Quarterly Comment – June 2016
Alphinity Wholesale Socially Responsible Share Fund

Alphinity Socially Responsible Share Fund

Market comment

One of the central features of the financial year just finished is the way that big-picture events have been driving financial markets. Company specific factors have frequently been thrown out the window and any number of big picture themes – whether economic, political or trade – have often tossed markets about like a trailer park in a hurricane. June was typical of this: the Brexit vote has been bubbling away for many months but most of the world thought that Britons would not be prepared to risk instability by potentially reintroducing some of the economic and social friction that existed before the EU. Bremain was always assumed to be the logical outcome.

The vote instead showed a slim majority in favour of withdrawing from the EU and a sharp sell-off occurred as markets got a sniff of this, although some was recovered by the end of the month. Unusually, Australia was front and centre as the event unfolded during our trading day. Losses were not confined to the UK stock market: the Pound fell sharply and the UK Prime Minister resigned, along with much of the opposition front bench.

In such circumstances as have faced us not just in the June quarter but for much of the year, whether the Fund's relative performance is over or under the benchmark has, to an unusually large degree, come down to the portfolio's macro positioning, i.e. whether it is over-orunder-weight oil/gold/resources/interest rates/currency or whatever else is running that day/week. And when these shifts take place on a frequent basis, often reversing themselves rapidly and sharply, it tends to produce grey hair for fund managers rather than sustainable alpha for funds.

While we hope this trend is past, it may be that this macro volatility might remain with us for a while longer. There is still a constitutional referendum to be held in Italy in October, then the US election in November which has the potential to provide a result that might be difficult for global financial markets to stomach. And heading into 2017 there will be an election in France in the first half, where the right-wing anti-immigration parties are resurging, and in Germany in the second half, where Chancellor Merkel is facing a serious challenge from similar forces.

It's fair to say that there was a lot of volatility during the year just finished. Australia's performance (ASX300 including dividends) was among the better of major markets, and over the financial year we were behind only the US and New Zealand markets, even though our total return wasn't much more than zero.

Will Brexit have big implications for the Australian market? That remains to be seen. It is certainly nothing like the existential threat to global markets as the last big dislocation, the collapse of Lehmann Brothers in 2008, when liquidity dried up completely for a period. This time banks are in much stronger capital positions and central banks seem willing to do whatever it takes to keep liquidity alive, so much of the impact should be constrained to the local currency and stock markets. There might even end up being some positives: after all the British people achieved in a day what many central banks have been trying to engineer for years – a sharply weaker currency – and if sustained that should be good for UK exports over time.

Some Australian companies highly exposed to Europe or the UK might suffer some flesh-wounds, but equally the eventual disentanglement from the EU may provide greater opportunities for some in the future. So other than another bout of market volatility, currency softness and risk aversion, it's probably not a big deal for us in the short term. More significant for Australia was the election here on 2nd July. It was a very close result and has delivered an even more "interesting" senate than the last one.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	-2.8	0.8	-0.6	7.3	7.7	8.1
S&P/ASX 300 Accumulation Index	-2.4	4.0	0.9	7.7	7.2	7.6

*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 Fund underperformed the overall market in the June quarter with only a few notable contributors or detractors. The biggest positive was the Fund's position in resource exposure Fortescue Metals followed by not owning Wesfarmers or Woolworths. The notable detractors were milk producer MG Unit Trust, online retailer Surfstitch and flag-carrying airline Qantas.

Market outlook

The financial year ended with markets dominated by the now very familiar themes of concerns about economic growth on one hand versus the support of lower interest rates on the other, and it is difficult to be too definite about which will dominate in coming months and over the new financial year. However, with interest rate settings here and around much of the world already pretty much at record low levels, it's hard to believe that further reduction will do much to alter the overall growth outlook or significantly re-rate the Australian equity market.

While "yield proxy" stocks in the infrastructure and Real Estate Investment Trust (REIT) sectors are likely to continue to be well supported while interest rates remain low, many of them are now trading at dividend yields well below the market average – a very different situation compared to that of a few years ago. Admittedly, their steady earnings growth back then was expected to be less than the overall market: this same steady growth rate is now looking quite attractive in today's low growth world!

