Quarterly Comment – March 2018
Alphinity Concentrated Australian Share Fund

This means War!

Market comment

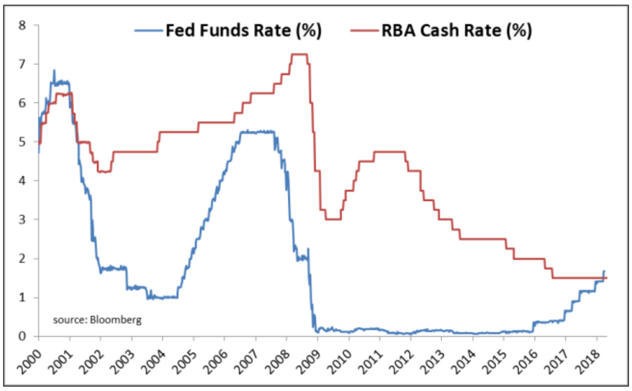
War seemed to be breaking out everywhere we looked at the end of the March quarter. There was an increasingly ugly trade war between the US and China. The Cold War re-emerged between Russia and pretty much everyone in the West, especially the UK, with defected double agents, tit-for-tat diplomat expulsions, nerve agents; in fact pretty much everything short of poison-tipped umbrellas. And of course there was continuation of the regular shooting wars we've become inured to in places like Syria. The one potentially bright spot was a possible easing of tensions on the Korean peninsula after the Winter Olympics, which was held almost in the demilitarised zone between North and South Korea. The quarter finished with steps towards rapprochement between the two Koreas and the possibility of the North's Kim Jong Un meeting up with US President Donald Trump – a meeting we'd love to witness. This aside however, the world looked like a somewhat less friendly place to be and that was reflected in the share markets.

The market was volatile in the March quarter, at least more volatile than we've been accustomed to in recent years. It started in January when the US market started to suffer the wobbles, the S&P500 falling 10% in a few days before clawing much of it back over the balance of the quarter – it finished down less than 2% in $US but flat in $A terms. The $A suffered a modest 2% depreciation against the $US but 4% against the Euro.

The Australian market (ASX300 including dividends) fared better during the sell-off, falling by only about half as much as the US, but also lagged the recovery and was down almost 4% for the quarter. We are pleased to be able to report that a solid January followed by a very strong February reporting season saw the Fund's portfolio do much better than the market for the quarter.

Global markets generally did a little better than Australia but even so most were flat to down overall. There weren't too many investable markets that actually rose in $A terms for the quarter: Singapore and New Zealand were pretty much it. Commodity prices were very messy however: some bulk commodities important to Australia were very weak in the quarter with iron ore falling sharply (-12%) as well as coking coal (-24%). Oil was up between 5 and 9% depending on the grade, and gold edged higher (2% in $US; 4% in $A) but not as much as one might expect considering all the geopolitical tensions: gold is meant to thrive under such circumstances. Aluminium fell 10% but the Base metals were mixed : copper was down 6% and lead 2%, while Nickel and Tin were 6% and 7% stronger respectively.

The US Federal Reserve Bank increased short-term rates again in March, the sixth since the tightening cycle started in late 2015 and taking it above Australia's equivalent cash rate for the first time in years. The market is expecting another two or three US hikes over the course of the year to finish around 2.5% which would still be reasonably low in absolute terms, especially considering the relatively late stage of the current US economic cycle. The chart below provides some context to these moves since 2000. By contrast, Australia's cash rate seems as if it will remain stuck at 1.5% for some time to come.



Portfolio comment

The Fund outperformed strongly over the March quarter, falling much less than the overall market. The best contributors were from a diverse range of sectors: global registry company Computershare, global investment bank Macquarie Group, global plumbing product manufacturer Reliance Worldwide and global wine maker Treasury Wine. Not owning NZ dairy company A2 Milk was the only notable detractor from returns.

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)	-3.8	-2.2	5.4	6.2	9.8	9.3	10.5
S&P/ASX 200 Accumulation Index	-3.8	-3.9	2.5	3.8	7.7	7.2	8.4

*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

There has been much comment about the return of volatility to financial markets thus far in 2018. An end to the rather unusual “Goldilocks” environment of the past couple of years has perhaps not come as that much of a surprise, but the cocktail of factors bringing that end about has had some unexpected elements to it. First among those are of course US President Trump’s announced plans for import tariffs on a range of goods, primarily from China, and the potential this brings for an escalation in global trade tensions. Second has been the data-mining scandal surrounding Facebook which has dented confidence in the whole US and global technology sector. Third has been the much greater rise in US short term interest rates compared to long term rates. Such a flattening of the yield curve has historically often been associated with economic recessions.

