Alphinity INVESTMENT MANAGEMENT

Quarterly Comment – December 2017

Alphinity Australian Share Fund

Summer Frenzy

Market comment

The Australian share market (ASX300 including dividends) had another modest upward move in December, rising by a little less than 2% making it a bit over 7% for the quarter and a pleasing 12% for the year. We wistfully remember the days when activity died early in December as the thoughts of market participants turned to the beach or the snow rather than making deals. This has not been the case for some years but in December 2017 the deals were frenetic. Some were of very significant size and inference, including those involving Westfield and Fox Broadcasting (see BTW2 on p4). Other deals involved initial public offerings, acquisitions, divestments, capital raisings, capital management – you name it, everything happened right up to the Friday before Christmas.

The long-promised tax cuts in the US finally passed through the legislature, meaning that corporate America will go from one of the highest corporate tax rates in the world, 35%, to around the middle of the pack at 21%. While this is higher than the 15% originally proposed, it does make Australia's 30% appear very high, further reducing our fine country's appeal as an appealing destination for global investment capital. A lower US tax rate may however be a fillip to future earnings for the companies in our portfolio with meaningful US operations, including Sims Metal Management, Treasury Wine Estates, Aristocrat Leisure, Macquarie Group and Reliance Worldwide. So too would any meaningful amount of $A weakness. The little Aussie battler remains stubbornly high despite the many pundits who have been calling it to fall below US70c for years, and the $A finished the quarter where it started, just above US78c. It actually appreciated by 8% against the $US during 2017, but fell 5% versus the Euro. The least surprising development in the market was another increase in official US interest rates; more surprising was that the $US subsequently fell.

Most equity markets held up well in the December quarter and Australian shares' total return of over 7% was the second-best of major markets, behind Japan's 12%. The US, UK and Hong Kong returned about 6% and most European markets were in the 1-3% range. For the year however we didn't fare quite so well relative to some other markets, at least in $A terms, although strong gains were experienced pretty much everywhere.

While our market matched the US's 12%, there were some better outcomes from markets like the UK (14%), Japan (15%), and most of Europe (14-20%). Hong Kong achieved an amazing 29% although, just across the border, Shanghai was only up 6.5%. Russia brought up the rear, being the only market to fall in 2017.

Most commodity prices were buoyant during the December quarter. Oil was very strong, rising by close to 20% after a bit of geopolitical tension in the Middle East and some supply disruption. Metallurgical Coal, used in the making of steel, was up a whopping 36%, bringing smiles to the big miners and their shareholders. Copper, which is generally a lead indicator of global economic growth, finished the year strongly, rising by 12% in the quarter and 20% for the year to close at a four-year high.

Portfolio comment

The Fund underperformed the market a little in the December quarter, with positions in Bluescope Steel, Origin Energy, and diversified miners Rio Tinto and Oz Minerals contributing nicely. Against that, however, were major bank NAB and global property group Lendlease which detracted slightly. The Fund outperformed for the year with help from Aristocrat Leisure, Treasury Wine Estates, Rio Tinto, produce grower Costa Group and Qantas, and the underweight in Telstra, offset somewhat by our positions in Fletcher Building and pallet-renter Brambles. The Fund outperformed for the year with help from Aristocrat Leisure, Treasury Wine Estates, Rio Tinto, produce grower Costa Group and Qantas, and the underweight in Telstra, offset somewhat by our positions in Fletcher Building and pallet-renter Brambles.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Since inception^ % p.a.
Fund return (net)	1.8	7.0	12.7	8.3	10.6	9.0	9.9
S&P/ASX 300 Accumulation Index	1.9	7.7	11.9	8.8	10.2	8.1	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.

^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

Many records were set in 2017, including new all-time highs in many equity markets. Some of the records, such as the number of days in the year on which the US Dow Jones Industrial Index set new record highs (71) were possibly more of curiosity value than any intrinsic importance, although that certainly indicates that equity markets last year were in an unusually buoyant mood. Some other records, while less headline-grabbing, were more noteworthy. Global Gross Domestic Product (GDP) growth looks to have been the strongest since 2011, and 2017 was the first year in a decade in which economic growth successively surprised more positively as the year progressed. And it is encouraging that economic growth was broadly-based, with both developed and emerging countries reporting solid numbers.

