alphinity INVESTMENT MANAGEMENT

Monthly Comment – October 2018
Alphinity Concentrated Australian Share Fund

A Red October

Market comment

October has a reputation in financial markets as a month in which things can go wrong in a big way. The Crashes of '29 and '87 both happened in October, as did a couple of "crashettes": 1997 (-14%) and 2008 (-10%) were particularly bruising periods. October '18 is not a month that will be remembered with any fondness but it wasn't even close to a crash, more a period of uncomfortable decline. In October 1929 the market came off by 26% and October 1987 was an absurd -42%; October 2018's fall was "only" 6% (ASX300 including dividends), making it the sharpest monthly fall since August 2015. We don't want to diminish this, it was a painful decline which pretty much robbed the market of its year-to-date gains, but in the context of several years of strong double-digit returns, it's not yet the end of the world.

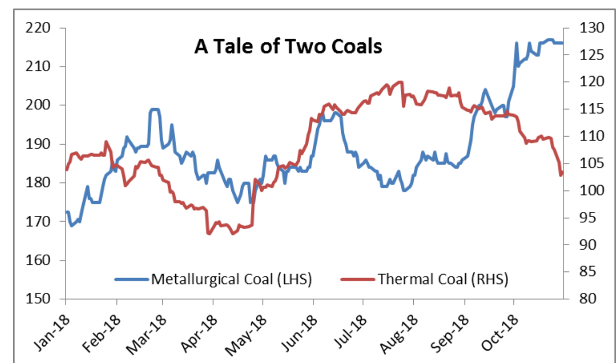
Global markets were mostly softer. The US market fell further than ours in $US terms, -7%, but the soft $A cushioned that fall to only 5% for Australian investors. The biggest losers were Mexico and Korea, both down 12-13% and Japan was close behind with a fall of almost 10%. Most European markets were also off about 7%. China continued its recent decline, also falling 7% as trade tensions built and the Twitter war continued. It was difficult to find anywhere that went up: Brazil was pretty much it with an incredible 11% gain for the month (22% in its own currency) thanks to its resource-heavy market and the finalisation of its long-running election hopefully providing a bit more certainty, albeit with a leader who might portend some interesting times ahead.

Resources were fairly resilient considering what was going on in the world, especially those most important to Australia. Bulk commodities – iron ore and metallurgical coal – held up quite well as they tend to be used for Chinese domestic demand rather than Chinese exports, and China's response to its own slowdown has been to ramp up domestic infrastructure spending which uses lots of those. Base metals were mostly softer and the price of energy fell sharply including thermal coal (-6%) and Oil (Tapis -5%).

The $A fell about 2% versus the $US during the month, finishing a little above the $US0.70 mark. This largely reflected $US strength as our dollar actually appreciated against some of our major trading partners including the Euro and the Korean Won. In economic news, short term interest rates remain at 1.5%, as they have been for ages now, after the release of soft inflation data. The level of unemployment has been a huge success story in recent years and it dropped to 5%, the lowest rate since 2012. Business and consumer confidence were both stuck around neutral levels, but showed tiny improvements on prior months. Credit growth however has become quite challenged, primarily impacted by property investors.

Portfolio comment

The portfolio underperformed the market's return in October. The best returns came from defensive names, mainly industrial property developer Goodman Group, registry and administration group Computershare. Not owning financial services company AMP helped as investor disquiet sent its shares down significantly after it sold its life business for what some investors thought was a very low price. More than offsetting these however were our holdings in mining services company Seven Group, Woodside Petroleum, UK bank Clydesdale and not owning either Commonwealth Bank or supermarket operator Woolworths, both of which outperformed in the falling market.



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)	-7.1	-7.6	5.1	10.7	8.1	11.8	10.3
S&P/ASX 200 Accumulation Index	-6.1	-5.9	2.9	8.2	6.0	9.2	8.2

*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 on 13 51 53 during Sydney business hours.

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Market outlook

Following the October correction, the Australian equity market is now trading at below-average long term valuation metrics. This should provide solid support from here. Of course, this is assuming that current earnings expectations are achieved. While there are plenty of global as well as domestic risk factors to consider, earnings in aggregate should still be able to grow in the low to middle single digits as the upside earnings potential for resource companies should largely offset risks to the downside from a weakening housing market and a tough operating environment for the banks.