While clearly unhelpful we don’t see any of these factors in isolation, or even collectively, as likely to determine the direction of equity markets for any sustained period of time. The concerns regarding trade seem overdone based on what has been announced so far, and the flattening of the yield curve appears to have more to do with the current “risk-off” sentiment in equity markets than the other way around. Of more significance to us is the slowing in a number of leading indicators of economic growth: at this point however these seem to indicate a levelling-off in growth rates rather than anything more sinister.

Following our recent visit to China we also concluded that growth rates there are stable rather than slowing significantly, and that a number of transitory factors have combined to delay the usual pick-up after the recent Chinese New Year. All in all, we continue to expect that 2018 will be a year in which constricted liquidity as central banks gradually tighten - led by the US Federal Reserve - will represent the real headwind for markets. This should however be balanced by solid earnings growth. We will be able to test this proposition in coming weeks as US and European companies start to report earnings from the first quarter of 2018.

Top 5 active overweight positions as at 31 March 2018	Index weight %	Active weight %
Macquarie	2.1	4.3
National Australia Bank	5.0	3.8
Commonwealth Bank of Australia	8.2	3.6
Rio Tinto	1.9	3.4
CSL	4.6	3.0

Portfolio Outlook

The portfolio has performed well over the last 12 months and so far in 2018. This has been driven by successful stock selection, manifested through solid consensus earnings upgrades for the majority of our positions in February, but also through a pro-cyclical sector skew. While we fundamentally believe that this overall positioning will remain valid, we do acknowledge that global growth prospects have moderated somewhat. We have therefore trimmed our Resource overweight slightly and added to some of our more defensive and yield-sensitive stocks.

One of the stocks we have added to is Macquarie Atlas Roads Group. Macquarie Atlas’ key asset is its 25% stake in French toll road operator APRR, which is enjoying steady traffic growth and toll increases. We see potential for a significant lift in Macquarie Atlas’ dividend profile over the next few years as expensive interest rate hedges roll off and the group refinances maturing debt at the much cheaper prevailing interest rates. Macquarie Atlas has also announced its intention to internalize the management of its operations rather than use Macquarie Group as an external manager. This process involves various contractual arrangements but meaningful costs savings should eventually be realised. While this process is complicated by various contractual arrangements, meaningful costs savings should eventually be realised.

The February reporting season also triggered some portfolio changes. We were disappointed by the poor margin performance in the US operations of Brambles Ltd. Although management is taking corrective action through a combination of cost efficiencies and price increases, the earnings outlook is likely to be less favourable than we had previously thought. Qantas was in the portfolio for most of 2017 before we exited late in the year on concerns about the impact of higher fuel costs. Following a pullback in the Qantas share price and a pleasing interim result which indicated that management is being effective in offsetting the fuel cost increase through other measures, not least through higher domestic airfares, we have re-established the position. At face value this might suggest a more cyclical exposure countering some of the earlier portfolio commentary. More importantly however it underscores that specific company factors, often driven by strong management execution, are generally the key drivers of stock performance.

Asset allocation	31 March 2018 %	Range %
Securities	98.3	90-100
Cash	1.7	0-15

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Traveller's Tale

Stuart went to Europe and Scandinavia in March, researching health care companies, visiting clinics and medical product distributors and attending a Brambles investor field trip in London. He visited Copenhagen, Hannover, Hamburg, Zurich, Basle, Budapest and Paris during his nine-day trip. In snowy Copenhagen he met with hearing aid manufacturers, one of which is partnered with Cochlear to share technology and develop bimodal hearing solutions.

Despite having fewer than 6 million people, Denmark supplies half the world's hearing aids. Six global hearing aid manufacturers supply 98% of the world market between them, and three of those six are located in Denmark. These companies service a very large market with around 15% of all adults having some degree of hearing impairment. Why are so many of these companies based in Denmark? Michael Porter, the famous Harvard Business School academic and author, has written about how businesses often develop in clusters: places in which a critical mass of skills, technology, capital, and other factors combine to create world-leading expertise in a specific product or service.

For the audio industry, the area surrounding Copenhagen is one such cluster. Not only are the three hearing aid companies we mentioned above based here, but also luxury stereo maker Bang & Olufsen and sound measurement firm Brüel and Kjaer. Denmark's expertise in sound technology can be traced back to 1904, when Hans Demant, whose wife had a hearing disability, founded William Demant Holding Group. 114 years later William Demant is the world's second-largest maker of hearing aids and its Oticon Foundation continues to fund research and support engineering students.

