Monthly Comment – April 2018

Alphinity Concentrated Australian Share Fund

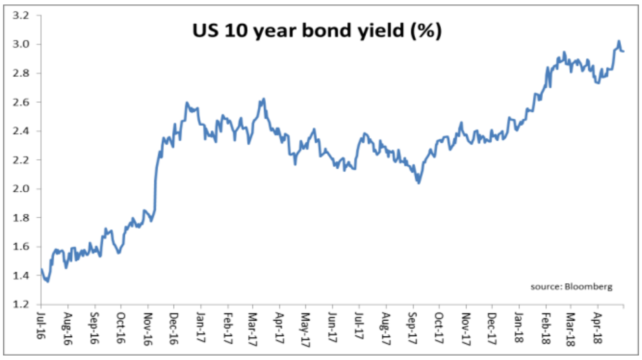
An uneasy peace

Market comment

The Australian share market (ASX300 including dividends) bounced back in April from its first quarter slump, rising almost 4% which took it back to the level it was at the end of 2017. The Fund however is well into positive territory for the four months of 2018 so far thanks to the excess returns generated in that period.

The trade war seemed to settle quickly as a degree of sense prevailed and genuine discussions gradually replaced tweets, at least for the moment. After eschewing the Trans Pacific Partnership free trade agreement, the US administration now seems to feel left out and is trying to muscle back in, but only if it could get a much better deal for itself. Meanwhile, the budding bromance between the leaders of both South and North Korea look soon to be cemented with talks that will include the US President, who seemed to pre-emptively claim the next Nobel Peace Prize!

The real story in the markets however has been going on with bonds. US 10 year yields exceeded 3% in April for the first time since 2011, although they had retreated to just below that at the end of the month. Higher yields often leads to a stronger $US; the $A softened along with most other currencies. Despite this, the Australian market outperformed most major global markets in April, its 4% matched by Hong Kong and the US and only bettered by the UK, France and Germany. Most commodity prices were quite strong in $A terms, another factor that helped our market.



The Australian economy is showing mixed signs of health. Employment growth continues to be solid and while Business Confidence, as measured by a NAB survey, moderated a little it remains firmly in positive territory. Consumer Confidence, measured by Westpac, is still positive but only just. The residential property market in major cities is starting to show some signs of stress after a long period of strength: this should not be a surprise considering the degree of attention that has been given to it by regulators with this outcome in mind.

The Royal Commission into the finance sector kicked off with quite a few casualties appearing even in the first week, including the departure of the CEO and Chair of one of the country's more august institutions. The Commission continues for at least the rest of the year, successively covering different facets of the system, and early indications suggest it could get quite messy for those involved.

Financial companies hence were the worst performers in the strong Australian market, being essentially flat for the month. A strong oil price led to Energy companies rising the most strongly, followed by Materials (mostly Resources), Health Care and Consumer Staples companies. Property Companies impressively matched the ASX300 despite the sharp rise in bond yields. Telecommunications companies struggled, as did those in the Consumer Discretionary sector.

Portfolio comment

The portfolio outperformed strongly in April with good contributions from companies in a variety of industries. The biggest positives came from not owning financial services companies AMP, ANZ or Westpac, all of which fared poorly after appearing at the Royal Commission. Positions in global gaming machine maker Aristocrat Leisure, diversified global miners Rio Tinto and BHP, global blood products company CSL, global wine producer Treasury Wine Estates and oil and gas company Beach Energy all provided strong returns. On the negative side were domestic financial services companies IOOF and Commonwealth Bank and global registry Computershare.

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)	5.1	2.6	9.3	8.9	9.7	10.2	11.1
S&P/ASX 200 Accumulation Index	3.9	0.3	5.5	5.7	7.5	7.9	8.8

*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

Can equity markets and bond yields both rise in 2018? At least for April the answer was "yes". Global equities moved higher, supported by a strong US economy manifested through a solid first quarter earnings season. At the same time, global bond yields increased (i.e. bonds fell in value), also because of the strong US economy. While April was clearly on the affirmative side, market action over the four months of 2018 to date suggests a draw between concerns over the impact higher rates will have on future economic growth, and the current environment which is undeniably strong. Our view continues to be that economic growth should be strong enough, and the rise in interest rates measured enough, to provide positive equity market returns. This view continues to be data dependent, as the US Federal Reserve likes to say, but so far so good.

Headlines in Australia have most recently been focused on the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industries in this country. While still early in the process, it looks like there will be significant ramifications for some individual companies, and potentially the structure of some financial industry segments. For the equity market and the Australian economy more broadly, the key question is what impact the likely tightening of responsible lending obligations for the banks and other mortgage providers will have on credit growth. Household lending had already slowed over the last couple of years, due to high levels of consumer indebtedness, leading to pedestrian earnings and dividend growth for the Banks. Stricter lending criteria will undoubtedly slow mortgage growth further and, while too early to tell, may have broader ramifications for the domestic economy if house prices are significantly impacted. With Banks close to a quarter of the Australian equity market, lower Bank share returns would be unhelpful for the overall equity market.

