Monthly Comment – April 2017
Alphinity Wholesale Australian Share Fund

Inching along

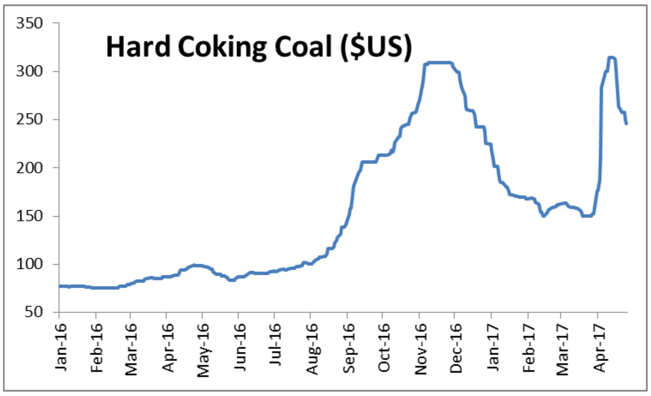
Market comment

The Australian market (ASX300 including dividends) inched ahead in April, up just 1%, bringing year-to-date equity returns to a reasonable 5.7%. Most major global markets were up 1% to 3% for the month in their local currencies (the exception being China at -2%) but with the $A down from just over $US0.76 to just under $US0.75 offshore returns in $A were approximately 2% higher for $US-based markets and approximately 4% higher for Euro markets.

These were quite impressive returns considering the degree to which geo-political risk was ratcheted-up in April. With retaliatory US air strikes on Syria, and a US aircraft carrier being moved close to North Korea after that country sent intercontinental ballistic missile tests towards Japan, it is a little surprising that markets were not a bit more concerned.

The end of April also marked 100 days since the inauguration of the US President, a period after which they traditionally take stock of progress so far. Despite his "Contract with The American Voter" detailing what he planned for that period, it is hard to point to many great achievements this early in his reign (see BTW). Politics played a part in Europe too with the UK announcing a snap election to be held in early June, and presidential elections in France which resulted in a decisive victory by neophyte centrist Macron over the far-right candidate, Le Pen. Presumably Macron's success will be a much-needed boost for the continuation of the Euro, as Le Pen would have sought to bring about a Frexit.

Bonds strengthened a little in April, with both Australian and US yields falling about 0.1%, and commodity prices were mixed. Hard Coking Coal, used in steelmaking, rocketed as the impact on production of the cyclone in North Queensland flowed through to shortages in China, initially by more than doubling in price but closing the month with a more modest but still large 60% rise. This however is likely to be tempered as production comes back on line and was not capitalised into the share prices of coal producing companies.



The price of iron ore, conversely, was down about 13% for the month after steel prices in China showed some signs of weakness. Oil softened a bit in $US but was little changed in our currency. Gold however was firm, rising about 3%, no doubt helped by the rising anxiety around North Korea.

Portfolio comment

The Fund performed a little better than the market in April. The best returns came from gaming machine maker Aristocrat Leisure, being underweight Telstra and not owning Fortescue Metals. There were no meaningful detractors.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	1.1	6.6	17.8	6.3	11.6	9.9
S&P/ASX 300 Accumulation Index	1.0	6.6	17.5	7.3	10.8	9.1

*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.

Monthly Comment – April 2017

Alphinity Wholesale Australian Share Fund

Market outlook

With the Australian equity market performing well so far in 2017 one can't help but ask how the market will fare as we enter the part of the year that, for largely inexplicable reasons, has often seen weaker returns. From a fundamental perspective the key risk is probably that valuations in most sectors other than Resources are starting to look a bit stretched, especially in the so-called yield proxy stocks. The rebound in these parts of the market sees stocks in some cases trading more expensive relative to bond yields than at any point in the last 12 months. As we've written before, we see the risk for bonds as being to the downside (i.e. higher bond yields), and we believe it wouldn't take much to trigger such a move. Despite the increased geopolitical risk and further falls in commodity prices, which typically would see a flight to "safe havens", bond yields have been gradually moving up since about mid-April. More recently bonds have been spurred-on by the US Federal Reserve's commentary that it still intends to raise cash rates further in 2017 as it sees weaker first quarter growth in the US as transitory. This, coupled with continued positive economic and political signals coming out of Europe, is supportive of our view that global growth will tick up in 2017.

