Monthly Comment - July 2017
Alphinity Wholesale Australian Share Fund

Marking time

Market comment

The Australian market (ASX300 including dividends) was unchanged in July despite modest intra-month volatility, continuing its recent lethargic trend. The market is now up only 1.8% for the calendar year to date. This is in apparent contrast to the US share market, which seems to continually reach new all-time highs, but any US outperformance has been more than undone by the rampant $A which rose by 4% against the $US and closed the month at $US0.80. The $A has appreciated (or perhaps the $US has depreciated) by 11% since the start of the year, entirely offsetting any returns for Australian investors in the main US benchmark, the S&P500, which has risen 10.6%.

It was a month for lethargic returns. Most major markets were negative in $A, but quite small negatives. European markets were mostly between -1% and -3%, the US -1.8%, the UK -1.6% and Japan -2.6%. The only noticeable (but still small) positive returns were from HK (+2.5%) and China (+2%).

Commodity prices in $A terms rebounded further in July. Oil lifted by about 5% after Saudi Arabia promised to cut its production levels quite sharply to reduce somewhat the current glut on world markets. Bulk commodities, Iron Ore and both types of Coal, were up between 9 and 15% in the month, but base metals were mixed. Some rose (Copper +2% and Nickel +4%) while others fell (Aluminium -5%, Lead -3%, Tin -2%). Precious metals were generally softer, as often happens in periods of $A strength. Hence resource-related companies were the best performers in July. Banks managed to bounce back somewhat after a horror couple of months, while companies in the health care, utilities and telecommunications sectors fared the worst.

It was a month during which Central Bankers had big impacts on markets. Australia's new Reserve Bank Governor worried a few people in his first major outing by suggesting that the "neutral" interest rate setting for Australia is probably 2% higher than (i.e. more than double) the current level of 1.5%. Fear of an imminent tightening set the $A running strongly, and even the attempt of one of his deputies to calm things down, by pointing out how un-linked our monetary policy has become from other countries' over the past decade, didn't help. It was compounded by the US Federal Reserve's fairly dovish comments, seemingly second-guessing themselves about the imminent need for rate rises, which sent the $US lower. A strong dollar is exactly what Australia doesn't need, as it acts to encourage imports and discourage exports.

Meanwhile it feels as if geopolitics should have had more impact. Increasing signs of dysfunction in Washington DC seems to have had no bearing on the US share market, nor did sabre-rattling from Communist despots with some new weapons.

Portfolio comment

The Fund fractionally underperformed the market in July. On the positive side positions in copper mining company Oz Minerals and electronics retailer JB Hi Fi added value to the portfolio. However the $A inflicted some damage on a couple of recent high-performers such as global gaming machine maker Aristocrat Leisure and global wine company Treasury Wine Estates. In addition, being underweight BHP also hurt a bit.

Performance[1]	1 month %	Quarter %	1 year %	3 years % p.a	5 years % p.a	Inception % p.a[2]
Fund return (net)	-0.3	-1.8	8.0	4.6	11.5	9.2
S&P/ASX 300 Accumulation Index	0.0	-2.5	7.0	5.1	10.7	8.4

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.

Monthly Comment - July 2017

Alphinity Wholesale Australian Share Fund

Market outlook

Have we decoupled? Global markets, and especially the US market, were boosted in July (at least in their in local currencies) by a strong Q2 reporting season during which both revenue and earnings came in ahead of expectations. The Australian market, on the other hand, trod water. To some extent this could be due to the local reporting season not kicking off until August but, as we discussed last month, it's unlikely that we will see the sort of positive news here that would result in meaningful earnings upgrades in aggregate. This divergence in performance has been evident for some months now.

