Monthly Comment – August 2018
Alphinity Concentrated Australian Share Fund

The Ides of August

Market comment

The month of August contained the rather unedifying Canberra spectacle of deckchairs not just being shuffled but furiously tossed overboard, while those doing the tossing seemed oblivious to the ship of state steaming swiftly towards an electoral iceberg. Ignoring the lessons of such recent history, which really should have been seared into political memories, for the fourth time since 2010 government members chose to throw overboard an incumbent Prime Minister in a desperate attempt to change public perception of their party in the few months remaining before the next federal election. Over the side also went some supposedly key policy objectives aimed at making Australia's economy more sustainable and competitive. With the sigh "et tu Mathias?", the former PM retreated to his New York apartment to lick his wounds (which is not easy after having been stabbed in the back!).

Apologies for mixing all those metaphors; there is a little more about the impact of these events on our market over the page. The good news however is that the change at the top was achieved without bloodshed, riots or tanks in the streets, as might have happened in some countries, and also with surprisingly little impact on financial markets. Considering the fraught circumstances, the Australian share market (ASX300 including dividends) did quite well to actually rise 1.4% in August. It under-performed US and Japanese markets in $A terms, but most European and Asian bourses were actually down for the month. The $A softened by about 3% against the $US, making up about half the US market's 6% return.

The year to June 2018 reporting season brought with it the normal torrent of information to challenge or confirm the investment theses of most of our companies, and contained its normal share of surprises. As we mention over the page, the season wasn't great and, while there were a few companies that had big share price reactions, not many of them were due to the company delivering a significantly positive surprise. In some cases just not disappointing was enough to get the share price running, possibly a result of short covering.

Commodity-producing companies performed poorly in August, largely as a result concerns around the building trade war between the world's two largest economies, the USA and China, even though the prices of the commodities themselves generally held up pretty well, especially in $A. Iron ore rose 5% and Metallurgical Coal 10%, while Thermal coal used in power generation was up almost 4%. Metals however struggled with most down around 5% even in $A; Aluminium which rose 5% being the exception.

Portfolio comment

The Fund performed in line with the market in August and, as generally happens during reporting season, there were lots of ups and downs in its constituent companies. The best contributors were our positions in global blood and vaccines player CSL, global industrial property specialist Goodman Group and global registry company Computershare. CSL has been in an upgrade cycle for some time, supported by a strong strategic vision and ongoing operational excellence. Goodman Group has been a consistently positive contributor to performance since we've owned it, and trends in the 2018 result leading into 2019 remain encouraging. Computershare performed well, it benefits from higher global rates and was helped by the soft $A. Not owning gas company Origin Energy, major bank Westpac or supermarket operator Woolworths also added some value.

On the negative side were BHP, Sims Metal Management, Rio Tinto, Reliance Worldwide, and not owning Telstra. Telstra has been a major contributor to performance over the past three years but it hurt a bit in August. While its financial result was poor, potential consolidation in the mobile market improved sentiment towards the whole sector. Sims Metal Management was impacted by the economic turmoil in Turkey, a key player in the scrap metal market. Reliance didn't meet lofty expectations and BHP and Rio were both hit by concerns over the potential for the burgeoning trade war to impact on global economic growth.

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)	1.5	6.9	20.9	15.0	11.8	13.4	11.9
S&P/ASX 200 Accumulation Index	1.4	6.2	15.4	11.5	8.9	10.5	9.4

*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

The solid market performance in August is a little difficult to reconcile as the 2018 overall reporting season was, if anything, slightly disappointing. Earnings growth of around 8% for the year just ended was solid enough although Resource and Energy companies did the heavy lifting while the Banks dragged the chain with multiple headwinds facing the sector. However, earnings revisions for the new financial year were muted overall, and the dominant theme for positive results reactions was a continuation of pushing up valuations of already expensive stocks. The Goldman Sachs strategy team summarised it well when they noted that the 15 best performing stocks had risen an average 17% since reporting despite earnings per share upgrades of only 1.5%, and these stocks were already trading on an average Price/Earnings ratio of 25x. Now, we know that stocks with earnings upgrades typically are those most likely to have more upgrades but this seems to be anticipating a bit too much too soon.

Consensus market earnings growth expectations for the new financial year is around 5% with largely the same dynamics as in the last financial year, i.e. Energy leading and Banks, Telcos and Utilities lagging. 5% appears to us to be a reasonable estimate and, trading as it is around long term averages of 15x this year's earnings and a dividend yield of about 4.5%, the market overall doesn't look particularly over-valued.

