Alphinity INVESTMENT MANAGEMENT

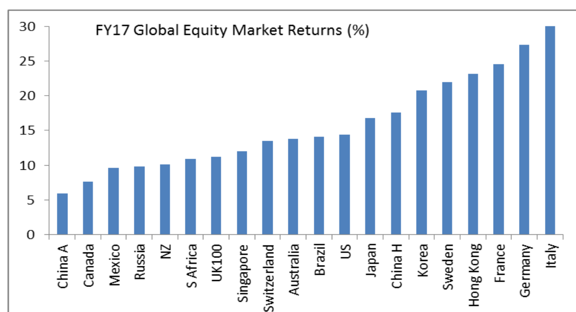
Quarterly Comment – June 2017
Alphinity Wholesale Australian Equity Fund

Out with the old

Market comment

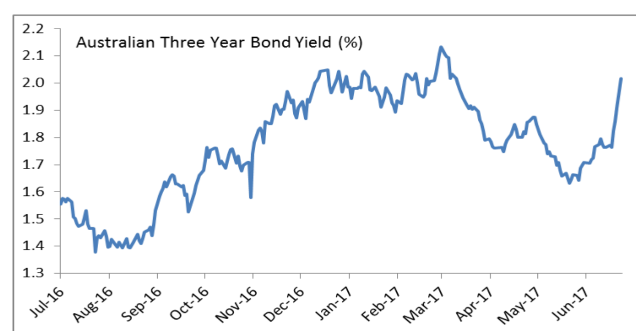
The Australian market (ASX300 including dividends) finished the Financial Year with a whimper, falling by 1.5% in the June quarter. Calendar year to date returns are still positive (+2%) but the market put in a respectable return of almost 14% for the financial year. We're pleased to report that your Fund did a bit better than each of those returns. The $A rose 1% over the quarter to just under $US0.77 but was volatile between times, falling below US74c in May.

Commodity prices continued to slide: Oil was down about 10%, Iron Ore down 20% but extremely fickle during the quarter, and most base metals down by a few percent. The prices of both Thermal Coal and Hard Coking Coal were about the same at the end of the quarter as at the start, but experienced wild swings between times. The commodity story was very different over the 12 months ending June: Oil was still soft but the various types of Base Metal were mostly up by between 13% and 27%, Iron Ore up 13% and the two types of Coal up 38% and 57%.



Global markets generally did better than ours in the June quarter: the US rose by 2.6% in $A terms and most European and Asian markets did 5-8%. Over the financial year Australia's returns were more globally competitive, coming in the middle of the pack although lagging the US by a fraction and much of Europe by more.

Global bond yields started to cause some angst towards the end of June, particularly in Europe where economic recovery seems to be taking hold. Short-dated German bonds have had negative yields for some time but these are swiftly rising towards zero. US bonds were never negative but did get pretty close to zero; these also are rising. Not surprisingly Australian yields are following suit, heading back towards recent highs, and this had an impact on yield-sensitive sectors of the share market such as infrastructure and Real Estate Investment Trusts. However the implication of rising yields is that economic growth is picking up, which is a positive for those sectors which are not interest rate sensitive, and bodes well for a continuation of positive returns for the coming year.



Portfolio comment

The Fund outperformed the market solidly in the June quarter and over the financial year just ended. The best contributors for the quarter were global gaming machine maker Aristocrat Leisure, global metal recycler Sims Metal Management and flag-carrier Qantas, and there were no detractors of note. For the financial year the big winners were Aristocrat, iron ore miner Fortescue Metals, Sims Metal, diversified resource company Rio Tinto, and global wine company Treasury Wine Estates, while not owning US/UK shopping centre owner Westfield and being underweight domestic telco Telstra also helped considerably. Detractors for the year were positions in logistics operator Brambles, building materials company Fletcher Building, and pharmaceutical maker Mayne Pharma.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	0.4	-0.4	15.4	6.2	12.5	10.8
S&P/ASX 300 Accumulation Index	0.2	-1.6	13.8	6.6	11.6	9.6

