Quarterly Comment – September 2018

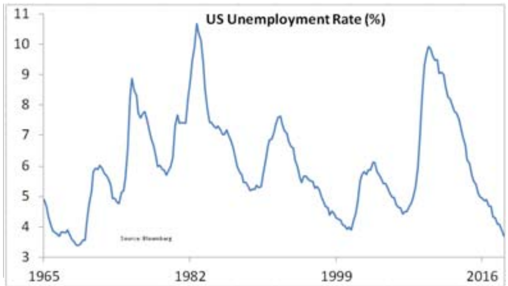
Alphinity Australian Equity Fund

Sprung

Market comment

The advent of Spring is generally associated with feelings of optimism and hope. The local market resisted those feelings in September, demonstrating a decidedly dour mood for much of the month. Notwithstanding that we'd had six consecutive months of rising share prices, and that the Trumpbo-charged US equity market was making still more all-time highs, our market (ASX300 including dividends) dipped 1.2% in September. This isn't a huge move, and it felt worse than it was, but it was still enough to take away much of the September Quarter's return. Including dividends, the Australian share market returned only 1.5% for the quarter. The weakening $A flattered global equity market returns but even so there was an unusually wide global variance, the best returns coming from Japan (+10%), Europe (Sweden and Switzerland both +10%, France +5%) and North America (US +8% and Canada +3%) while markets in some of the more troubled economies struggled (Turkey -21%, Argentina -7%, Greece -6%).

Our market could have been a lot worse considering some shock-horror stories in the media about impending doom in the domestic housing sector, the more tangible lift in trade tensions between global gorilla economies US and China, and even more uncertainty around whether and/or how Brexit will proceed. The powerhouse US economy however apparently remains resilient for the time being, with its rate of unemployment reaching new long-time lows: it reached 3.7% in September, the lowest level since the 1960s. The US Federal Reserve Bank (Fed) lifted short term interest rates a further 0.25% in September, to 2.25%. US ten year bond yields continue to move upwards, finishing the month above 3% and tracking even higher into October.



Commodity prices were mixed during the September quarter although those most important for Australia held up pretty well, especially given the soft $A. Prices of Iron Ore, Metallurgical Coal, Thermal Coal, Gas and Oil all rose over the quarter; base metals however were quite weak, particularly Lead, Nickel and Cobalt which were all off more than 10%. Despite the implication low unemployment has for US inflation Gold did not act as an inflation hedge, falling 5% in $US terms and 2.5% in $A.

Domestic economic news remains nervously positive despite the turmoil that has been going on at the political level. The Reserve Bank's cash rate remains at 1.5%, and appears to be stuck there for the foreseeable future. Household consumption, government expenditure and exports were all net contributors to economic growth in the most recent national accounts. Business Confidence remains positive but is softening and Consumer Confidence is neutral. Australia's unemployment rate remains reasonable at 5.3%, with good numbers of full-time jobs being generated in recent months.

The biggest domestic negative is the slump in the housing market, with low auction clearance rates in Sydney and Melbourne and increasing evidence of falling house prices. For the moment it appears to be a modest correction to a market that a year ago had been quite overheated, but should it become more entrenched there might be more cause for concern.

Portfolio comment

The portfolio provided a slightly lower-than-market return in the September quarter. The best returns came from global registry Computershare, Caterpillar dealer Seven Group and gas producers Beach Energy and Woodside Petroleum. Offsetting these however was the position in global gaming company Aristocrat, and being underweight or not owning global pallet renter Brambles, domestic incumbent telco Telstra or gas producer Origin Energy, all of which outperformed the market 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)	-1.4	1.1	16.8	12.8	8.7	12.5	11.4
S&P/ASX 300 Accumulation Index	-1.2	1.5	14.0	12.2	8.2	11.2	10.0

*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 august 2011, at which time Alphinity Investment management commenced managing the Fund and started the transitioning of the portfolio to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2011. Therefore, the inception date for the return for the fund is 1 September 2011. 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

Another month, another set of records for the US equity market. So what is there to worry about, aside from the fact that the Australian equity market has been struggling to keep up? Quite a few things, in our view. While an end to the run in the US market would be unlikely to be positive for global equities, a continuation of the run potentially also creates its own problems.

The driver behind the US market's strength has been its economy firing on all cylinders: this has been driving strong corporate earnings growth, and received further turbocharging from Trump's tax cuts earlier this year. The problem is that the rest of the world, especially emerging markets, are feeling the effect of the Fed raising interest rates to keep the US economy from overheating. So far only a few countries are looking particularly distressed, such as Turkey, Argentina and South Africa, but increasing funding costs and weakness in some commodity prices could end up being a problem for a broader group of countries, Australia included. To date the global economic slowdown has been fairly orderly (though investors exposed to emerging markets may disagree!) and economic growth rates are still largely positive, but the risks are rising and the trade war, even if it increasingly looks like it's targeted at China alone rather than traditional friends and foes alike, is not helping.

