Monthly Comment – January 2018
Alphinity Concentrated Australian Share Fund

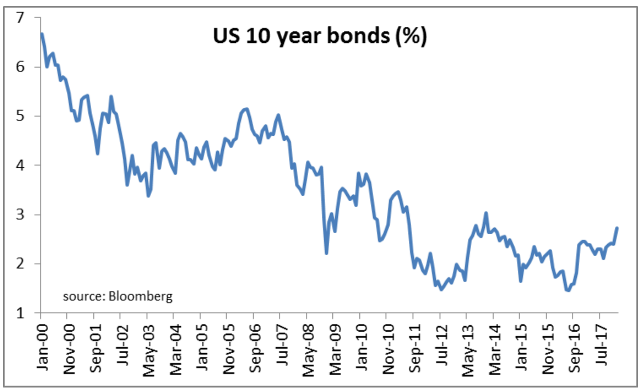
On Hold

Market comment

The Australian share market (ASX300 including dividends) essentially marked time in January, falling only fractionally and lagging (in $A terms) most offshore markets other than Canada, New Zealand and Japan. Most European markets were up between 1% and 4%, and the US rose by almost 2%. The big news during the month was in the currency and bond markets. Senior US officials made somewhat conflicting statements about their desires for a weak currency, the market duly followed and sold the $US sharply, continuing the softening trend it established last year. The corollary of that, combined with more good news out of China, was a rampant $A which breached $US0.81 by month end, a three-year high. While this is not helpful to our exporters, it is more confounding to most currency forecasters out there who have been consistently calling for a sub-70c dollar.

One thing about 2018 is that there is an unusual degree of optimism – albeit in some cases cautious optimism – about the global economic outlook. For the first time in a long time it appears that all major economies are set to report reasonable economic growth in 2018 – and this backdrop is usually positive for the Australian economy, another factor which has been probably supporting the $A.

Countering that, however, is the rise in bond yields – here and in the US – that has been taking pace in recent months, and has accelerated since the start of the year. We keep track of bond yields as they can often be harbingers of risk: bond markets often identify issues and start to worry about them while the equity markets are blithely trundling along half-blind. US yields have been very low for some time, an outcome of low cash rates, stubbornly-low inflation and the massive amount of unconventional monetary policy that has taken place around the world. Now that central banks have largely stopped being the incremental buyers of government bonds, it seems there aren't too many people out there willing to put money away for 10 years for almost no real return so yields are climbing. Interestingly as well, US and Australian bond yields have pretty much converged, and the two cash rates are in the process of doing that too. Australian yields have always been higher than the US for a number of reasons, including us having higher historic inflation and having fewer offshore buyers. Over the last few years the differential has been gradually reducing and is now in territory previously uncharted.



January marked the first anniversary of the inauguration of Donald Trump as US President. While it has been a tumultuous period in many respects, the President pointed to the share market as a marker of his success. Indeed the year to 19 January 2018 was great for US shares: the S&P 500 Index was an almost unbroken upwards diagonal line from 2263 to 2810, a 24% rise (onto which you should add just under 2% for the modest dividends paid by US companies). Some of the rise might be attributable to Mr Trump's policies, in particular the sharp reduction in company tax rates, although a reasonable amount could also be because of the robust economy left by his predecessor. However that marker might turn against him at some point.

Resource prices were mixed during the month: Oil continued its recent upward trend, no doubt helped by some frigid conditions in the northern hemisphere. In base metals, Copper fell 5% but Zinc and Nickel were a few percent higher. Aluminium was also off 5%. The biggest fall was in Hard Coking Coal, which is used in blast furnaces for steel making, which was off 20% even though Iron Ore was virtually unchanged.

Portfolio comment

The Fund outperformed the market nicely in January. The best returns were from electronics retailer JB Hi Fi, global wine company Treasury Wine Estates and global investment bank Macquarie Group, while not owning diversified miner South 32, which performed well during the month, cost a little.

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)	0.1	2.9	13.4	9.6	11.1	10.1	11.1
S&P/ASX 200 Accumulation Index	-0.5	3.0	12.2	7.3	9.1	8.2	9.1

[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.
[3]Numbers may not add due to rounding

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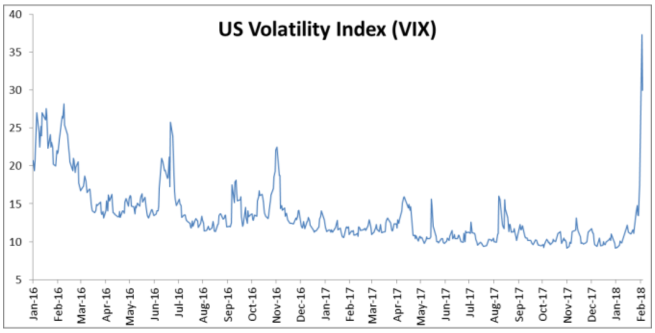
Market outlook

Global equity markets over the last couple of years have been largely driven by strong earnings growth coupled with low interest rates thanks to low inflation readings. Australian earnings growth, which to date has been lagging global earnings, has also picked up with the rise in commodity prices. The new year started out pretty much the same way that 2017 left off, however the last few weeks have been very different. The key question is whether this just a return to more normal levels of volatility, or is it the beginning of something more sinister?



