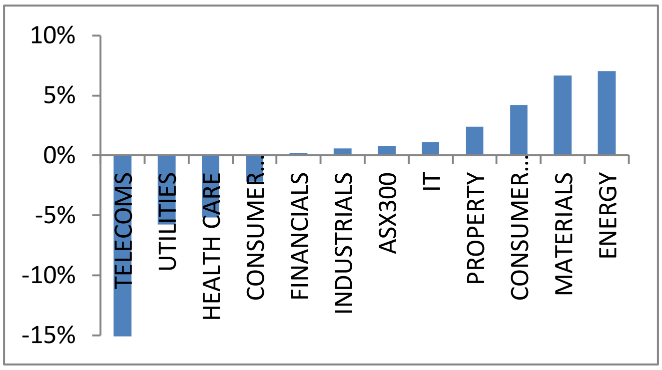
Quarterly Comment – September 2017

Alphinity Australian Share Fund

Becalmed

Market comment

The market (ASX300 including dividends) was frustratingly flat for the September quarter. While each of the three months provided positive returns, both July and September were as close to zero as you could possibly get. Of course, there were as always some significant individual sector movements. Companies in the Energy and Materials sectors were up about 7% each; conversely the Telecoms sector was down 15% and Utilities and Healthcare were both down about 5%.



Commodity prices were mostly stronger in $A terms during the September quarter, contributing to the good returns from the Materials sector. The different classes of Oil rose by between 10% and 18%, Thermal Coal by 18% and Metallurgical Coal by 25% although Iron Ore was on the soft side. Base metals were generally quite strong, rising between 6% (Copper) and 14% (Zinc).

Globally, Australia's 0.8% return for the quarter ended up towards the bottom of the pack as most investable markets struggled to perform and the $A appreciated by 2%. Major European markets returned between +1 and +5% and the US rose by 2%. We have been fascinated by the small but steady onward march upwards in the US S&P500, which kept hitting fresh all-time highs during the quarter despite the increasing imminence of higher interest rates.

Bond yields in Australia and the US resumed their upward path during the quarter, which hurt the performance of most yield-sensitive stocks, following the US Federal Reserve's Jackson Hole conference. Its conclusions were vague, however markets are still expecting that the benchmark Federal Funds rate will go up again by the end of the year. This rate has been held at a very low level since the financial crisis almost a decade ago, with only three small upward moves in the last two years. Yet with signs that US economic cycle is maturing, the Federal Reserve (Fed) doesn't want to be caught in a slowing economy without any easing capacity available to it. Fed Chair Janet Yellen appears unlikely to be re-appointed when her term expires early in 2018 and the identity of her replacement may turn out to be critical to the progress of US monetary policy.

There were elections in both NZ and Germany during September and in both cases the incumbent won the most votes although not enough to win government in their own right. Germany was considered vulnerable to the return of the far right in reaction to the large wave of immigration in recent years, so even a minority win for Angela Merkel is probably good for markets.

Portfolio comment

The Fund outperformed the market's modest move in the September quarter. On the positive side of the performance ledger were positions in plumbing innovator Reliance Worldwide, diversified resource company South 32, and financial services group IOOF Holdings Ltd, as did the underweight position in telecoms player Telstra. The only negatives to speak of were positions in steelmaker Bluescope Steel, Aristocrat Leisure which was fighting against a rising $A all quarter, and being underweight diversified resource play BHP.

Performance[1]	1 month %	Quarter %	1 year %	3 years % p.a	5 years % p.a	7 years % p.a	Inception % p.a[2]
Fund return (net)	0.0	0.9	10.9	7.0	10.9	8.7	9.2
S&P/ASX 300 Accumulation Index	0.0	0.8	9.0	7.1	10.0	7.7	8.3

Past performance is not a reliable indicator of future performance.

[1] Returns are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.

[2] 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 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 Service team on 13 51 53 during Sydney business hours.

Alphinity Investment Management

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Market outlook

The longer the Australian equity market continues to move sideways, the more pertinent becomes the question of what will make it break out – either to the downside or the upside. So far the upside scenario has been held back by fairly subdued earnings growth and perhaps also signs that some companies might have run out of their capacity to compensate for low earnings growth by increasing dividend payouts.