Perhaps the most interesting development in 2016 so far has been the resurgence in commodity prices and consequent performance of Resource stocks. We have spent considerable time on this topic in previous monthlies which highlighted the main drivers as the moderation of the $US and growth stimulus in China. However, the resilience shown over recent months in the face of several events and data points that would not normally be seen as positive for demand growth (soft US Gross Domestic Product, Brexit, moderating activity in China), is noteworthy. Some of it can probably, somewhat perversely, be explained by low growth reducing the likelihood of US Federal Reserve (Fed) rate hikes which would lead to $US strength. Some of it is self-reinforcing, as a higher oil price and resilient $A is putting some upward pressure on commodity cost curves. And some of it is likely due to the fact that economic activity in the second half of the year in China, despite recent weakness, should be well supported by the infrastructure projects that have only just been kicked off, as per the findings of Stephane's China research trip in May.

Either way, in our view it is likely that the lows of both commodity prices and Resource stocks occurred in February and, while current prices are not the beginning of a new multi-year upcycle for commodities, they reflect a reasonably sustainable level even in a well-supplied market. This should be supportive for sector as well as overall market earnings growth in FY2017

Portfolio outlook

Last financial year proved difficult to navigate from both a stock and macro perspective. What to expect this year and how much investors should be prepared to pay for companies today depends almost entirely on what interest rate assumptions one is willing to make. Plug in an interest rate close to current spot rates for the next several years or longer and many valuation metrics, including PEs and dividend yields, look quite reasonable or even attractive. However, lower rates for longer should also mean that investors should reduce their longer-term growth expectations for most companies, something we feel many are failing to do. But were you to use rates at levels anywhere close to longer-term averages and most companies look expensive instead.

Of course, there are always companies for which operational performance is still likely to be the key driver of shareholder returns. The Alphinity portfolios are starting FY17 with a relatively neutral macro setting: there are as many arguments that can be raised for owning yield proxy stocks, gold stocks and currency stocks as against. We instead, as is usually the case, focus on identifying stocks where operational execution will be key. In the Resources sector (now slightly overweight) we continue to favour Fortescue Metals for its superior cost management and debt reduction potential. In the Energy sector (where we are underweight based on expected stubborn oversupply) we see Oilsearch as being best positioned to deliver a strong production growth profile, with the capex synergies from an aligned expansion in PNG between it and oil majors Exxon Mobil and Total being especially underappreciated by the market.

In the Healthcare sector (which we are overall underweight due to expensive valuations) we see strongest earnings upside in Cochlear. Of the other overseas earners in the portfolio, our largest exposure is to Brambles. The company delivered a very solid interim result in February which pointed to strong underlying earnings growth in both the CHEP pallet pool business and its newer IFCO reusable plastic crates pooling business. At the small to mid-cap end of the market we continue to see opportunities in Costa Group, MYOB, Link Group and the recently-added Mayne Pharma. All up, we believe the portfolio is well positioned in what remains quite a volatile economy and equity market.

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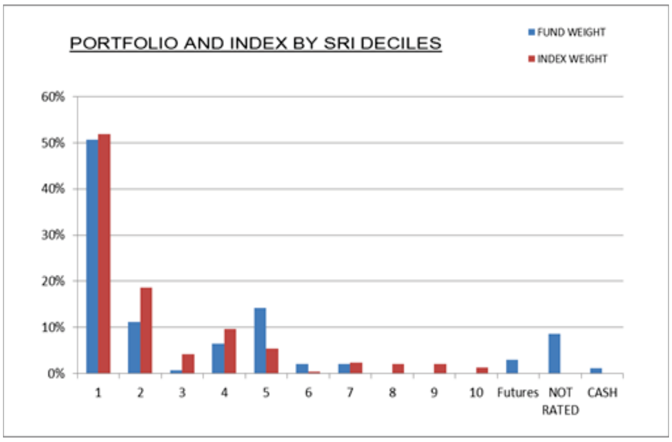
Sustainability Score

Alphinity's external advisor, CAER, assesses the Alphinity Socially Responsible Share Fund portfolio on a monthly basis to ensure that it complies with the Fund guidelines, and tests the Fund's holdings as to the sustainability of the companies held according to ESG criteria. Their most recent assessment was that the Fund had Environmental factors 33% better than the market; Social factors 17% better than the market; and Governance factors 20% better than the market. The Fund's overall Sustainability Score was 70, which compares to that of the ASX300 of 54.