*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 to a single manager investment strategy on 12 August 2011, at which time Alphinity Investment Management commenced managing the Fund and started the transitioning of the portfolio to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2011. Therefore, the inception date for the return for the Fund is 1 September 2011.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

Earnings growth of the ASX200 rebounded strongly in the financial year just finished, to around 20% up on the prior year. The majority of this growth has been driven by a sharp rebound in earnings in the Resource sector, with the rest of the market likely to have delivered a modest 4-5% improvement (we won't know the final number until the August reporting season is done). Considering sluggish wage growth, modest consumer spending and some cost headwinds, this would be quite a good outcome.

So what can we look forward to in FY18? Probably a similar mid-single-digit growth rate to last year for non-Resource stocks, but a much lower rate of earnings growth for Resource companies as commodity prices settle somewhere in between the troughs reached in early 2016 and the peaks of earlier this year. Interest rates are likely to remain supportive even though some of the upward-repricing of loans pushed through by the Banks, especially on interest only investor loans, will likely dampen overall property demand.

The input cost headwinds from higher energy prices for corporates are well known by now, and many companies have worked hard to find ways to ameliorate this by making cost savings elsewhere. However, the impact on consumer spending from gas and electricity bills that, in many parts of the country, have increased by as much as 20% is yet to be well understood. Add to that ongoing premium increases well above inflation for home, car and health insurance and it's easy to see that the health of the consumer is likely to be the greatest risk to the economy in the year ahead, despite employment growth surprising positively in recent months.

Higher premium rates however will be supportive for the insurance sector, providing claims costs remain under control, and after some lean years increased spending on infrastructure and mining services should also help the broader market. As always there are many factors influencing the outlook for the Bank sector: loan repricing, lower deposit rates and cost efficiencies on the positive side; but modest credit growth, the bank levy and higher capital requirements on the negatives (assuming no major deterioration in credit quality). The "new normal" for the Bank sector of low to mid-single digit earnings per share growth looks here to stay.

The Resources sector is a conundrum. Market expectations are, in our view, too pessimistic for the sector but equally it is hard to see a big enough increase in commodity prices to result in meaningful earnings growth for most companies. Strong cashflow and much-improved balance sheets may see capital management (such as share buybacks) assist at the earnings per share level. The Infrastructure and Healthcare sectors are trading expensively relative to history, and we find those valuations difficult to justify despite acknowledging the strong cash flows and structural growth drivers in those sectors.

Top 5 active overweight positions as at 30 June 2017	Index weight %	Active weight %
Aristocrat Leisure	0.9	2.1
Macquarie Group	1.9	2.0
Treasury Wine Estates	0.6	2.0
National Australia Bank	5.1	1.9
AGL Energy	1.1	1.9

Yet the overall market is trading close to historical multiples, so mid-single-digit earnings growth across the market and maintaining the current dividend yield should enable the market to generate a return of 7-10% over the coming year. An earlier and more abrupt end to the very easy global monetary conditions poses the main risk to this scenario, but that is unlikely to occur without much stronger economic growth which would be more supportive of earnings growth and the equity market overall.

Portfolio Outlook

The portfolio generated solid absolute and relative returns in FY17. An overweight to Resources, especially in the first half of the financial year, and successful stock selection across several sectors were the main drivers of outperformance. The sharp market rotation into cyclicals during early 2016 presented both challenges and opportunities, but individual company performance rather than sector membership has become the chief determinant of the Fund's relative performance. We believe this should continue to benefit the Alphinity process and sustain portfolio performance.

