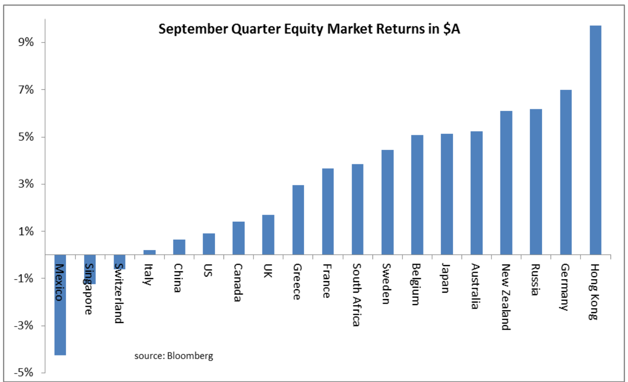
Quarterly Comment – September 2016

Alphinity Wholesale Socially Responsible Share Fund

The Final Countdown

Market comment

September is often a dangerous month on global markets. People who track these things have found that September and October are generally the worst months for equity market returns. October has a particularly bad rap after the two big stock market crashes – in 1929 and 1987 – both happened in that month, but the rot on both occasions started the prior month. So it is with some relief we can report that, at least in $A terms, things weren't too bad this time. The ASX300 (including dividends) rose by 0.5% in the month and was up 5.2% for the September quarter. Australia was the best-performing major market in September and behind only Hong Kong (9.7%), Germany (7%), Russia and NZ (both 6%) for the quarter.



The biggest mover in the commodity space over the quarter was Coal. The recovery in China's economy and some supply constraints there meant that in $A terms thermal coal (used for power generation) rose by 36% and metallurgical coal, used to transform iron ore into steel, rose by an incredible 125%. While these prices have already elicited a supply response from Chinese coal producers and will likely subside a bit from these levels, it will still be a boon for Australia's export income. The price of iron ore itself was fairly flat, having made significant gains earlier in the year. The oil price (Tapis) fell about 7%. The $A was reasonably firm over the quarter, as often happens when commodity prices rise. It appreciated by 5% against the Pound and 3% against the $US but was relatively stable against other major currencies.

Central bankers remain highly influential on markets. The US Federal Reserve decided not to raise its short-term rates this month but left December as a live possibility. The European Central Bank may be going the same way: its current easing program runs out in March 2017 and may not be extended, at least as generously. The Bank of Japan said it would now target keeping the ten year bond yield at 0%. Locally, our Reserve Bank changed Governors but not short term rates.

As we enter the other dangerous month, the US election draws inexorably closer. The eyes of the world are firmly fixed on the events there, a bit like when you pass a car crash on the freeway. Rarely – possibly never – have the two mainstream candidates been so disliked or mistrusted by the US voting public. And with voting being optional there the published polls, which are neck-and-neck, do not necessarily reflect the likely outcome. It could be that only the truly passionate will turn out to vote, increasing the possibility of an unexpected outcome. Yet one will be president and from this distance the possible outcomes for global economics and politics seem binary: will the US remain engaged with the world – a reasonably benign policeman compared to some of the alternatives out there – or will it withdraw from our region as has been suggested by the more insular candidate, leaving the South China Sea to the most powerful local player?

Australia has a particular interest in maintaining its current good relations with both the US (vital for security) and China (vital for trade) concurrently. It would not be helpful for us to be forced to choose between one or the other.

Portfolio comment

The Fund outperformed the overall market nicely in the September quarter. The best contributors included health food exporter Vitaco, NZ window maker Metro Performance Glass, mobile phone company Amaysim, iron ore producer Fortescue Metals and English language testing company IDP Education. The only notable detractors were health insurer Medibank Private and property company GPT Group as well as not owning either Wesfarmers or resource company South32, both of which performed well during the quarter.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	0.8	6.1	9.7	6.0	12.1	8.8
S&P/ASX 300 Accumulation Index	0.5	5.2	13.5	6.0	11.0	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

When is a trend long enough to call it a trend? During the last two years equity markets have been characterised by "earnings scarcity" which has seen investors pay more and more for the companies which are able to achieve noticeable earnings growth while shunning cyclical stocks in general and resources stocks in particular. And ever-lower bond yields, largely due to the modest economic growth which has led to this earnings scarcity, have similarly seen investors scramble for stocks with a decent dividend yield.

However, this environment appears to be gradually changing due to a confluence of factors. Most notable has been the rebound in commodity prices which has led us to conclude that we have had a change in sector leadership, both in terms of improvement in earnings outlook and relative sector performance. A stabilisation in economic growth in China together with a weaker $US were the first reasons behind the brighter outlook for the Resource sector, but since then a gradual improvement in the global industrial production cycle and lower than expected supply growth has provided additional support. With rapidly improving balance sheets, many stocks in the sector have now been outperforming since the start of the year, and some even longer. We expect this trend will continue barring any unforeseen developments in China.