So is it time to go defensive, sell cyclicals, raise cash, buy consumer staples and secular growth companies? Maybe, but apart from the fact that this type of market timing is incredibly difficult to get right, the strength of the US economy and the prospects of higher US inflation as labour markets continue to tighten is typically associated with cyclical leadership of equity markets. Cyclical companies, and especially raw material producers, generally provide a good hedge against inflation until tighter monetary conditions curbs economic growth, and that tends to be the point at which investors favour earnings certainty.

The Australian Resource sector is also supported by strong balance sheets across the board after three years of strong cash generation and asset rationalisation. The problem with "secular growth" companies is that they already trade at record premiums after a decade of ultra-low interest rates. While it's never easy to pick the winners or even the general direction of the equity market, it does feel as if the risks are building. It's increasingly difficult to point to any particular part of the market that doesn't face increased uncertainty.

Asset allocation	30 Sept 2018 %	Range %
Securities	96.6	90-100
Cash	3.4	0-10

Portfolio Outlook

Following solid outperformance and absolute returns over the last year or so, the last couple of months have proved a little more challenging. The combination of a few owned stocks that disappointed in the August reporting season, a few previous losers (that we don't own) that have rebounded since June as investors try to anticipate the bottom in these stocks, together with the ongoing momentum in the burgeoning Australian Tech sector despite already lofty valuations, have proved difficult to offset despite our fair share of winners.

As we discuss in the Market Outlook, the market is currently struggling to work out which sectors and stocks will provide leadership in the months and year ahead. While we continue to monitor and form our own view on these issues, our main focus remains on identifying quality, attractively-valued companies in an earnings upgrade cycle. Of course, broader macro issues are always an important factor in providing headwinds and tailwinds for certain sectors and companies. However, over the years we have found that focusing on an individual company's earnings outlook has enabled us to identify the winners from both a company and a sector perspective.

So, where are we currently seeing earnings upgrades? The energy sector is clearly leading, boosted by the strong oil price and we continue to see room for consensus expectations, and thus share prices, to move higher. The Resources sector is a bit more mixed but the prices of bulk commodities, iron ore and coal, have been largely stable to rising, especially in $A. Typically it's proven correct to be overweight this sector when China stimulates its economy as is presently happening. While the stimulus is occurring because of the trade war and some indications of a slowing economy, we continue to see the sector as attractive, not the least when also considering the inflation outlook previously discussed.

Banks continue to look underwhelming to us, with the Royal Commission only adding to the broad-based slowdown in credit growth that was already underway. Individual stocks with unique earnings drivers are typically behind consistent outperformance, and Computershare, Macquarie Group, Goodman Group, Suncorp and Woodside Petroleum are some companies that presently display the characteristics we're looking for.

Top five active overweight positions as at 30 Sept 2018	Index weight	Active weight
Macquarie Group	2.3	2.3
Computershare	0.6	2.3
Goodman Group	1.0	1.9
Suncorp Group	1.1	1.6
Woodside Petroleum	2.1	1.6

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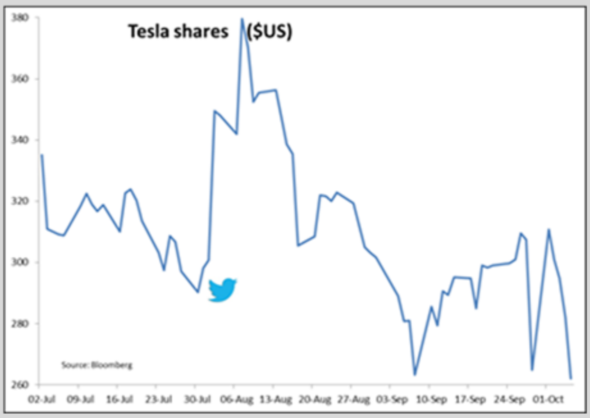
BTW

Elon Musk is a force of nature and, so he seemed to think recently, a law unto himself. Musk co-founded PayPal and reaped a small fortune when eBay bought it in 2002. He parlayed that into a large fortune by establishing several highly-innovative new businesses. His most famous is Tesla automobiles but he's also started SpaceX (right), brain engineering company Neuralink and even come up with a whole new mode of transport, Hyperloop (left), which proposed using vacuum tubes to move people vast distances at high speed. Tesla has been a disruptive player in the very traditional automobile manufacturing industry, however it can't be said to be a financial success as the company has not yet turned a profit. The market is expecting Tesla to become profitable in the 2019 financial year. (This picture, by the way, is of a musk-scented Elon Musk air freshener you can buy for your Tesla, or any other car really.)

Musk always seems to be convinced that Tesla shares are undervalued. In August, with the shares trading at a little over $US300, he tweeted "Am considering taking Tesla private at $420. Funding secured." The shares quickly shot upwards as buyers, who thought they had a hot stock tip from the horse's mouth, emerged and some with short positions in Tesla shares desperately tried to cover their positions. Later in the month Musk stepped back from the plan, and has since been subject to a US Securities and Exchange Commission (SEC) investigation, and is now facing several class action lawsuits, largely from hedge funds alleging stock manipulation. The shares also stepped back from their "manipulated" peak and are now trading below pre-tweet levels, as the chart below shows.



