Alphinity INVESTMENT MANAGEMENT

Quarterly Comment – December 2015
Alphinity Wholesale Concentrated Australian Share Fund

Better late than never

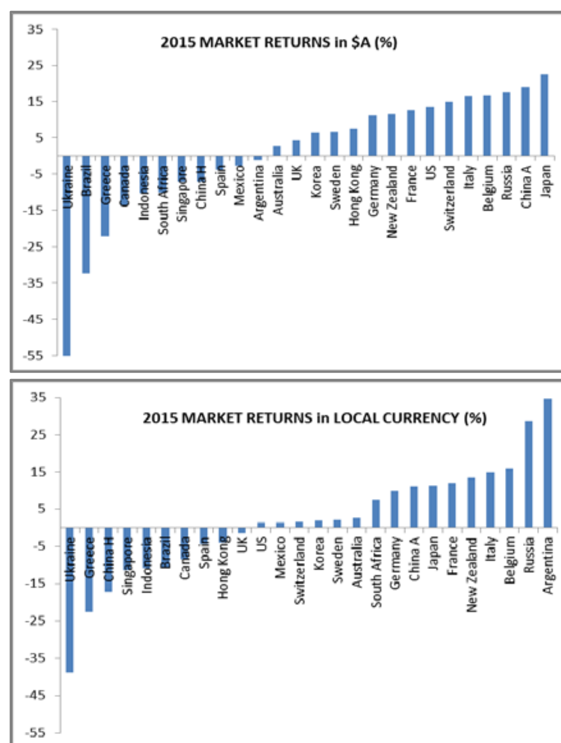
Market comment

Santa Claus arrived quite late to his traditional end-of-year rally and 2015 finished up better than it might have. The market (ASX200 including dividends) was looking quite sick at one stage in December, down as much as 5% mid-month, so to close up 2.7% represented quite a big recovery. Australia generated good returns for the December quarter, and at +6.5% was only behind New Zealand and China for the quarter. For the year however the local market eked out a gain of less than 3%. This modest raw number however conceals some very significant moves in individual company share price: there was ample opportunity to blow up in 2015 especially if you were on the wrong side of the call on resource stocks.

The least surprising event in December was the US Federal Reserve (Fed) raising official interest rates, the first change since 2011 and the first increase since 2006. The world did not fall apart (or at least not immediately) – in fact the move caused/coincided with a shift in global equity market sentiment from negative to positive and markets rallied from that day into the year end. The US was still down 2% for the month, along with most global equity markets and, surprisingly considering their higher interest rates, the $US itself. The main European markets were all down 3-4% in $A; Asian markets fared a little better with most being only 1-3% lower.

Australian energy and resource shares had an annus horribilis in 2015, those sectors being down about 30% each: now between them those sectors make up a meagre 16% of the ASX300, a far cry from when they were as much as a third in 2011. The other sectors did the heavy lifting to keep the overall Australian market just in positive territory. Recent resource price trends continued in the fourth quarter with iron ore down 22%, base metals down 7% and gold down 5%. Crude oil continued its recent trend: Tapis fell 26% in $US terms despite some geopolitical challenges. The silver lining is that lower fuel prices should turn out to be a modest tail wind for discretionary spending in Australia.

Over the whole of 2015 there was, as always, a wide range of market performances and the weak $A (-11% against the US) flattered offshore returns. The best returns in $A terms were from Japan (+22%) and China (+19%, although this was partly reversed in the first days of the new year) while some European markets did +11-15%. The US returned +13% but the UK only managed +5%. Many markets went backwards in 2015, including HK-listed Chinese shares (-7%, 26% worse than their Shanghai-listed peers), Singapore (-7%) and Australia's resource-producing peers South Africa (-10%), Canada (-14%) and Brazil (-32%): in this context our returns were quite creditable. Argentinians might have been celebrating their 35% market return until they took the currency into account; in $A it was slightly negative.



Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	3.7	9.1	7.5	12.3	9.2	10.7
S&P/ASX 200 Accumulation Index	2.7	6.5	2.6	9.2	7.0	8.3

*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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Portfolio comment

The portfolio outperformed the market nicely again in the December quarter, continuing its strong run relative to the fairly subdued market. Its biggest winner was not owning shrinking resource giant BHP and owning lots of Westpac, petrol retailer Caltex, gaming machine maker Aristocrat Leisure and winemaker Treasure Wine Estates, while not owning telco Telstra helped. Only medical insurer Medibank Private and not owning blood fractionator CSL were notable negatives.

Over the whole year the Fund produced very strong returns. The biggest positive was again from not owning BHP Billiton, although positions in Aristocrat, global investment bank Macquarie, gas pipeline owner APA, and Caltex were also very strong contributors. Not owning ANZ, Woolworths or Origin also helped. There were only two negatives of note, from not owning CSL and major bank NAB.