It is probably true that the Australian economy is on a different trajectory, or is at least not moving in synch with the improvement seen globally, as subdued disposable income growth is constraining consumer confidence and spending. This would normally not necessarily be a significant impediment for the Australian equity market as 35-40% of our market's earnings is generated offshore, and a restrained domestic economy usually leads to a weaker Australian dollar which would further boost offshore earners. However, while only early in the new financial year, the $A has so far strengthened rather than weakened, especially against the US$. It is little consolation that this strength has more to do with the $US depreciating: the effect is the same, it makes overseas earnings less valuable and reduces the competitiveness of Australian exporters, thus impeding an important backstop of the domestic equity market.

One of the positive developments so far in FY18 has been the recovery in several commodity prices such as iron ore and coal. This has again opened up a meaningful gap between most analysts' price forecast and spot prices. If this were sustained over the next couple of months we would expect another round of earnings upgrades to support the sector which, in contrast to some other parts of the market, looks attractively valued despite the stronger A$ taking some of the gloss off the upside. So while the local bourse perhaps does not have some of the attributes that is propelling the US market to new record levels, most notably a large tech sector, it should at least offer a degree of resilience should the US' record run come to an end.

Asset allocation	Actual %	Range %
Security	97.6	90-100
Cash	2.4	0-10

Portfolio outlook

The unexpectedly-strong $A has hurt the share prices of a number of Australian companies so far in the new financial year. The net impact on the Alphinity portfolios has been slightly negative as portfolio holdings such as the prices of major holdings Aristocrat Leisure, Treasury Wine Estates and Macquarie Group have lost some of their recent gains. Forecasting exchange rates has proven difficult over both the short and long term and we certainly don't claim to be able to tell whether this latest move will prove to be temporary or longer lasting. However, we have over the years found that underlying operational performance has a greater impact on share price performance than movements in the exchange rate. We remain enthusiastic about the outlook for the above mentioned companies.

The case for our overweight of the Metals & Mining sector has strengthened with the rebound in commodity prices after a period of expected destocking by commodity users in China. Underlying growth in demand appears solid, in our view, and while this sector remains cyclical and will invariably need to invest in new projects in order to sustain and grow production, a number of companies are rapidly becoming debt-free and should be able to meaningfully increase cash returns to shareholders.

The August reporting season is now upon us and, while not all of our holdings are reporting (some have March or September balance dates), the season will test many of our positions and investment theses. Capital management has become an increasingly important way to reward shareholders in a low growth/low interest environment such as we presently are in, and we believe several of our holdings have the potential to announce increased dividends and/or buybacks that should be well received. Key candidates in our view are AGL, Qantas, S32 and Bluescope Steel. We look forward to reporting the outcome of reporting season next month.

Top 5 active overweight positions	Index weight %	Active weight %
National Australia Bank Limited	5.2	2.0
Macquarie Group Ltd	1.9	2.0
Aristocrat Leisure Limited	0.8	1.9
Rio Tinto Limited	1.8	1.8
Treasury Wine Estates Ltd	0.6	1.8

Monthly Comment - July 2017
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BTW

In a crash that reverberated around the world, the unthinkable happened recently: an experimental driverless Uber went through a yellow traffic light in Arizona, ran into a car and tipped onto its side. We'll resist jibes about Volvo drivers: this story is about non-drivers!

It shouldn't happen. One of the most powerful arguments made by proponents of driverless cars is safety, these things are supposed to be so much safer than cars driven by a person with a brain and a mobile phone. Driverless technology is supposed to anticipate all the dangers that a person might miss and avoid them. So how did the crash occur?

The human driver of a much lower-tech Honda had pulled out from a side street in front of the Volvo as it was going through the yellow light at speed. Even the best electronics and programming can't overcome the laws of physics: the driverless car couldn't stop in time, hit the Honda and rolled onto its side. Thankfully there was no passenger in the Uber, you can just image how many stars that would have been given as a rating if there was! There were two Uber people inside though, one was classified as the "driver" even though the car was in autonomous mode at the time of the crash. He (or was it the car?) escaped an infringement but the Honda driver was charged with failing to give the right of way. While ever there is a mixture of human-piloted cars and autonomous cars on the road, accidents will be inevitable. Will it be the case that the human is always at fault as the machine can do no wrong?

