Alphinity
INVESTMENT MANAGEMENT

Monthly Comment – January 2016
Alphinity Wholesale Concentrated Australian Share Fund

An Unhappy New Year

Market comment

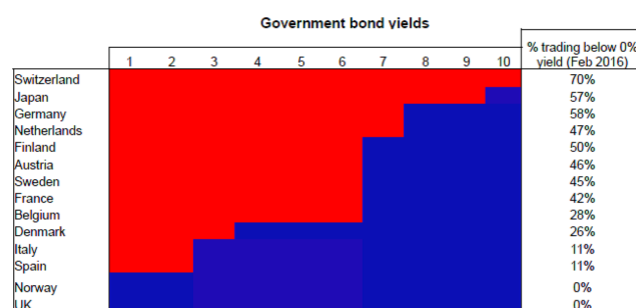
The market looked unwell virtually from day 1 in January. Australia's market being down 5.5% (ASX200 including dividends) was actually pretty good compared to many offshore markets: the US was down 8%, Italy 10% and Greece 12%. Asia also mostly fared poorly: Hong Kong -10%, Singapore -9% and Shanghai a whopping -22%, and even Chinese shares listed in HK were down 15%. In this context Australia's outcome was almost respectable even if absolutely poor. The $A fell a couple of cents which mitigated some of offshore investors' pain. Why was there so much instability? We discuss this a little in BTW over the page.

Bond markets continue to do strange things. Going back a few years even the notion of negative interest rates was ludicrous; this new phenomenon however has taken over much of the developed world to the extent that whole yield curves have become negative in some places (see adjacent chart). Australia is an honourable exception, although even our bonds are trading at yields that have only ever been seen in the past year.

It is hard to fathom why anyone would buy a bond with a negative yield. After all, if you hold it to maturity you are guaranteeing that you will make a loss, as you are paying more for the bond than the total of its face value and any coupon you will receive in the interim, getting back just the face value at the end. And if you plan to sell it before maturity, you are relying on yields being even more negative in order to make a return. Some obviously must think it is better to regain most of your capital than potentially lose a portion of it as might happen in another asset class, but the risk/return equation seems poor to us. Australia still has positive yields either side of 2% across the curve, and it is difficult to conceive of a situation where ours might become negative.

Resource prices continued their recent trend, which is mostly down. Iron ore and lead fell 4%, copper 3% and nickel 2%. Oil had fallen 28% by mid-month to its lowest price since 2003, although it bounced back from its mid-month lows to finish only 7% lower at $US35 per barrel – a far cry from the >$100 price only 18 months ago. Gold was an exception, rising 5%.

As we go into the February interim reporting season we will again be mining the rich seam of data that will inevitably be exposed and see whether our investment theses are supported or disproved. But with all that is going on elsewhere in the world there is a decent chance that any fundamental news that comes out might end up being swamped by macro events.



Source: Deutsche Bank

Portfolio comment

the portfolio outperformed the market in January, continuing its strong run relative to what has been quite a subdued market. The strongest contributions were from health insurer Medibank Private, winemaker Treasury Wine Estates and Sydney Airport, while not owning big bank ANZ or resource major BHP helped. Partially offsetting that however was our holding in global investment bank Macquarie Group, thought to be a loser from market volatility, and not owning telco Telstra or conglomerate Wesfarmers, both of which performed a little better than the very soft market.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	-5.2	-1.1	-1.9	8.1	8.0	9.4
S&P/ASX 200 Accumulation Index	-5.5	-3.6	-6.1	5.5	5.7	7.1

*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

Low growth, low valuations, low returns: 2016 is shaping up as challenging year for equity investors. While the sell-off to date looks somewhat overdone, the equity market's role as a leading indicator should not be ignored. Business confidence is likely to take a knock, as is consumer confidence, which will not help what is already a weak corporate earnings outlook.

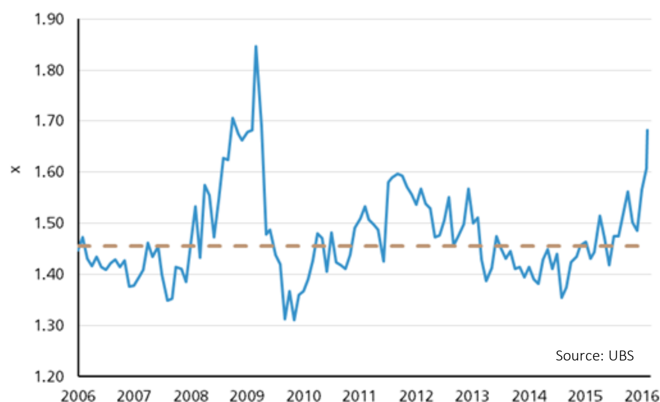
The saving grace is that valuations and growth expectations are already fairly low and, in Australia, we still have room to cut interest rates should economic conditions deteriorate materially. The support from reasonable valuations, including a highly attractive dividend yield of close to 5%, and risks to growth thus appear fairly evenly balanced. Key risks to monitor are likely to continue to be whether the US recovery is stalling and how much China is slowing. In both cases we think there are enough positive factors to avoid a US recession and Chinese hard landing.

