Monthly Comment – February 2017
Alphinity Wholesale Concentrated Australian Share Fund

Frantic February

Market comment

February represented the usual deluge of information of reporting season, during which companies with a June year-end report half-year results, and those with December year ends full year results. In these days of continuous disclose you would think that the potential for surprise is fairly limited, but the market if anything is becoming more surprised, with some really significant share price reactions to relatively small up- or down-side surprises. Over the course of the month the market (ASX200 including dividends) rose a pleasing 2.3%, continuing the positive run since the US election in November. This was quite solid compared to most markets, with only the US (+2.5%), China and Brazil (both +3) doing better. Most European markets were flat to down slightly, with only Russia's market falling meaningfully (-7%). The $A was slightly stronger against most major currencies.

Reporting season was unusually bright, producing a larger-than-usual number of positive earnings surprises. Numbers generated by Deutsche Bank suggested that 55% of companies beat estimates – a little higher than normal, and suggest a corporate sector that is in better health than they had thought. In fact, 2017 might end up being one of those rare years in which aggregate expectations for market earnings is upgraded rather than downgraded, as is the usual case. When you combine this with recent economic data suggesting Australia has dodged recession yet again (at least one defined in the traditional way, which is two consecutive quarters of negative Gross Domestic Product (GDP) growth) then this might end up being a pretty good year in the equity market. It is worth noting however that the bulk of the upgrading is happening in a very narrow group of sectors, resources and some related industries - which may make return prospects fairly selective this year.

Resource prices once again put in mixed performances in February. Metals prices varied: nickel and aluminium were both quite strong, rising 10% and 5% respectively, but most others fell a few percent. Gold was 3% higher but iron ore shone brighter, rising 9%. The price of oil was essentially unchanged.

Bond yields here and in the US couldn't really work out what to do, remaining volatile but closing the month roughly the same levels at which they started. The bond market is clearly torn between still-low inflation in much of the world, and the potentially inflationary impact of the fiscally-led recovery plan being proposed by the new US presidents firm details of which are yet to emerge

Portfolio comment

The Fund performed just behind the market in February. The best returns came from diversified resource giants Rio Tinto and BHP as well as global wine producer Treasury Wine Estates. On the negative side was global logistics company Brambles, which provided a soft operating update during the month, and not owning blood fractionation company CSL.

Market outlook

What a difference a year makes! Twelve months ago there was a lot of uncertainty in financial markets about a range of issues: the Chinese economy, rising bad debts for Australian banks, the UK's EU referendum, and an upcoming US election to mention a few. As we now know, despite Brexit, Trump and a weakened Australian Government, the Australian equity market returned a strong +22% for the year to the end of February. Everything else being equal, this would mean limited upside from here, or even negative returns, to get back to long term averages, but of course everything never is equal.

Unless politics gets in the way, and admittedly this is quite unpredictable, global economic indicators currently suggest that global growth should strengthen in 2017. As we've discussed in previous reports the Achilles heel of the improved growth outlook to date is that it's been fairly narrow, with most of the improvement having taken place in the Resource sector. There are however encouraging signs that it's becoming more broadly-based. The Australian market in many ways is a microcosm of these issues, and this was illustrated by the February reporting season. In aggregate, it was one of the best reporting seasons for some years and earnings growth expectations for the 2017 financial year (FY17) were actually revised up to a strong 17-18% growth.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	1.9	5.7	23.1	8.6	13.2	11.0
S&P/ASX 200 Accumulation Index	2.3	5.9	22.1	6.5	10.6	8.8

*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.

Alphinity INVESTMENT MANAGEMENT

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The bulk of the strong earnings growth in the first half of FY17, and indeed the upgrades for the full year, were delivered by the heavyweights in the Resource sector. Earnings growth elsewhere was less impressive but still better than last year, with a welcome, if modest, improvement for the Banks and several other large-cap stocks. While the median stock is likely to only deliver earnings growth around 4-5%, total earnings growth, even excluding Resources but assisted by the larger end of the market, is now forecast to be a reasonable 6-7%.

While the Reserve Bank of Australia's (RBA) monetary policy appears to be on hold for the foreseeable future the equity market is soon likely to have to deal with higher US cash rates and higher bond yields both here and overseas. Following the correction in many interest-sensitive sectors, or so-called yield proxy stocks, that has taken place since mid-2016, and stronger earnings growth elsewhere, the market should be better prepared to deal with somewhat higher interest rates. Despite the hard act of following such a strong performance in 2016, and the fact that another positive return year would make it six in a row, reasonable valuations and decent earnings growth are both supportive of such an outcome.