Australia set another impressive record. Even though economic growth lagged a bit due to the drag from falling capital expenditure in the Resource and Energy sectors, we eclipsed previous record-holder The Netherlands' 26-year run up to 2011 by reaching 105 quarters without a recession (using the classic definition of two consecutive quarters of negative GDP growth). While too early to be definitive, nothing at the start of 2018 suggests a recession is imminent.

The US unemployment rate improved to a 17-year low of 4.3% and a range of US labour statistics are now the strongest since the 1970s. Many commodity prices, while not at record levels, finished the year at multi-year highs. Another record of sorts was the low level of inflation across the globe relative to the strength seen in other economic numbers. As a consequence, bond yields in the US and Australia were largely unchanged for the year despite a fourth quarter surge.

As always, there are a number of reasons why the year ahead could turn out differently to our current expectations. However, at this stage most forecasters expect another year of solid global economic and company profit growth. The key question for equity markets will again be around how long this "Goldilocks" environment of good growth and low interest rates can continue. While some under-utilised capacity still exists in parts of developed Europe, Asia and South America, the so-called "output gap" looks to be closing in the US and in several of the emerging economies in Eastern Europe.

With inflation and interest rates having surprised to the downside for some time now, years in fact, it would perhaps be imprudent to predict a radical change this year. Having said that, the better-than-expected global GDP outcome in 2017 not only shows that things eventually change, but also that the world should be a step closer towards a degree of normalisation for US interest rates. Given equity market valuations in general are reasonably elevated, any disappointment on either side of the growth/inflation ledger would not be taken well by investors.

Top 5 active overweight positions as at 31 December 2017	Index weight %	Active weight %
Macquarie Group	1.9	2.5
Rio Tinto	1.9	2.3
Aristocrat Leisure	0.9	2.2
BHP Billiton	5.7	1.6
Computershare	0.5	1.6

Portfolio Outlook

Regular readers might think we're starting to sound a bit repetitive but our view remains that, in the current environment in which global growth and especially interest rates are more likely to surprise to the upside than the downside, an overweight to global cyclicals (i.e. Resource and potentially Energy stocks) continues to look like a reasonable position. These sectors stand to gain the most from any better-than-expected global growth and, although not completely immune to higher interest rates, should be less vulnerable than many so-called long duration stocks (a rise in the interest rate causes a decrease in value). While obviously also exposed to any growth disappointment, the relative valuation appeal of many of the stocks in these sectors (or perhaps the unusually high premium afforded to more operationally defensive companies) also makes us lean towards them.

China, as always, remains the key risk for the Resource sector. Chinese leader Xi Jinping's "Beautiful China" speech at the Communist Party Congress in October signaled an increased focus on quality of life and environmental controls, however the rate of economic growth required to realise this vision appears not too different to recent years' growth outcomes which bodes well for resource demand. Furthermore, our most recent visit to China suggested that order books and production growth remain healthy.

It's too early to be too definite about the impact of the recently-approved tax cuts in the US for individual Australian companies as each has its own debt structure and transfer pricing framework, and changes to US tax deduction criteria are difficult to assess from the outside. However, overall, we believe the portfolio is well positioned to benefit from what will in some cases be a significant reduction in tax liabilities.

Investment cases are often the strongest when there are multiple earnings drivers and, in our view, Computershare is one such company. At the core of our investment case has been the growth in its Mortgage Services platform which, after some large business wins, is starting to deliver increased scale benefits and a new source of earnings growth. This, combined with a successful cost-out program based around process automation, led to management raising its earnings guidance for the current financial year at the company's Annual General Meeting late last year. However Computershare also has some cyclical tailwinds. Corporate activity – Mergers and Acquisitions and other capital management – are now picking up from cyclically depressed levels; and interest income from the company's significant cash balances is gradually increasing along with higher short term rates in the US and elsewhere. Finally, over time the company will likely benefit from the lower US tax rate. For these reasons we believe the company has entered an earnings upgrade cycle which we expect will continue in the year ahead.

Asset allocation	31 December 2017 %	Range %
Securities	98.1	90-100
Cash	1.9	0-10

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BTW

Bitcoin became one of the more prominent financial markets topics of 2017, ending the year being quoted in the finance report on the evening news alongside the $A and stock market indices. It has raised a number of queries about whether it is a new asset that people should be investing in.

