Alphinity INVESTMENT MANAGEMENT

Monthly Comment –October 2017
Alphinity Concentrated Australian Share Fund

Stocktober!

Market comment

After having been flat for months, the market (ASX300 including dividends) staged something of a break-out in October, rising by 4%. Most international stock markets were also a few percent higher in $A terms, the only real exceptions being Mexico (-6%) and Japan (+9%).

Japan had a snap election in which incumbent PM Shinzo Abe was returned with a landslide. His party won about two thirds of lower house seats and his authority has been decisively cemented. The Japanese share market reacted positively, sending the benchmark Nikkei 225 index to the highest point since 1996. It remains a long way from its 1989 peak however; as the chart shows it still needs to go up another 76% to reach that level.

Election fever continued in many other places during October. There was no sign of sausage sizzles or queues at polling booth in China's amazingly efficient election. President Xi was re-elected unanimously for another five-year term on a show of hands. We in the West tend to look down at the Communist system but when you compare the outcome of the Chinese political process and its Government's ability to execute strategic priorities to, say, that of the US or even Australia, you have to question which works best. Providing of course the people at the top know what they're doing and act in a benign manner towards their citizens.

Elections were kind to millennial politicians: in Austria a 32-year old became president; and a whole month after the NZ election, a 37 year-old became the youngest-ever female leader of a country.

The $A softened a couple of per cent during the month, and $A commodity prices were generally firm. Oil rose sharply, bulk commodities were mostly softer and base metals mostly slightly higher, although Nickel jumped by 20%.

A contributing factor to strong stock markets in October was the Trump administration in the US. It re-announced plans for corporate and personal tax cuts which, should they get through Congress, would greatly reduce both the complexity of the US tax system and the tax burden on companies, at a cost of around $US1.5 trillion to the federal budget by some estimates. The US's company tax rate of 35% is one of the highest in the world, beaten only by the United Arab Emirates' 55%. The proposed new 20% rate would bring the US much closer to the UK and much of Europe but still well north of Ireland's 12.5% or the 0% that applies in a number of countries. Australia's seems likely be stuck at the 30% mark forever.

October marked 30 years since the Crash of 1987, an anniversary which brought out lots of commentators trying to link conditions then with now, largely on the basis of a round-number anniversary. We explore this a little in BTW over the page, but suffice to say history did not repeat itself: quite the opposite in fact.

Portfolio comment

The Fund performed a little better than the market in October. The best performers for the month largely had exposure to a significant degree of offshore earnings: gaming machine maker Aristocrat Leisure, steel producer Bluescope Steel, investment bank Macquarie Group and winemaker Treasury Wine Estates. Lendlease and ANZ Bank both detracted from returns

Performance[1]	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Since inception % p.a.
Fund return (Net)	4.1	5.9	18.5	10.0	12.7	10.0	11.1
S&P/ASX 200 Accumulation Index	4.0	4.7	16.1	6.9	10.3	8.2	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.
[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 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

On safe ground? Global equities markets have continued to rally as economic data releases and corporate earnings news have largely been positive. Economic institutions such as the Organisation for Economic Co-operation and Development and International Monetary Fund have become more optimistic in their global growth forecasts and the most recent minutes of the US Federal Reserve Bank upgraded its description of US economic growth to "solid". Some Central Banks around the world have responded by taking steps towards "normalising" interest rates (i.e. increasing from the present extremely low levels) but, as long as inflation stays low, it's unlikely that interest rates will rise rapidly. When rates finally reach the "normality" they are likely to be considerably lower than what was thought of as neutral before the global financial crisis (GFC). Equity markets are likely to continue to be supported as long as this lower for longer scenario remains in place.

One cannot ignore however that, just as US equity markets are setting new records, so too are job market statistics in the US and elsewhere with data the best since the 1970s and US consumer confidence at a 13-year high. How much longer this can go on without a response in wage growth and ultimately inflation is hard to tell. Suffice it to say not much is factored into current valuations, which continue to increase as the market rises and are outpacing even robust earnings growth.

The Australian equity market has lagged global markets somewhat year to date despite a stellar performance in October. The explanation is simple: our economic growth has not kept pace with global markets. The composition of the Australian equity market, with a heavy weighting towards Banks, Property and Resources, has probably not helped either. Resource stocks should benefit from a better world economy though as China continues to have an outsized impact on commodity prices. The end of the drag from declining capital expenditure in the Resource sector should help the domestic economy, and infrastructure spending on the east coast of Australia is also boosting growth. How much this will be offset by slowing housing construction remains to be seen but this, together with high consumer debt levels and slow consumer spending, is likely to see any eventual Australian interest rate increase well after many overseas markets. So while we perhaps haven't seen the same economic improvement as has occurred globally, our equity market may well continue to be supported by lower interest rates for even longer

Portfolio Outlook

The pleasing performance of the Fund this year has been driven by solid earnings momentum across several stocks and sectors. Some high-multiple stocks we don't own, particularly in the Healthcare and Technology space, have had a resurgence recently which has offset some of these gains. While some are great companies, in our view their high valuations make them risky investments.

