Monthly Comment - February 2018
Alphinity Concentrated Australian Share Fund

Bouncing Around

Market comment

The market (ASX300 including dividends) started February on the sour note that January had finished on. Wall Street was in the process of tanking, recording a quick 10% correction in less than two weeks before recovering quite strongly. Australia rarely does well when that sort of thing is happening, although our fall was a little more subdued than that of the US: we were down by only about half as much. Pleasingly, our market had recovered all those losses by the end of the month and the US was only fractionally lower in $A terms. The US S&P500 actually fell by 4% in $US in February but the $A fell 3.6%. Most European markets were generally a few percent softer, as were Asian markets except for Japan which was up by almost 2%.

Our market was buoyed by what felt like the best Reporting Season for some time. Despite a whole lot of gloom over the past year around the state of the economy and consumer and household debt, it seems things weren't that bad after all. There were exceptions, as always, but the number of companies that beat the market's earnings expectations and had earnings upgrades was greater than usual. Employment data was strong even though wage rises remain subdued, and local rates remain on hold with no change likely any time soon. Both business and consumer confidence remain modestly positive.

The big picture continues to impact. Our dollar rose and fell during the month but that mostly reflected the opposite move in the $US. New US Federal Reserve Bank Governor Jerome Powell made his first testimony to congress which seemed to confirm the path that Janet Yellen started out: gradual rate increases, and the market is looking for three more 0.25% moves this year. But the White House probably had more of an impact with the seeming outbreak of a trade war after imposing steep tariffs on steel and aluminum imports.

While ostensibly aimed at China, there was some collateral impact on Australian steel producers. US bond yields moved meaningfully higher and now exceed Australian yields. This hasn't happened many times in the past and no doubt contributed to the $A softness; further softness would not surprise. European yields are also starting to edge up as its larger economies' economic recoveries gather pace. Commodity prices were generally higher in $A terms, with steel-related bulk commodities moving up more than 10% and base metals all a few percent higher. Energy was the exception with oil 2% lower and gas prices off by 7%. A return to synchronized growth in the major world economies is generally positive for commodity prices.

Portfolio comment

The Fund outperformed the market strongly over the February reporting season. The best contributions were from positions in a broad spread of sectors: blood fractionator and flu vaccine company CSL, steel product maker Bluescope, diversified miner Rio Tinto, registry company Computershare, and berry/avocado grower Costa Group. Not owning diversified miner South 32 or major telco Telstra also helped returns. The position in Woodside Petroleum, which raised capital along with its otherwise positive result, detracted as did not owning NZ dairy producer A2 Milk.

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)	1.5	3.7	13.0	8.0	10.3	10.0	11.2
S&P/ASX 200 Accumulation Index	0.4	1.7	10.1	5.1	8.0	7.9	9.0

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.

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Market Outlook

Equity markets around the world appear to have stabilised following the sharp selloff in the first week of February. A global economy that is expanding at a solid pace, strong earnings growth and inflation readings that continue to suggest only a gradual rise in interest rates have all contributed to calm market nerves. This is consistent with our general thinking that 2018 will be a more challenging year for equity investors than the strong 2017, albeit one where earnings growth will in the end trump higher interest rates.
Globally, the most recent reporting season provided further evidence of the strongest profit growth outlook for many years. It should however be noted that comments about rising input costs featured frequently in management commentary. While most also expressed confidence in passing these cost increases on to their customers, it is clearly something we need to monitor for any potential impact on company profit margins should price increases turn out not to be sustainable. It is also a potential warning sign for general inflationary pressures. Leading indicators for global growth are also close to historical peak levels and, while the level of growth should be more important than whether the growth rate is accelerating or slowing slightly, this might lead to some additional market consternation later in the year.

The White House continues to provide almost daily market-moving news flow. Following the largely positive reaction to the US tax cuts, despite the risk that it might be adding fuel to an already strong economy, the proposed import tariffs on steel and aluminium have been met with almost universal condemnation, including from many within the President's own party. It is too early to tell how far-reaching these tariffs could be and indeed if they will be approved by the US Congress. However, concerns over global trade wars are clearly unhelpful in any market environment.