Recent weakness in commodity prices is perhaps at odds with this view, and of course particularly relevant for the Australian equity market. To us, the sharp selloff of the iron ore price appears to be driven by positioning rather than a change in underlying demand. Just as buyers were trying to get ahead of the curve by buying early when prices were moving up, they have now stepped aside and are running down inventories while hoping for a better price in coming weeks or months. This process may have some way to run but, as we concluded from our recent visit to China, underlying demand remains robust. Market observers are also fretting about the implications of tighter credit restrictions on economic growth in China. We find this slightly confounding as Chinese authorities have proven to be particularly adept at keeping its economy on a stable growth path, and we would have thought the incentive to do so is particularly strong in the lead up to China's October Party Congress.

In summary, we wouldn't be surprised to see some correction in the Australian equity market over coming months. Valuations, especially in some parts of the market, look on the expensive side, commodity prices may continue to be volatile in the short term, and the bank reporting season will likely remind investors that this large sector's earnings growth remains subdued. Countering that, a largely supportive global growth outlook and the back-stop provided by solid dividend yields on many shares should limit any downside.

Asset allocation	30 April 2017 %	Range %
Securities	98.0	90-100
Cash	2.0	0-10

Portfolio Outlook

Over the last year the portfolio has, in addition to a number of stock specific drivers, added value from both being overweight Resources and being underweight yield sensitive sectors. While relative performance has remained positive, this positioning has more recently been challenged by a strong rebound in some of the yield sectors, especially infrastructure stocks and a sell-off in Resources names. The weakness in Resources is more understandable given the sharp decline in many commodity prices and in particular iron ore, but the continued strength in infrastructure stocks is more surprising, in our view. Admittedly bond yields are below their calendar year peak in early March, but equally they are also still well off their recent lows of mid-April, yet this group of companies has continued to perform strongly. This looks unsustainable to us and, given our view that bond yields are likely to continue to move up, we have further underweighted the sector by reducing our holdings in Sydney Airport and Spark Infrastructure.

We have retained our moderate overweight to Resource stocks but, despite valuations in the sector looking increasingly attractive, we would like to see prices stabilise before further increasing our exposure. This should occur as underlying consumption and short term demand become aligned in coming months. Earnings upside for the sector is, in our view, still likely in FY18 but the potential for positive surprises in the remainder of this financial year is now limited. Outside of these sectors, while acknowledging that overall market metrics are looking harder to justify, we continue to see opportunities in companies that will benefit from higher domestic gas and electricity prices such as AGL and Origin. We also expect to see a gradual return to capital spending by Resource companies which should help the resource sector-exposed companies which have been added to the portfolio in recent months, such as Orica and Downer.

Bank performance is likely to be capped from here however after a strong run, due to the modest earnings growth outlook for the sector. Our key exposure here has for some time been National Australia Bank. The recently-concluded bank interim reporting season has further strengthened our view that NAB has the best potential to improve its profitability and, as a consequence, reduce its valuation discount to the sector.

Top 5 active overweight positions as at 30 April 2017	Index weight %	Active weight %
National Australia Bank	5.7	2.0
Aristocrat Leisure	0.8	2.0
Treasury Wine Estates	0.6	1.9
Macquarie Group	2.0	1.7
AGL Energy	1.1	1.6

BTW

100 days is a fairly meaningless period of time: a little more than a quarter of a year, a little less than a third; breaking into triple figures seems to be the only reason to note it. And the fact that it has been a period for review by every presidency in living memory. While Trump himself has decried this practice, he set himself up for a fall just before the election by issuing his Contract with the American Voter, which listed 28 things he would achieve in his first hundred days. US online magazine Quartz put out quite a nice summary of his progress against his own scorecard, complete with a graphic, reproduced below, showing how he presumably would have rated himself using tag-lines typically attached to his Tweets.

The first six related to "draining the swamp" – cleaning up alleged corruption and collusion in Washington DC. He would do this by imposing term limits on members of Congress; a hiring freeze on all federal employees (except military, public safety and public health); requiring that every new federal regulation must result in the elimination of two existing regulations; a five-year ban on officials becoming lobbyists after they leave government service; a lifetime ban on White House officials becoming lobbyists for foreign governments; and a ban on foreign lobbyists raising funds for American elections.

The second group of promises was aimed at protecting jobs in America: renegotiate or withdraw from the North American Free Trade Agreement; withdraw from the Trans-Pacific Partnership; label China a currency manipulator (which would trigger certain penalties); end foreign trading abuses that unfairly impact American workers; lift restrictions on the production of shale, oil, natural gas and "clean" coal; allow vital energy infrastructure projects, like the environmentally controversial Keystone oil pipeline from Alaska; and cancel payments to UN climate change programs and instead use the money to fix America's water and environmental infrastructure.

