Monthly Comment – May 2016
Alphinity Wholesale Australian Share Fund

Election Fever

Market comment

The biggest piece of market-impacting news that happened in May was not much of a surprise: the calling of a double-dissolution Federal Election for early July, making it just about the longest campaign in living memory. The second was the Federal Budget; the third was the Reserve Bank cutting official interest rates to the lowest point since Federation, 1.75%, with hints of more to come. While each of these factors in isolation could have been taken negatively, the market (ASX300 including dividends) put in another decent performance rising just over 3% in May, helped along by solid overseas market moves.

Offshore returns were even stronger thanks to the crumbling $A: it fell from $US0.76 to $US0.72 during the month. While most major markets also produced low single digit returns in their own currencies, the $A fall means local investors would have done better in offshore Developed Markets: almost 9% in both Japan and the US and about 5% in the UK, New Zealand, Switzerland and Hong Kong. Chinese shares were essentially flat for the month in $A and many Emerging Markets were down a few per cent.

May featured a mini-reporting season: those companies with a March or September year end. There are only a handful of such companies but some are quite large including three of the major banks, most building materials companies and one of Alphinity's larger holdings, Aristocrat. It's fair to say that there were some mixed results, most notable being the dividend cut by ANZ. The US market also had its quarterly reporting season which was surprisingly upbeat: earnings in aggregate did fall but not as badly as the US market had been expecting.

There are some big macro themes still impacting on markets but, at the risk of speaking too soon, it felt as if markets started to behave a bit more normally in May than had been the case for the past few months. Headwinds remain however: the imminent UK vote on whether or not to stay in the European Union, which has become known as "Brexit", has been quite disconcerting and the polls in the lead-up suggest it may be a very close race indeed. The impact on the UK economy could be very significant and is unlikely to be positive. Mixed signals from the US Federal Reserve keep emerging but it's becoming more evident that another US rate rise is imminent.

Commodity prices during May mostly gave back some of the strong gains of previous months. The prices of gold and most base metals were lower although the soft $A offset much of that; currency could not however make up for the fall in Iron Ore which continued its roller coaster ride: down 25% in the month. Not surprisingly, most resource stocks struggled in May. Not Oil: it continued its recent run of strength thanks to supply disruptions in various parts of the world, not least from massive bushfires afflicting the major oil producing area in Canada.

Portfolio comment

The Fund outperformed the overall market marginally in May with few notable contributors or detractors. The biggest positive was the Fund's position in gaming machine manufacturer Aristocrat Leisure which reported strong first-half results, followed by the underweight position in diversified resource company BHP Billiton which fell after its very strong run in April. The only notable detractor was our holding in resource company Rio Tinto.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	3.1	9.7	-3.5	7.3	8.2	9.0
S&P/ASX 300 Accumulation Index	3.1	11.7	-2.1	7.7	7.3	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.

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Market outlook

With only a month left of the 2016 financial year the Australian equity market including dividends is up a little more than 3%, which is approaching our prediction at the beginning of the year of mid to high single digit returns. Our outlook however was based on modest, but still positive, earnings growth: in fact earnings growth has turned out to be slightly negative. With earnings for most sectors having disappointed, the market is now looking a little stretched from a long-term valuation perspective. Future gains are thus, at least in the short term, increasingly reliant on investors' willingness to pay a higher multiple for those earnings. Lower Australian interest rates offers a degree of valid valuation support, but are also at least in part an indication of a fragile economy. While Gross Domestic Product (GDP) growth continues to be solid, it is being driven mainly by higher production volumes in mining, oil and gas. These volumes are being sold at relatively depressed prices, resulting in subdued earnings and wage growth lagging GDP growth.

After a strong run in the market of more than 10% over the last three months, an imminent Federal Election and continued uncertainty around the timing of the next rate hike by the US Federal Reserve leads us to expect that investors will at least pause for reflection in coming months. On a positive note, Stephane has come back from China with increased confidence in economic activity for the remainder of this year. Some observers have been pointing to recent soft data points there as an indication that the growth pickup in China has already passed but based on his experience we think this is too pessimistic. The infrastructure investments announced in February are likely to support economic activity at least for the remainder of this year: after all not even China can build subways in a couple of months!

Asset allocation	31 May 2016 %	Range %
Securities	98.0	90-100
Cash	2.0	0-10

Top 5 active overweight positions as at 31 May 2016	Index weight %	Active weight %
Goodman Group	0.8	2.6
Aristocrat Leisure	0.5	2.2
GPT Group	0.7	1.6
Adelaide Brighton	0.2	1.6
Brambles	1.4	1.5

Portfolio outlook

In a world in which the macro outlook continues to be highly uncertain, we are encouraged to see that great individual company results, such as those delivered in May by Aristocrat and James Hardie, are still well rewarded by investors. Investing in companies which can deliver earnings ahead of consensus expectations is core to the investment process at Alphinity.