And while it's easy to focus on the negative fallout from the collapse in commodity prices, it shouldn't be ignored that the resulting lower input costs should be supportive for both company margins and peoples' disposable income. This positive impact may become increasingly evident as the year progresses.

Portfolio outlook

The current heightened level of market uncertainty in our view warrants a relatively defensive portfolio positioning. This however begs the question – what is a defensive company in today's market? Following the stark divergence in performance over the last year, the valuation dispersion between stable or growing companies and more cyclically-exposed companies is now the highest since the financial crisis, as the chart below shows.

P/E Dispersion of ASX100 ex-Resources
(80th percentile divided by 20th percentile PE)



Is a defensive company something like Domino's Pizza Enterprises? It has almost doubled over the past 12 months including dividends, has an impressive track record of strong earnings growth along with what still appears to be a number of growth opportunities, but was trading in January on a FY17 earnings multiple of almost 50x, three times that of the overall market. Or is a defensive company something like resource giant BHP Billiton? It has almost halved over the last year including dividends, although its earnings are set to decline by more than two thirds this financial year. To us, neither looks particularly defensive.

Alphinity seeks to invest in companies that are in, or are about to enter, an earnings upgrade cycle. We are strong believers in the serial correlation of a company's earnings trajectory: that is, up to a point, good news tends to be followed by more good news and bad news by bad.

By not investing in stocks whose earnings are under pressure we aim to avoid the "value traps", companies that appear to be on low multiples but in reality are not as their earnings are way over-estimated. But it is equally important to avoid the "growth trap". All good things eventually come to an end: analysts get overly optimistic about the sustainability of a trend, competition catches up, management makes a mistake or it gets sidelined by a regulatory change. More often than not, this coincides with it trading on a high earnings multiple, and high multiple stocks are generally not very forgiving of any disappointment. This is why the other key criteria for a stock being selected for the portfolio is that the company is also undervalued.

The earnings scarcity of recent times has driven up the premium for stocks with a degree of earnings growth so such companies at a reasonable price have been increasingly challenging to find. Nonetheless, we believe that a number of our portfolio holdings have these attributes. Companies such as Caltex, Adelaide Brighton Cement, Aristocrat, Medibank and Goodman Group are all in strong positions to continue to deliver positive earnings revisions even though they are not trading at multiples that are too far away from historical averages. We expect these types of companies will see us through what looks to be a difficult time for the equity market.

Asset allocation	As at 31 January 2016 %	Range %
Securities	98.4	90-100
Cash	1.6	0-10

Top 5 active overweight positions as at 31 January 2016	Index weight %	Active weight %
Westpac Banking Corporation	7.9	6.1
Goodman Group	0.7	3.9
Commonwealth Bank of Australia	10.3	3.8
Sydney Airport	1.1	3.4
Aristocrat Leisure Limited	0.5	3.3

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BTW

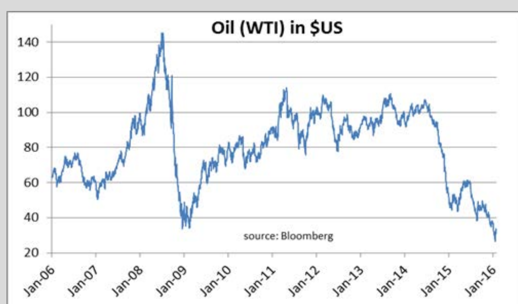
The turmoil in global markets in recent months has been quite disconcerting, and working out the root cause/assigning blame is not easy: as is often the case there was no single factor, more a confluence of events which contributed to extreme risk aversion in January, a month which is quite thinly traded to start with. Low volumes tend to exacerbate market moves, in both directions. Some of the factors have been:

Global Monetary Policy: US rates going from zero to not much more than zero in December should not have mattered very much, and if anything it has been countered by increasingly easier monetary policy in Europe and Japan. In any case, it increasingly appears that the next US rate rise will be later rather than sooner.

Japan: has extended its already unconventional QQE (Quantitative and Qualitative Easing) policy by instituting a regime of negative interest rates for various classes of investors. It is (still) attempting to rejuvenate its economy by lowering the Yen, injecting some inflation and increasing export competitiveness.