Market outlook

Will January set the tone for 2016? The market return at the start of January has surprisingly often set the course for the rest of the year. However, there are enough times when it has not been the case for it to be a pretty unreliable indicator. And that is just as well given a fairly shaky start to the year so far! The main worry is by now a familiar one – low economic growth, and thus by inference, company earnings growth.

Data across most regions has been disappointing and it is at this point difficult to see what could provide an upside surprise at the macro level. Possibly a stronger than expected quarter one Gross Domestic Product (GDP) figure in the US, but even then this would really be due to an easy comparison against a weak quarter last year rather than a real sign of strength.

The upside case for equity markets is thus possibly more a case of avoiding some of the downside scenarios, such as a hard landing in China (unlikely in our view) or a recession in the US (not impossible but unlikely). There appears to be enough momentum in employment growth to avoid a US recession and we think the Fed will remain very cautious in changing its interest rate settings.

The Australian equity market is trading on a forecasted PE (price to earnings ratio) of approximately 15x and a dividend yield of more than 4%. Assuming an unchanged earnings multiple this would only require mid-single digit earnings per share growth for total returns to approach 10%, which is not an unrealistic outcome, in our view. Outside of Resources, where earnings are likely to struggle again this year given continued pressure on commodity prices, the earnings outlook is reasonable.

While Bank earnings – or at least their earnings per share – will be negatively impacted by the dilutive equity raisings undertaken during 2015, credit growth, a benign bad debt environment and mortgage repricing should offset some of this. A weaker Australian dollar (FY16 average to date is 14% below FY15) will continue to boost profits for a large part of the Industrial sector. The Australian consumer now also appears to be more comfortable with spending some of the solid growth seen in disposable income in recent years. This is borne out in consumer spending growth over the last 12 months' of around 6%, which is close to longer term averages.

Portfolio outlook

With risk to GDP growth firmly to the downside both globally and domestically, we retain a cautious stance on most cyclical sectors, especially resources and energy. There is however also a positive side to the commodity price collapse. There are few direct beneficiaries from the low oil price except for Qantas, in which the Fund has a holding. The main thesis for owning Qantas is not however the oil price (although it is clearly helping!) but rather a much improved domestic travel market outlook with steady demand growth and lower capacity additions since Virgin raised the white flag in the bitter market share war of 2013-2014.

Indirectly, the fall in the oil price should also continue to support the Australian consumer which is already benefiting from low interest rates, recent years' appreciation in house prices and a relatively stable employment market. Recent headlines in the retail sector have been adverse, with two well-known retailers operating more than 430 stores between them (Dick Smith and Laura Ashley) going into administration in the first week of the new year. We see this as more a consequence of poor individual execution and a changing competitive landscape than anything fundamental, and we see the consumer sector and other services sectors as more immune than most to the current macro challenges.

Last month we wrote about our investment in Super Retail Group which has been a positive addition to the Fund so far. It is also exposed to a number of other stocks which should be benefiting from solid consumer spending such as Tabcorp, Treasury Wine Estates, Costa Group, Aristocrat, Sydney Airport and Qantas. We go into 2016 confident that the investment process which has delivered good risk-adjusted returns for so many years in so many market conditions will deliver again, regardless of the economic environment that transpires.

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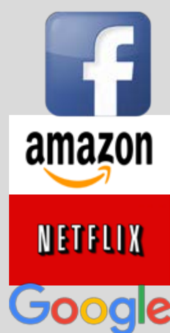
Alphinity Wholesale Concentrated Australian Share Fund

BTW

This Fund does not invest in US equities but there are many lessons we can learn by looking at such a large, diverse market, one that makes up almost half the capitalisation of total world markets.

US share returns in 2015 might have looked pretty good from our side of the world but, as we noted earlier, this year it was all about the currency: in $US it made only tiny gains even including dividends, just half the modest 3% local currency return of the Australian market. This was the worst US outcome since the Global Financial Crisis year of 2008 and the second worst in 20 years.



But it could have been a lot worse, and probably was for some investors. The four so-called FANG stocks (Facebook, Amazon, Netflix and Google) were massive outperformers. Between them they constituted only 3.3% of the benchmark in December 2014 but had risen to almost 6% by the end of 2015. Amazon and Netflix both more than doubled over the course of 2015; Facebook and Google (or Google's new holding company which for some reason is called Alphabet Inc) were up 34% and 46% respectively.

