alphinity
INVESTMENT MANAGEMENT

Monthly Comment – May 2018
Alphinity Australian Share Fund

Quitaly

Market comment

Everything was going along quite nicely in May until late in the month when Italian politics, of all things, almost brought it undone. Italy is not known for a stable political system – it is one of the few countries that made Australia's recent revolving-door Prime Ministership look good – but the collapse of its coalition government, necessitating another election and the possibility of another country threatening to exit the Euro, brought back some jitters in the markets. Any election in the current times risks the election of populists: politicians who espouse ostensibly popular courses of action but rarely with any credible plan or even chance of making the change voters want. One such popular cause is the withdrawal of Italy from the Euro. This of course needed a new Grexit/Brexit-like description. Exitaly sounds a bit clumsy. No, it would have to be Quitaly.

The Australian share market (ASX300 including dividends) came off towards the end of the month to finish a modest 1.2% higher for the month, moving 2018 year-to-date returns from zero to still not very much. The Fund however has done considerably better than this due to the excess returns that have been generated over the first five months. In $A terms, Australia was one of the better-performing global markets: Canada and the US did fractionally better with 2% but most ended in negative territory. The Borsa Italia of course struggled, down 11%, and European markets were generally down by between 4 and 8%. Asian stocks were down by less with the exception of Korea's 5% fall after very mixed signals coming out of preparations of peace talks. The $A itself was about half a cent stronger against the $US in the month, and close to 4% stronger against the Euro.

Commodity prices remained quite firm with seemingly robust economic numbers still coming out of China: Metallurgical Coal was up 5% and thermal 10%; oil prices were 3-4% higher depending on the grade. Base metals were generally a little stronger with the exception of Nickel, which was up 11% in $A terms.

Portfolio comment

The Fund outperformed strongly in May. On the positive side, plumbing product manufacturer Reliance Worldwide performed well after announcing a significant acquisition in Europe. This necessitated a substantial share issue which the market supported enthusiastically and drove the shares significantly higher. Our position in gaming machine maker Aristocrat Leisure contributed heavily after reporting strong first half results during the month which led to further earnings upgrades in the market. Macquarie Group reported full-year earnings which positively surprised the market during May. The Fund's underweight position in Telstra again added to performance during the month after the company hinted at disappointing earnings for the second half, resulting in further earnings downgrades.

Our positions in Treasury Wine Estates and Link Administration detracted from returns in May. While Treasury has been a strong performer since we bought it in 2015 – the share price has more than trebled since then – but it underperformed in May after stories emerged about a delay in customs clearance for some of the wine it is exporting into China, raising fears that it might be collateral damage in stressed relations between the respective governments. There has to date been no impact on sales as it has sufficient stock in its Chinese warehouse, but we are monitoring it closely to see if it is likely to be an enduring situation which might require some action.

Link Administration also cost some performance after the Federal Budget revealed plans that would radically cut the number of small and dormant super fund accounts. Part of Link's business is to administer super funds and its earnings is perceived to be at some threat as a result of the changes; the share price however was hit a lot more than any reasonable assessment of any potential financial impact. We are observing this situation closely as well and will act if further information comes to hand that changes our current view.

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)	2.1	2.8	13.1	6.9	9.4	9.4	9.9
S&P/ASX 300 Accumulation Index	1.2	1.1	10.0	6.0	8.8	8.2	8.7

*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

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Market outlook

If we needed any more evidence of financial markets having become increasingly jittery, the month of May certainly provided it. When was the last time election uncertainty in Italy sent US bond yields plunging and triggered a global equity market selloff? The US – North Korea on-off-on-again summit twists and renewed trade concerns caused further turbulence. This nervousness is understandable considering record-high equity markets in many places and the unknowns associated with the withdrawal of unprecedented monetary stimulus currently underway in the US and Europe.

We have so far taken a cautiously optimistic view of how the year will unfold and, while we note the slowdown in economic growth rates suggested by some leading indicators, we continue to feel that growth rates are just moderating rather than actually going backwards. This view has been further supported by our visit to China during the month which suggested that activity levels there remain solid. The events of May have done little to alter this view. European data releases have been on the weaker side over the last few months and Japan appears to be spluttering again. However the lead indicator of US manufacturing, which had also been slowing, actually pointed to an acceleration in the rate of activity in May. Global growth thus appears largely on track and global bond yields also look set to continue their gradual rise, rather than staging a significant breakout in either direction which would be more problematic.

In Australia, first quarter economic growth surprised to the upside, largely due to higher commodity export revenues as consumer spending and wage growth remains subdued. A softening domestic housing market looks to add further uncertainty to Australian prospects but in summary, there are as usual pluses and minuses for the global economy as well as our economy and, by extension, corporate profit growth. This is also true on a sector basis with, for instance, Banks having a number of challenges while Resource companies are enjoying strong commodity prices and cashflows. All in all, mid-single digit earnings growth and similar equity returns continue to look like a reasonable working assumption for the balance of the year.