Broader macro themes will of course continue to influence both the market direction and the relative performance of companies and sectors. Given the stretched valuation, in our view, of most yield-sensitive companies we remain underweight. Bond yields have fallen somewhat so far in 2017 primarily after a fairly soft first quarter GDP number in the US but, while economic data and inflation looks a bit more mixed today than it was six months ago, we believe bond yields are more likely to go higher than lower from this point. The Resource sector is in many ways the inverse of yield stocks. Improved market earnings expectations and lower commodity prices in the last few months may have reduced the potential for earnings surprise upside somewhat. However given attractive valuations, it would not take much in the way of stabilising commodity prices for this sector to start to do better again. We have a decent overweight to this sector, albeit smaller than six months ago.

Our exposure to the domestic consumer has been minimal over the last year, and we have also avoided property companies with exposure to retailers. This has served the portfolio well, as the weak consumer environment combined with investor concerns about likely disruption from online shopping in general, and more specifically the much-heralded arrival of Amazon, has put pressure on share prices in those sectors. This, in our view, may have opened up some opportunities. We suspect that the short-term impact of Amazon will be less than feared but the long-term impact may be even greater than expected. Companies that should be best able to cope with increased online competition are likely those that already have demonstrated an ability to do well in a competitive, low-margin business environment.

Asset allocation	30 June 2017 %	Range %
Securities	97.3	90-100
Cash	2.7	0-10

BTW

The world has just marked an important technological anniversary: ten years of the iPhone. Yes, it's hard to believe that it was only ten years ago - 29 June 2007 to be precise, the very eve of the Global Financial Crisis – that the iPhone was first released. It was a device that revolutionised mobile telephony. It wasn't the first smart phone, it arguably wasn't even the best smart phone, but it changed our cellular world.

At the time, a mobile phone was pretty much either not smart or was a Blackberry. Remember those tiny Nokias, those flip-phone Motorolas? The Blackberry was fantastic at some things, emails in particular (we still miss that keypad…) but was not great for making phone calls and completely sucked at browsing the web. There had been a few attempts by other manufacturers at smart phones but Apple leapfrogged them all. The first model was a slick-looking unit that was a delight to use, but it wasn't sold in Australia as it didn't work with our phone networks. This was rectified by the release of the iPhone 3G a year later and the rest is history.

The killer feature of the iPhone was Safari: a web browser that operated in pretty much the same way as a desktop computer, making it easy to search for things while on the move. This sounds obvious now but it was revolutionary back then. The other key to the iPhone's success was the App Store. Although not quite open source, the app store enabled people outside Apple to develop applications which would make the phones even more useful. Once vetted by Apple (and a cut of any revenue extracted of course), these appeared on the App store for downloading or purchase by iPhone users. The subsequent release of the iPad in 2010 built on this and, importantly, further entrenched users into the Apple "ecosystem" so they were unlikely to go anywhere else.

Later iterations – we are now up to the iPhone 7 and the 8 is meant to come out later this year – made further refinements and the iPhone defied the well-established trend of consumer electronics price deflation. Despite a profusion of sharply-priced competitors, the price of iPhones has steadily marched higher. Browsing our favourite consumer electronics store's site, we were struck that the cheapest iPhone 7 available was $1079 but you could buy a store-brand 65" Ultra High Definition TV for $999. 65 inches! Or a brand-name 50" UHD TV. Admittedly these would be difficult to carry around or make phone calls with, but the technology going into a large-screen TV is surely not that inferior to a phone, and its screen would cost astronomically more. Apple is financially cleaning up, so it's no great surprise that it has become the most valuable company in the world, with a market capitalisation of $US750 billion.

What do you do when you are worth so much? Build a new house obviously. Apple is putting the final touches on a new circular edifice in Cupertino, just east of San Francisco in the heart of Silicon Valley. The building cost more than $US5 billion, features glass walls and a carbon fibre roof fabricated in Dubai, and apparently it can be seen from space – at least until the 9000 trees Apple planted there grow.