The Australian reporting season broadly followed the script from overseas, with in aggregate better than expected interim results. Full year earnings expectations overall were confirmed or slightly increased, which is also better than normal. However, the overall growth rate in our market continues to lag global growth. There are several reasons for this but they largely stem from the modest pace of economic growth in the domestic economy. Globally-impacted cyclical sectors Resources and Energy maintained earnings leadership while Banks, Consumer Staples, Utilities and Telcos saw the biggest downgrades to earnings.

We see no reason for these trends changing in coming months. All up, earnings growth of around 5-6% and a dividend yield of about 4.5% continue to support mid to high single digit annual returns, similar to those of recent years.

Portfolio Outlook

Notwithstanding the modest market return during the month, the Fund performed well. The February reporting season is always an important time to get a read on how companies have performed since the last reporting date and how things are looking for the full financial year. As we know, good company news is typically followed by more good news and bad news more often than not followed by more bad news. Hence, good company news, leading to earnings upgrades during the reporting season, is important not only for the stock reactions during this month, but also for what it suggests for coming months and, in many cases, years

Pleasingly, a large number of our holdings across several different sectors reported strong results, which triggered earnings upgrades and positive share price reactions. Our broader portfolio is positioned with a bias towards Resources and away from interest sensitive sectors. This positioning did assist, but importantly our stock selection within these sectors was an even more important factor of outperformance.

There will always be a few changes to the portfolio following a reporting season and we look forward to discussing them in coming reports. However, barring a significant change in broader macro trends, our conviction in our current portfolio positioning remains strong from a top down, bottom up, or stock specific perspective.

Asset allocation	Actual %	Range %
Security	98.2	85-100
Cash	1.8	0-15

Top 5 active overweight positions	Index weight %	Active weight %
Macquarie Group Ltd	2.0	4.2
National Australia Bank Limited	5.1	3.9
Rio Tinto Limited	2.1	3.6
Aristocrat Leisure Limited	1.0	3.4
Commonwealth Bank Of Australia	8.3	3.1

BTW

Another month, another crypto currency story. Sorry, we'll find another bandwagon to jump on soon but this one just keeps getting better and better! As the real or ephemeral riches involved in the various Coins abound, so too does the interest of those with impure motives. The authoritative *New York Times* reported during the month that a whole bunch of old-fashoned crimes were being committed with a new-economy twist, and all around the world too. Here are some of them:

- Late last year in New York City, a man apparently was held captive by a "friend" until he transferred over $US1.8 million worth of Ether, the #2 cyber currency. One hopes he looks for better friends in the future!
- On Boxing Day, the chief executive of Ukrainian virtual currency exchange Exmo, Pavel Lerner, was abducted and only freed after the company made a ransom payment of Bitcoin worth around $US1 million, apparently from Mr Lerner's personal funds.
- Assailants in Phuket, Thailand, accosted a young Russian man in January and kept him in his apartment, blindfolded, until he logged onto his computer and transferred about $US100,000 worth of Bitcoin to an online "wallet" they controlled.
- In Turkey, a businessman was forced to hand over the passwords to his virtual wallets which contained nearly $US3 million worth of Bitcoin after having his car stopped by an armed gang in Istanbul. They appeared to know all about his Bitcoin holdings, according to local news reports.
- Even in Ottawa, the capital of the normally peaceable, law-abiding Canada, three men armed with handguns unusccessfully attempted to coerce employees of Canadian Bitcoins exchange to make a transaction; two of them escaped but one was captured soon after, chased down by police dogs as seen in the CBC News picture below. He has been charged with five counts of robbery with a firearm, five counts of pointing a firearm, five counts of forcible confinement, one count of wearing a disguise, one count of carrying a concealed weapon, one count of conspiracy to commit an indictable offence, one count of possessing a firearm while prohibited, and one count of possessing a loaded, regulated firearm. That sounds like few years behind bars.