Top five active overweight positions as at 31 May 2018	Index weight	Active weight
Aristocrat Leisure Limited	1.2%	2.3%
Macquarie Group Ltd	2.2%	2.1%
Computershare Limited	0.5%	1.8%
Rio Tinto Limited	2.1%	1.7%
Goodman Group	0.9%	1.7%

Portfolio Outlook

The financial year about to end has so far been a good one for equity markets overall, and even more so for Alphinity Fund investors as our relative performance has been pleasing. Importantly, rather than just getting one big thing right, the key contributing stocks to this performance have come from a number of different sectors of the market. In addition, some, like fruit and berry grower Costa Group, are primarily operating in the domestic economy while others, such as Rio Tinto, are truly global companies. What they all have in common is that they have delivered earnings growth ahead of what the market expected.

As discussed above, the global macro outlook looks like it's becoming a bit more complicated with growth rates likely to have peaked while interest rates and other monetary conditions are still being tightened. In such an environment a well-diversified equity portfolio becomes even more important.

Following strong outperformance of resource companies we have trimmed our sector exposure a bit. Commodity prices are still holding firm and there are few signs of any significant capacity additions so the sector remains an attractive investment opportunity in our view. This is especially the case from a domestic perspective as the Banks continue to struggle with low credit growth, ever growing compliance costs and bad debts that, while showing no immediate signs of deteriorating, are unlikely to get much better from current historically very low levels.

We are continuously reminded of how critical good management is to the success of a company. In May the portfolio benefited from Aristocrat's continued flawless execution of its strategy of growing share in its core slot machine markets while expanding into the broader global online games markets with the two bold acquisitions it made last year. Macquarie again showed the benefits of its transformation from an Investment Bank to a global asset manager with another record result. Reliance Worldwide was already fast-growing plumbing supply company when it made a company transforming acquisition in Europe that saw the share price soaring.

We will continue our endeavour to identify stocks like these on your behalf where an attractive valuation intersects with a positive earnings trajectory and a management team can that execute well-formulated strategy.

Asset allocation	31 May 2018 %	Range %
Securities	98.5	90-100
Cash	1.5	0-10

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BTW

We equity investors are generally thought to be optimists as we usually seek the upside case in an investment. Bond investors worry more about risk, their chief concern being the prospect of not getting their capital back. For the owner of a bond who holds it to maturity, the very best outcome you can hope for is to get the face value back and have the half-yearly interest coupon paid along the way. You bear the risk that inflation will eat away at the value of that face value (for instance according the Reserve Bank's nifty inflation calculator had you bought a 30-year bond in 1988 the present buying power of its face value would be only 45% of what it was back then). You also bear the risk that the issuer of the bond might not be able to repay.

This does not appear to be a very good risk/reward equation to us. We much prefer the equity market. Admittedly there is a much greater chance that a share you buy might end up being worth zero should the company you invest in turn out to be a dud. But you generally get plenty of warnings when things start going badly, and the chance of choosing a whole portfolio of duds is small, especially if you use a half-decent fund manager.

The upside case for equities is compelling. Even the poor old Commonwealth Bank, in its current beaten-up-by-the-Royal-Commission state, has provided astounding returns for shareholders since its initial listing in 1991 at $5.40. At the end of May it was trading at $69 per share and had paid even more than that in dividends (with juicy franking credits attached) over the intervening 27 years.

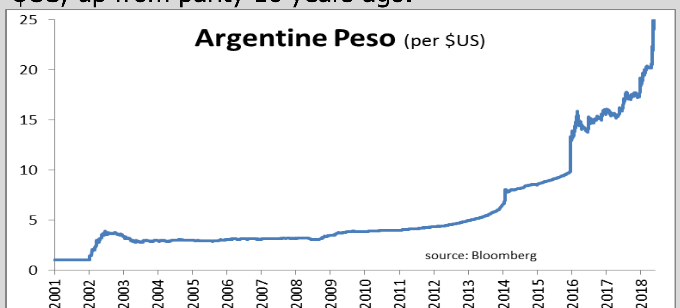
One of the more impressive examples of good equity returns in Australia would have to be blood-products and vaccines company CSL. It listed in 1994 at $2.30, or effectively 77c considering a 3:1 share split that took place in 2007. That company's share price in May was $185 and, while CSL's 1% yield hardly makes it a high-paying company, its annual dividend today is more than double the split-adjusted Initial Public Offering price. This upside potential is the exciting attribute of equities lacking in bonds. By contrast, the periods during which bonds are exciting are generally when you don't want to be there!