Asset allocation	30 June 2016 %	Range %
Securities	97.7	90-100
Cash	2.3	0-10

Top 5 active overweight positions as at 30 June 2016	Index weight %	Active weight %
Goodman Group	0.8	2.7
Aconex	0.1	2.1
Sydney Airport	1.1	2.1
Metro Performance Glass	0.0	2.0
IDP Education	0.0	1.8

Fund details	
Manager inception date	1 September 2010
Fund inception date	30 June 2000
Fund size ($A)	13.3M
APIR code	HOW0121AU
Fees	
2014/15 ICR	1.15%
Management fee	1.15% p.a. of the net asset value of the Fund
Performance fee	Nil
Buy/sell spread	+0.20%/-0.20%

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BTW

The classic comedies *Yes Minister* and *Yes Prime Minister* gave us many insightful windows into the strange world of politics and its interaction with bureaucracy under the Westminster system which, although quintessentially English, is generally thought to be quite similar to the situation here. Looking at the show now is a little comical considering the 1980s fashions and production values but the humour itself, tinged with large doses of irony, stands the test of time. *Yes Minister* even pretty much predicted the whole Brexit thing: just have a look at https://www.youtube.com/watch?v=EkpS-yBj7gY

But as chief mandarin Sir Humphrey Appleby said in one episode: "*Minister, two basic rules of government: Never look into anything you don't have to. And never set up an enquiry unless you know in advance what its findings will be.*" UK PM David Cameron violated both principles by agreeing to hold the referendum into EU membership in the first place, some say just to relieve a bit of short-term political pressure he was under a few years ago, and has ended up scoring what well may be the biggest own-goal since the US invasion of Iraq. It cost him his prime ministership only a year after achieving a stunning electoral victory, and the legacy of his six years as PM has now gone from having presided over a reasonable post-financial crisis economic recovery to a likely recession followed by the need to extract itself from almost half a century of close integration with its near neighbours. Bregrets, he probably has a few…

Cameron's successor, whoever that is, will need to make a range of decisions which are unlikely to be compatible with the real or imagined promises of the Exit camp prior to the referendum: which was effectively that a thousand flowers would bloom if we could just get those pesky Belgians off our backs. Now, we at Alphinity are quite fond of Belgians and don't wish to take sides, but we couldn't help noting the dawning realisation that took place immediately after the vote – exemplified by a petition supported by millions of people within days to hold a re-match. This is understandable: if it had been a very clear majority one could accept the peoples' verdict and move forward into the new economic uncertainty confident of wholesale citizens' support. But 48-52 is hardly a clear endorsement of such a significant move.

Some things about the vote are quite telling. Of the 46 million people eligible to vote, 17 million voted to go versus 16 million people to stay. 13 million didn't bother to vote at all, so with a bit more engagement the outcome could have been quite different. 72% turnout is reasonable by UK standards – the last few UK general elections have been in the 59-66% range – but low relative to the almost full attendance levels we are used to given the compulsory nature of voting in Australia. However closer inspection reveals a Britain fractured along a number of lines. Scotland, Northern Ireland, the City of London and much

of the South East voted strongly in favour of remaining. The higher your level of education the more likely you are to have voted to stay. The younger you are the more likely you are to have voted to stay. The higher your socio-economic demographic the more likely you are to have voted to stay. Most significantly, the younger you are the more likely you are to have voted to stay, and these are the people who will have to live longest with the implications – a bit of intergenerational angst might arise in the future.

It is possible that the Exit camp thought that a voting outcome like this might put pressure on the EU to come crawling back to them with further concessions to make life a little bit easier on Britain. As it happened, the initial reaction in Brussels was the other way, effectively saying – "You want out? Get out then!" It really has no incentive to make the UK exit easy or pleasant as that would just encourage any other wavering members to do the same, potentially leading to the re-fragmentation of Europe, and potentially the reestablishment of old trade barriers and border controls.