The October selloff had some interesting features, as cyclically exposed stocks weakened on growth concerns at the same time as structural growth stocks gave up a meaningful amount of their valuation premiums as higher bond yields challenged long-duration valuations. Another characteristic of the market weakness was that it was most pronounced amongst small to mid-size companies. This is consistent with historical risk-off moves but also explained by the fact that this part of the equity market has seen the largest valuation premium build-up relative to history over the last few years.

China's ability to maintain solid economic growth in the face of US import tariffs will be an important factor for Australian resource companies. The Chinese government has announced a number of stimulus initiatives in recent months to offset the impact of potentially lower export growth. We would expect more to come should the trade tensions escalate further in the new year.

With most commodity prices holding up well, we see this part of the market as well supported in terms of earnings momentum as well as valuations. The balance sheet strength and strong cash flow of the sector, which we have previously highlighted, have been manifested by large capital management initiatives from the large bulk companies, BHP and Rio Tinto. This is a very different situation to previous cyclical peaks when over-investment in the boom years quickly resulted in balance sheet stress and, ultimately, reduced dividends.

To us, the most significant risk to the market remains the valuation premiums afforded to the growth sectors of the market. The probability of higher US bond yields continues to look high. While this part of the market has already corrected significantly, it remains vulnerable in this environment.

Top five active overweight positions as at 31 October 2018	Index weight	Active weight
BHP Billiton	6.6	3.6
Macquarie Group	2.4	3.6
CSL	5.4	3.3
Goodman Group	1.1	3.1
Suncorp Group	1.2	2.8

Portfolio Outlook

Mixed economic signals and investor sentiment continues to provide challenges for portfolio construction. With global growth slowing, rather than deteriorating rapidly, and higher bond yields likely to continue to put pressure on highly valued growth stocks, it is in our view difficult to become too pessimistic about global cyclicals such as the Resources and Energy stocks, especially those exposed to Chinese stimulus efforts.

Our Resources specialist, Stephane, is heading to China yet again this month to get first-hand information about how the economy in general, and the commodity-consuming infrastructure and property sectors in particular, are travelling. Recent visits from other Alphinity team members have painted a mixed picture for the Chinese consumer-exposed sectors but, similar to the global growth outlook, a moderate slowdown rather than anything more sinister appears to be the overall message.

The recent Bank reporting season turned out pretty much as expected. Slow credit growth, margin weakness and increased compliance and remediation costs all featured prominently on the negative side but, equally, pristine credit quality and solid capital generation means that dividends look safe for now. The attractive dividends yields offered by banks shares have provided some much-needed support for the sector recently. However, we think this will prove temporary and that investors, once dividend checks are in the mail, will again focus on the multiple factors challenging bank earnings growth which should remain well below long term trend growth.

We continue to see more evidence of solid premium growth in the insurance sector. An early full-year profit upgrade from Steadfast (one of our positions in the sector) was a highlight in October. Encouragingly, while Australia continues to lead in terms of premium increases, global insurance premiums also appear to be improving. Our position in QBE will benefit from this.

Given the more uncertain market outlook we have been looking for some defensive, high quality but reasonably-priced stocks with relative earnings upgrades to add to the portfolio to complement our more cyclical exposures. Two stocks that fit this bill are Coca Cola Amatil and ASX. Defensive, by definition, means they are not leading in terms of earnings growth in a strong economy but equally they both should be relatively immune to downside risks such as weaker consumer spending on the back of a slowing housing market.

Asset allocation	31 October 2018 %	Range %
Securities	97.6	85-100
Cash	2.4	0-15

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BTW

Months like October can leave you feeling a bit grumpy so we thought we might have a whinge about the media. You can blame the media for all sort of ills, and the charge of #FakeNews has become almost universal since it was introduced to the world during the last US presidential election (was it only two years ago??). But one aspect of the media that really annoys us is the reporting of financial news – in particular the complete lack of context often used in times of turmoil. This annoyance is exacerbated when the journalists really should know better, particularly those working for the premier financial publications of our country (you know who you are!).

