alphinity INVESTMENT MANAGEMENT

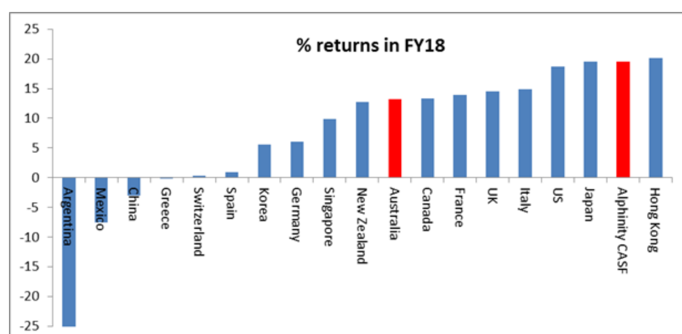
Quarterly Comment – June 2018
Alphinity Concentrated Australian Share Fund

Summit Fever

Market comment

June marked the end of the 2018 Financial Year (FY18), a time to take stock of where we've been, where we are now and where we're headed. It didn't feel like it for much of the time, but the year actually panned out quite well for our investors. Total return for the market (ASX300 including dividends) was a little over 13%, and for Fund investors a good deal more than that, as shown in the table below.

The financial year to June 2018 turned out to be a pretty good one for equity market investors, unless they were keen on South America. Most global markets provided solid returns in $A terms, as well as or even better than ours. The $A itself finished at the lowest point for the year, US74c.



Commodity prices have been resilient despite fears of slowing China, however the biggest concern has been the price of copper. We've written previously about copper – it is one of the more reliable lead indicators of global economic activity as a key constituent of much infrastructure and many finished goods.

June was obviously the time for summits. There was the G7 in Quebec, attended by seven of the world's largest developed economies. There was also the lesser-known Shanghai Cooperative Organisation summit in Beijing, attended largely by what would once have been called eastern bloc countries. Then there was the most spectacular summit, between US President Trump and North Korea's Kim Jong Un. Over the course of a couple of days in Singapore, those two world leaders once and for all sorted out some of the issues dividing their regimes, just like their predecessors had several times over the past couple of decades.

The quarter finished off with a re-eruption of tariff wars between the USA and pretty much everyone else in the world. Markets were remarkably sanguine about it all – possibly not really believing it will come to anything. The rhetoric from the US has become increasingly strident, with numerous fights being picked with some of its traditional allies, like Canada and Germany, and a fair bit of cosying-up going on to some of its traditional foes, like Russia and the aforementioned North Korea. In short, there have been mixed messages going out to pretty much everyone. It seems that, as he approaches two years since his election, the not-so-new US president is living up to his promise to shake things up, not just in Washington but around the world. It is to be hoped that this is all part of a cunning and well-thought-out longer-term plan.

The Australian economy seems to be at another cross-road, with the housing market now apparently softening after several years of strong gains. Banks, a traditional mainstay of our market, are likely to be fairly subdued into FY19 as a result of regulatory action and the ongoing Royal Commission. Demand for resources out of China continues to be robust and although many commentators have been calling for its economy to slow for some time, our on-the-ground research suggests otherwise. It remains to be seen how the progress of the trade war between China and the US will change this of course. Commodities were mixed, as usual, with Base Metals generally softer but Energy continued to rise in price with Gas, Oil and Coal all sharply higher over the quarter, exacerbated by the soft $A.

Portfolio comment

The Fund outperformed nicely over the June quarter with positive alpha in each month and good contributions from companies in a variety of sectors. Notable positive contributors included gaming company Aristocrat Leisure and financial services company Macquarie Group, both of which announced strong results during the period, as well as plumbing products company Reliance Worldwide which made a significant and quite accretive acquisition.

Also helping were companies we don't own or are underweight which performed poorly during the quarter.

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)	3.3	11.0	17.7	12.8	12.7	11.6	11.7
S&P/ASX 200 Accumulation Index	3.3	8.5	13.0	9.0	10.0	9.1	9.2

*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

These included financial services group AMP, telecoms company Telstra and global logistics service provider Brambles. The only companies that detracted noticeably from returns were registry company Link Administration and financial services company IOOF.

The quarter topped off a pleasing financial year for Fund investors thanks to its holdings in companies like Rio Tinto, Macquarie Group, Aristocrat Leisure, Treasury Wine Estates, CSL, Reliance Worldwide, Costa Group, and having little or no exposure to Telstra, AMP or Origin Energy. The only detractors of any size were companies we didn't own: Santos, AGL Energy and A2 Milk.