Equity markets are typically driven by two factors: earnings growth (or expectations thereof) and liquidity. 2017 had almost the perfect combination of strong earnings growth and ample liquidity. This can only last for so long until the strong growth uses up all the spare capacity, which causes input costs such as labour to start to rise, which leads to an increase in inflation, which in turn leads to higher interest rates and reduced liquidity. It is likely that we are close to such a situation, especially in the US, and that 2018 might be a more challenging year in equity markets than last year. Just how challenging will largely be determined by the pace of interest rate rises. A gradual increase supported by solid earnings growth should be manageable, and in fact peak valuations of equity markets have historically been associated with higher bond yields than currently prevail. Based on current economic conditions we see a fairly gradual increase in interest rates as the most likely outcome.

A scenario in which interest rates rise rapidly and liquidity is withdrawn aggressively would negatively impact growth and cause a severe market downturn. While this can not be ruled out of course, it currently looks less likely in our view. The recent sell-off, while clearly triggered by the steady rise in bond yields over recent months, appears to a large degree to be technical. Instruments like low volatility Exchange Traded Notes and their ilk, which have grown significantly in size in recent years, have led to forced selling in order to neutralise positions.

While we expect this situation should clear itself over the next few weeks, it does need to be remembered that the growth and size of these relatively new instruments make it difficult for anyone to be completely confident of having full foresight of any snowball effects the increased volatility may have. However providing economic growth is not impacted in a meaningful way we don't think investors should be too alarmed.

Portfolio Outlook

The portfolio has performed well over the last twelve months, and this has been driven both by a number of individual investment cases as well as benefiting from our sector skews, being overweight to Resource stocks and underweight to rate-sensitive stocks in general and the real estate investment trust sector in particular. This broader portfolio positioning still makes sense to us in the context of the recent market volatility.

If our view that global growth will remain robust is correct, and that the main risk to equity markets is from inflation, then Resource exposures should offer good protection. Yield proxy stocks have mostly struggled over the last six months or so while bond yields have been moving up. Yield proxies may offer a more interesting investment proposition should yields stabilise around current levels, but such a call may be premature given the current environment.

The February reporting season always brings with it a wealth of information about most of stocks in the Fund's portfolio, as well as the many more we don't own. The Fund enters this period with good momentum from strong commodity prices for our Resource sector exposures, and from predominantly favourable management commentary from annual general meetings late last year and various market updates since. We look forward to seeing these affirmed for our positions in the upcoming results and their attendant commentaries.

Top 5 active overweight positions as at 31 Jan 2018	Index weight %	Active weight %
Macquarie Group	2.0	3.3
NAB	4.9	3.9
CBA	8.6	3.6
Rio Tinto	2.0	3.5
Aristocrat Leisure	1.0	3.4

Asset allocation	31 Jan 2018 %	Range %
Securities	99.2	90-100
Cash	0.8	0-10

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BTW

We wrote a piece about Bitcoin last month. A lot has already happened in the rapidly-moving cyber currency space, even just in the first few weeks of 2018. The price of Bitcoin peaked at close to $US20,000 the week before Christmas; by the end of the month it had fallen to $14,000, and a further 30% to below $10,000 by the end of January. The downward trend continued in February. This is still not a bad outcome if your entry cost was a few hundred dollars per coin; not so good if you bought near the top. But that's always the case for speculative vehicles.

What also happened in January was a massive hacking scandal in Japan which resulted in the loss of a different type of crypto currency: NEM (New Economy Movement) coins. Hackers were able to get in and take 523 million NEMs, which trade at about $US1 each. How much is $US500 million? A lot: we recently found this photo of a pile of cash.

This is $205 million, which was captured by authorities in a US drug-bust in 2007. Amazing to think that a single hack managed to capture 2½ times this much in NEM coins! The Coincheck exchange had the NEM coins stored in a "hot wallet" – a critical mistake. Hot wallets are supposedly highly-secure data systems but, being connected to the internet, are vulnerable to hacking: in order to provide real security Coincheck should have stored them in a "cold wallet" – a machine which is not plugged in anywhere other than a power point. Storing coins in a hot wallet is the digital equivalent of carrying a bundle of cash around with you.

This is the second major crypto-hack that has taken place in Japan. The first was in 2014 when trading platform Mt Gox, the dominant Bitcoin exchange of the time, was pilfered of about $US500m of Bitcoin. Mt Gox went broke and the people for whom it was holding coins could only cry in their beer; since then Japanese regulators have been overseeing similar exchanges, of which there are now 16. In fact, it has become a Japanese verb: to be "goxxed" is to be taken advantage of by an online merchant. Unlike Mt Gox however, Coincheck is promising to refund up to 90% of the coins stolen, which is a much better outcome for "investors" than it could have been.