Yield stocks have only been underperforming for about the last three months, coinciding with higher bond yields. How much and how fast bond yields will increase from here is difficult to predict but it would be surprising if the US Fed didn't increase the cash rate before the end of the year and, unless we get a repeat of January's growth scare, this should produce even higher bond yields and continued underperformance by yield stocks.

It's too early to say that a uniform trend of underperformance has been established for high Price to Earnings stocks but performance has been more mixed in recent months and investors have been reminded that earnings disappointment is typically very costly for highly valued companies. So overall, while we wouldn't expect all economic data points to surprise to the upside, it appears to us that relative sector performance will continue to shift in the direction we have seen so far this year. What this means for general equity market performance largely depends on whether the slightly better earnings growth outlook can overcome the higher bond yields. It's a fine balance but modest positive equity returns would be a good outcome, in our view.

Portfolio Outlook

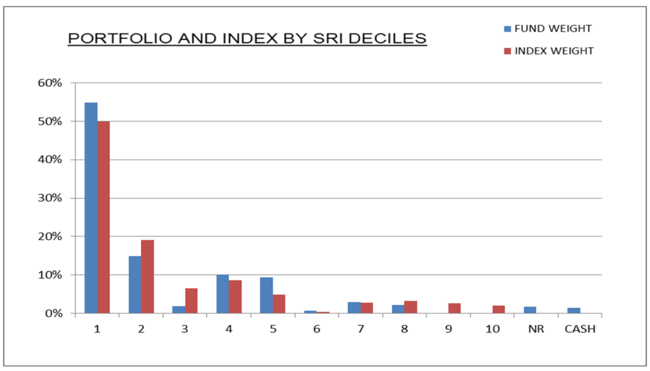
Over the course of the year we have been gradually shifting the portfolio to reflect the broader market trends discussed above. Initially this was achieved through increasing the weighting to the Resource sector, which we have been overweight since June. We continue to be more optimistic about the earnings surprise potential in Resource stocks than for Energy stocks, although we have recently opportunistically reduced our underweight to the Energy sector after the sector had underperformed noticeably. Fortescue and Rio Tinto have been our main Resource exposures over the last year for their leverage to a higher iron ore than is reflected in current market expectations. We have recently also Sims Metal Management which has very strong balance sheet, which will provide capital management options, as well as a large cost reduction program which will provide further earnings upside.

As discussed last month, we have also more recently been reducing our exposure to the 'yield proxy' sectors from an already below benchmark position. While local bond yields may pause at around current levels and wait for further directions from the US Federal Reserve Bank, the case for further outperformance by high-yield sectors from their already-stretched valuation levels looks increasingly challenging. However, some individual companies with relatively high yields still look attractive to us, such as Spark Infrastructure and Goodman Group in the utilities and Real Estate Investment Trust sectors respectively. Spark trades on a yield of more than 6.5% with low-risk growth of 5% per annum for the next five years, while Goodman has established a unique global position in industrial real estate with a focus on modern logistics solutions. We expect this platform to continue to provide steady earnings growth in coming years.

Overall, we believe that the Fund's balanced investment approach should benefit from any return to a market environment in which sector and stock performance is less dominated by ultra-low bond yields, which have led to the unusually high multiples the market has been willing to pay for earnings growth.

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 21% 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.



Alphinity INVESTMENT MANAGEMENT

Quarterly Comment – September 2016

Alphinity Wholesale Socially Responsible Share Fund

Traveller's Tale

Johan went to the US in September. It was primarily to check out how the US shale companies are coping with the low oil price but he also took the opportunity to attend Fisher & Paykel Healthcare's investor day which was held in San Diego, with a brief visit to its facility just across the border in Tijuana, Mexico.

F&P and its larger Australian peer Resmed Inc, which is owned by the Fund, have both built successful global businesses in the sleep apnoea and medical ventilation areas. While Resmed retains leadership in sleep apnoea, F&P has built an impressive ventilation and respiratory support business with some very exciting growth opportunities. As both companies have expanded they have located new manufacturing capacity in low-cost countries: in Resmed's case Singapore and Malaysia, while F&P chose Tijuana. Mexico and New Zealand have a good time zone overlap which was a critical part in the choice of location.

As it's turned out Kiwis and Mexicans also get on very well which has been an important factor in the success so far. This is probably as much a testament to F&P as it is to any overt similarities between Mexicans and New Zealanders, because it's clear that its special corporate culture informed the way it has approached the Mexican expansion. Of course, the proximity to the US and the lower production costs were the primary strategic rationales for the move, but from the start the operations have had local management. In addition, several Mexican nationals have now taken up permanent positions in New Zealand.