Market outlook

We see few reasons to change our core view that tighter monetary conditions will be the main challenge for equity markets in coming months. Global economic growth is also slowing, which may reduce the tailwind for corporate profit growth somewhat especially at the more cyclical end, but that on its own shouldn't be enough to derail markets.

Underlying the only slightly lower outlook for global growth is an increased divergence in economic performance between the US and most of the rest of the world. The US economy appears to have strengthened further in recent months and, while that in isolation should be a good thing, it is likely to lead to higher US interest rates and a stronger $US which also has the effect of tightening monetary conditions in many $US-dependent emerging markets which don't really need any tightening at this point. This to us looks like the key risk in terms of the global economic outlook.

While Europe and China have also showed some moderation in some of their respective leading indicators, growth in those regions remains relatively stable, in our view. Even though increases in official interest rates in Australia still look some time off, our equity market is clearly not immune to the reduction in liquidity affecting global markets. However, at least in a relative sense, Australia has several things going for it. Firstly, despite its large Resource sector, Australia overall has a relatively defensive market compared to its Asian neighbours and would stand to benefit from a more defensive asset allocation by regional investors. And secondly, as we have written before, the $A also acts as a meaningful balancing factor as any weakness boosts the value of Australian companies' offshore earnings and increases the competitiveness of our internationally trade-exposed sectors. The Australian market's strong performance during recent global equity market woes suggests that these factors are currently at play. While after another strong year for domestic equity investors it may be prudent to have a more cautious view of returns for the next 12 months, on balance we feel that there are good prospects for another year of positive returns.

Portfolio Outlook

The Australian market has shown great resilience in what has become quite a choppy global environment. Some of the reasons for this were discussed above but, while macro factors are always important to be aware of, we find that company specific factors are typically more important drivers of share prices, even in cyclically exposed industries.

For example, Both Rio Tinto and Fortescue Metals are predominantly iron ore producers. Yet Rio Tinto shares generated a positive total return of 39% in FY18 while Fortescue had a negative return of 10%. An increased price discount for Fortescue's lower grade iron largely explains the difference, with Fortescue's earnings expectations more or less unchanged on a year ago while Rio has continued to enjoy consensus earnings upgrades. The difference was not as stark in the Bank sector but still, -7% for CBA vs +4% for ANZ illustrates the same point. As tighter monetary conditions and potentially slower economic growth pose valuation risks for highly valued so-called growth stocks and earnings growth risks for more cyclically exposed companies, in-depth stock analysis becomes even more important.

The Fund heads into FY19 and the imminent August reporting season with strong earnings momentum across multiple sectors. Pleasingly, most of this earnings momentum has been due to company specific drivers rather than macro tailwinds. Qantas is one stock in the portfolio that fits this description well. From a macro perspective there are both some tailwinds, such as an improving demand from the Resources sector, and headwinds, such as the rising oil price. Key to our confidence in Qantas however is the overhaul of the company's cost structure that has been undertaken over the last 3-4 years, with additional opportunities still available. This has provided the company with a superior cost position to its rival in the domestic market and thus the ability to offset the increase in its prudently-hedged fuel bill, through increased ticket prices. Internationally, a reworked partnership with Emirates has freed up capacity for Qantas to increase its Asian route network as well as introduce the first direct flights from Australia (Perth) to London as the airline takes delivery of new long distance aircrafts. Together with the potential for further capital management, the company has unique earnings growth drivers to offset any significant rise in its fuel bill.

Asset allocation	30 June 2018 %	Range %
Securities	98.5	85-100
Cash	1.5	0-15

Top five active overweight positions as at 30 June 2018	Index weight	Active weight
BHP Billiton	6.6	3.8
Macquarie Group	2.4	3.7
CSL	5.3	3.6
Aristocrat leisure	1.2	3.3
Computershare	0.6	3.0

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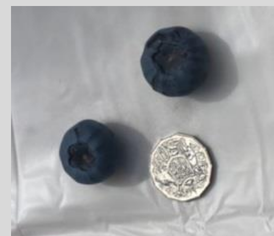
Traveller's Tale

It was a bitterly cold and rainy June afternoon in Sydney when Bruce slipped out of the office early, caught a train to the airport and jumped onto a Qantas 737 bound for Cairns. It wasn't for a holiday sadly, he was booked on a Jetstar flight back the next night. He went to meet with management of portfolio holding Costa Group and to view some of its operations on the Atherton Tableland, a little to the west. He arrived in a few hours later to a balmy 25° evening and people ambling around without the need to be rugged up against the cold.