Portfolio Outlook

The February and August reporting seasons are always good times to take stock of sector positioning and to review the investment cases of each company in the portfolio. For some, where industry data is difficult to obtain and monitor, management commentary on performance and outlook at results announcements are often the key drivers of share prices. In the Resource sector while management of course can make a big difference over time, commodity prices, which change on a daily basis, are usually more important drivers. In these cases earnings reports, which are generally preceded by production reports, are more often confirmation of earnings trends than something that changes the share price trajectory.

This February reporting season was no exception and, while Resource companies continued to get the strongest earnings upgrades, this sector underperformed the market for the month as investors fretted over the sustainability of current prices. We share some of these concerns and, while we think consensus earnings estimates will ultimately prove too pessimistic, the companies exposed to bulk commodities (iron ore and coal) such as BHP, Rio Tinto and Fortescue Metals could come under pressure when the iron ore price corrects, as the coal price already has, to more sustainable levels. We have reduced our sector weighting somewhat more by adjusting our positions in BHP and RioTinto, having sold out of Fortescue earlier in the year.

China's renewed efforts to close down older and less-efficient steel capacity is also a double-edged sword for coking coal and iron ore. On one hand reducing steel capacity is hardly good news for demand, but on the other hand improved steel capacity utilisation should support steel prices, and in turn iron ore prices, as steel producers become less focused on costs in order to maintain operating margins. How this will work out for the bulk commodities is difficult to call, but it should be positive for Bluescope Steel which will benefit from strong steel prices and healthy operating margins, as will scrap recycler Sims Metal indirectly. Hence we have skewed our Resource exposure further towards the steel names.

The reporting season was generally pleasing for our portfolio with strong results reported by AGL, Treasury Wine, Lendlease, Medibank, Wesfarmers, among the larger names and Link, and MYOB among the mid-caps. Aristocrat Leisure's AGM update was also very positive. We also owned some stocks that disappointed, such as Tabcorp, Brambles and to some extent Fletcher Building. We have exited Tabcorp and trimmed the latter two. We further increased our underweight to yield-sensitive stocks by trimming positions in Sydney Airport, Spark Infrastructure and Goodman Group. While still solid companies, they may be vulnerable to further increases in bond yields in our view. We remain somewhat uninspired by the low growth outlook for the Banks but also recognise that even a small improvement in their earnings outlook will make a difference, especially as this would remove some of the downside risk from increasing bad debts. As such, we have moved to a modest overweight in that sector.

Overall, we're encouraged by the portfolio's performance so far in FY17. We remain positioned for a stronger global economic growth outcome with a consequent rise in global bond yields. In addition, we have a number of companies that are not reliant on the broader macro environment to beat consensus' earnings estimates. The interim reporting season has strengthened our conviction.

Asset allocation	28 February 2017 %	Range %
Securities	99.2	90-100
Cash	0.8	0-10

Top 5 active overweight positions as at 28 February 2017	Index weight %	Active weight %
National Australia Bank	5.7	5.7
Australia and New Zealand Bank	6.0	4.2
Macquarie Group	2.0	3.9
Rio Tinto	1.7	3.6
Treasury Wine Estates	0.6	3.1

Alphinity INVESTMENT MANAGEMENT

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BTW

We believe any fund manager which likens its own investment style to Warren Buffet should be immediately discounted. There is only one Warren Buffet, and we can think of no other investors who have the scale, scope, timeframe or mandate flexibility to be able to invest to generate the sorts of returns that the Oracle of Omaha has managed over his career.

But we do like quoting Warren – he has the ability to enunciate deep truths in a folksy way that resonates with most people, hence his annual shareholder letter in the Berkshire Hathaway annual report is often useful reading. The 2016 missive was issued recently, ahead of its annual general meeting in May, and it doesn't disappoint. It can seem to be a little self-serving (for instance noting that the book value of the company has risen from $19 per share to more than $170,000 since he took over in 1965, although this understates the true value substantially) but it is also often quite frank about things that have not proceeded according to plan. In the latest Buffet related the purchase of a business for $US434 million in 1993, US shoemaking company Dexter, as an egregious error: in Warren's words its value "promptly went to zero". Not only that, it was compounded by having paid for the company not with cash but with 25,000 Berkshire Hathaway shares which today, at about $US250,000 per share, would be worth more than $US6 billion. That's some mistake, and one that most would choose not to mention. But of course there are more than enough counter-examples to justify his reputation.

His 28-page report starts with a table showing his performance each year since 1965. It concludes that, while the S&P500 has provided great returns, almost 10% per annum, he has achieved 20.8%. And due to the magic of compounding over such a long time, the impressive 127x total return of the market was easily eclipsed by Berkshire Hathaway's amazing 19,726x. It wasn't always success: some years he underperformed markedly. Of the 15 years in which he underperformed the S&P500 some years were quite mild but there were a few shockers, like 1999 when he returned -19.9% while the market did +20% - a 40% delta! Or 1975 when he did 35% worse than the market. But, the successful years obviously made up for that.