On the other hand, and as seen again this last month, a weaker Australian dollar is supportive of Australian equity returns, as overseas earnings become more valuable and exporters more competitive. The most recent currency softness probably has more to do with stronger demand for the $US, as interest rate expectations have moved up in the US. However should the Australian economy weaken significantly relative to the rest of the world, a lower Australian dollar would soften the impact somewhat.

Asset allocation	Actual %	Range %
Security	98.8	90-100
Cash	1.2	0-10

Portfolio Outlook

Notwithstanding the somewhat uncertain macro outlook, the Fund's portfolio fundamentals remain favourable. Consensus earnings revisions continue to be positive for the majority of portfolio holdings and returns are pleasing. Earnings leadership in 2018 globally has shifted to the Energy sector with Technology losing some of its prior momentum. The oil price remains one of the more difficult factors to forecast but with stronger demand, a disciplined OPEC (the Organisation of the Petroleum Exporting Countries) and signs of costs starting to increase in the US onshore market the recovery in the oil price does not look unjustified. And as we pointed out a couple of months ago, consensus expectations for the oil price is now below the spot price for the first time in several years.

A supportive macro backdrop by itself is however not usually enough for us to invest, especially not in a commodity like oil. One of the additions to the portfolio in the Energy sector this year has been Beach Petroleum. Beach meets our investment criteria as the company, in addition to leverage to the oil (and gas) price, has several other earnings and value drivers, in our view.

Firstly, relatively new management has through focus and strong execution been able to significantly improve the prospects for the company's legacy core operations in the Cooper Basin where management has increased production, lowered costs and taken meaningful steps to extend the life of its resource base.

Secondly, the acquisition of Lattice Energy, the upstream oil & gas assets formerly owned by Origin, looks set to deliver significant cost synergies through increased scale and focus. The Lattice portfolio also includes a 50% stake in the Waitsia onshore gas project in Western Australia. The project which is expected to achieve FID (Final investment Decision) by June 2018 and production in 2020 does not appear to be fully reflected in Beach's share price despite the owner of the other 50% of the project, AWE having been acquired by Japan's Mitsui which provides a full see through valuation.

Beach has already provided a reasonable contribution to the portfolio's outperformance and there are many other companies with similarly strong investment cases in the portfolio.

Top 5 active overweight positions	Index weight %	Active weight %
NAB	4.9	3.7
CBA	7.9	3.6
Macquarie Group	2.1	3.5
CSL	4.8	3.5
BHP Billiton	6.2	3.5

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Traveller's Tale

An important part of investing is getting out of the office to conduct due diligence on your companies so, hard on the heels of the most recent vintage, Bruce went to Adelaide to meet with wine industry experts and further research the wine industry generally, and portfolio holding Treasury Wine Estates specifically. TWE is the second-biggest producer of wine in the country by volume – having premium brands makes it by far the biggest by value – and the scale of its operations is evident when you see some of its sites. It's been in the portfolio for a couple of years and has contributed nicely to returns in that time.

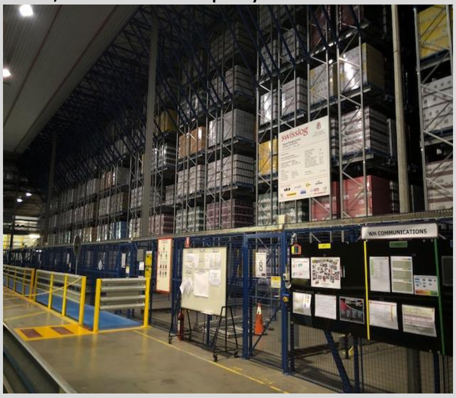
He also went to the company's winemaking and bottling plants at Bilyara in the Barossa Valley. Going to a place like this dispels any romantic wine-making notions one might have had of bare-foot maidens standing in open barrels crushing grapes with their feet. This is a big, industrial facility, one of three in the group. Bilyara produces most of the company's "masstige" wine (masstige is a mass-prestige, a little more expensive than "commercial" wine which is generally below $10 a bottle, but less than the "luxury" wine which is generally above $25). Commercial wine accounts for the bulk of the volume of Australian wine production but luxury is where the money is made: it is much smaller volume but very high margin. Treasury has a number of brands which address the luxury part of the market, chief among them being Penfolds.

Being the middle tier, the Bilyara winery is also the middle in volume. It has stainless steel wine storage tanks that can hold a total of 100 million litres – that's 130 million bottles of wine – which seems big until you realise that the commercial wine facility in Karadoc, just over the Victorian border, is twice the size. Luxury wine is made in a much smaller ("only" 20,000 litre) winery.

