Monthly Comment – February 2019

Alphinity Concentrated Australian Share Fund

Racing ahead

Market comment

The recovery from the December quarter slump continued in February with the Australian share market (ASX300 including dividends) rising an impressive 6% and your Fund doing even better than that. Combined with January's strong returns the market is now back within a whisker of its most recent peak in August 2018, as this five-year chart shows.

The December quarter rout was at least in part caused by the US Federal Reserve Bank (Fed) raising rates and tightening liquidity, combined with a burgeoning trade war between the US and China and a few other externalities like the ongoing slow-motion train wreck that is Brexit. The recovery, likewise, was sparked by the Fed recanting on its tightening views and spurred on by the trade war (possibly) dissipating, although this is a day to day proposition.

Global equity markets all did pretty well in $A terms, with Brazil the only significant market to fall. Chinese shares bolted, rising close to 17% as signs of a trade war break-through built. Australia's 6% was matched by the US, UK and France but beat pretty much everywhere else. The $A continued its month-to-month see-saw, this time falling by 2.5% back to $US0.71. Energy prices rose quite sharply with most types of oil up almost 10%; bulk commodities like Iron Ore and Metallurgical Coal rose by 3 - 5% but Thermal Coal, used for electricity generation, fell slightly after (unconfirmed) stories about Australian coal being turned away from a Chinese port. Base metals were all quite firm, most rising mid-single digits although Copper, widely seen as a precursor of global economic activity, was up close to 10% in $A.

February of course is Reporting Season, a time during which any company with a June or December balance date informs shareholders details of its financial and operational performance for the prior six months. With hundreds of companies reporting in the space of about three weeks it represents a torrent of information and, occasionally, insight. After going through many accounts and meeting with many management teams we test the investment theses of companies we own and review companies we don't own to see if we should, and this reporting season worked well for the Fund's portfolio. We generally use the wash-up of reporting season to adjust positions in the portfolio taking into account what we learned: in some cases exiting positions which have become stretched or whose outlooks are deteriorating, in other cases buying into or building on existing positions that have even better prospects than we'd previously assumed.

Sectoral returns, as usually is the case, were mixed. The only really poor sector was Consumer Staples, which fell a couple of percent, as the three largest companies in that sector announced disappointing earnings. The Banks sector was the best performing, followed by Energy, Resource and Tech stocks. Can this rate of returns be maintained? Certainly not, 10% is as much as you might reasonably expect in a year let alone two months, but to the extent that it is partially a recovery from last year's poor returns it doesn't necessarily mean the next move will be back down.

Portfolio comment

The Fund outperformed even the very strong market nicely in February with the best contributions coming from mining services company Seven Group, big bank ANZ, global asset manager Macquarie Group, insurance broker Steadfast and from not owning supermarket operator Woolworths which underperformed for the month. The only noticeable negatives were from our holding in health care company CSL which lagged the strong market on regulatory concerns despite reporting a reasonable result, and not owning big bank Westpac.

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)	6.8	11.3	6.6	14.1	9.1	12.2	10.7
S&P/ASX 200 Accumulation Index	6.0	9.9	7.1	12.9	7.3	10.0	8.8

* Returns are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.
^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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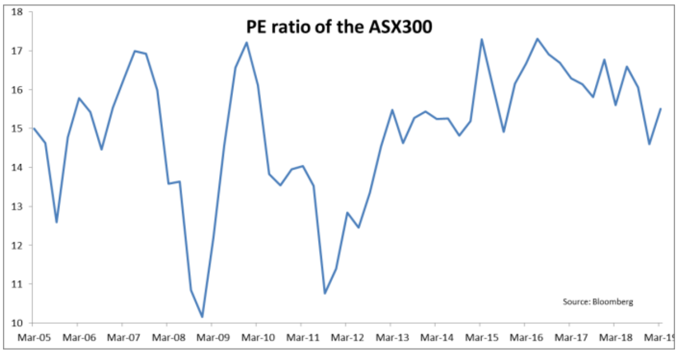
Market outlook

As welcome as the sharp market rebound in January and February has been, it has also brought with it some familiar challenges, the main one being the valuation premium being paid for earnings growth. While the fall in bond yields and softening rhetoric from the US Fed, not to mention our own Reserve Bank, regarding the direction of short term interest rates should be most supportive for long duration stocks, the re-rating our market has experienced has been significant. Many stocks, especially those in the burgeoning Australian technology sector, have gone on to new record levels. And even though the search for growth by investors is understandable given a weakening domestic economic outlook led by the cooling housing market and its flow-on effect to consumer spending, it does make that highly-valued part of the market vulnerable to any renewed sell-off in bond markets or increase in credit spreads.