He would also "restore the rule of law": cancel allegedly unconstitutional executive action memorandums and orders; select a new Supreme Court judge; cancel all federal funding to Sanctuary Cities (these are places which are willing to harbour illegal immigrants); begin removing criminal illegal immigrants; and suspend immigration from terror-prone regions as well as institute "extreme vetting".

The big ones however were getting actual legislation through. The key areas were personal tax reform and simplification; ending the practice of offshoring jobs; a trillion dollars in Infrastructure; school choice; repealing and replacing Obamacare; instituting tax deductibility for the care of children and the aged; ending illegal immigration; establishing a task force on violent crime; restoring national security by spending up on the military; and cleaning up corruption in Washington. Getting all these things through would restore prosperity to our economy, security to our communities, and honesty to our government.

So has the contract been fulfilled? Sadly, according to Quartz at least which must (presumably) be a left-wing purveyor of Fake News, only five of the 28 are able to be considered a **Tremendous!** success. These are eliminating regulations, withdrawing from the TPP, lifting energy restrictions, cancelling unconstitutional actions (of which there were none found), and the appointment to the Supreme Court. Unfortunately most of his 100-day promises fall into either the **Sad!** or **Total Disaster!** categories. No wonder Trump's approval rating is the lowest of any new president in recent US history: at the end of April 41% approved of his performance while 55% disapproved. Even George W Bush had 57% approval and only 25% disapproval. In one way however he's in a better state than the now widely-revered Ronald Reagan: by this stage in Reagan's presidency he'd survived an assassination attempt. Sad!

Monthly Comment – April 2017
Alphinity Wholesale Australian Share Fund

BTW2

A lot of anxiety has been reflected in the share prices of Australian retailers recently, mainly due to stories about the imminent entry of global shopping behemoth Amazon to the Australian market. Amazon has grown massively from its roots as an online book seller in the late 1990s and is now one of the biggest retailers in the world. According to Bloomberg it is on track to exceed $US160 billion of sales this year and $US200B in 2018. Its founder Jeff Bezos recently overtook Warren Buffett as the world's richest person (although partly because Buffett has been giving some of his assets away): Bezos' 16.7% of the company has a market value of about $US76 billion.

Amazon has actually been in the Australian market for a decade or more albeit as an importer. It already takes hundreds of millions of dollars of sales – up to $1 billion by some estimates – from Australian buyers but until now the goods have been shipped out of places like Hong Kong, Singapore or the USA, a process that is quite clunky and expensive.

The big news in April was official confirmation of its plans to open warehouses here, which caused something of a rout in retail stocks. After all, Amazon's business model is to provide the cheapest goods at the best prices with excellent customer service – a winning formula most would admit. Price is a massive focus for Amazon: it presently has little appetite to make profits, preferring to seize as much market share as it can and not worry about profits until the future when presumably there are fewer competitors to worry about. Bezos is fond of saying to incumbent retailers "your margin is my opportunity."

Exactly when and in what form we will get to experience Amazon is less certain: Amazon Marketplace, its platform for other retailers? Certainly, this will be the first to launch. As a full-line retailer? Maybe, but that may take more time. As a provider of fresh food and grocery? Probably not at first. One service that is almost certain is Amazon Prime, where people pay a modest annual subscription in return for access to a whole bunch of streamed video as well as free delivery on pretty much anything. This has proven to be a very successful driver of sales and loyalty in other markets and is an obvious candidate for an Australian launch. Appetite is clearly exists here: web analytics firm Hitwise reports that Australian Google searches containing the word "Amazon" have almost doubled this financial year.

So who will be the losers out of this? They are not hard to identify – pretty much anyone with a high fixed cost base which sells easily transportable, high-margin goods will face stiff competition from this nimble player with little sunk investment and no existing profitability to defend. Much of the discretionary retail sector has been sold down sharply even though Amazon's actual launch might still be a year or two away. Hence there may be some value emerging among high quality retailers with strong sales, and we have recently taken a small position in JB Hi Fi on this basis. But from a longer term perspective there is certainly increasing risk.

Any winners? We can really only point to landlords of industrial property. Goodman Group is the dominant player in logistics facilities in Australia and a big Amazon landlord elsewhere in the world, so it would be well positioned to do the same for Amazon here. A large new tenant like this wouldn't make or break the business but every little bit must help.

Alphinity Investment Management

Level 12, 179 Elizabeth Street
Sydney NSW 2000
T 02 9994 7200
F 02 9994 6692
W www.alphinity.com.au