There's nothing the media likes better than a shocking headline and this was reinforced during this month of rocky markets. While it might make people buy the paper or read the story, the content of the story often doesn't live up to the hype of the headline. And the nature of things in the current media milieu is that once it appears on the newspaper's website, it will be parroted on radio and TV news soon after. So when the market takes a hit of over 2%, as it did one day in October, the inevitable headline across print and electronic media was "$50 billion wiped off the value of shares!".

At one level this is correct, the aggregate value of the market had declined by almost $50 billion. But a bit of context would be helpful: when you consider that the total value of all Australian shares is around $2 trillion, $50 billion is not all that much. It would be like someone walking around with $200 in their pocket dropping $5 in the street: it would have been better if it hadn't happened but it's not the end of the world. But we guess that "Small decline in share market!" doesn't quite generate the same number of clicks. And of course you never see, when the market goes up by the same amount, a headline shouting "$50 billion added to the value of shares!".

A similar but subtly different comment is when you see something about "the biggest points decline in history". It is rarely a rise. An index point in and of itself is meaningless, what matters is the proportion that point represents of the index. So if the Dow Jones Industrial Average, for instance, is at 25,000 and falls by 2%, that's 500 points. If the index were 2000 and it fell by 500 points it would be 25%, a lot more news-worthy than 2% but, again, saying 2% doesn't have the shock factor. It's really just trying to make something significant out of something that's not.

Then there is the hyperbole. We often see quite modest moves described in florid language that makes you think the world is about to end. The currency is said to have

"plunged" when it is falls from say 72c to 71.5c after a piece of data might have been released. That is a long way from a plunge, it would be more correct to call it a modest decline of less than 1%. Currencies do sometimes plunge - Argentina's and Turkey's are current examples. But the reportage is rarely that insightful.

Another thing is the need to attribute a cause to something that happens. Sometimes the reason a share rises or falls is because of a tangible and obvious event, like an acquisition or a downgrade. At other times it is just the balance between buyers and sellers: if a large shareholder is intent on exiting a position and there aren't many buyers around the shares will go down a lot, but the only person who really knows this is the seller. The media however will often search for and attribute a spurious reason for such moves. We know this as we are often approached for comment and asked to confirm or come up with those spurious reasons!

Why does all this matter? We feel that shock/horror reporting scares people unnecessarily by focusing on the minutiae and ignoring the big picture. It makes people worry about the ups and downs and rather than focusing on what's really important for them. It's a bit like watching somebody walk up a hill while playing with a yo-yo. If you focus on the yo-yo you just see the rise and fall, but it you focus on the person you see that the yo-yo is actually going up overall. If you're checking your super balance every day and trying to time getting in and out of a company's shares or even a whole asset class on a daily or monthly basis, you will have a stressful life and risk potentially missing some big moves entirely.

We feel that media organisations' readers/viewers would be better served by a bit less hyperbole and a bit more balance in financial reporting, but we can't say we're particularly optimistic about that happening any time soon.

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Traveller's Tale

Managing equities portfolios is not all about the bright lights and big cities, sometimes it takes you to more obscure places as Johan found recently. The upside however was that he discovered a way of getting to London from Continental Europe that felt more like catching a flight in regional Australia.

He landed in Amsterdam after the usual 24 hours from Sydney, and after a quick shower at the airport and a meeting in Amsterdam he travelled on to Groningen, two hours north, for the second meeting of the day.

When planning his trip and investigating his options of getting from to London, where he needed to be the next day for a round of company research meetings, he'd discovered that budget airline Flybe flew from Groningen to London Southeast Airport. Despite not having heard of the airline or either airport, not to mention some less than positive feedback on Trip Advisor regarding the transport challenges of getting into central London from the destination airport, he optimistically booked his ticket.

He wasn't quite prepared for the size of the plane or the propellers with which it was fitted, but the weather was fine and, after just over an hour in the air, he landed at an even smaller airport than that from which he had departed. With only 20 or so passengers on the plane and no other arriving flights in sight the customs process was a breeze, much better than the usual schlep through Heathrow, and catching the train into London was no trouble at all. After a long day he arrived at his hotel happy in the knowledge that he'd not only saved a considerable amount of money and travel time but had also experienced something new. Sadly, one of the consequences of Brexit is that experiences like this will be much more difficult.

For further information, please contact:

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