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INVESTMENT MANAGEMENT

Quarterly Comment – December 2018
Alphinity Australian Share Fund

A Tale of Two Markets

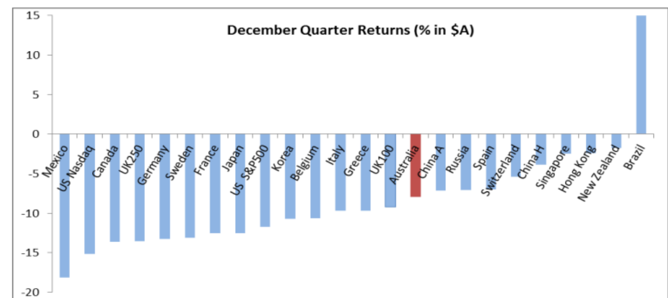
Market comment

"It was the best of times, it was the worst of times." So wrote Charles Dickens in his book A Tale of Two Cities. That was 160 years ago but he could have been talking about financial markets in 2018. Everything was going swimmingly up to the market's peak in August. We'd have been pretty happy to close off the year then and avoid the final third of the year – unfortunately that wasn't an option and we had to deal with the fairly nasty market as it evolved. And it wasn't just share markets: Deutsche Bank tracks 70 types of assets across stocks, bonds and commodities and 63 of them – 90% – fell in value in $US terms in 2018. Only one asset class fell in value in 2017.

2018 will probably not be remembered with much fondness in business or in politics: it seems everyone everywhere was feeling a bit fractious by the end of a tough year. The two cities Dickens was writing about were Paris in the French Revolution and London a few decades later: in December one of those was in flames. The Gilets Jaunes movement in France brought Paris to a standstill several times and caused the French President to back down on fuel tax increases, not before some serious damage to public infrastructure. In the other, the Brexit debacle stumbled along towards some sort of finality but not before the UK Prime Minister was challenged for leadership and forced to go back to Brussels cap-in-hand seeking more concessions the EU was never going to grant. Long-time German Chancellor, Angela Merkel, resigned from her party's leadership and announced that she would retire at the end of her current term. The US President's former lawyer was sent to jail amidst scurrilous allegations and furiously-tweeted refutations. US short term interest rates were once again raised, to the President's chagrin, and the year finished with many US government departments shut down for lack of agreement on funding. China reported its slowest economic growth rate in the modern era as US tariffs began to bite. A senior Chinese executive was arrested in Canada; soon after two Canadian execs were arrested in China in what could be a concerning trend. Japan's economy once again went backwards and even that generally reliable economic powerhouse, Switzerland, reported negative third quarter economic growth and a subdued outlook.

The outcome of all this was extreme volatility in most equity markets, particularly that of the US, in a period during which normally there is not much going on.

Australia by comparison was a relative haven of stability and sanity, even with all the end-of-year political positioning ahead of a 2019 federal election. Our share market, too, did a little better than most although it still followed them lower. The ASX300 (including dividends) was flat in December but fell 8% for the quarter, 3% for the whole of 2018. The quarter's 8% seems like a lot but ours was actually one of the better performing major markets even after the impact of a weak $A, which fell 9.5% against the $US for the calendar year. This inflated the US market's return; in $US terms it returned -9% for the month, -14% for the quarter and -5% for 2018. This was despite what should have been good news of continuing strong employment growth and a sharply falling oil price: oil was down 38% for the quarter. The growing evidence of political dysfunction outweighed that.



The price of Iron Ore was strong, rising 9% in the quarter, and Brazil's ore-oriented equity market performed very well as a result but it was the only one of note to keep its head above water. BTW on page 3 expands a little on market returns for the year.

To continue with Dickens: "…it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way – in short, the period was so far like the present period…". And today's present period.