Who was responsible for this virtual heist? No one really knows yet but suspicions have been firmly fastened upon the villain that is blamed for most things, North Korea. It has a proud history of cyber-crime, a need to avoid trade sanctions – something which cyber currencies can facilitate – and an interest in destabilising its foes, especially South Korea and Japan which have both been early and enthusiastic adopters of cyber currencies.

But maybe it wasn't North Korea after all: there seems to be an established kingpin of cyber currency-related crime. Russian Sergey Medvedev (we're sure he's no relation to Russian Prime Minister Dmitri or Aussie hopeful-crushing tennis player Daniil) was recently arrested at his home in Bangkok. Medvedev is one of the founders of Infraud, a specialist criminal online market place for nefarious buyers and sellers of stolen identities, stolen credit card information, credit card skimming devices, ATM compromisers, narcotics, weapons, protected animals and illegally-obtained government documents.

Infraud typically secured payment for these things with the difficult-to-trace cyber currencies and had apparently accumulated more than 100,000 Bitcoin, which would have been "worth" around $US1 billion at the end of January (but probably a lot more or a lot less when you come to read this). His team didn't escape either. Twelve others were arrested in the US, France, the UK, Italy, Kosovo, Serbia and even little old Australia, and they will all be extradited to the US to face charges. We're not sure exactly what the charges are but considering the name of his organisation and that its motto is *In Fraud We Trust*, we suspect that the word "fraud" might feature prominently. Arrest warrants are out for another 20 suspects.

The enabling technology, blockchain, may have wider application but the legitimacy of many of the Coins themselves at this point must be questionable. It won't always be the case: it is probably just a matter of time before a legitimate Central Bank somewhere in the world issues its own, with the backing of a real balance sheet. There's been a bit of chat along those lines, including from the Bank of England, but so far the only tangible evidence of an officially-sanctioned cyber currency has been from Venezuela.

In January the Venezuelan government announced the formation of the Petro. It will be backed not by the local currency, the Bolivar, rather by the country's enormous oil reserves. It wants to issue Petro to raise around $US6 billion, instead of issuing government bonds. Hyper-inflation has rendered the Bolivar almost worthless, and its virulently anti-US government would no doubt find prospect of issuing $US bonds unappealing, even if they could find people willing to take the credit risk after being placed in default last year.

But it's not just countries with dodgy finances looking at these things: even prestigious US university towns are considering it: Berkeley, in San Francisco, recently said it will issue a Coin backed by its own debt to raise funds to build affordable housing and provide services to homeless people. Berkeley felt the need to do so after the recent big income tax cuts changes in the US: one of the side effects is reducing funding for affordable housing. But in reality the Coin is just a high-tech front for a municipal bond issue, the sort of thing that's been going on for hundreds of years.

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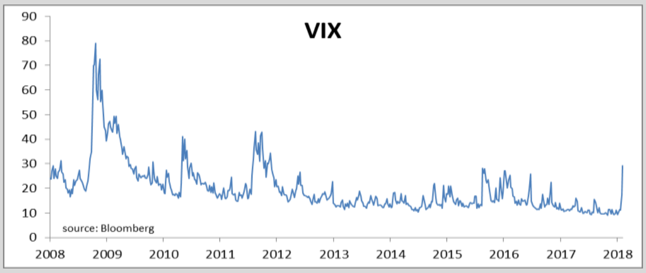
BTW2

Volatility has become the new buzzword around the markets in recent weeks, but what does it mean?

According to Investopedia, Volatility is “a statistical measure of the dispersion of returns of a market index. Volatility can either be measured by using the standard deviation or variance between returns from that market index”. Essentially, it is the magnitude of the daily ups and downs of the market.

When you look at a stock market index, sometimes its movements are fairly small, as has been the case for the most recent 18 months or so; sometimes the moves are fairly violent, as might occur around a market crash. A degree of volatility is normal but does spike from time to time: the chart below is a ten-year version of that on page 2: it certainly shows that current levels are elevated relative to the last couple of years but far from unprecedented, and actually well below levels during the GFC in 2008/9, or the Euro crisis in 2011, and the same as the TRiUMPh of 2016.



We at Alphinity are not overly concerned by volatility – in fact we embrace it. Providing the volatility doesn’t get out of hand, as was almost the case during the GFC when at one point it appeared that the world’s financial system might have a meltdown, volatility such as we’ve seen very recently can provide astute stock-pickers with some wonderful opportunities to set their portfolios up for substantial future outperformance. It might be a bit messy for a while as you go through the worst of the churn, but a clear view of relative valuation and keen insights into the specific drivers of the companies in your investment universe can enable you use swings in share prices to sell out of positions where fundamentals might be deteriorating, and buy into those that might have been excessively sold down and now represent outstanding value.

This is the opposite of index funds which have become so popular in recent years. They merely replicate the ideas of whoever compiles their index, and constantly rebalance by selling stocks that are outperforming regardless of their outlook, buying underperforming stocks instead.

While these sharp market moves might make for good headlines and breathless TV news reports about “X billion dollars being wiped off the share market”, don’t be too scared by volatility: providing it doesn’t become excessive, and there is little sign of that to this point, volatility is really our friend.

Alphinity Investment Management

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