One thing a driverless car can't do is anticipate the sometimes irrational actions of people who are in control of every other car on the road. If every car were driverless then perhaps the smart systems could all be communicating with each other and this sort of event could be programmed out. But any program is only as good as the person writing the code: how can you be sure that every possible eventuality has been taken into account and provided for?

Then there's the matter of hackers, and they don't need to be computer geniuses either. US researchers recently found that a few strategically-placed stickers are enough to fool a driverless car into mistaking a STOP sign for a 45mph sign; a person would see through it right away. A high-school prank could have terrible consequences.

Uber is not giving up on propagating driverless cars. It halted its program in Arizona for a few days while it was being investigated but then re-started it, and there have been no accidents since. For the moment, while still proving the concept, Uber requires two "drivers" in each car, somewhat negating the benefit of being driverless. It says that at this point driverless cars still "require human intervention in many conditions, including bad weather". Uber has been quite open about its desire to eventually do away with human drivers altogether, which will presumably solve its poor relations with its drivers, many of whom resent the recently-departed CEO's flippant assessment of their job prospects in a driverless world: "Look, this is the way the world is going. The world isn't always great."

Alphinity has expanded: Stuart Welch joined the Australian Equities team in July. Stuart is fresh from seven years at Fidelity International in Sydney and has packed a rich variety of experience across Equities Funds Management, Private Equity and Structured Products, both in Australia and the US, into his nearly 20-year career. He comes with a CFA, a Business Degree from UTS and a M. Phil in Management Studies from Cambridge. He will start by covering the Healthcare sector and, over time, will also take on Transport and Infrastructure stocks. Welcome Stuart!

Monthly Comment - July 2017

Alphinity Wholesale Australian Share Fund

Traveller's Tales

Qantas has been a great contributor to portfolio returns over the past year and is generally still one of the better airlines to fly with but, as quite frequent travellers, sometimes even our patience is tested. Hence the terse "sell Qantas" phone call that came through from Johan one morning in July.

He wasn't serious, and we didn't actually sell our Qantas holding, but it was one of those testing times. To be fair it wasn't initially Qantas' fault. Johan was flying back from Sweden and was supposed to connect in Hong Kong to a Cathay flight to Sydney. His flight from Stockholm, however, was late leaving so the easy connection he was supposed to make wouldn't work. No problem, Cathay booked him onto the next available flight to Sydney, which happened to be with one of its partners, Qantas. Because of the Sydney Airport night curfew this flight was ten hours later. But these things happen and there wasn't anything anyone could about it.

As far as Cathay was concerned, it had no need to worry any more about Johan. He was directed to the Qantas lounge and settled in for a long wait. But the bad luck didn't end there. Soon enough the message came through that his new Qantas flight had been delayed for seven hours, with new departure time 2AM. It was actually 3AM before everyone was in their seats and ready to go, only to be told that there was a vital part on the plane that had to be replaced. The part was swiftly sourced from Boeing but then the next problem arose. The part couldn't be delivered as by then the airport was closed. Not only that, passengers couldn't get off the plane, or at least could only go as far as the air bridge, for the same reason. Who knew an airport as major as Hong Kong's wasn't open 24 hours a day? We do now.

The problem went on for some hours, which Johan spent with several hundred new friends and his lanky frame squished into an economy seat. Passengers were eventually let off the plane as the airport woke up again, and a tense waiting period began as the next night curfew in Sydney was quickly approaching. The boarding call did eventually come through but by that point the usually-gruelling 22 hour schlep from Europe back to Sydney had turned into 46.

We don't feel too sorry for Johan. After all, he had a nice holiday back in Sweden, and aren't delays like these just a first-world problem? Considering all that could go wrong with getting into a tube of aluminium and travelling at almost the speed of sound, 10 kilometres above the planet across continents and oceans half way around the world, a big delay like this one isn't the worst thing that could have happened. Johan did get back eventually, we missed a day of his company but he arrived in the end, just in time for another reporting season. This one will be the 60th in his career, but who's counting?

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