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)	-0.9	-11.0	-3.0	6.0	5.2	10.2	8.2
S&P/ASX 300 Accumulation Index	-0.2	-8.4	-3.1	6.7	5.6	9.5	7.6

*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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Portfolio comment

The Fund underperformed the market in the December quarter but outperformed over the year. The best returns came from our holdings in logistics property developer Goodman Group and a higher-than-normal weighting to Cash; not owning gas company Origin Energy or building materials manufacturer Boral also helped. These positives were swamped however by poor performance by property developer Lendlease, mining services company Seven Group, UK bank Clydesdale, gas producer Beach Energy, building materials company James Hardie and not owning toll road operator Transurban.

Market outlook

There's a saying on Wall Street: "As January goes, so goes the year" and the statistics seem to agree. Statistics of course are all based on long term averages so not only is it too early to say how January will pan out, what it implies for the full year should not be relied upon either. What we have seen this early in the new year is that volatility and mixed economic data will likely be with us for some time. Not only has this been evident in the first few days of January, we've been seeing it for several months now. It also appears to be happening in the US where the weaker-than-expected purchasing manager survey suggested that the US is joining the slowdown that has been seen in much of the data coming from Europe and many of the Emerging Markets for some time. Equally however, another stronger-than-expected employment report and solid wage growth indicates that, as has been the case globally, things in the US are just slowing rather than collapsing.

Following the significant selloff that occurred in late 2018, most equity markets are now trading at or below their long term averages. Earnings expectations may still be too high, more so in the US than Australia, and there will no doubt be some companies caught out by the increasing cost of borrowing. For much of the last couple of years we were in an environment in which there have been many winners and few losers, although since about August it had switched around to being many losers and almost no winners. The situation in early January increasingly looks to us like a more normal equity environment with a more normal distribution of winners and losers. In other words, we expect an equity market in 2019 where wholesale selloffs, such as we've recently experienced, will be replaced by movements based on company-specific news flow. This is clearly not without its challenges, as growth is likely to remain on a slowing trajectory, but should be a lot more manageable than the last few months have been.

And while he was possibly only stating the obvious, the US Federal Reserve Chairman's recent comments that its policy is flexible and it is listening carefully to financial markets should be supportive, and may have acted as the catalyst to what would be a welcome change in market behaviour.

Portfolio Outlook

Now that 2018 is done, and after negative returns from the Australian equity market and, despite its outperformance, even the Fund, the question becomes: what does 2019 hold for us? Our reasoning above about the general market environment should support renewed outperformance in the coming year, presuming we are correct. We have reduced the overall risk to the portfolio of a worse global growth slowdown and are largely invested in companies which, in general, have below-market levels of gearing and thus should be less susceptible to increasing corporate credit costs. However, the Fund also remains exposed to a number of companies whose earnings trajectories we believe are being underestimated by the market.

In an environment in which growth will be more challenging to find, and with risk to that growth elevated by cyclical factors, we expect that investors will become more willing to reward companies which can even modestly outperform consensus expectations, and also be willing to pay more for earnings certainty. If this is the case quality companies, as defined by profitability and cashflow, should continue to do well. Consistent with this view we have recently increased our exposure to the Healthcare sector by adding slightly to our position in CSL and buying back into Resmed. Both companies score highly from the perspective of financial strength as well as potential to deliver better earnings than the market expects from a solid pipeline of recently-launched and future products.

Continued price strength of some commodities, our view that growth in China will, like global growth, moderate rather than collapse, and cheap valuation also justifies a continued overweight to the Bulk commodity sector, particularly BHP and Rio Tinto. Outperforming gold stocks have hurt the relative performance of the Fund since the market sell-off began in late August. The gold price, and share price of gold companies, have been supported by investors seeking a safe haven from the market downdraught. While acknowledging that the combination of a weak $A and higher $US gold price offers some earnings upside, we struggle with the gold sector from a valuation perspective. Outperformance of gold companies from here would, in our view, require further overall market declines. While this is something that cannot be ruled out, it does appear less likely following the savage December quarter selloff.