Why did Apple develop the iPhone? The business opportunity is obvious in retrospect but success was certainly not assured at the time; apparently it was working on what became the iPad but the late, great Steve Jobs saw a bigger opportunity in merging it with telephony. He put the iPad on ice for a couple of years before launching it to massive success in 2010. For the phone he originally proposed a clock-wheel, similar to the control on the original iPod and reminiscent of old-fashioned telephones, but that was quickly favour of a touch screen. Now ubiquitous, it was quite revolutionary at the time. Doing away with physical buttons allowed much greater screen real estate, although at the expense of functionality. It augmented predictive text with Autocorrect, which sometimes overcame the touch-screen keypad's issues but sometimes magnified them.

The iPhone 8 is due out later this year, this is supposedly what it will look like, the most noticeable differences from the current phone being an edge-to-edge screen at the front, a glass back with twin rear-facing cameras and chrome edges. It may charge wirelessly and will likely come in three sizes, and the fingerprint reader could be replaced with facial recognition or iris scanning. All will be revealed, no doubt with typical fanfare, around September.

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BTW2

Another important landmark occurred in June: the market capitalisation of Tesla (briefly) surpassed that of BMW. That's right: the American company which until recently made only one model (it recently launched a SUV with silly doors), about 100,000 cars a year, was considered by the global investment community to be more valuable than the hundred-year-old manufacturer of 2.5 million cars and 150,000 motorbikes, with brands including Rolls Royce, Mini and the Ultimate Driving Machine™ itself.

BMW's market cap at the end of June was €53 billion, or $US60 billion. It is the world's fourth-highest valued car-maker after Toyota (¥19 trillion/$US173B), Daimler Benz and VW (both about €68B/$US77B). At one point during June Tesla's market cap reached $63 billion although it closed the month just below that. However Tesla is still comfortably bigger than US peers General Motors ($US53 billion), Ford ($US44 billion) and Fiat Chrysler (a paltry $US16 billion). In fact even Ferrari (listed on NASDAQ with stock code RACE) had a bigger market cap than Fiat Chrysler, the company from which it was spun out in 2015.

So why is Tesla worth so much despite producing far fewer vehicles than any one of the abovementioned car companies other than Ferrari? Is it because it is highly profitable? Apparently not, in fact Tesla is highly unprofitable. In its most recent financial year it made a loss of $US725 million, or -$5 per share. Admittedly it did make almost $US340 million at the EBITDA level (i.e. before interest, tax, depreciation and amortisation) but that pales before the might of BMW's €17 billion EBITDA in the same period, and net profit after tax of €7.4 billion, or €11 per share .

Is it because of expected growth? That's a more compelling argument as BMW has grown its sales by 26% since FY13 (not bad we would say) whereas Tesla has quadrupled in the same period: if you extrapolate that growth rate long enough and you might start to see some value. Tesla will likely release a third model to this year, the imaginatively named Model 3, which will bring the entry price point down to more mainstream levels and presumably sell by the truck load. But even so Tesla will struggle to crack 500,000 cars.

The disparate numbers means that poor old BMW trades on an earnings multiple of less than 8 times, whereas Tesla commands 72 times (or it would if its $5 EPS were a profit rather than a loss!). The other established automotive names are undeniably cheap (which of course doesn't necessarily make them good investment): Daimler and Ford 7x earnings, GM and VW less than 6x, Fiat Chrysler sub 5x. It doesn't make much more sense if you use EV/EBITDA multiples: on that basis Toyota is on 9.5x, Daimler Benz on 2.3x, the Americans all around 2x, litigation-hit VW on a paltry 1.4x and BMW 5.5x. Tesla is on 110x. Solving the Tesla valuation conundrum is beyond the scope of this column but it may be as simple as there being one group of investors out there who are willing to apply less-demanding financial metrics in order to justify putting money into a disruptive start-up tech company like Tesla, and a different group willing to support traditional old heavy-industry car manufacturer, and are willing to on their equity investments.

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