Alphinity INVESTMENT MANAGEMENT

Monthly Comment – August 2017
Alphinity Wholesale Concentrated Australian Share Fund

Treading Water

Market comment

After doing nothing in July, the Australian share market (ASX200 including dividends) did almost nothing again in August, rising just 0.7% for the month. There was actually quite a lot of movement between the start and the end of the month, and individual stocks had some massive moves as often happens during reporting season, but the fact remains that our market overall seems becalmed. The market has returned less than 1%, two months of the new financial year, and indeed the eight months so far of this calendar year has provided just 3.8% in total, most of which would be dividends. While this is better than being down, it is hardly an exciting outcome. Thankfully your Fund has managed to provide better returns over all periods than the market.

Despite little overall movement, many stocks zoomed up and/or down during August. This often happens during reporting season, which is when companies with December or June year-ends release their financial results. Many also provide an update as to current trading, and some (although increasingly few) provide earnings guidance for the year ahead. Only one of the four big banks reported – the others have September year-ends – but it was also hit by a scandal involving alleged money laundering which has the potential to result in enormous fines. This somewhat distracted people from the record profit that bank reported, a whisker under $10 billion. Banks generally dragged on the market's performance in August, as did Telecommunication stocks after Telstra announced a cut to its dividend from FY18.

Resources however were quite buoyant, reflecting strong commodity prices. The commodities used in steel-making, Iron Ore and Coking Coal, were up 8% and 17% respectively reflecting ongoing solid Chinese demand; Gold was up 5% largely thanks to Korea, and the metals were all firmer: Lead was +3%, Copper +7%, Aluminium +11%, Zinc +13% and Nickel +16%. Oil conversely fell in price slightly.

Geopolitics remains noticeable with the sabre-rattling on the Korean Peninsula becoming louder by the day, culminating in a missile launch that provocatively passed over Japanese territory. Not that financial markets seem terribly concerned: the Japanese and South Korean markets were both down only about 1% for the month, and the Yen actually appreciated as it is perceived to be a "safe-haven". Doesn't seem very safe to us!

Jackson Hole Montana was the place to be in August. It is the venue for the Economic Policy Forum, an annual gabfest of Central Bankers, featuring speakers like Janet Yellen of the Fed (US Federal Reserve) and Mario Draghi of the European Central Bank. What do Central Bankers talk about? Hard to say but Yellen's message was, if anything, counter to new the deregulatory mood in US political circles which could end up being career-limiting for her. An Obama appointee, Yellen's term is up at the start of 2018 and her re-appointment is not assured. She gave no hint on the short-term future of US interest rates and the $US fell in value. Draghi was reasonably upbeat on the global economy. He acknowledged that inflation was still too low in Europe but made no comment on the strength in the Euro (which is up more than 13% against the $US since January), so it kept strengthening. Overall, the markets heard a fairly dovish message from the Hole, resulting in bond yields edging further down.

Portfolio comment

The Fund outperformed the market's modest move in August nicely. The best contributors for the month were global wine producer Treasury Wine Estates, diversified resource company Rio Tinto and health insurer Medibank Private. Not owning embattled telecoms company Telstra or major bank Westpac and being well underweight CBA also helped. On the negative side were the positions in steel-maker Bluescope and insurer Suncorp and not owning conglomerate Wesfarmers or miner 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)	1.1	1.0	12.7	7.7	12.9	10.6	10.6
S&P/ASX 200 Accumulation Index	0.7	0.9	9.8	5.1	10.6	8.6	8.6

Past performance is not a reliable indicator of future performance.

[1] Returns are calculated before 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.

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Market outlook

The August reporting season confirmed that Australia is struggling to keep pace with international markets, although this may not be apparent from the reported results. Overall earnings growth was strong in FY17, driven by higher commodity prices for resource companies, and earnings growth of non-resource companies was a reasonable 5-6%. The issue has more been the company outlook statements which have in general been a little disappointing. As a result, FY18 earnings growth forecasts were lowered by about 2 percentage points during August, and growth this year is now expected to be less than in F17. The Australian dollar will be an additional headwind if it stays at its current high level. All is not lost however as commodity prices have strengthened again, driven by robust demand in China. Analyst earnings forecasts are yet to reflect anything close to current spot prices for bulk commodities (iron ore and coal) and metals such as copper and aluminium. Earnings growth risk for resource companies is now firmly to the upside. It has sometimes been a wild ride over the last 18 months but the balance sheets of many resource companies have now been transformed, greatly reducing the risk in the sector, and with only modest capital investment plans there should be more cash available to come back to shareholders.