Asset allocation	30 Dec 2018 %	Range %
Securities	97.1	90-100
Cash	2.9	0-10

Top five active overweight positions as at 31 Dec 2018	Index weight	Active weight
Goodman Group	1.1	2.3
Macquarie Group	2.2	2.1
CSL	5.4	1.9
Computershare	0.6	1.8
BHP Group	6.5	1.6

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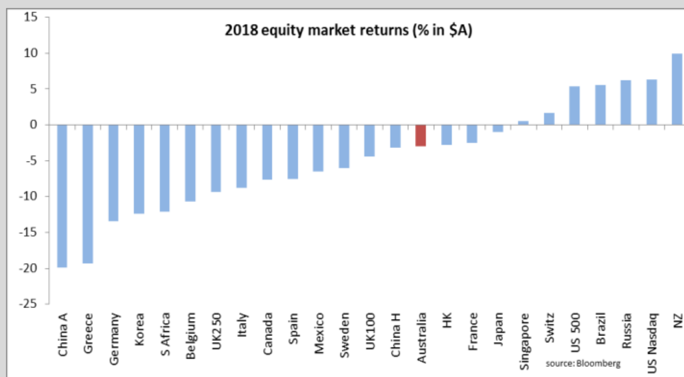
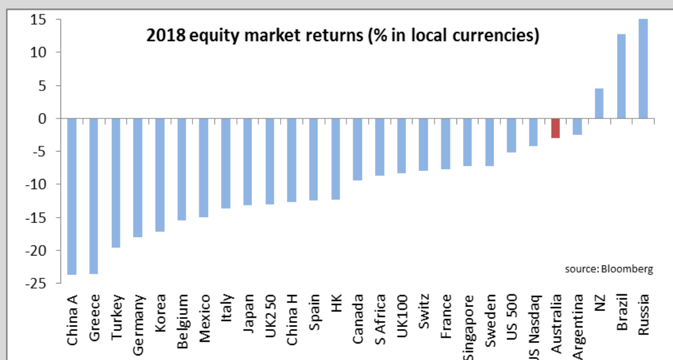
BTW

It was indeed a year of two markets. Ours rallied about 8% in the first eight months, paused in September then October felt like an air pocket, falling 6%. November was down another 2% and December ended flat although it was off 4% at its worst. The quarter was even more extreme in the US: October was -7%, it staged a small recovery in November but December was nasty: -15% up to Christmas Eve before a sharp recovery in the thin post-Christmas market limited the fall to 10%. Santa completely missed Christmas Eve and turned up on Boxing Day instead. It was apparently the worst December for US shares since 1946.

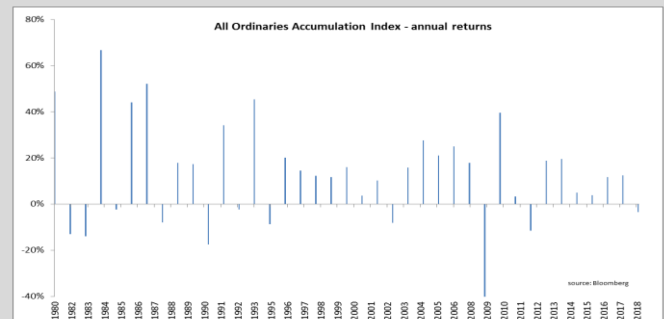
The chart below shows the range of outcomes for equity markets, including dividends, in various parts of the world for the year, translated into $A (we've left out the worst two, Argentina -47% and Turkey -36%, as they distort the chart too much).



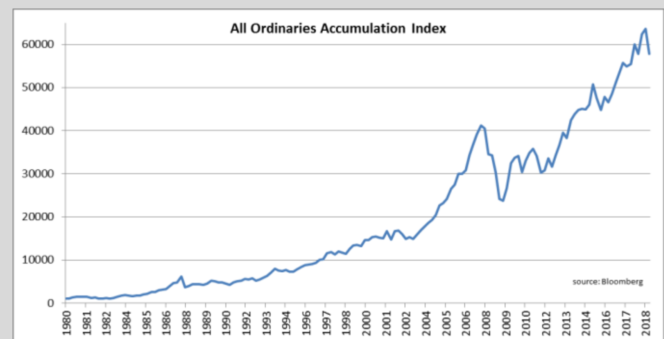
So the places to be invested in 2018 year were the US, Brazil, Russia and New Zealand. The US however was in the black entirely due to the $A which fell by about 10% during 2018, from $US0.78 at the start of the year to just over $US0.70. The $A was also down 12% against the Yen and about 5% against each of the Renmimbi, Euro, $NZ and even the Brexit-affected Pound. Putting market returns in their local currencies paints a slightly different picture (we've left Turkey and Argentina in this one, it demonstrates how much those countries' currencies depreciated) but the winners were largely the same.