We don't have too much sympathy for the shorters: selling shares you don't own in the hope their prices will fall doesn't seem like a very constructive way of earning a living to us. We accept to some extent the short sellers' technical argument that their practice can contribute to market efficiency through providing liquidity and price discovery, however the potential that the practice has to facilitate unhelpful or even unethical behaviour seems quite problematic to us. We sometimes witness companies' managment take pleasure in "squeezing the shorts" when announcing a better-than-expected result or undertaking market-friendly activity such as capital management, which can cause people with short positions to scramble to buy them back and send the share price of the company sharply higher.

However we can also see the difficulty a statement like Musk's presents to regulators. While maybe there really was a genuine plans to privatise the company, there is also the chance that some manipulation might have been going on. Twitter was not the right forum to announce such a move, and concerns about not keeping the market properly informed was the trigger for the SEC investigation. Musk subsequently stepped back from the takeover, citing feedback from investors that they overwhelmingly wanted it to remain listed.

Whether that is genuinely the case is moot, but after a brief negotiation with the SEC Musk stepped down as Chairman of Tesla (retaining his position as CEO) and agreed to pay a $US20m personal fine. Tesla was also fined $US20m and had to agree to increased controls around governance and communications. The SEC implied the board should muzzle his Twitter activity but Elon didn't seem to get that message. We can't imagine the SEC would have taken very kindly to Musk provocatively referring to it in another tweet as the "Shortseller Enrichment Commission" only days after the settlement.

Tesla is now in an interesting situation. It is undeniably the leader in its space but has also had the electric vehicle market pretty much to itself for some years. It is making cars with prices so high that most people can't afford them, no matter how good or disruptive they are. While the company might soon turn profitable, our choice of electric vehicles will increase massively over the next few years as European, Japanese and Chinese manufacturers all join in, most likely at prices that appeal more to the masses. Perhaps Musk was wise to step back from taking over the rest of the company.

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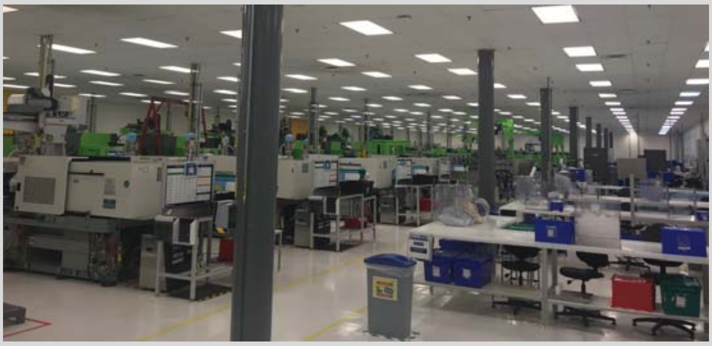
Traveller's Tale



Stuart went to the US and Mexico in September, to San Diego to see medical device company Fisher & Paykel Health and its Maquiladora in Tijuana (right). US companies have long been establishing manufacturing operations in Mexico, known as Maquiladora, attracted to the large pool of relatively cheap labour and its proximity to the home market. Tijuana has the largest concentration of medical device manufacturers in all of North America with more than 40 firms operating there, employing around 40,000 Mexican workers.

Maquiladora growth in Mexico accelerated in the 1990s following the implementation of the North American Free Trade Agreement (NAFTA). NAFTA created a sufficiently stable operating environment to allow for long term manufacturing investments and while Tijuana is already dotted with large manufacturing facilities, there are many cleared and levelled sites intended for new plants down the track. This was thrown into some doubt when one of President Trump's first actions in office was to issue an executive order to withdraw from NAFTA, followed by the implementation of tariffs on steel and aluminium. Not to mention the wall.

The Trump administration has since renegotiated the trade arrangements, which are now renamed the "US Mexico Canada Agreement". Apparently Trump liked that the acronym matched that of the United States Marine Corps, until they added the A for Agreement. A number of changes were made, largely relating to the auto and dairy sectors, but probably the most important change for Mexico was to Chapter 11. Chapter 11 provided protections for investors in Mexico or Canada should one of the NAFTA governments change the rules, and contributed to the stable investment environment. However these protections will be eliminated entirely for Canada and mostly for Mexico other than for some key industries such as energy (big oil obviously lobbies better than most) and telecoms (better to have Mexican than Chinese).

With increasingly erratic US policy decisions coming from the White House, losing Chapter 11 protections is proving somewhat concerning. After all, nervously watching Twitter for US policy gyrations is hardly conducive to making large, long term investment decisions. It is probably wise for some of those companies to be considering geographically diversifying their manufacturing exposures. We suspect many of the large vacant lots in Tijuana may look much the same a few years from now.

Alphinity Investment Management

Level 12, 179 Elizabeth Street
Sydney NSW 2000
T 02 9994 7200
W www.alphinity.com.au