However, when you consider risks to global growth from trade tensions, the fallout from tightening liquidity in emerging markets rising, and pockets of the market trading at record levels, some sort of correction is looking increasingly likely. As always, such events are never easy to time, but the number of warnings signals are clearly increasing.

Top five active overweight positions as at 31 August 2018	Index weight	Active weight
BHP Billiton	6.3	3.8
Macquarie Group	2.4	3.7
Aristocrat Leisure	1.2	3.3
Woodside Petroleum	2.0	3.2
Computershare	0.6	3.0

Asset allocation	31 August 2018 %	Range %
Securities	97.7	85-100
Cash	2.3	0-15

Portfolio Outlook

The August reporting season delivered its usual mix of well- and poorly-received results. However, the share price reactions to those results in a lot of cases seemed less intuitive than normal, as numerous stocks that saw their earnings estimates trimmed paused only momentarily before they continued their upward trajectory. We're not too concerned about these developments as it is the earnings trend that eventually wins, in our experience. Portfolio construction has however become increasingly challenging as the choice we are facing has progressively become between "cheap" stocks with an uncertain earnings outlook due to their leverage to broader economic macro factors; or stocks with some structural growth tailwinds but which are "expensive". Neither group holds broad-based appeal at this point, in our view, though the balance sheet strength of many of the stocks in the Resource sector makes this sector a much less risky proposition compared to a few years ago.

The answer instead probably lies somewhere in the middle, where the combination of earnings certainty and reasonable valuation provide some protection against a more uncertain equity market outlook. The fund already holds a number of these positions. And while we will not compromise on our philosophy of investing in companies with earnings potential that is better than that which the market expects, it looks increasingly like this part of the market will be the best place to seek new investment ideas.

Mirvac Group is a company that has many of these attributes. This stock was added to the Fund earlier in the year and we have recently increased the position somewhat. The company has skilfully navigated what is now a cooling domestic residential property market as well as the challenges in Australian retail property leasing by concentrating its malls in areas of high demographic appeal and repositioning to offering an increased amount of services rather than goods. Mirvac is also profiting from the strong upswing in the office leasing markets in Sydney and Melbourne, where its buildings are concentrated. Having also subtly changed its business model by partnering more with external parties such as sovereign wealth fund who provide third-party capital, Mirvac has also been able to reduce the risk it takes in property development and ownership. Overall, with a reasonable valuation and some appealing earnings upgrades, Mirvac sits nicely in the Fund's portfolio.

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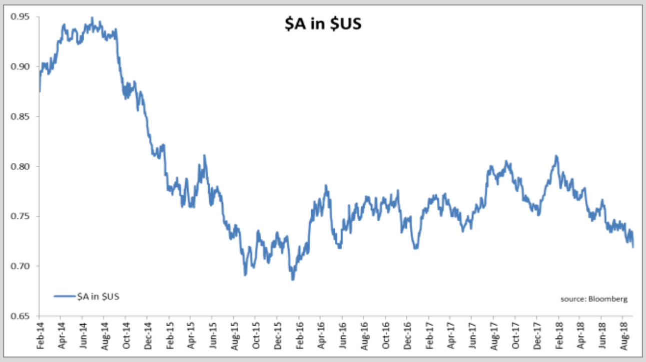
BTW

Political instability can wreak havoc in financial markets but in our case, other than a day or two of minor stock market wobbles and a weak – although hardly plummeting – currency, it went almost unnoticed. The currency move was at least partially a result of $US strength, as many other currencies also experienced some softness over the month. Why was it not worse? Why did the market not spit the dummy much more than that? With a change of government now even more likely at the next election some time before May 2019, why wouldn't the prospect of a (supposedly) business-unfriendly government have a bigger impact on shares in Australian companies?

Difficult to say for sure, but it could be that the federal political situation in this country has been in such disarray for such a long time that the market thinks it doesn't matter that much any more, and that any new government will probably be no more unfriendly to the big end of town than the current one which put a special levy on high income earners, a discriminatory tax on banks, even devising a special one for Macquarie Group when it realised that wasn't actually a bank; called a Royal Commission into the powerhouse financial sector; has been unable to agree on energy policy for a decade; and even attempted to effectively nationalise a coal-fired power station close to the end of its life when the listed company that owned it wouldn't play by rules that suited the idealogical position of a few in that government. Maybe business can't do worse under a new regime?