Apart from Resources, August provided few general clues about sector prospects, with company-specific factors dominating. With few unique factors to drive the Australian equity market from here, the domestic market is likely to follow the general direction of global markets. The second quarter reporting season overall was solid across most global equity markets, and the global economic outlook is generally encouraging, although it remains clouded by suppressed inflation and low bond yields. To many investors this keeps the low volatility 'Goldilocks' narrative alive – growth is good enough, but not so good as to risk financial tightening.

Equities generally appear to be relatively attractively valued against very low bond yields, but many global markets look quite fully valued on absolute metrics. In addition to the rising geopolitical risks in North Asia, the market's reaction to any real attempts at tapering and shrinking balance sheets by Central Banks is a key risk factor. Since the Lehman Brothers collapse 2008, the world has seen almost 700 interest rate cuts and around $US11 trillion of central bank asset purchases. It is as yet unclear how breaking this circuit will play out.

Portfolio Outlook

The Fund performed well in August, building on a solid 12 months. Achieving outperformance is generally a combination of investing in "winners" as well as avoiding "losers". This reporting season was no exception: the companies delivering good results and confident outlook statements were in the main rewarded with positive share price reactions while those that disappointed were often savagely dealt with.

We were encouraged by the reporting season as the majority of our portfolio holdings delivered results that were followed by consensus upgrades for the years ahead. Moreover, our experience and indeed the foundation of our investment philosophy is that earnings upgrades (and downgrades) are serially correlated, i.e. a stock that gets consensus earnings upgrades is likely to experience further upgrades in the months ahead: this is the earnings upgrade cycle we want to leverage. Conversely, stocks that have received downgrades tend to experience more downgrades over time. Upgrade or downgrade cycles only last for so long: for some companies it goes on for several months, for others it can be some years, so we devote a lot of effort to identifying when a trend is running out of steam.

Importantly, we aim to ensure that the companies we invest in are also attractively valued. This is a discipline that has served us well over the years, even though at times greater patience has been required in some periods when markets have perhaps been less focused on valuation parameters. We see the current environment as well balanced, providing further opportunities for our portfolios.

Asset allocation	Actual %	Range %
Security	98.2	90-100
Cash	1.8	0-15

Top 5 active overweight positions	Index weight %	Active weight %
National Australia Bank Limited	5.4	5.4
Australia and New Zealand Bank	5.7	4.8
Rio Tinto Limited	1.9	4.3
Macquarie Group Ltd	2.0	3.8
Aristocrat Leisure Limited	0.9	3.2

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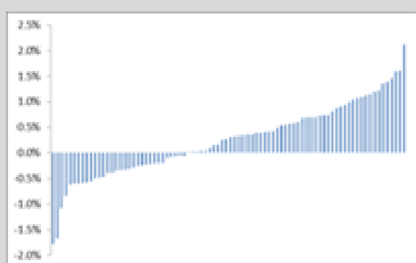
BTW

We were heartened recently to see a story from Japan. Thanks to the trend towards passive management (including indexed funds, factor investing and so-called smart beta), active equities managers such as ourselves have felt a bit under the pump. "You can't outperform the market" is a refrain from some, citing studies which supposedly show that the average manager underperforms the benchmark. These studies are generally based on the US market, not Australia where quite the opposite has been the case over the long term, particularly in the case of boutiques such as Alphinity.

We humbly submit that our funds have outperformed the market. In fact the end of August marked seven years since Alphinity assumed management of your Fund, and seven years is generally accepted as representing at least a full market cycle. The last seven years has covered a wide variety of market conditions. We started during the recovery phase from the GFC, endured a couple of nasty market downturns (2011 and 2015), a mining boom then a bust, a blow-off rally in bonds, Quantitative Easing in Japan, Europe and the USA, and so on. Over that seven years the Australian share market (ASX200) has performed well, providing a total return of 78% despite the overall economy growing only 35% (nominal GDP June seven years to June 2017).