While the August reporting season provided few clues as to where stronger earnings growth might come from, we continue to see earnings upside in the Resource sector, despite commodity prices having pulled back somewhat from recent highs. Rio Tinto also highlighted the potential for further capital management in the sector with its announcement of a new US$2.5Bn buyback in addition to the $1Bn announced only in August. The much talked about East Coast infrastructure boom is now also well underway, while the drag from the decline in mining investment is levelling off. Recent macro data has been encouraging with the latest Purchasing Managers Index and job vacancy data pointing to improvements ahead. It may be too early to declare the end of the recent below-trend wages growth but the trough is likely to have been seen. In addition, it does look like some of the lower growth in dividends seen in August can be explained by companies finally committing to some capital spending, which should eventually create additional earnings. On the negative side of the ledger is the approaching decline in housing construction. We see a double digit decline not only in apartment construction but also in detached housing activity.

On the other hand it is also quite easy to point to downside risks in both Australian and Global equity markets, which are firmly centred around interest rates moving higher. Despite reasonably steady or improving global growth rates, year-to-date inflation has been elusive to many economies and this has kept bond yields suppressed. Some of the factors holding back inflation, especially in the US, appear transitionary and, as seen in September, it doesn't take much for bond investors to get nervous. How severe any bond-led equity market sell-off would be will largely depend on what corporate profit growth will do. If higher interest rates are accompanied by stronger growth the impact should be limited, however there are segments of the market for which it is difficult to paint a positive scenario even if higher interest rates are associated with better economic growth. So-called yield proxy sectors such as infrastructure and long duration sectors like healthcare will be both disproportionately negatively impacted from a valuation perspective, while also benefitting less - if at all - from stronger economic growth. In other words, these companies look vulnerable under most outcomes other than weaker-than-expected growth and continued low inflation. That scenario cannot be ruled out but is looking increasingly less likely.

Portfolio Outlook

The Alphinity portfolio continues to be positioned for reasonable economic growth and gradually higher bond yields. We see the Resource sector as providing the best combination of earnings upside risk and attractive valuations, with the opposite being true for many bond yield proxy stocks. Several yield-proxy stocks have already struggled to perform this year despite low bond yields as they have faced increased competition (Telstra) or subdued rent increase prospects/limited development opportunities (Westfield, Scentre Group, Stockland). They, together with the so far better performing infrastructure stocks, continue to look vulnerable to higher interest rates impacting valuations, in our view. Our largest active position in the Resources sector is Rio Tinto. The company has exposure to several commodities where we believe the market is assuming commodity prices that are too low. The new CEO and the Board have shown strong discipline in returning surplus cash generated from operations and asset sales to shareholders. Our analysis points to further capital management opportunities over the next 12-18 months. Importantly, while many companies in this sector are currently generating strong cashflow, RIO is somewhat unique in that it also has several large-scale high-return projects underway. These projects will secure RIO's long term production profile.

The portfolio's exposure to the East Coast infrastructure boom is largely through Lendlease and Downer Edi. We head into the November Bank reporting season with a modest overweight. We see some earnings upside from the material re-pricing of investor and interest-only loans that has occurred over the course of this year but remain mindful of the limited ability of the major banks to grow their loan books further, both from a market share perspective as well as due to the overall low credit growth environment. Our key exposure to the sector is National Australia Bank, which is on a path to sustainably lift its returns relative to the other banks as it reallocates its capital to higher returning areas such mortgages and its core small and medium-sized enterprise business.

Asset allocation	30 Sep 2017 %	Range %
Securities	98.3	90-100
Cash	1.7	0-10

Top 5 active overweight positions as at 30 Sep 2017	Index weight %	Active weight %
Rio Tinto	1.8	2.5
Macquarie Group	1.9	2.4
National Australia Bank	5.5	2.1
Aristocrat Leisure	0.9	2.0
Goodman Group	0.9	1.6

BTW

The US has been beset by hurricanes recently – you can see here the concurrence of Harvey, Irma and Jose approaching the country, then Maria hit a couple of weeks later (Katia and Lee thankfully avoided it). This has been the worst hurricane season in years. Admittedly, the last few years have been particularly benign but 2017 has more than made up for that.

We felt for those in Houston, Texas which suffered from Hurricane Harvey. Houston is a city we know well, mainly from Stephane's Oil & Gas research, but it underwent a deluge of biblical proportions, and around 80 Americans died as a result of the storm. Remember Hurricane Katrina, which devastated New Orleans in 2005? The Washington Post calculated that the volume of rain that Harvey dropped on Houston and its surrounding areas was about four times that generated by Hurricane Katrina: about 20 trillion gallons (at 3.8 litres per US gallon this makes 76 trillion litres; we won't even try to work out how many Sydney Harbours or Olympic swimming pools that represents). The consequent flooding was incredible, which brings us to the topic of insurance.