So it was with some surprise that we noted recently the rank optimism of at least some bond investors, in the context of Argentinian bonds. Argentina has had its share of economic challenges over the years and has defaulted on its debt a number of times in the past. We hadn't actually noticed that the country had become solvent but a restructure in 2016 brought it back to the markets.

Governments default on debt when they can't or won't pay it back. Can't because its financial situation has deteriorated such that it just isn't able to; or won't because domestic imperatives seem more important than the interests some foreign bond holder: after all foreign bond owners don't generally vote. It was a bit of both when the state of NSW threatened to default during the darkest days of the 1930s depression. Then Premier Jack Lang would rather pay the salaries of public servants than send interest payments to the largely British creditors. As he put it, "the same people who conscripted our sons and laid them in Flanders' fields... now demand more blood, the interest on their lives". Lang was dismissed by the State Governor in 1932 and the payments went ahead.

Until the middle of last century, Argentina was, like Australia, one of the most prosperous countries per capita in the world, thanks to farming and resources. The fine buildings of its capital Buenos Aires made it known as the Paris of the South, but since 1982 Argentina has defaulted on its debts five times. It completed a debt restructuring program in 2016 and then last year it issued $US-denominated bonds. One would think that previously-fleeced debt markets might have baulked at providing more capital but it appears not. Argentina even issued bonds with a 100-year maturity. That surely is the definition of optimism: not just that you'll be around in 100 years to collect your principal, but that nothing will go wrong in the intervening century.

As it turned out, it didn't take long at all for something to go wrong and in May, less than a year into its 100-year commitment, the government of Argentina started talks with the IMF (International Monetary Fund) about getting relief from its debt obligations. This doesn't necessarily mean default but it must be a bit worrying for creditors. Argentinian 2117 bonds were trading above 8%, 86c in the dollar, at the end of May. We suspect this might still prove to be a selling opportunity. In the first few days of June the IMF offered the country a $US50 billion credit line. The real damage has been done to the Argentine Peso: it now takes 25 to buy one $US, up from parity 16 years ago.



Australia and Argentina were in similar situations at the time of WWII and we should be very thankful that strong institutions, generally sensible governments (much as we hate to admit it), a more diverse economy and more than a bit of good luck led our country down a different path.

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Traveller's Tale

Andrew spent the last week and a half of May trying to overcome jetlag through a procession of meeting rooms at a range of financial institutions in London and New York. Business travel can be painful but every now and then the timing works in your favour and as it turns out, spring in the Northern Hemisphere is a great time to visit. He was also the first in the company to test the new 17 hour non-stop Perth to London leg that Qantas recently started, on its new Boeing 787 Dreamliner. Andrew's verdict was that while it is a very nice new aircraft, 17 hours is a very, very long time to be sitting at the back of the bus.

He had to spend a weekend somewhere, and it happened to be in New York. When in New York in spring you have to head up to the Bronx to take in a baseball game at Yankee Stadium where he saw the Yankees being belted by the Houston Astros. It also happened that game one of the basketball finals was on that weekend; he couldn't get to that game but fortunately the Americans do a good sports bar.

The bar was much more comfortable than the very full English pub, complete with warm larger, the week before where he saw Liverpool's goalkeeper commit two howlers in the European Cup Final against Real Madrid. Andrew reckons he also did some work on this trip, but clearly during sports season in the Northern Hemisphere there are some things you just can't miss.

Sports season also sees the release of the annual Forbes list of the hundred most highly-paid athletes. It becomes clear pretty quickly into which sport you want to direct your child for maximum earning capability, and it's not baseball. The farcical Mayweather/ McGregor fight saw those two take the top spots, each receiving the equivalent of the Gross Domestic Product of several small African nations. You'd never want them to box: you really want them playing soccer, or football to be more precise. Argentinian Lionel Messi (US$111m) and Portugal's Christiano Ronaldo (US$108m) and Brazil's Neymar da Silva Santos (US$90m) rounded out the top five earners. Messi could actually be Argentina's major source of foreign exchange, although he probably keeps it in Euros in Barcelona. You have to go all the way down to position 37 to find your first baseball player. Clayton Kershaw, who we'd never heard of, earned a tidy US$35m pitching for the LA Dodgers. By sheer number in the top 100, Basketball is by far the winner. With LeBron James (US$86m) and Steph Curry (US$77m) leading the charge, basketballers make up 40 of the top 100 highest-paid athletes. NFL (American Football) players make up 18, Baseball 14, Soccer/Football 9, Golf 5, Tennis 4, Boxing 4, and Motor Racing 3. The sports you don't want your kids in are Mixed Martial Arts, Track and Cricket, with only one each.

But you have to ask, just how happy are they? Does all that money buy them fulfilment? Instead they could be a fund manager going to see yet another insurance company in a meeting room in the famous Gherkin building in London. There is nowhere Andrew would rather be!

Alphinity Investment Management

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