In the current situation whereby US unemployment has recovered back to long term averages yet cash rates there are still only 0.25% and US bond yields are not far off record lows – with a not too dissimilar situation in Australia – stock selection rather than making bold sector calls seems to be the most prudent course of action. As such we are confident that the portfolio's investments in companies such as Adelaide Brighton Cement, Brambles, Medibank, Treasury Wines and Syrah Resources, in addition to the aforementioned Aristocrat and James Hardie, will continue to deliver strong results.

From a macro perspective it's tempting to assume that the "yield proxy" stocks are now factoring in bond yields that cannot be sustained at these ultra-low levels for too much longer. However, subdued economic growth and few signs of an imminent pick-up in inflation are not suggesting an immediate turning point. As such we remain only slightly underweight the yield theme, with a preference for Real Estate Investment Trusts (REITs) over pure infrastructure/utility stocks due to the REITs' lower leverage and more conservative payout ratios. With the recent improvement in commodity prices, we have seen a meaningful turnaround in the earnings revisions of Resource companies. While concerns around issues such as China's credit expansion and some additional supply in some commodities, including iron ore, hitting the market next year tempers our enthusiasm somewhat, Stephane's findings on his recent research trip continues to support our moderately overweight sector stance.

Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size	$135.6M
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%

![Alphinity Investment Management]

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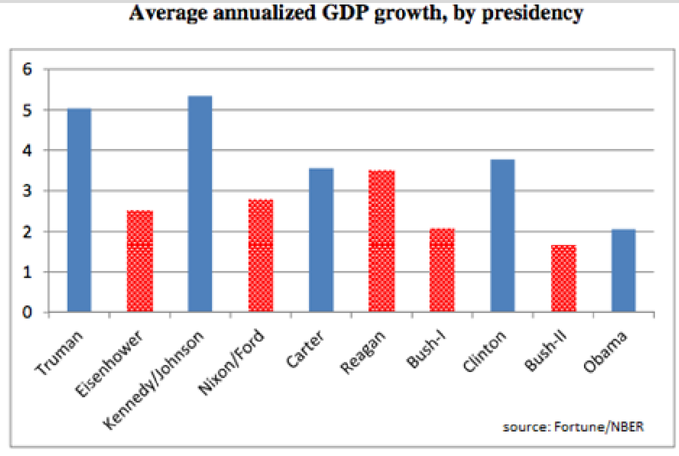
BTW

With Australia in the grip of election fever, however light that grip might be, it must be remembered that we are not the only place in the world in which elections are topical. If you thought our eight week campaign is tedious, feel for the citizens of our great friend the USA which seems to have a perpetual election campaign. Yes, not long after the inauguration of a new (or re-elected) president the race seems to kick off, slowly building into a frenzy of commentary about incomprehensible terms like electoral colleges, Super Tuesday, delegates, super delegates, tied and untied delegates and so on that culminates in what we are presently seeing: the finalization (sic) of the candidates of the two major parties, Democrats and Republicans.

It now appears that this race will be between two people who are commonly known by just their first names: Hillary and The Donald. Both have significant reasons not to be acceptable candidates. Clinton has a long history of service to the public as former First Lady, Senator and Secretary of State in the Obama administration, but she also has number of real or alleged legal issues that may or may not derail her candidacy in the remaining months leading up to the November polling date. Trump is, well, Trump and many even on his own side cannot understand how he came to be the best prospect for election out of the entire Republican party.

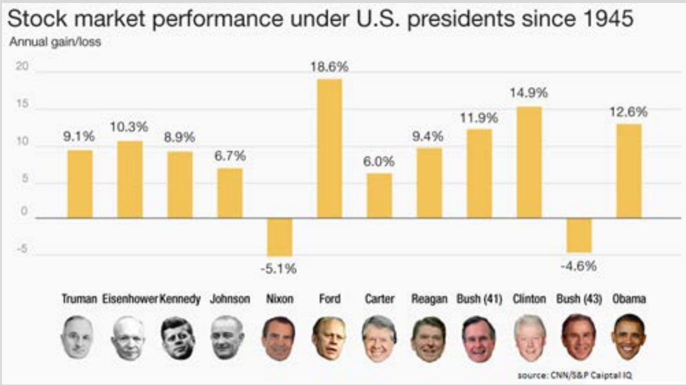
It will be for many a polarising and invidious choice. Will a third person submit themselves to the people to provide someone more acceptable? And if they do, without the preference system that applies in Australia, will they just end up splitting the vote of the person closest to their own political inclination and thus guarantee the enemy gets in? This happened in 1992 when many of Ross Perot's 20m votes probably prevented George Bush Snr's 39m beating Bill Clinton's 45m. It also happened in 1996 when Perot's 8m votes was pretty much the difference between Bob Dole's 39m and Bill Clinton's 47m. Perot gave up after that, but at every election there have been at least a few challengers from outside the major parties. There were ten candidates in the 2000 election but the only one most Australians would probably have heard of is consumer campaigner Ralph Nader, who ran as a Green in 1996, 2000 and 2004.