China: has been sending out mixed messages regarding its increasingly flexible currency peg to the $US: was this to boost exports in response to a soft domestic economy or more about preparing for greater integration into the global currency system? Its economy is slowing and its focus has been changing from industrial to consumer – this is rarely a smooth transition

Oil price: seems to be the big one. The price of oil fell almost 30% between January 1st and 17th before bouncing sharply. If you expand and look at the chart below really closely you can only just see that bounce. While on the face of it a falling oil price is deflationary, and therefore concerning to central bankers, in reality the low oil price is overwhelmingly good for most countries, companies and people. If you produce oil or gas of course it's a problem: your income falls sharply.



The revenue bases of players like Saudi Arabia, Venezuela, Russia and Islamic State are no doubt hurting (although it is hard to feel much sympathy for some of these!). But if you import much of your energy needs, as do China and Japan, or drive great distances in a big V8 pickup as most US consumers seem to, then a low oil price is actually quite good.

The market's greater initial concern around low oil prices is the impact it will have on the credit-worthiness of oil-producing companies (see next point). Some are looking at the low oil price as an indicator of impending recession – after all the last time prices were near this level they were the darkest days of the GFC. Back then however the low oil price was largely caused by a lack of demand due to the poor global economy: this time it is largely excess supply for a number of reasons including unconventional oilfields in the US, overproduction by some OPEC members and the looming re-entry of Iran's low-cost, high volume oilfields.

There are no doubt, many more factors in play. Global equity markets (as measured by the MSCI World Index in $US) were down 8% from the start of December to the end of January, and down 14% since the most recent market peak in May 2015. So are we in a new bear market or is this just another opportunity to get set at appealing prices?

Equities by their very nature have volatile prices so sometimes it is just a matter of your timeframe. But Citi Research's Global Strategy Team recently updated their fairly systematic method of determining the risk of a global bear market and concluded that it isn't yet time to panic. At the most recent market peak in May 2015, only one of the 18 factors they look at pointed to trouble; eight months later that has increased to only four.

This contrasts with 17 of the 18 flashing warning signs in March 2000 (after which the MSCI fell by 51% and 12 of the 18 in October 2007 (preceding a fall of 56%). Citi concluded that, on balance, global equity valuations still aren't stretched, especially relative to the very low bond yields prevailing pretty much everywhere, and that there is also little sign of the M&A bubble that normally precedes such events. Having said that the MSCI is still down 14% since last May which is not something that pleases anyone.

We're certainly not panicking but it's fair to say we're taking quite a cautious view of where things might be going from here.

Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size	$12.2M
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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Traveller's Tale

One of the great pleasures of analysing stocks is the opportunity to get out into the field and meet Real People doing Real Things. This is how Bruce ended up on the northern outskirts of Melbourne one steamy day in January to see the biggest mushroom farm in Australia. Owned by fresh food operator Costa Group, it churns out 250 tonnes of mushrooms a week, supplementing Costa's other four growing facilities around the country which all add up to more than 40% of the country's mushroom supply. Tight quarantine laws mean import competition is completely absent.

The polite version of the old jest is that you are a mushroom if you are "kept in the dark and fed manure". Yes, darkness and manure (in this case poultry) is involved but it probably won't surprise anyone that there's a bit more to growing large volumes of mushrooms than that.

Costa has more than 600 people working at that site, and in order to churn out that volume of product of consistent quality week in and week out requires a highly technical process which has been refined to perfection over the decades.

When the farm was first established more than forty years ago it was a long way from anywhere; now there are houses just across the fence and the developers are sniffing about. Costa finds itself with a vast expanse of land in (almost) suburbia which must be worth quite a bit. But having suburbia that close also creates challenges around noise and aroma – notwithstanding the fact that the farm has been there a lot longer than the houses.

Considering the process, we were surprised by the lack of strong smells there but one can see the day arriving when they will need to move the whole thing to another site. The pain of this will be assuaged by the enormous amount of money they will get for the land but that is likely still some years away. In the interim they are getting on with the job of growing white and brown mushrooms which are sold through supermarkets and independent grocers.

Along with the 250 tonnes of finished product Costa also ends up with a further 70 tonnes of mushroom stalks which have generally been disposed of on neighbouring farms as stock feed. Considering mushrooms are 90% water, this has been a lot to give away – they are in the process of testing a bio-fuel process that will not only generate gas to help power the farm but also reclaim much of this water to re-use in the growing operations, which should supply close to half their needs. Considering the farm uses 2 million litres of water a week, this is a massive benefit both to the farm and to the water supply.

Alphinity Investment Management

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