He covers a number of topics in a rambling way but one interesting thing this year is a dissertation on the reason for his preference to invest almost exclusively in the USA, America's economic dynamism. We have reproduced some of it here.

One word sums up our country [the USA]'s achievements: miraculous. From a standing start 240 years ago – a span of time less than triple my days on earth – Americans have combined human ingenuity, a market system, a tide of talented and ambitious immigrants, and the rule of law to deliver abundance beyond any dreams of our forefathers.

You need not be an economist to understand how well our system has worked. Just look around you. See the 75 million owner-occupied homes, the bountiful farmland, the 260 million vehicles, the hyper-productive factories, the great medical centres, the talent-filled universities, you name it – they all represent a net gain for Americans from the barren lands, primitive structures and meagre output of 1776. Starting from scratch, America has amassed wealth totalling $90 trillion. It's true, of course, that American owners of homes, autos and other assets have often borrowed heavily to finance their purchases. If an owner defaults, however, his or her asset does not disappear or lose its usefulness. Rather, ownership customarily passes to an American lending institution that then disposes of it to an American buyer. Our nation's wealth remains intact. As Gertrude Stein put it, "Money is always there, but the pockets change."

Above all, it's our market system – an economic traffic cop ably directing capital, brains and labour – that has created America's abundance. This system has also been the primary factor in allocating rewards. Governmental redirection, through federal, state and local taxation, has in addition determined the distribution of a significant portion of the bounty.

America has, for example, decided that those citizens in their productive years should help both the old and the young. Such forms of aid – sometimes enshrined as "entitlements" – are generally thought of as applying to the aged. But don't forget that four million American babies are born each year with an entitlement to a public education. That societal commitment, largely financed at the local level, costs about $150,000 per baby. The annual cost totals more than $600 billion, which is about 3½% of GDP.

However our wealth may be divided, the mind-boggling amounts you see around you belong almost exclusively to Americans. Foreigners, of course, own or have claims on a modest portion of our wealth. Those holdings, however, are of little importance to our national balance sheet: Our citizens own assets abroad that are roughly comparable in value.

Early Americans, we should emphasize, were neither smarter nor more hard working than those people who toiled century after century before them. But those venturesome pioneers crafted a system that unleashed human potential, and their successors built upon it. This economic creation will deliver increasing wealth to our progeny far into the future. Yes, the build-up of wealth will be interrupted for short periods from time to time. It will not, however, be stopped. I'll repeat what I've both said in the past and expect to say in future years: Babies born in America today are the luckiest crop in history.

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BTW2

A lot people think Australians are obsessed with property prices, but with the upward trajectory of recent years it is easy to see why this subject causes a great deal of joy and/or concern, depending on one's position. In February last year a story made a lot of commotion for a while: The Big Aussie Short. This rather alarmist piece was put out by a hedge fund manager who opined that Australia had "one of the biggest housing bubbles in history", and was due for a US-style bust. His conclusion was to short-sell the Australian banks funding this bubble. The market is littered with people who have bet against the might of Australian banks over the years, and we were amused to note that in the period since that report Sydney property prices were up more than 20%, and Melbourne 15%. We're not saying of course that there isn't a bubble, just making the point that getting one's timing wrong can be the difference between genius and failure in a high-stakes game like shorting stocks.

But high property prices are a real concern for many, particularly those who want to buy for the first time, and of course the high capital values also feed into high rents. We found some interesting stats on where we sit on the global scale of property rents - just like our valuations: quite high. U.K. property site Nested surveyed global apartment rents and found that Sydney is the 8th most expensive place in the world to rent, at £2.85 per square foot. Melbourne wasn't much better, coming in at 19th at £1.69 per square foot (there are about ten square feet in a square metre). Brisbane's £1.50 was in 26th place, one spot after Auckland.

The most expensive wasn't Hong Kong, to our surprise it came in third behind New York and San Francisco, the worst at £3.81/sqft, no doubt inflated by the booming US tech sector. After HK was Dubai, Singapore, Washington DC and Geneva. After Sydney came Zurich and Los Angeles; London was #10, although to be fair this last four were within a couple of pence of each other, and we note that had it not been for the massive Brexit-related devaluation of the Pound last year that London would be way up the list.

Nested estimated it takes an income of £40,800 (~$A66,000) for a single person or £77,500 (~$A125,000) for a family to afford Sydney rent; Melbourne obviously a little better at $A47,000 and $A90,000. With Australia's average income at about $A83,000 according to the Australian Bureau of Statistics, you can see why many find it tough to survive on a single income

Alphinity Investment Management

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