The portfolio has for some time been positioned with an overweight to Resource stocks. We remain positive about the Resource sector despite the strong performance it has already delivered. Our view was reinforced by Stephane's recent trip to China. He found that economic momentum there remains sound, driven by infrastructure as a lot of the work that has been approved over the last 12 months is yet to commence. The much publicised reining-in of the property sector by officials appears to be orderly, and history suggests that regulators will be quick to take their foot off the brakes if things start to slow more than intended. The Chinese Government's aim to prioritise environmental issues are very real and the mandated steel production cutbacks during the coming winter months, while largely short term measures, are being strictly implemented. This may have a temporary negative impact on demand for Iron Ore but should be supportive of steel prices. The portfolio has exposure to both, through holdings in Rio Tinto and Bluescope Steel.

The portfolio has also been underweight interest-sensitive sectors for an extended period. This has partly been based on our view that these stocks will be vulnerable from higher interest rates, but also for stock-specific reasons. For example Telstra and retail REITs are struggling with increased competition and subdued consumer spending respectively. Even without those stock-specific challenges, stronger global growth poses a dual risk to these stocks as their operational leverage is limited and, as discussed earlier, valuations would be negatively impacted by higher interest rates.

The Bank interim reporting season has just concluded and, as usual, delivered some positives and negatives. Overall, results illustrated the point we have been making for some time: Banks are in a structurally lower growth environment than we have seen for the last couple of decades. This is however also reflected in valuations which, in our view, makes the sector a reasonable investment. Interestingly, despite the major banks looking increasingly similar in terms of business mix as NAB and ANZ retreat from their offshore exposures, a difference is starting to emerge as to how they are responding to the low growth domestic environment. Both are taking an aggressive approach to reshaping their businesses through staff reductions as well as reinvestment in technology and new business processes. This is not without risk but, if targets are met, should deliver significant benefits. The portfolio's main major Bank exposures are to NAB and ANZ.

Asset allocation	30 Oct 2017 %	Range%
Securities	98.9	90-100
Cash	1.1	0-10

Top 5 active overweight positions as at 30 Oct 2017	Index weight %	Active weight %
National Australia Bank	5.6	5.5
Rio Tinto	1.9	4.8
ANZ Bank	5.6	4.6
Macquarie Group	2.0	4.4
Aristocrat Leisure	1.0	3.4

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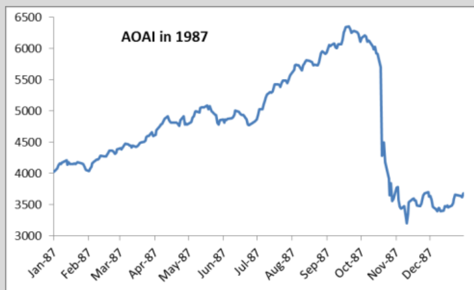
BTW

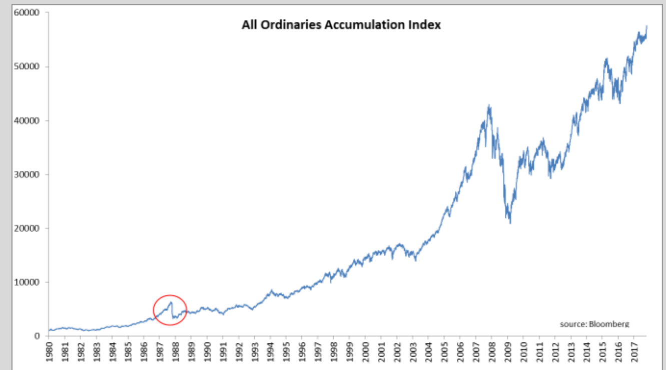
The events of October 1987 are seared in the minds of those who worked through it – not that there are too many of many left still in the markets now. Alphinity has two, both of whom were novices at the time. 1987 was well before mobile phones and the internet: instead we had fixed phones, telex machines, runners and open-outcry trading on the Stock Exchange Floor on Bond Street. But as for the Crash of '87, looking at the chart opposite you almost wonder what the fuss was about. With the perspective of time, 1987 is just a blip (circled); the impact of the GFC in 2007-2009 wasn't the same straight line down but was actually worse. We've used the All Ordinaries Accumulation Index (AOAI) here as the ASX300 Accumulation Index didn't exist back then. The AOAI peaked mid-September 1987 at 6350 then drifted lower, in sympathy with the US market. After serious falls on Wall Street, our market plummeted 25% on October 20 and by the middle of November the index had fallen to 3200: it had halved in two months. Ouch.



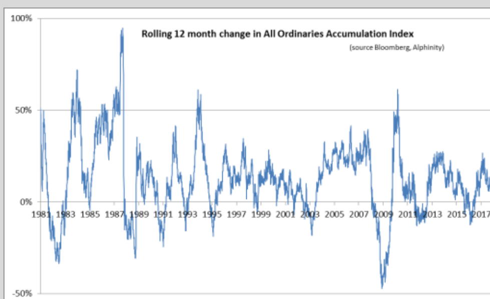
The context however was an extraordinarily strong lead-in: the period leading up to October had been incredible, such that even after the massive falls in October and November the AOAI was down only 10% for calendar 1987. Being down 10% for the year is a poor outcome but not outside the range of expected outcomes for the asset class, and certainly not the disaster it felt like at the time.