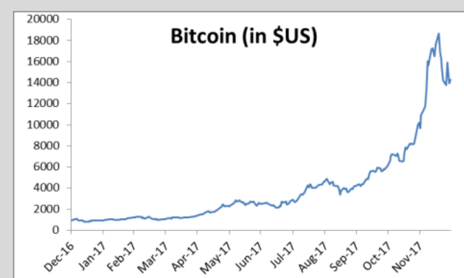
Bitcoin is a cyber-currency. It only exists online, unlike the physical currencies, coins and bank notes, we use on a day to day basis. There are plenty of other cyber-currencies too, with catchy names like Etherium, Ripple, IOTA, Bytecoin, Litecoin, Dogecoin, Mooncoin and so on. There are more than a thousand, and coinmarketcap.com shows most of them. Bitcoin, the price of which went up by 14 times in 2017, was the first and is the biggest hence its prominence, but it wasn't even the best performing: that title went to Ripple which went from two thirds of a US cent to $US2.28: a solid 350 times!

A currency is generally defined as "a medium of exchange and a store of value", something you can use to trade goods and services. Currencies are typically issued by a country's central bank, although sometimes it is by trading banks, as in Hong Kong. Currencies themselves are made-up things, pieces of paper that people use for transactions because they have confidence that it is worth what it says on the note or coin. When a currency loses peoples' confidence it quickly loses value. Venezuela and Zimbabwe are recent examples, but there are plenty of others around the world over time. Once upon a time currencies were supported by hard assets such as gold and silver but for a long time now they have been backed only by peoples' confidence in the issuing authority, usually the government. These are known as "fiat" currencies, as it is essentially government fiat, or decree, that gives it its value.

The fact that fiat money is not backed by hard assets, and is therefore vulnerable to declining value, was one of the main reasons for cyber currencies gaining resonance in the first place. Although it does seem a bit odd to prefer a cyber-currency backed by absolutely nothing and no one to a currency backed by a government with the power to tax its citizens. And with so many new coins popping up, it is hard to argue that there is much scarcity value. Bitcoin is not issued by anyone. It was established a decade or so ago by someone going by the name of Satoshi Nakamoto. His/her/their true identity has never been properly established but at one stage a couple of years ago Satoshi was thought to be a middle-aged chap named Craig Wright living in Roseville, on the leafy north shore of Sydney.

Bitcoin is essentially an algorithm containing very complex mathematics and tracked by a distributed ledger, and was set up to only ever be 21 million coins. 17 million of those coins are presently in the public domain, the rest are yet to be "mined". As for a gold mine, the coins are all there, you just need to get to them. And like a gold mine, as the reserve dwindles it takes more and more effort to extract the resource. Mining Bitcoin is done by applying computing power to solve complex algorithms – if you solve enough you can earn ownership of a Bitcoin. Mining requires large amounts of computational power which consumes vast amounts of electricity. On one estimate, the amount of electricity used just for Bitcoin annually – ignoring all the other coins out there – is 37 TWh, more than is used by Denmark and almost as much as the whole of New Zealand in a year. And the higher the Bitcoin price goes, the more incentive there is to mine. This doesn't seem to us like a great use of the world's scarce natural resources.

The first commercial transaction using Bitcoin took place in May 2010. A US programmer named Laszlo Hancyez exchanged 10,000 bitcoin for two pizzas. At the 2017 closing price, those pizzas would have cost more than $140 million, not a great trade. They might have been good pizzas but we doubt they were good enough.



Bitcoin had a wild ride in 2017, starting the year below $US1000 and finishing just above $US14000, and hit almost $US20000 at one point. A lot of money could have been made at various times, and lost as well. But this sort of "exchange rate" volatility shows Bitcoin's limited usefulness as a store of value. How can you put your trust in something that is as volatile as that? If you'd exchanged, say, a $US20000 car for 1 bitcoin mid-December, you would have ended up being $US6000 worse off by the end of the month.

It's not that good at being a medium of exchange either. The nice thing about cash and the existing electronic payment systems is that they're quick and relatively cheap, two things Bitcoin is not. Visa's global platform can process as many as 50,000 transactions a second; confirming a bitcoin transaction can take 20 minutes or longer. Electronic payment systems generally charge a fraction of a percent of the transaction value; Bitcoin transactions tend to cost at least a few dollars. So while it might make sense to use Bitcoin for big-ticket purchases (if you can get around the volatility angle), it is hardly suitable for mass market transactions.

