle East. So after reporting season was done Stephane set off for Iran and Saudi Arabia to find the answer. The Saudis are of course the biggest oil producers in the world, while Iran is sitting on top of about 150 billion barrels of oil – fully 10% of global reserves – which have been used quite sparingly in recent years as US sanctions have prevented much of the world from buying it.

The issues between the USA and Iran are deep-seated and long-standing – not least, America's support of the Shah in the 1960s and 70s before he was deposed by the revolution in 1979. The recently-installed democratic government is paving the way for a rapprochement, and some of the sanctions against Iran's nuclear activities have recently been lifted providing the real prospect of a lot more Iranian oil reaching the already glutty world market. This is causing some stress between the major oil producing nations.

Iran has firmly declared its intention to lift production back to pre-sanction levels, which would represent a 1mbpd increase from current production level, and this is almost equivalent to annual global demand growth! How quickly and to what extent it can actually lift its production will have an impact on the oil supply demand dynamics and price. Although the Saudis and the Russians are arguing for a freeze in OPEC production (after themselves reaching record production levels), not cuts, the new production by Iran will just prolong the time it takes for the market to return to balance.

Notwithstanding the outbreak of slowly improving relationships between Iran and the USA, signs of the old feud are plain to see in Tehran. Stephane took these photos showing the stars and stripes with bombs and skulls, and a parody of Lady Liberty painted on the walls of the previous US embassy.

The impact of the sanctions are still obvious when trying to travel there. Having been cut off from the global financial system for so long some things we take for granted, like paying your hotel by credit card just can't be done, so Stephane had to carry a substantial amount of US dollars with him to pay bills. He also had to make the tough decision of whether to travel back to Tehran from the city of Yazd in an very old Airbus A300 (complete with well-used ashtrays) that had been maintained to uncertain standards during the long embargo, or nine hours by car braving driving practices not normally found in most countries. The plane won out, but only just.

Alphinity Investment Management

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