Just looking at indices however misses a lot of nuances: some individual companies were reasonably lightly impacted while others were trounced. Household names (although hardly blue chips) like Bond Corp, Bell Group, Rothwells, Quintex, Elders, AdSteam and so on, which were all very highly-valued companies before the crash, were headed for oblivion. Others, higher quality companies like BHP, Amcor, Amatil (which in those days was largely a tobacco company), and the three big banks (this was pre-CBA) suffered flesh wounds but had largely recovered within a year or two. With the benefit of hindsight, the Crash of 1987 provided an amazing buying opportunity, providing you had cash available and chose the right companies. Of course having the cash and choosing the right companies is always the challenge.

Can we learn lessons from the Crash of '87? Could it happen again? Is it about to happen to again? Yes, Yes, and Probably Not But Who Really Knows. There are now circuit-breakers in most major markets' trading platforms that should mean that times of major dislocation in trading will be met with suspended markets in order to give people/machines a chance to sit back and think about things before it gets too bad. Animal spirits and herd instincts are fundamental to markets, and with all those open-ended passive investment vehicles trading blindly out there, it is probably inevitable that at some point there will be a rush for the door. But so many alarmists have called the top of all sorts of markets – equity, bond, housing and so on – for so long and so often that most sensible people give such views the inattention they deserve.



The chart above appears to show almost a smooth upward progression until the GFC but this is distorted by time and scale: the reality was very different. The chart below expresses the same data differently. In any twelve-month period since 1980, the AOAI has gone up by as much as 94% (the year to 4 August 1987) and fallen by as much as 46% (the year to 16 December 2008), but the important things to note are (a) it hasn't fallen below zero all that often; (b) the market generally bounces back before too long; and (c) the time it spends above zero tends to be more frequent and of greater magnitude than the time below. Of the 9346 days observed in this chart, the index was higher than the same day a year before 77% of the time. From a risk/reward point of view, equities stack up pretty well over the long term.



In fact, with the AOAI at 57,966 at the end of October, had you invested $100,000 at the 1987 peak (a month before the crash) you would have more than $900,000 today. That looks impressive but unwinding compounding brings us back to earth; still, even 7.6% per annum compound growth is OK. Had you invested at the November bottom you'd now have more than $1,800,000 and made 10.1% per annum. And that's just the index: had you used a decent managed fund which was able to get a bit above benchmark each year you'd have even more.

Comparing the almost manic market conditions leading into the 1987 and 2008 slumps with the fairly subdued nature of the market now and the absence of hyped-up valuations outside relatively small number of companies, there is reason for some optimism that things aren't about to crash. But if anyone tries to tell you with any great degree of certitude that a crash is upon us (or a boom for that matter), take it with a large grain of salt.

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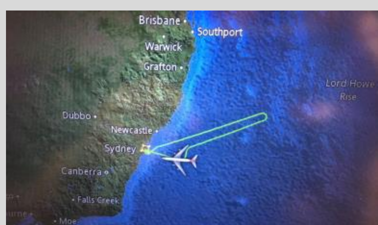
Traveller's Tales

Richard is in the final stages of a Masters Degree in Information and Data Science from the University of California Berkeley. While some of the course is conducted remotely, he also attends some sessions in person. So it was on a Saturday in October that he boarded one of the ageing Qantas 747s, expecting an uneventful flight to San Francisco. It was not to be. A hour or so out of Sydney came the announcement that the plane had a problem.

When you are sitting ten thousand metres above a vast ocean, the last thing you want to hear is that there's a problem. It turned out to be a malfunctioning auto-pilot rather than something more critical so there was no imminent danger. But rather than sitting there with their hands on the controls for another twelve hours, the pilots determined that the best course would be to return to Sydney for repairs. His photo of the flight path shows the sad story. They dumped fuel to get the plane back to a safe landing weight and headed back to Sydney. After a few hours sitting on the tarmac the problem was sorted and they took off again. Although he arrived in San Francisco several hours later than intended, it didn't have much impact on his plans – unlike all those on the plane with connecting flights.



While at Berkeley, Richard attended lectures and seminars and, along with his fellow students, visited some high-tech companies in the San Francisco/Silicon Valley area including accommodation disruptor AirBnB and enterprise software firm WorkDay. Americans are generally not afraid of sharing their views and, as always, there was a diversity of opinion about the direction of the country.

While he was in the US he received this $1 note as change. In a striking piece of civil disobedience, someone had gone to the trouble of having a special stamp made to enable George Washington to reflect his disenchantment with the prevailing political and social millieu. We've blanked out some of the letters in order to preserve the sensitibilities of our readers but the more worldly among you can probably work it out.

Alphinity Investment Management

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

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