Much like with the wind turbine industry, Denmark has successfully nurtured development of the audio industry through university, industry and government relationships, often referred to as the 'triple helix'. For example, in 2009 the Danish government founded the Danish Sound Innovation Network, a hub for research institutes and universities, businesses, public organisations, policy makers and professional users. The benefits of clustering, together with collaborations such as this, have enabled Danish hearing aid companies to continue to develop new, industry-leading products. For example, GN ReSound was the first to deliver 2.4GHz technology in hearing aids for direct connectivity, and in 2013 they launched the first-ever hearing aid made to operate with iPhones, something Cochlear replicated for its cochlear implant sound processors last year. Australia has followed Denmark's lead by establishing The Australian Hearing Hub in 2013, a federal government initiative that brings hearing and healthcare organisations, including Cochlear, together with Macquarie University to collaborate on research projects.

Companies globally are also collaborating to share technology and leverage their research and development budgets. For example, Cochlear entered into a technology development and licensing agreement with GN ReSound in 2011 to gain access to the 2.4GHz direct connectivity technology and has subsequently established the Smart Hearing Alliance with GN ReSound to develop and commercialise bimodal solutions (interoperable hearing aids and cochlear implants).

So while some traditional, low-tech manufacturing clusters are being disrupted by globalisation and automated manufacturing processes, high tech industries are engaging in research-centred collaborations such as these in order to remain innovation leaders. Looking forward some low-tech clusters will likely be disrupted and go away, while high-tech clusters will these will likely continue to form and flourish.

Showing his commitment to the Fund's investors, who have exposure to major global blood products manufacturer CSL, through the Fund, Stuart attended the International Plasma Protein Congress in a much more temperate Budapest (below). CSL has recently launched some new products, and the other blood companies also continue to innovate. Overall, the outlook for CSL's products remains quite attractive. Most of them enjoy a strong position relative to their competitors, while also being significantly more effective than previous treatments. As a result, CSL should be able to grow the market and, at the same time, take market share from its competitors at attractive prices. This further supports the Fund's position.

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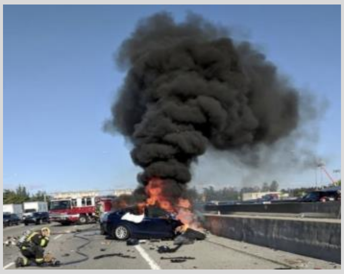
BTW

The cause of autonomous motoring was set back in March after two fatal accidents took place in quick succession in the USA involving cars driving themselves. The first was in Tempe Arizona, a test bed for Uber's autonomous vehicle efforts. One of its cars, a Volvo driving at night, didn't "see" a cyclist who was pushing her bike across the road, running her down. The technology should have been able to identify the hazard despite that dark. There was a human attendant aboard who should have been ready to take over but she did not. In the video the crash the attendant is seen looking down at the time of impact, probably checking her phone.

Shortly after, a software engineer on his way to work in Silicon Valley with his Tesla on Autopilot (a glorified cruise control) steered into a road barrier. He also should have been sufficiently alert and in control to react to the hazard caused by some unclear road markings but for whatever reason did not intervene, with fatal consequences. The car's lithium ion batteries were crushed, causing a nasty and hard-to-extinguish fire.



We love technology but the assumption that society will immediately and enthusiastically embrace autonomous vehicles is optimistic. The primary argument in favour is safety: just think how great it will be when there are no humans involved in the driving process to stuff things up? No one breaking road rules, speeding, making silly maneuvers – in theory these can all be programmed out. However humans are also writing the code which will control the actions of the vehicle, and that code will only be as good as the ability of the people writing it to anticipate everything that can possibly go wrong and make the car respond appropriately. Autonomous vehicles are fantastic in controlled environments, but the world in which we live is a long way from being controlled: quite the opposite in fact. This is also the case in a lot of fields, particularly our own. There is a very human temptation to think that machines are able to do things much better and cheaper than humans, but their ability to anticipate every possible outcome is much more limited.

The Uber trial in Arizona has been suspended while officials try to work out how this accident happened. It is probably little consolation to the cyclist or her family that she was collateral damage in the quest for the advancement of autonomous driving technology, but the fact remains that if it were an inattentive human controlling the car the same thing could easily have happened.

An unresolved question is who will be held liable for the crash, Uber, or Volvo, or the "driver"? Local police haven't quite worked that out yet but, being the USA, you can be sure that it will be lawyers at ten paces and that a multimillion dollar settlement will be required to make it go away.

Alphinity Investment Management

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