Not that you could call the 50-odd-year European experiment a unqualified success. The common currency which has been in place since 1999 has acted as something of a straight-jacket on economic flexibility in what is a vast region with very diverse economic characteristics. Had Greece it its own currency when it was suffering from its issues not that long ago (and which are still bubbling away in the background and could again flare up) it could have imposed a massive devaluation, impoverishing its citizens to an extent (which happened anyway) but providing some much-needed stimulus to tourism and exports to get the Greek economy back on a competitive footing. As it has turned out it has been stymied by the strong Euro and remains on its knees even after several years of pain.

Of course the subtext of the UK referendum was immigration. It arguably became conflated with whether or not people liked all those foreign people coming in, rather than just a question of being in or out of Europe. Unfortunately the same question is being asked in other countries on the Continent and it doesn't take too much imagination to foresee situations arising in which the good judgement and behaviours of populations are subverted by fear or resentment into regrettable actions. In times like these it feels quite good to be sitting on a big island on the other side of the world, pretty much as far away from all that as you can get.

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Traveller's Tale

Not long after our recent piece on Tesla, Bruce travelled to an event at the Tesla showroom in the Sydney suburb of St Leonards, just across the bridge from Alphinity's Sydney office. Having been promoted as a "Tesla Test Drive" he was a little disappointed on arrival to find that it was a drive *in*, not *of*, this revolutionary electric vehicle, although a drive of was offered at another time should he be seriously considering buying one. Notwithstanding this, he was still happy to have the chance to chat with the sales dude and go for a little spin, even if it was in the passenger seat. He came away more convinced that this is the way of the future, and that ICE cars (that's Internal Combustion Engine for those not in the loop), while not in any immediate danger of disappearing, will become the exception rather than the rule at some point in the future.

Tesla has managed to answer most of the conventional arguments against electric cars. One is range, but with sufficient battery capacity to theoretically get you about 500km before running out of oomph – at which point a lengthy re-charging session would be required – this would be an issue only for those regularly driving long distances. For the vast bulk of us, a few hundred k's is plenty. The salesman even had a neat counter to the argument that you would just be swapping emissions at the tailpipe for emissions at a dirty coal power station somewhere else. Apparently the process of refining petrol from crude oil is a massive user of energy, so you need to also take those emissions into account when comparing ICE and Electric vehicles. A quick google of this matter came up with some views that it takes about 6kWh of energy (not necessarily electricity) just to refine a US gallon of petrol – this alone is almost enough to take an EV the same distance as an ICE car, even before factoring in petrol use.

The biggie however is price. Starting around $120,000 and as much as $250,000 for the top model if you tick all the boxes. And you really have to, with cool options like Autopilot (cruise control), Bioweapon Defence Mode (a fancy air filter) and of course the $15,000 Ludicrous Speed Upgrade: price is the barrier for most potential buyers. (Incidentally Tesla's Autopilot feature was dealt a blow recently when one crashed into a semi-trailer in Florida, killing the driver, when apparently the colour of the truck which was crossing a freeway made it blend into the road and it wasn't identified as a hazard by the car. Maybe be a bit more development is required.) If we had that much spare cash we'd put it into the Fund rather than buying a depreciating asset like a car, but the next model Tesla 3 should bring that down to a more affordable level. The big carmakers are now frantically developing a competing range of purely electric vehicles which will expand the choices available at lower price points in coming years. With a bit of luck, cars like these will become like most consumer electronics and just keep getting better and cheaper with each iteration.

The drive itself was very impressive. Gliding silently and smoothly even on Sydney's rough roads, at one point the salesman slowed the car almost to a stop and then planted his foot: the pace of acceleration in almost total silence was exhilarating and, one imagines, could become quite addictive. The top model with the Ludicrous Speed Upgrade boasts supercar-beating acceleration: 0-100km in 2.6 seconds, which makes it the fastest four-door in the world, beating all but a handful of specialist cars. Lower-spec models are almost as fast. The car itself is spacious and comfortable, and between the front seats there is the biggest and clearest screen you can imagine which operates pretty much every function in the car. In all, Tesla offers a compelling proposition with only its price really getting in the way of much greater sales.

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