A further small number of large companies also did well: Microsoft made a decent 22% return; McDonalds did quite well with 30% for the year. Industrial conglomerate GE and evil tobacco company Altria both did more than 20% and hardware giant Home Depot close to 30%. Adding these to the FANGs, just nine companies which accounted for 8.5% of the S&P500 at the start of the year were 12% by the end. Such a concentration of returns makes having picked the right stocks vital for overall portfolio returns. By contrast the biggest single stock in the S&P500, Apple, fell by 3%: not too far from the tree. Given the high multiples on which all are trading a US value manager might not have owned any of these, which would probably have meant a lean Christmas indeed.

Such concentration also had a distorting effect on sector returns. On the face of it, the S&P500 Consumer Discretionary Index, which contains 96 stocks, did quite well in 2015. It rose by more than 8%, five times the increase of the whole market, and the sector's market cap increased by $US113 billion. Deconstructing the numbers, however, Amazon alone increased in value by $173 billion for the year, more than the total rise of the sector. Netflix, Nike, Starbucks and McDonalds, added a further $100 billion between them. Obviously there were plenty of stocks which had negative returns as well: 23 of the 96 fell in value by more than 20%, totalling almost $200 billion.

Amazon is now a $US300 billion market cap company. It started out as an online book seller back in the 1990s but has morphed into on retailer of pretty much anything you can think of, and is also a major provider of data centre services around the world. According to Bloomberg, it is trading on 110 times the earnings of the year just finished. Should present market forecasts come to fruition, its multiple will fall to a relatively "cheap" 63 times 2016 earnings. Amazon had a little cash and no net debt the last time it reported but its sales growth is staggering. It has never paid a dividend, but it was getting earnings upgrades most of the year which is no doubt why it performed so well.

Contrast this with Apple. It is twice the size of Amazon, almost $600 billion market cap, and 3.3% of the S&P500 but is trading on only 10x earnings. It had $200 billion of cash on its balance sheet and only $50 billion of debt at its last year end, which was September 2015. Apple's earnings forecasts started getting downgrades towards year end. We find relative share price movements generally follow earnings revisions.

As always, stock picking is the key. This is why you need a manager with a sensible process and a good record of getting a reasonable reward for the risk you are being exposed to. But an index fund will only ever get the index return, regardless of what that might be.

Asset allocation	As at 31 December 2015 %	Range %
Securities	98.9	90-100
Cash	1.1	0-10

Top 5 active overweight positions as at 31 December 2015	Index weight %	Active weight %
Westpac Banking Corporation	8.1	6.4
Macquarie Group Ltd.	2.0	4.3
Commonwealth Bank Of Australia	10.6	4.0
Goodman Group	0.7	3.7
Aristocrat Leisure Limited	0.4	3.1

Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size ($A)	13.0M
APIR code	HOW0026AU
Fees	
2014/15 ICR	1.00%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions payed) above the Performance Benchmark
Buy/sell spread	+0.20%/-0.20%

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Travelling Tale

Residing as we do next door to a large, quite nice hotel in Sydney, it comes as no surprise to us that the inbound tourist market from China is booming. According to official figures there were 4.85 million short-term visitors to Australia in the Olympic year 2000, 120,000 of which were from China, 2.5% of the total. Tourism has been steadily growing to the point that in the 12 months to October 2015, the most recent data available, there had been more than 7 million short term arrivals of which 994,700 – 14% – were from China, and that number is growing at 20%. That means about 2700 people are flying in from China every day. While some arrivals would be for business, it is likely that the vast bulk are here for a holiday. Each holiday-maker spends on average $A6600 while in the country.

Source: ABS

Some are coming on traditional carriers like Qantas and Cathay, but most would be on the profusion of Chinese carriers that have been increasingly coming in, like Air China, China Airlines, China Southern and China Eastern. Second tier carriers like Hainan, Shenzhen and Xiamen are also attempting to get access – clearly this trend has some way to run.

China overtook the USA as the biggest-spending nationality on international tourism in 2012, and by 2014 Chinese nationals were spending $US165 billion on tourism outside their own country, a massive 27% increase over the prior year. This compares with the USA's spending of a mere $110 billion. However is not just Australia that is the recipient of this boom, in fact we come a fair way down the pecking order.

Excluding Hong Kong and Macau, which are (sort of) domestic destinations, most went to Asian destinations (Korea, Thailand, Japan, Singapore, Malaysia and Indonesia) with France, the USA and Italy rounding out the top 10. Australia came in at a poor 13, between Switzerland and Italy. But with the $A well off its highs of a couple of years ago, affordability must be looking pretty good even with after China's own modest currency devaluation, so the prospect of winning even greater share for Australia is looking pretty good. Your Fund will benefit from this not just from its holding in Qantas, but also in Sydney Airport which gets a fee for every person coming through.

Alphinity Investment Management

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