But to more important things: what would a new President mean for the markets? Perversely, considering that the Republicans are seen to be the party of big business and the Democrats the party of the workers, it appears that both the economy and the share market do better under Democrat rule. There is no plausible explanation for this – lots of theories of course and we know that correlation and causation are two separate things. But as *Fortune* reported in 2014, when the distinguished and impartial National Bureau of Economic Research, chaired by prominent Ivy League economists, looked at the differences they concluded that the gap between the two was "startlingly large". The chart below shows economic growth under the various post-war presidencies and it appears that Ronald Reagan is a rare shining light on the conservative side.



" The U.S. economy not only grows faster, according to real GDP and other measures, during Democratic versus Republican presidencies, it also produces more jobs, lowers the unemployment rate, generates higher corporate profits and investment… Indeed, it outperforms under almost all standard macroeconomic metrics" said the NBER – this seems fairly definitive to us!

CNN did a similar exercise on the S&P500 but included cute little pictures. It found that, with the exception of Gerald Ford, the stock market mostly did better under Democrats too.



So when you look at the alternatives facing the US, if for some reason you happen to feel guilty about hoping for a relatively left-wing Clinton presidency, at least there are some economic reasons to justify that feeling.

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Traveller's Tale

We've been to some dangerous parts of the world in the pursuit of research insights. Usually it's our Energy and Resource analyst, Stephane, who ends up being forced to sleep in a Yurt in Mongolia, clambering down a platinum mine in South Africa, or dodging road-blocks in Iran while our consumer analyst rarely needs to endure anything worse than the wilds of the Napa Valley. That said, travelling can be a dangerous exercise no matter where you are, which is why you should all buy your CoverMore travel insurance policy before travelling. Andrew found this out recently at the very end of a couple of weeks doing research in the UK and US. Covering Financials, he usually only has to worry about tripping over an errant computer cable in an insurance company call centre on his research trips, rather than becoming an insurance statistic himself. Unfortunately the trip to the airport for the long flight back to Sydney didn't quite go to plan.

Travelling through the New York suburb of Queens on his way to JFK, Andrew heard a loud crash and felt a large bump: two cars back the driver of an old Toyota had not been paying sufficient attention, hit the Honda in front and pushed it into back of Andrew's vehicle. Fortunately he was in one of those rolling behemoths beloved in NYC – a large black Ford/GM/ Chrysler truck with enough seats for a football team – or things might have been more serious. As it was the poor Honda behind made good use of its crumple zones and the truck was not too badly damaged.

Coincidentally Andrew had been discussing in a meeting that very day the fact that motor accidents are on the rise in the US: as employment picked up and with the low oil price, more driving was taking place. The meeting concluded that the advent of driverless technology had the potential to change the insurance industry by drastically reducing crashes and fatalities – the infamous Google car crash notwithstanding.

Unfortunately driverless technology has yet to grace the streets of Queens, and considering the average age of US cars is more than 11 years, it will take some time to permeate the US carpool. But as he stood beside a busy Friday afternoon road in Queens, bags in hand, hoping to get another ride soon or face telling his family that he'd missed his flight, it did get Andrew thinking: "How many lives could driverless technology potentially save in the US? And would a driverless Uber car have picked me up by now?"

US road fatalities peaked in 1972 at 54,589. With Americans' grudging adoption of seat belts and progressively safer cars, this number has fallen to around 32,000 today – roughly 10 people per 100,000 population. For context, Australia has around 1,200 road fatalities a year which equates to about 5 per 100,000. So there are certainly plenty of potential benefits in adopting a technology that should dramatically improve safety.

However the countries likely to be early adopters of driverless technology like the US, Australia or parts of Europe, are those that need it least, in a relative sense. China for instance has road fatalities of around 260,000 a year (~19 per 100,000) and India is close behind at around 240,000 (17 per 100,000). Libya holds the record at a dismal 73 but anyone planning to go on holiday to Thailand should probably note that it is the second worst country per capita for road deaths: 36 per 100,000 population. Driverless Tuk Tuk's anyone?

Alphinity Investment Management

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