Your Fund has managed to add a considerable amount of value over and above the market return: an investment in the Fund at our inception with distributions reinvested is worth 103% more now than at the start. Two thirds of monthly returns have been above benchmark (see chart) and the ups have been bigger than the downs. Pleasingly, we've done this while exposing you to just a modest increment of volatility over that of the overall market, resulting in an information ratio over that period of 1.27; we hope you, our investors, are pretty happy with that outcome, and feel that the modest level of fees is money well spent.



Anyway, the story said that the Japanese Government Pension Investment Fund, which has assets of ¥145 trillion (that's ¥145,000,000,000,000 or about $A1.65 Trillion) was looking to no longer allocate equities funds to passive managers. Passive investing is essentially buying a benchmark: whatever makes up the benchmark ends up in the same proportions in your portfolio. It is appealingly simplistic and extremely cheap to do, all you really need is a computer and the benchmark composition. The thing is, what you end up investing in is what a benchmark compiler somewhere thinks constitutes "the market", regardless of whether or not the stocks themselves are intrinsically good investments, or are even appropriately valued.

We've seen what happens when a company falls out of favour, and then out of bed. The price can tank, down 10, 20, 30% in a day. It can even go to zero. Do you want to be exposed to that sort of move? In a passive fund you are, by definition, while the stock is in the benchmark. We think active management is a better way to go (obviously we would say that) so we employ smart people with insight into the critical issues facing companies, and expend an enormous amount of research effort on finding gems and avoiding the ticking time bombs. We can get caught sometimes but our investment process, which uses quantitative tools to aid strong fundamental research, generally enables us to avoid most of the bombs.

It was the rationale JGPIF gave that we found interesting. It was worried that *"the rise of passive funds will damage the market's ability to allocate resources efficiently in the economy… [As a] long term and a universal owner we need to make sure that the market will continue to be efficient."* What did they mean by that? One of the important functions carried out by investors such as ourselves is to allocate capital. Capital is a scarce resource (just ask anyone who doesn't have any!), and active managers discriminate between alternative uses of the scarce capital available and seek to allocate it to where it will generate the best return. We invest in companies that have good prospects and don't invest in companies that don't, or that won't use your capital well. Passive investing does the opposite. It allocates capital blindly, favouring companies that are big rather than those that are good and that have the ability to produce better returns.

We're not calling the end of passive investing – the momentum is too great and the appeal is obvious providing you don't think about it too deeply – but things like this story give us some hope that the job of astute capital allocation is not lost to active managers. Sorry if it appears self-serving, but you owe it to the sustainability of the global financial system to which we are all exposed not to give in to the siren call of passive investment, and keep supporting skilled active managers!

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Traveller's Tales

Having been stuck at the desk for months and having survived another frantic reporting season, it was with some relief that Bruce headed to Asia to do some research involving, among other things, one of the property companies in the portfolio, Lendlease. His whistle-stop trip covered Hong Kong, Shanghai, Singapore and Kuala Lumpur, all in five days. There was no time for browsing markets or cultural sightseeing but he did see his fair share of hard hats and cranes. The high-vis culture is generally less stringent in Asia but was very evident at the sites on which Lendlease is involved.

His first time to KL, he couldn't help but be impressed by the ambition of the place despite the issues the country has faced over the years. The literal translation of Kuala Lumpur is "muddy confluence" as it grew up in the 1800s around mining at the meeting place of two major rivers. KL is presently home to what not that long ago were the tallest buildings in the world – the two 88-storey Petronas Towers. Several higher buildings have been built since, and the current record is held by Dubai's Burj Khalifa.

Not far from Petronas is the massive TRX development, part of which Lendlease is working on. TRX is adjacent to a 45-hole golf course (2x18+9) and at the end of what will, in a decade or so, be a very high speed train that will put Singapore in theoretical commuting distance. Indonesian developer Mulia, however, is in the process of building a 106-storey behemoth.

The Signature Tower (pictured) is being built by a Chinese construction company and, although not quite half way up, it is already taller than pretty much anything in Sydney or Melbourne. It won't challenge the Burj Khalifa but funnily enough it will end up being just a few metres higher than Petronas.

Alphinity Investment Management

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

Alphinity has expanded again! Richard Hitchens joined the team in August as Senior Quantitative Analyst, taking over from Shane Kelly who is moving to the UK. Richard has been in the markets since the early 1990s, working mainly in senior quantitative roles for JBWere, RBS and most recently Credit Suisse. He is an actuary, having studied at the University of Melbourne, and is in the final stages of a Masters degree in Information and Data Science from University of California Berkeley.

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