So, not a good store of value or a good means of exchange: that doesn't make it a very good currency. What's it good for then? Jargon is one thing: it has spawned a whole new language including terms like Mining, Blocks, Forks, Hash, Proof of Work, Proof of Stake, Forging (an unfortunate term but nothing to do with fraud), Segregated Witness or SegWit and many more. And the jargon tends to add mystique to the insiders and exclude those who are not in the know.

Bitcoin is also good for speculating. We tend to make a distinction between investors (who own an asset for a period of time based on their assessment of its fundamental worth) and speculators, who often don't care what they're trading as long as it moves around a lot and they can get in and out quickly. Bitcoin is a great speculation tool.

There are some useful learnings coming out of the cyber-currency phenomenon. Other coins, such as Ripple, have been developed to overcome Bitcoin's practical limitations and might represent a bigger threat to established currencies over time. But the most likely game-changer is probably Blockchain, the distributed ledger which is enabling technology which underlies all the coins. Blockchain has the potential to be applied to many different transactions which rely on trust and speed in areas such as banking, share registries, land titles and so on. Regardless of whether or not crypto-currencies take over the world, Blockchain is here to stay and could end up having a big impact in some industries.

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Alphinity Australian Share Fund

BTW2

Two very large and noteworthy deals took place in December, both of which involved octogenarian Australian self-made multi-billionaires effectively selling out of businesses they and their families spent decades building. While this could to some extent reflect the stage of life of both, it also represents tacit recognition of the negative structural forces at work in both industries – retail property and media – and the likely direction of future trends.

Frank Lowy, 87, is a classic rags-to-riches story, well known to us all. From a penniless refugee who arrived in Australia after World War II he started with a delicatessen in the western suburbs of Sydney and over 60 years, parlayed that into a global shopping centre brand – Westfield – which is now recognised as one of the very best operators in the world, as any visitor to the Westfield centres in Central London or Century City in Los Angeles will attest. He is selling his stake in Westfield to French/Dutch property group Unibail-Rodamco for a very large amount of cash and a large amount of stock. He and his family will for the moment retain that stake in what will be a much larger business, but perhaps more importantly he's secured his own legacy by propagating the Westfield name across more even high quality property around Europe, property that online retail will increasingly challenge.

Rupert Murdoch, 86, is selling bits of his US-listed 21st Century Fox to The Walt Disney Company. While Murdoch didn't exactly start penniless – his father left him a decent legacy when Rupert was only in his 20s – but he certainly took the ball and ran hard with it, going from just a modest daily newspaper in Adelaide to his current status of undisputed global media titan. He did this partially by making some gutsy acquisitions but also by building many businesses, even some industries, from scratch.

Disney is already a major media company, owning among other things the American ABC TV network, cable sports channel ESPN, and the Disney and Pixar film studios. It will pay $US52 billion for some parts of 21st Century Fox Inc, a company that was spun out of Australian-listed News Corp in 2013 (and disappeared from our bourse in 2014). The bits they are selling will include the Fox film and TV studios, cable networks, a handful of regional TV stations and its enormous European satellite pay TV platforms, Sky. The Murdochs will become the largest individual holders of Disney stock but, like the Lowys holding in Unibail, it will be quite small as a percentage of the total equity. In exchange they will exit an area of activity that is increasingly being challenged by streamers like Netflix. Rupert is however keeping the Fox News and Fox Sports cable networks, he obviously enjoys the influence they bring.

Another similarity between the deals is that both companies had for a long time been operating more like private companies than public ones. In both cases the most senior executives happened to share their surnames with the founders and there was little external evidence that merit had been involved in their appointment. The Lowy family openly objected to the scrutiny that goes along with being entrusted with meaningful amounts of other peoples' capital, preferring that we just trust them and not ask too many questions. Murdoch resisted more passively, but there was never even a façade of accountability to the minorities who owned the majority of stock.

21st Century Fox disappeared from these shores years ago but we will miss not having Westfield on our market. It was unique in that this Australian company offered pure non-Australian exposure (⅔ US, ⅓ UK) which at certain times was quite appealing. One thing Westfield did not have was profit upgrades: since its last restructure in 2014, net earnings revisions have only been down.

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