Monthly Comment – May 2017

Alphinity Wholesale Concentrated Australian Share Fund

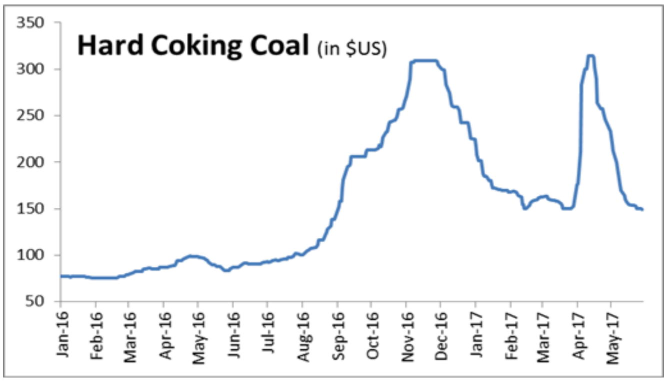
Budget Bank Bash

Market comment

The Australian market (ASX300 including dividends) in May gave up some ground, falling by 2.7%. May, as is usual, included the Federal Budget. This event is normally quite unexciting for the equity market; this year however the government sprang a new levy on the five biggest banks (ANZ, Commonwealth, Macquarie, NAB and Westpac) with the aim of raising a fairly chunky $6 billion over four years, all in the name of budget repair. Banks were already under a bit of pressure after fairly subdued bank earnings reports earlier in the month so the levy was the last thing they needed. It was received with the predictable squawking and a sharp fall in bank share prices. The combined market capitalisation of the five banks involved fell by 11% or $54 billion, many times the size of the levy itself. Banks aside the market did OK, particularly the Telecommunications sector. Telstra bounced a little after some fairly dismal recent months. Whether this can be sustained remains to be seen.

Global markets were better than ours. Most major ones were up a couple of percent, especially in $A terms after our currency softened a touch during the month. The US market rose 2% in $A, even though doubt is increasing over the ability of the new administration there to convert its economic reform plans into reality. Despite this the US market remains close to all-time highs after delivering quite a solid quarterly earnings season. European stocks did even better, most being up 4-5% for the month. The UK had its own dynamic: the FTSE 100, which is largely made up of global companies with non-Sterling revenues, performed in line with other European markets, up a bit over 4%. The FTSE 250 on the other hand, which is more focused on the domestic UK economy, was up by a much more subdued 1.5%. The UK was in the final stage of an election campaign aimed at shoring-up leadership ahead of negotiations to take Britain out of the European Union.

The prices of most major commodities were essentially unchanged in May other than the bulks, iron ore and the two types of coal, which were quite soft. The roller-coaster ride continued in the price of Metallurgical Coal, which is used in blast furnaces for converting iron ore into steel. It was down almost 40% for the month, although this just took it back to the price at which it was trading at the start of April.



Portfolio comment

The Fund outperformed the market nicely in May. The best returns came from global gaming machine maker Aristocrat Leisure, global wine producer Treasury Wine Estates, global logistics property developer Goodman Group, and global metal recycler Sims Metal Management. Being underweight Commonwealth Bank also helped significantly. This was partially offset by not owning Telstra, and positions ANZ, National Australia Bank and Westpac all underperformed.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	-2.1	2.2	14.9	8.1	14.8	10.9
S&P/ASX 200 Accumulation Index	-2.8	1.5	11.1	6.0	11.9	8.7

*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.

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Market outlook

The outlook for the Australian equity market is once again being challenged by faltering, possibly even stalling, company earnings growth. But rather than bringing about a meaningful pullback (other than in the banks) the market so far has responded by bidding up the old favourites of the low growth, low yield, low volatility era which appeared to have ended with the market rotation last year.

So how sustainable is this second round of the chase for yield? While bond yields are well off their 2017 highs in March, equally yields remain well above trough levels of a year ago. Could bond yields fall further? Absolutely, and they need to in order to justify current share prices of infrastructure companies such as Transurban and Sydney Airport, which are back at record highs. In the Health Care sector, which is one of the market's favourite structural growth sectors, several companies' share prices have had similar record runs. Interestingly however (and this is one of the reasons we think the market looks a bit vulnerable at the moment) the breadth of this second round of the chase for yield is more narrow than the last, as company fundamentals seem to be an impediment for some sectors and companies. One by one the yield-sensitive sectors have faltered – Telecoms: multiple profit downgrades; Real Estate Investment Trusts: concerns over consumer spending and the shift to online retail; Banks: low credit growth, increasing capital requirements and now the bank levy. The appeal of yield has, as a result, fallen onto a much smaller number of pure infrastructure stocks.