The other main concern is a deteriorating earnings outlook for domestic stocks in general. The just-concluded reporting season has shown that, in addition to companies impacted at the topline by the housing downturn, many suffered margin pressure from higher input costs such as raw materials and energy. Even though the downward revision to aggregate full-year earnings growth expectations was modest at less than one percentage point (which in the context of only 3-4% expected overall earnings growth is not insignificant) this was primarily due to solid results in the Resource sector. Together with further commodity strength, not the least for the heavyweight bulk commodity companies, this resulted in mid to high single digit positive earnings revisions for the Resource sector.

The current strength in commodity prices, together with legitimate valuation discounts in Banks and Building Materials companies due to heightened earnings risk, has left the market trading at around its long term Price/ Earnings ratio average. Using longer-term valuation metrics the Resource sector is now however also starting to look more fairly valued.



In summary, we can't find too many arguments to support a great deal further equity market appreciation in the short term. Having said that, when you consider the uncertainty in the property market, the lowest bond yields the country has ever seen and low interest rates in general, the prospects of the alternatives don't look much better. Perhaps we should not underestimate the power of TINA: maybe compared to equities **T**here **I**s **N**o **A**lternative.

Portfolio Outlook

The Fund's strong performance during the February reporting season gives us further confidence in the positioning of the portfolio. While reporting periods will always bring some positive and some unexpected negative outcomes we were generally very pleased with both share price reactions and earnings forecast changes during the month. This should put the portfolio in good stead in coming months as our experience is that companies delivering well received earnings announcements typically benefit from the same earnings drivers also in coming periods.

Importantly, the portfolio remains well diversified and is, in our view, not overly reliant on any particular sector outlook as the outperformance year to date has been almost entirely driven by stock selection rather than by being in the right sectors. Of course, we need to continue to keep monitoring valuation parameters and reviewing what we believe is factored into the share prices of individual portfolio positions.

Some portfolio changes are inevitable after such a deluge of new information, some large individual share price movements and the strength of the overall market in general. We will be reporting on some of these movements in coming months.

Asset allocation	28 Feb 2019 %	Range %
Securities	98.0	90-100
Cash	2.0	0-10

Top five active overweight positions as at 28 Feb 2019	Index weight %	Active weight
Macquarie Group	2.5	4.3
CSL	5.3	4.1
ANZ Banking Group	4.9	3.4
Goodman Group	1.3	2.8
Mirvac Group	0.6	2.5

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BTW

One of the features of the current global economic milieu is the demand for luxury goods. This can be attributed to a couple of factors: rising wealth generally and the bouyant Asian – especially Chinese – consumer.

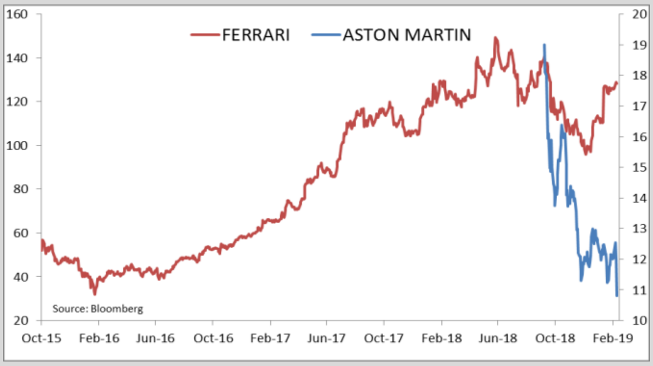
While living standards around the world have generally been rising and levels of poverty have reduced significantly in the past decade, there has been a disproportionate increase in wealth in the top tier of demographics in most countries thanks to strongly-performing asset markets in the wake of the financial crisis a decade ago. Booming share markets and rising property values in most parts of the world have been helped by the massive injection of liquidity in following years to stave off economic sclerosis. It is probably fair to suggest that asset markets have become so adicted to the drug of easy monetary policy such that even modest actions to clamp down on access to that easy money has resulted in withdrawal symptoms. You just need to look at the US equity market's behaviour in the final quarter of 2018 to see how sensitive it has become to taking money out of the system, and how much relief was demonstrated when the Fed backed down. And where the US share market goes, so the rest of the world tends to follow.