This of course might turn out to be wrong should we change government after the next election. For the first time in a while the policy differences between the two sides seem to have some significant differences, and some may not be especially friendly to equity markets, such as winding back some aspects of dividend imputation. But, as always, business will need to deal with the hand it is dealt and, should the new government's majority be large enough, some legislative certainty and consistency would probably be welcomed. That's to the extent what happens in Australia matters, after all, one of the key features of many Australian companies is substantial operations outside the country.

Successful companies can only go so far in Australia before needing to look further afield to grow. You can only take over so many domestic competitors before the regulator starts getting anxious, then you caneither choose to become a conglomerate and expand into different industries, or look offshore. There aren't that many examples of consistently successful conglomerates around the world – Warren Buffett's Berkshire Hathaway is one of the few we can think of, and we would argue Berkshire Hathaway is a very special case. You just need to look at the performance of our large home-grown



conglomerate, Wesfarmers, to see the mixed results they can produce. Wesfarmers had an enviable record for the first twenty or so years of its life as a public company after listing in 1984 but the period between 2007 and 2017 is best forgotten. In our view it paid too much at the wrong point in the cycle to expand into an unfamiliar industry. At one stage during the financial crisis, this threatened the very existence of the company, then it subjected shareholders to a decade of suboptimal returns. It is interesting to note Wesfarmers' share price performance since it started to "deconglom-erise" earlier this year by selling off large chunks and anouncing the demerger of Coles: its shares finished August at all-time highs.

Expanding offshore is the other alternative for growth. NZ is the most logical next step but, with a population about the same size as Queensland, doesn't make that much difference. And while one might think there are great cultural similarities between our countries, it is amazing how often Australian companies struggle in NZ. You really need to look to populous areas like Europe, Asia or the USA for meaningful expansion opportunities and, while there are a number of Australian companies who have done it well, there are probably more who have done it poorly.

But the trend offshore overall has been quite positive for the Australian share market. We point to companies like CSL, Macquarie Group, Computershare, Lendlease, Treasury Wine, James Hardie, Boral, Goodman Group, Aristocrat, QBE, Dominos, Amcor, BHP, Rio Tinto, Brambles and many more which have overcome the tyranny of distance to build or acquire large and in many cases successful businesses outside Australia. Diversifying away from the relatively small Australian economy gives our stock market, which is incorrectly perceived in some circles to be a one-trick (resource) pony, a degree of resillience. Importantly it also diversifies us away from the $A. Our free-floating dollar acts as an economnic shock absorber from external events and it is quite nice, when things are going poorly at home, to also have offshore operations whose earnings are increasing in value as the $A falls.

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Traveller's Tale

Hot on the heels of reporting season Andrew headed to Brisbane to take part in an unusual gathering, Xerocon. If Berkshire Hathaway's annual shareholder meeting is known as "Woodstock for Capitalists", Xerocon should probably be "Woodstock for Accountants" – that is if Woodstock had lasers and a nightclub DJ going at 8 in the morning. (For those below retirement age, the Woodstock reference is explained here).

Attending Xerocon was a serious research trip to learn more about Xero's fast growing cloud-based accounting platform, which has taken on a life of its own in small businesses in NZ, Australia and now the UK. In Australia they are in a battle with local incumbent MYOB and, in the UK, Sage. You only need to look at the share price trends of those two (down) versus Xero (up) to see that so far new technology is winning the battle. Intuit in the US has fought back successfully so far, helped by the fact that US small businesses have been very slow adopters of the cloud.

While Andrew did attend a number of meetings with the expected PowerPoint presentations about the product and growth plans, these were presented by management in tight black T-shirts trying to show they were anything other than accountants. But it wouldn't be a Xerocon without an intense fun factor as well. Have you ever seen 3500 or more suburban accountants letting their hair down? There was a range of speakers (he's learnt all there is to know about what is meaningful in life from the author "The subtle art of not giving a ****") as well as several different entertainment options. At one stage Andrew found himself in a swimming pool full of plastic balls and blow-up flamingos, placed there for people to jump into and rummage around. What does that have to do with accounting software? We're not entirely sure but it would only have added to the incredible loyalty to and advocacy of the product on the part of the attendees. Don't worry, there was a life guard on duty.

Xero started out in New Zealand but annoyed its kiwi shareholders enormously earlier this year when it changed its place of incorporation to Australia; now we claim it as our own. Just like we do Russell Crowe, sort of.

[We'd like to point out that Andrew is not an accountant. He was thought to have too much personality so studied to be an actuary instead. He obviously had too much for that as well as he ended up in equities funds management!]

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