In the high-growth expensive segments of the market a number of former favourites have not participated this time as their earnings outlooks have become more uncertain for company-specific reasons, for example Domino's Pizza which has domestic franchise concerns, Carsales.com's maturing business model and slower episodic growth for domestic hospital operators. While these developments are natural phases of individual companies' earnings cycles, they contribute to slower overall earnings growth. Banks have to deal with weak consumer spending, which is unlikely to get better as the housing market slows, and now their earnings outlooks have been further inhibited by the bank levy. The Resource sector, while looking relatively attractively-valued to us, is unlikely to find strong support until commodity prices stabilise. So overall it is difficult to be confident that the share market can continue to show the resilience it has so far this year. Fortunately, at least in a relative sense and despite our concerns about the valuation of some infrastructure stocks, it continues to have the support of low interest rates, at least at the short end, and this is unlikely to change in the foreseeable future.

Portfolio Outlook

We are pleased with the portfolio's solid relative performance in May, and also over the last 12 months, as it was achieved despite strong rallies in many yield-sensitive stocks that we are underweight and with little help from other broader sector themes. Instead our returns have been supported by primarily individual company positions across a range of sectors, backed up by solid operational outlook statements. We believe this supports our view that the current market environment, following last year's sharp sector rotation and "value rally", should see a more balanced factor performance which in turn should benefit the Alphinity process.

Having said that, we wouldn't want the recent yield recovery to continue for too much longer as we find the valuations of these companies increasingly difficult to justify. We feel more confident in stocks that are getting earnings upgrades, especially where they are in the early part of an earnings upgrade cycle. We see companies such as AGL and Orica at the larger end of the market and Sims Metal Management, Steadfast Group, Downer EDI and Reliance Worldwide at the smaller end as being at relatively early stages of their respective earnings cycles. On the other hand companies like CSL, Treasury Wine Estates and Aristocrat Leisure are more advanced in their earnings progression and, while this is increasingly reflected in their share prices, we think earnings expectations have not yet become overly optimistic.

Resource stocks have become more difficult as the year has progressed. Solid valuation support (with much stronger balance sheets) coupled with earnings upside in FY18, even at current commodity prices, are keeping us overweight although, as for the rest of the market, stock selection has become increasingly important.

Asset allocation	31 May 2017 %	Range %
Securities	97.8	90-100
Cash	2.2	0-10

Top 5 active overweight positions as at 31 May 2017	Index weight %	Active weight %
National Australia Bank	5.3	4.2
Aristocrat Leisure	0.9	3.3
Macquarie Group	2.0	3.1
Goodman Group	0.9	3.0
Rio Tinto Limited	1.8	2.7

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BTW

The IT world has contributed richly to the English lexicon. Over the years a plethora of words and acronyms have been created or repurposed to suit this rapidly-moving industry. Hardware, Software, Firmware and Malware are all things in the IT world. But a new one (to us luddites at least) was prominent this month: Ransomware. This is software designed to surreptitiously enter one's PC and lock it up. The only way to regain access is to pay the developers of the software money to unlock it. Most peoples' lives are pretty much stored online these days so this would be a very distressing event. As a crime it may be preferable to kidnapping a family member, but is still not a nice thing to do.

One weekend in May a hacking group called The Shadow Brokers, which may be related to villain du jour North Korea, hit millions of PCs around the world with the virus WannaCry. Australia was mercifully spared. The ransom requested was a few hundred dollars, probably small enough just to be nuisance value for many people and maybe worth paying to get your data back. If you didn't pay within a couple of days the demand doubled. If you didn't pay at all, the threat was to delete the files completely. It is thought that only a couple of hundred people paid up so the scam probably wasn't all that lucrative for the perpetrators.

What was to blame for this outrage? The longevity of XP, as it turned out.