Luxury goods manufacturers have been experiencing boom conditions for some years as a result of the factors mentioned above. One only needs to wander a block from Alphinity's Sydney office to see people lined up outside the Gucci shop – cordoned off and patiently waiting to be admitted by the security guard when space opens up by other customers departing. Gucci's parent company, Kering, has been a strong performer in an otherwise largely challenged French share market in recent years, and its peer Louis Vuitton Moey Hennesy has been an astounding performer over a long period of time: the combination of expensive handbags, expensive champagne and expensive cognac is compelling.

Italo-American car market Fiat Chrysler worked this out a few years ago when it listed its Ferrari division in 2015. With the rather tacky ticker of RACE it provided the opportunity for a bunch of over-wealthy fast car fanciers to get financial exposure to the success of that brand without also having to be exposed to the far more plebian Dodges or Fiats. It seems to have worked: Ferrari is now capitalised at $US24 billion, a multiple of about 30 times earnings, which is pretty impressive for what in reality is still a heavy industrial manufacturing company. Its former parent, by contrast, which makes close to 5 million cars and trucks a year, is worth only $22 billion and is on a multiple of 4 times earnings.

Aston Martin's private equity owners saw this success and followed suit. Aston Martin is a brand steeped in British automotive history and probably most famous for its 50+ year association with the incrediby successful James Bond movie franchise. It has changed ownership a number of times over the years but was bought by Ford in the late 1980s. Ford owned it for close to 20 years and spent an enormous amount on development and factories but ended up selling it for about $US1 billion in the tough times of 2007.

Aston Martin Lagonda Limited (AML) listed on the London Stock Exchange in October last year at £19, a price that implied a valuation for the whole company of about $US6 billion. Its listed history since then looks more Johnny English than James Bond: fair to say it hasn't been a great experience for investors. While admittedly the markets were undergoing a fairly tough period at the time of listing, AML shares are trading a lot below the IPO price and have completely missed out on the bounce in markets so far this year.



The IPO price implied a multiple of around 20 times future earnings which, on the face of it, might have appeared reasonable relative to Ferrari. Ferrari however has been highly profitable for many years and is expected to build on that in the future; AML's record under private ownership was very mixed. The market's earnings expectations for AML have been going lower since November and have trended down ever since. It is now trading at only 13 times 2020 earnings. So is this a chance to pick up some cheap supercar shares? As always, caveat emptor. Just as with buying cheap supercars, you probably need to be either very brave or very inexperienced.

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Traveller's Tale

Jeff, one of our Global Equity PMs, went to Florida during the month to attend a big consumer company conference and came back with lots of stories about marijuana. Not from his own experiences obviously, he's far too clean living for that, it was about what North American companies are up to in the space.

A number of US states have legalised marijuana in recent years, the most prominent being California and Colorado. The official situation is complex however as the drug remains illegal at the federal level so there are significant restrictions around what companies can do with it. Across the border though, Canada legalised cannabis in 2018 and a whole industry has since flourished, with much value generated in its share market as a result. There is also a flourishing cannabis sector listed in Australia, centred around Tasmania where opium poppies have been grown for many years, although most of the companies are tiny and the regulatory regime here is more complex.

Cannabis is increasingly being seen in the US as an alternative to alcohol to provide people with a "buzz" with (arguably) fewer negative health or social impacts. US beverage company Constellation Brands, which mostly makes beer, wine and spirits, bought into US-listed Canadian marijuana company Canopy Growth last year. It spent $US4 billion to take a 38% stake in what is still an early-stage company that makes hundreds of millions of dollars of losses a year, but which Constellation must believe has the potential to justify that level of valuation in the future.

Canopy Growth made a most interesting presentation to the conference. Cannabis apparently is not a product just for stoners and those suffering from difficult-to-treat medical conditions. Its view is that the addition of various types of cannabis derivatives across a large number of consumer products will become a significant disruptive force. These will include athletic drinks, animal health, anxiety, treatment of Post-Traumatic Stress Disorder, pain relief, sleep, health & wellness and alcohol. Canopy Growth estimates – conservatively in its view – that the global opportunity for cannabis could be in excess of $US500bn.

The company is also building an intellectual base for the medicinal application of cannabis products with 15 human trials and four animal trials currently underway in Canada, chiefly in the area of anxiety and sleep disorders. Canopy has so far registered 32 patents and has a further 140 pending, in areas including cannabis-based beverages, medical treatments, device & delivery technologies, processing and plant genetics.

So far Constellation has been fairly vague about its longer-term plans for its investment in Canopy Growth but maybe one day we'll see a marijuana-infused Corona beer on the market. Regardless of what happens to Constellation, in the longer term cannabis has the potential to have a big impact on many existing consumer companies so it is something we will be watching closely.

For further information, please contact:

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