F&P is not alone in having identified Tijuana as medical manufacturing hub. There are today close to 40,000 Mexicans working for 50 or so medical device manufacturers in and around Tijuana. But we got the feeling that the true partnership F&P has established is indeed unique. Let's hope Mr Trump's wall doesn't get in the way of this positive development!

Nothing could be further from the low key management approach of F&P than the Texan oil industry so the 15 or so meetings in Dallas and Houston with several of the oil majors, leading shale producers and oil services companies provided a strong contrast. The industry appears to have got some of its swagger back after having weathered its worst downturn since the 1980s, including the (brief) drop in the oil price to the mid-$20s in January. The subsequent recovery to the mid $40s has been helpful, but equally important have been cost reductions and improved technology which has produced impressive well productivity gains.

Most producers expect to maintain or even increase production next year, and if prices move above $50 - which many expect it to - the industry stands ready to deploy the improved cash flow which will lift production even further. While geopolitics and the actions of OPEC (the Organisation of the Petroleum Exporting Countries) will remain significant and unpredictable factors that will influence the oil price, the swift production response and economic viability of the US shale industry has likely moved the goal posts permanently, placing a ceiling on any eventual oil price recovery. With the equity market already factoring in a high oil price, we continue to prefer the Resource sector over Energy for our commodity exposure.

Texas of today is a much more economically diversified state and has weathered this downturn better than many expected not only from how the oil and gas industry has responded but also from a growing technology presence and other new-age industries.

However, not everything in Texas has changed: they go out of their way to retain their wild west image as this photo from one of the lunch stops between meetings illustrates.

And across the parking lot was Texas National Outfitters, where anyone could shop for the essentials like a new gun, a crocodile vest (which is so heavy it needed an extra waist strap for support), or boots made from elephant skin (these weren't on open display, available only from the back room). We reckon that only in Texas would you find a shop like that, and a salesman whose opening line was "Would you boys like a whisky?"!

Asset allocation	30 September 2016 %	Range %
Securities	98.6	90-100
Cash	1.4	0-10

Top 5 active overweight positions as at 30 September 2016	Index weight %	Active weight %
Goodman Group	0.8	2.4
Sydney Airport	1.1	2.1
IDP Education	0.0	2.0
Macquarie Group	1.9	1.8
Metro Performance Glass	0.0	1.7

Fund details	
Manager inception date	1 September 2010
Fund inception date	30 June 2000
Fund size ($A)	13.8M
APIR code	HOW0121AU
Fees	
2015/16 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

Poor Deutsche Bank. It is one of the most important systemic financial institutions in Germany, indeed in Europe, and it maintains a successful operation here in Australia. But its share price peaked at more than €90 in 2007 and Europe hasn't been a great place in which to operate since then. DB shares fell sharply in September, from €13 at the start of the month to just €10 at the end. What went wrong?

There have been lots of issues lingering on from the financial crisis but the hit last month's was from the US Department of Justice saying it would fine DB for practices that operatives of the bank might have engaged in around Residential Mortgage Backed Securities in the lead up to the GFC. Whether or not the activities occurred, the unfortunate facts are that (a) Deutsche Bank is a big target, and (b) Deutsche Bank is an easy target as it is foreign. If it wants to continue operating in the largest financial market in the world, it needs to pay up.

But how bad could a fine be? Pretty bad as it turns out. The initial claim by the Department of Justice was for $US14 billion. This translates to €12 billion or $A18 billion at present exchange rates. In the context of a major global bank however surely that could be absorbed by the massive capital reserves it has in its vaults? As it turns out, no. Even though the assets on the DB balance sheet total €1.8 trillion, the bank's entire market value at a €10 share price was only €14 billion. The fine imposed by US authorities equates to more than 80% of DB's entire market capitalisation. To put this in perspective, the smallest of Australia's major banks, NAB, has a market cap of $A75 billion, more than €50 billion.

What to do? Clearly DB would not be able to pay that vast amount without severe consequences for its solvency. Should it undertake a big capital raising to come up with the funds? Going to shareholders for this purpose would probably not go down very well and would dilute existing shareholders materially. A German government bail-out then? Unlikely, for similar reasons: imagine justifying to the German people an investment in the country's biggest bank solely to pay an egregious fine to another country's government? There doesn't seem to be an easy answer to the dilemma. The only bright spot might be that US regulators can be fairly malleable. The $14 billion might have just been an ambit claim positioning the Department of Justice for a more reasonable outcome. But even if the fine is halved it's still a very big number.

Fining is good business for regulators. The *Financial Times* says that since the crisis banks around the world have been fined more than $US350 billion, money that generally flows into government coffers rather than to the parties that were financially injured. But the burden of paying these fines has principally fallen on bank shareholders rather than the executives responsible for the conduct, very few of whom have faced much more serious a consequence than losing their jobs or bonuses. This doesn't seem very equitable to us.

Alphinity Investment Management

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