The Atherton itself feels a bit like the Garden of Eden, complete with the snakes. Its lush soil, high rainfall and steamy tropical climate make it ideal for some crops. Avocados are well established in the region and Costa is in the process of planting many more trees. It's also using some innovative growing techniques that should enable it to produce a lot more fruit with a much smaller increase in water use. Avocado trees take several years to reach their full fruit-bearing capacity so is it by nature a long term investment. Water is of course critical to any agricultural activity and that part of the world is served well by natural rainfall, dams and readily-accessable aquifers.

Costa also has a significant packing operation there that takes in other growers' fruit as well. The fairly simple shed puts through about a million trays of a year, each tray with 13-18 avocados depending on size: that's a lot of guacamole. A lot of care is taken when picking and packing as minor damage can have a big impact on the realisable price. Pickers are not paid piece-rates as often happens in the industry, they are paid an hourly rate and encouraged to harvest carefully rather than speedily.

Costa was the first to plant blueberries in the region a few years ago. A different variety of berry is needed for that climate but developing varieties is something Costa is very good at. It has developed and patented a large number of different berry varieties over the years and earns substantial royalty income from licencing these to other growers around the world. Some of the varieties they came up with were interesting but not necessarily commercial: one had enormous berries as can be seen here. It is hard to seeing consumers warming to a 125g punnet with only three or four berries in it! There's no genetic modification involved: it is all from natural cross-breeding. It was nice to see bee hives dotted around the berry plantations – Costa gives access to local apiarists and their bushes provide food for the bees in exchange for their polination.



One of the great things about the climate is the incredible productivity it engenders. In the south it generally takes about three years from intital planting to commercial berry production; in the Atherton you can get a decent crop after the first year. They don't know yet whether this means the productive life of a bush will be shorter than it is down south but after several years there is no sign of a drop-off in productivity. The hot climate created other challenges however: pests and diseases meant a lot of learning and adapting was required in the early years.

The outcome of growing berries in North Queensland, northern NSW and Tasmania is that Costa can provide fresh, locally grown blueberries into supermarkets 50 weeks of the year at reasonable prices most people can afford, which is great for consumers and Costa shareholders.

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BTW

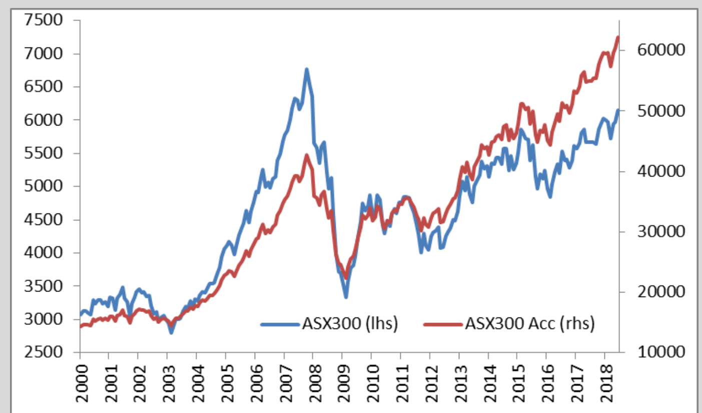
"The market", as measured by the S&P ASX300 price index, finished June close to a ten-year high at 6152 but remains well short of the 6770 all-time high it reached in October 2007, the eve of the Global Financial Crisis, despite Australia's economy cannily side-stepping the recessions the rest of the world sustained. What's going on?

The ASX300 is essentially an amalgamation of the market values of the 300 Australian companies S&P considers most relevant. But some of the companies which were highly-valued names back in 2007 didn't last too long when things started to get tough: as Warren Buffet likes to say "You only find out who is swimming naked when the tide goes out". The tide went out a long way in 2008 and some of those names either didn't survive, or were left as mere shadows of their former selves. Remember Babcock & Brown? Rams Home Loans? Allco? ABC Learning? These and many others represent lost index points that will never be recovered.

Whole sectors were affected too. Quite a few property companies had near-death experiences and, despite some strong returns in recent years, the ASX300 Real Estate Investment Trust index is still not much more than half the level it got to during the euphoria of 2007. One of our portfolio positions, Goodman Group, has more than trebled since we bought it, but it would need to more than treble again to get back to the price at which it traded in 2007.

Looking at a price index however only tells half the story. The measure you should use is the Accumulation Index which includes dividends. Dividends are a hugely important component of equity returns, so any analysis that ignores them will be misleading. On that measure our market is well ahead of the 42686 that it reached in 2007 – in fact we passed that point in back in 2013 and are now 46% further ahead at 62275. Neither measure includes the additional benefit of franking.

For share investors, the important thing is not the index, it's the individual shares that you own. A half-decent fund manager should keep you away from some of the more dodgy investments, focusing instead on companies with decent prospects. We'd much rather be in an actively-managed fund than invest in an index, where you have to own the bad companies as well as the good ones.



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