Why the rise in violent crime? As the *Times* quoted Chanut Hongsitthichaikul, an investigator with the Thai Police investigating the Phuket case: "The advantage of Bitcoin [for criminals] is that it's hard to verify. We asked the victim how to track it since they know Bitcoin better than us. We asked them how to check the receiver. They said there is no way." You see, people don't have to associate their identity with their Bitcoin address, as is necessary with traditional bank accounts. Even in Switzerland, the traditional home of secret banking, the ability to avoid being identified is largely defunct, so those largely untraceable Coins must look pretty good to the criminal classes.

Even normally staid servants of the public have been ensnared by crypto-temptation. This month a number of Russian nuclear physicists at a top secret nuclear warhead facility have been arrested after it was discovered that they were using their massively powerful super computer to mine bitcoin. Not only that, it was also announced this month that two employees of the otherwise noble Bureau of Meteorology in Australia have been suspended after allegations of similar behaviour were made.

What do we make of crypto-crime? It shouldn't surprise anyone really – wherever there are large amounts of value there will be people trying to separate it from those who own it. This happens in established markets all the time, and often to a much greater magnitude than the examples we've shown here, so we shouldn't be too surprised about it turning up in cyberspace. But it does sort of go against the ethos of cyber currencies: that they are building a new world online that is free from the things that are wrong with the offline world.
In more Coin-related ~~madness~~ news, this month ageing but iconic martial arts actor Steven Segal entered the space. He's promoting a Coin named Bitcoiin2Gen (this is not a typo, it's meant to have two i's). He's pushing it as a "superior or more advanced version of [the] original Bitcoin". If you get in quickly, before the launch of trading a few days before April 1, you can buy coins for just $5, and the company projects they will be worth $US388 by the end of the year – that's a very nice return. Let us be very clear – we are not advocating you invest in Bitcoiin2Gen: quite the opposite in fact! But it begs the question: why would the company sell coins for $5 now if they'd be worth $388 in such a short timeframe? Why not wait and sell them then? Bitcoiin2Gen itself said in a press release "we would like to inform the community that we are not an MLM company or a Pyramid Scheme or any Scam." That's a relief! (MLM refers to Multi-Level Marketing, a common practice in some industries whereby sales people recruit other sales people, leading to many people getting a slice of every sale). The old maxim applies: if it sounds too good to be true, it probably is.

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Travellers Tale

Bruce headed to the US hard on the heels of reporting season to check out developments in the consumer sector. He was there this time last year, in the delightful Napa Valley north of San Francisco where the best of the best US wine is produced to see management at portfolio holding Treasury Wine Estates. This time he went to another wine region but it was not quite as delightful. It was in the San Joaquin Valley of California, a couple of hours east of San Francisco, not far from Fresno. This is the US equivalent of the Riverina or Sunraysia regions in Australia where a lot of the grapes are grown to produce cask wine. Casks are becoming popular in the US, known as bag-in-box, but the wine is more likely to end up in 1 gallon (3.8 litre) glass flagons: very classy. Inland California, just west of the Sierra Nevada mountain range, is fairly desertous but incredibly productive. This is largely thanks to irrigation – the snow-melt from the mountains usually provides ample water. Almonds are a massive crop there as well, and mile after mile of blossoming almond trees was quite a sight.

There he met a man who is a bit of a legend in the wine industry. We don't name him but his family has been growing grapes and making wine for more than a hundred years and he's been running his own business for almost fifty. He owns tens of thousands of acres of vine-bearing land, mostly in that area but some also in the Napa, and is known for producing wine at very low prices - as low as $US2 a bottle. He also owns all the production facilities and logistics needed to get the wine to consumers.

An older gentleman obviously, he is probably a billionaire but, apart from the large gleaming Jag parked outside, you would never know it from his office. It was essentially what is known in the US as a trailer, a prefabricated building similar to that you might find as a site office on a building site. It wasn't quite as old as the company but must have been pretty close, and not what you might expect of the daily work place of such a wealthy person. You can see from the outside that it had seen better days and the inside, packed with bottles of wine, wasn't any fancier. He deals with pretty much all of the industry and relishes holding audiences with corporate fat cats in such humble surroundings. As sole owner, he only has himself to answer to, which means he is able make decisions quickly and free from outside pressures. It was impressive to see someone in their twilight years still so engaged and driven, and obviously loving what they do.

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