Windows XP was released in 2001 to great acclaim. It was Microsoft's first relatively stable business-grade operating system. The software was already past its use-by date when superseded by Windows Vista in 2007 but Vista wasn't well-liked and a lot of people stuck with XP rather than upgrading. Windows 7, 8, 8.1 and 10 followed (9 apparently went missing in action) but still XP lived on in peoples' hearts and machines. Microsoft stopped producing updates some years ago which it thought would drive people to newer, safer versions, but it did not. Windows XP remains in use by about 7% of all PCs around the world – this doesn't sound like much but it equates to tens of millions of machines still using this obsolete software. As Wired magazine put it: "A computer running XP today is a castle with no moat, portcullis raised, doors flung open, greeting the ravaging hoards with wine spritzers and jam."

Thankfully the perpetrators were not very sophisticated. The virus was stopped in its tracks by 22 year old geek Malwaretech (not his real name). Completely by accident he found a way to short circuit the virus, activating a "kill-switch" in the code, by means too arcane to relate here. Malwaretech gets lots of kudos in the tech industry but it seems his only tangible reward is the ability to include on his resume: "stopped vicious ransomware in its tracks", which can't be bad for his job prospects.

The kill-switch stopped the virus from spreading to other computers, but those already infected still had to be somehow unlocked. The tech community swung into action and within days there were a number of programs designed to release files without a ransom being shared around freely.

If nothing else this incident will have raised peoples' awareness of their vulnerability to factors as simple as an old operating system. After all, it is quite possible that a new, improved and less fragile piece of ransomware might be coming to a PC near you.

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Traveller's Tale

Andrew went around the globe in a week and a bit during May – this sounds very glamorous but doesn't always turn out that way. He spent the time seeing a bunch of financial services companies in the UK and USA, including 19 meetings on insurance alone! Alphinity: taking the pain so you don't have to.

A gem among those meetings was the topic of Cyber Insurance, very topical as the WannaCry ransomware attack happened while he was in London. Whilst most categories of insurance outside Australia remain fairly challenging, given the huge amounts of excess global liquidity out there looking for returns, Cyber Insurance is booming. But it is still very under-penetrated when you consider how pervasive cyber everything is to our lives, and how fast the IoT (internet of things) is growing. The cyber insurance market globally is estimated to be around US$2.5bn a year and the industry expects it to grow at least 10-fold in the next 10 years. But they probably need to be 100 times bigger: German insurer Allianz estimated that the cost to the global economy in 2015 from cybercrime was US$445bn! That equates to losses the size of the natural catastrophe market with only a tiny insurance premium pool to cover them.

The issues became quickly apparent when discussing the topic with insurance executives: with cyber risk, what are you actually insuring for? And how can you accurately price for something that is unknown and still rapidly evolving? You can model hurricane risk based on a long history of data, geography and weather patterns, but how do you model cyber risks that change daily? Does it need to cover things like business interruption, theft, director and officer liability, personal liability, property risks, regulatory costs, reputational costs, media costs?

What if being hacked causes your business to physically harm a large numbers of people, by causing something like a car or plane crash? Or when you get a class action because your share price falls after a data breach? The list is very long and mostly untested.

Between 2005 and 2015 there were 5029 reported data breaches in the US involving 675m personal records: no wonder insurance companies and corporates are worried. One of the biggest individual data breaches so far was at US retailer Target, and it puts the issue into context. Its breach involved the personal details of 70 million people. The immediate cost of dealing with the breach alone was $148m; Target's share price fell 18%, it incurred significant reputational damage which impacted sales, a number of executives lost their jobs and the company has since been hit with numerous class actions and fines. The original release said that insurance covered up to $38m.

There also appears no standard as to what cyber insurance actually is. One insurer said all it would cover is the cost of getting systems back up and running and the security consultants to sort it out – quantifying the rest of the potential loss is just too hard to insure. The biggest risk insurance companies see at present is potential liability for unintended cyber exposures in other insurance they write, in say D&O or property insurance, and as such are rapidly adding cyber risk exclusions to existing traditional insurance policies in order to try and limit exposure. There have been reports of Smart TVs and other appliances being hacked to send spam emails. Could you be liable if your TV was hacked and caused disruption to a business through, say, a denial of service attack? It's quite possible that cyber exclusions will start appearing in personal insurance policies soon!

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