In this context –3% for the year for Australian shares wasn't too bad. Negative returns happen from time to time, as the next chart shows, but thankfully not frequently. The All Ordinaries Accumulation Index, which has a longer history than our preferred ASX300, has sustained 11 negative years since it was established in 1980. Three of the negatives, including this year, were smaller than -5% and only once in 39 years has there been two consecutive negative years: they were 1981 and 1982. These were preceeded by a +49% in 1980 and followed by a +67% in 1983.



So having a down year is regrettable but it's not the end of the world. 2008's -40% did feel like the end of the world, although we didn't know then that it would be followed by a + 40% in 2009. Of course the maths is that falling 40% then rising 40% doesn't get you back to where you started, you'd still be 16% below the starting point. It took a few years for the market to fully recover from the 2008 experience – that didn't happen until 2013.



Each year has its own unique conditions and characteristics so we can't at this point predict with great confidence what 2019 will bring. The first days of January were decidedly weak with a profit warning by Apple and poor manufacturing data in both China and the US, although this was followed by very strong US employment data. With the Australian share market starting the year at a the lowest earnings multiple since 2006, there would need to be some pretty significant earnings disappointments ahead for the market to be lower again at the end of this year.

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Traveller's Tale

We have seen the future, and we like it. Bruce went to the central west of NSW to check out an asset owned by listed company, New Energy Solar. On a stunning late-spring day he drove four hours out of Sydney, across the Great Dividing Range to Manildra to see a newly-built solar farm. He met the land-owner and heard the story of the solar farm's development, which took about a decade from conception to commissioning.

Solar power generation has been booming in recent years although most has been on the roofs of houses. Large-scale commercial operations like this have been difficult to make stack up financially considering the high capital cost and lack of regulatory certainty at the federal level. This however has now been largely solved by the falling cost of solar panels. When this farm was first proposed in 2008 it was estimated that it would cost around $400 million dollars, and would have required huge subsidies to be viable. By the time it was actually built the total cost had come down to a bit over $100 million and only a relatively small subsidy was required. This is very different to what normally happens with construction projects, i.e. the cost goes up over time. The key difference was the enormous fall in the price of panels over the period.

The end result is a huge paddock covered with solar panels that adjust position to follow the sun during the day. In this sun-rich part of the world, it reliably pumps out 56MW of electricity in daylight hours, a little less when there's cloud cover. For context, even a small coal-fired power station like Collie in WA produces around 300MW so you do need a lot more solar projects, but a bit of geographic diversity is a good thing as it provides greater resilience to the network.

Manildra is a great location for solar: there's lots of sunshine, good local demand for power with two power-hungry flour and canola mills nearby, and the national electricity grid runs right past the boundary so getting power into the network is relatively easy. This is not the case for some renewable energy projects.

The impact on neighbours is minimal: there is no mining required to fuel it so no truck movements, no noise, no smoke or any other types of emissions, and hardly any people movements either as only one or two people are needed on-site to deal with any physical issues that might arise. In fact most aspects of the farm can be remote-controlled from Sydney. The panels just sit there quietly with just the occasional "whirr" as they reorient themselves during the day. And the loss of productive land is minimal: once the vegetation grows back fully the paddock can again be used to graze sheep. The only issue becomes providing power when the sun isn't shining. There's an enormous amount of research going on around the world to develop cost-effective storage so surely it's just a matter of time before technology reaches the point at which this can be achieved.

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