The higher you go in the quality tiers, the more traditional winemaking techniques play a part. Barrels are critical to make high-end wine but they don't come cheaply. Made from French or American oak, they cost on average about $1000 each, and TWE has a couple of thousand of them. The barrels are generally used for about five years before their usefulness runs out. Interestingly, some commercial wines which need oak might have a porous bag of wood shavings placed in the steel maturation tanks, effectively a big teabag! But there was none of that in evidence at Bilyara, the wine it makes is much higher-end than that. Quality is the key to making good wine and there is a very sophisticated technical lab on site to make sure that things don't go awry. Everything is incredibly clean and organised as it needs to be when handling so many different varieties, styles and brands through the same facility.

The bottling plant is a mechanics dream, or nightmare depending on how you look at it. Built in the mid 2000s when the company was owned by Fosters, it is still pretty much state of the art and would be matched by few globally, let alone in Australia. In fact it would probably be difficult to justify spending that amount of capital today but TWE still has the benefit of it. Being able to clean, fill and pack and ultimately store that number of bottles is essential when you have such a volume of wine.

And store they do. While Bilyara isn't a place for maturation (some wines are stored in the bottle for a couple of years before being sold; these are taken offsite), there is a very large warehouse with a fully automated crane system that store and retrieves pallets of wine cartons until they're sold. Wine is sent off from Bilyara to retailers, or to the company's own off-site temperature-controlled storage/maturation facilities, or straight to Port Adelaide where it goes onto ships and around the world, to Asia, North America and Europe. Some lower-end wine is shipped in bulk, in big bladders like the inside of a wine cask, for bottling in the US or UK to avoid having to ship heavy glass unnecessarily.



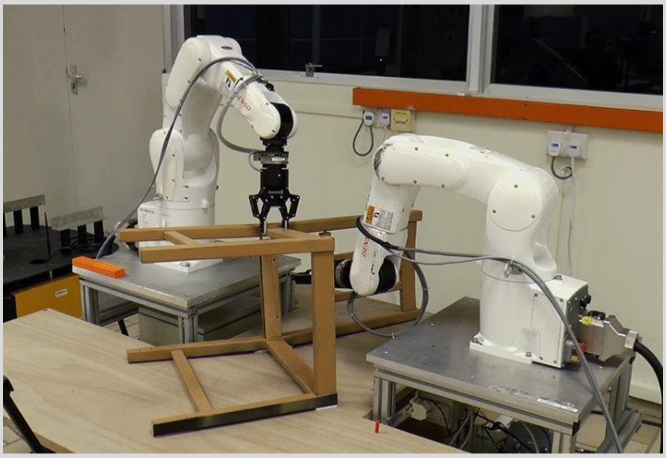
In all, a huge and impressive venture that is spreading good cheer around the world and providing much-needed export income for Australia.

Quarterly Comment – April 2018

Alphinity Concentrated Australian Share Fund

BTW

There is something of a Swedish flavour to the Alphinity offices. 16.7% of our entire workforce was born in that great country, although all are now naturalised dinky-di Aussies. There is hence quite an affinity with flat-pack furniture and Allen keys, although none of our office furniture was self-assembled. But there was an air of mourning a year or so ago when the idiosyncratic but very Swedish Ikea founder Ingvar Kamprad passed on and (no doubt) was placed in a blond-wood coffin for the journey to his final destination, wherever that might have been. So we had to take notice of the piece in the *New York Times* about Ikea furniture in April. Apparently scientists in Singapore have produced a pair of robots which, working together, can assemble those iconic homewares. Is there nothing those robot things aren't able to do?



Well, quite a lot as it turns out. The two robots, which you can see doing their thing in this video, were "trained" to assemble a chair, one of the simpler things you can get from Ikea, by being fed ordered instructions on how the pieces fit together. It took the robots nine minutes to complete the task (you'll be pleased to know the video is much quicker than that) but we must point out that the bots were not required to unpack the parts from the cartons and dispose of the styrofoam, nor were they forced to rip open the plastic bags full of bits, nor indeed did they need to follow those inscrutable pictograms. Instead, all the parts were pre-sorted for them and the scientists spent three years (!) "training" them. The robots were equipped with grippers, force detectors, and 3D cameras to work it all out. As with most Ikea construction projects, the robots didn't get it right the first time, in fact it took them several attempts with the scientists having to tweak their instructions along the way.

It's not the first time robots and Ikea have come together. Obviously there are many robots involved in manufacturing the products, and in 2013 another team of scientists had some robots put a table together, but apparently a chair is a lot more complex than a table. At this rate it will be around 2095 by the time they get around to being able to construct a Svärta bunk bed or Malsjö sideboard. But as the NYT itself said: "With the help of experts in artificial intelligence, the researchers may be able to create a robot that can build a chair by following spoken directions or by watching someone else do it first. Or maybe they'll eventually develop one that assembles furniture in a way that is truly human: by ignoring the manual altogether."

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