One of the conundrums of buying insurance is that generally the best outcome is that you waste your premium. While needing to use it might mean you get some value for the money you've spent, it also means that you would have suffered a considerable loss. But if you have a very valuable asset like a house, it is imprudent not to have insurance as the loss you might incur is incredibly greater than the relatively small premium you pay. The whole system works because usually only a very small percentage of policies need to make a claim each year, so there is a pool for the insurance company to pay out from when needed. Insurance companies themselves take out insurance policies – reinsurance – to cover them in the event that a really big event like this eats up all the pool.

Flood insurance is more problematic. If you're not in a flood-prone area you won't take it up – why would you? If you are in a flood-prone area you do need it, but any insurer offering flood cover knows there's an extremely high likelihood of having to pay out on it so the premium is usually very high. So high in fact that it can become uneconomic or unaffordable for people to take it up.

That's where the government steps in. In Australia this can take the form of bullying insurance companies to go easy on the distinction between water inundation which is usually covered, and flooding which is generally optional. We see this time and time again after a major event, such as in Lismore earlier this year.

The US has the National Flood Insurance Program. This started in 1968 and has been providing a level of cover to communities at high risk unable to get (or unwilling to pay the price for) commercial flood cover. The problem is that the scheme is quite badly underfunded. Even before Harvey hit it had a $US24 billion deficit, and the level of cover it offers is stuck well in the past: the last time it was changed was in 1994. The maximum building cover you can get – whether for a single house or an apartment block – is $US250,000, and $100,000 for contents. While probably better than having no cover at all, these amounts wouldn't go very far.

Less blanket media coverage was given to the massive floods that hit Bangladesh, Nepal and India at the same time despite it displacing 40 million people and causing at least 1200 deaths. Such is life.

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Traveller's Tales

Johan was watching those hurricanes develop in the US with special interest as he was due to jump on a plane to the US for a week of visiting building materials companies in Texas, Michigan, Alabama and Florida. Those plans had to change at the last minute so the closest he ended up getting to the hurricane-affected areas in the end was Dallas, Texas. While Dallas is in the same state as Houston, Texas is a big place and there was no evidence of the storm, in fact it was as hot and dry as it usually is.

Despite the extreme rainfall in Houston, if you compare it to New Orleans after Hurricane Katrina the loss of life was far less as Houston doesn't depend on a city levee or dam walls to keep the floods at bay. The record insurance claims predicted for Houston and parts of Florida have more to do with the greater population and the intensity of economic activity in the region relative to New Orleans 12 years ago. As the week went by, a common theme was that Houston was drying out quickly but there would still be plenty of interruption to business just from the simple challenge of people being able to get to work. There will be a number of big projects needed to get Houston back to normal. Around 25 schools will need to be knocked down and rebuilt in Houston, while in Florida it's more repair work on roofs and exteriors than total rebuilds.

All up, while there will likely be a short term negative earnings impact for Australian companies such as Boral and James Hardie which have large presences in that part of the US, the repair and rebuild should create some additional demand over the next year or two.

Otherwise, the general sentiment in the residential housing construction industry, and indeed the broader US economy, continues to be one of steady recovery where the availability of land and labour are bottlenecks that are unlikely to go away.

While Johan had been looking forward to visit Florida, and would rather have spent less time in dodgy airport hotels during that week, one of the benefits was that he didn't need to take a flight with Spirit Airlines between Detroit and Orlando. Spirit is an "ultra-low cost carrier": this three hour leg cost Johan $US113.19 which we admit is pretty cheap. According to the U.S. Department of Transportation's Bureau of Transportation Statistics, Spirit has had seven times as many official complaints against it than any other airline operating in the United States. Even the Secretary of the U.S. Department of Transportation has warned travellers that Spirit Airlines doesn't care about its customers. Spirit was fined $US100,000 in 2015 for effectively imprisoning a plane-load of passengers on the tarmac at Houston for close to four hours without giving them the opportunity to "deplane" (i.e. get off it) or offering them any food or drink as required by DOT regulations.

But sometimes there is no alternative to taking unappealing flight options like Spirit in order to fit in as much as possible during a research trip. He was however given a $4.50 credit by Spirit Airlines towards his next flight, if such an event were ever to happen.

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