Quarterly Comment – March 2019

Alphinity Australian Equity Fund

Pausing for Breath

Market comment

After such strength in the first two months of 2019, it wasn't a great surprise that March saw the overall market stop for bit of a breather. The ASX300 (including dividends) moved only fractionally higher in March but, when combined with the two strong months leading in, the ~10% upward move for the quarter represented a very healthy start to the year. Over the quarter the best sectors to be exposed to were an unusual combination of IT and Materials (primarily Resource stocks); the worst were Consumer Staples (mainly the supermarkets which disappointed in reporting season) and Financials. Both sectors still put in positive performances but fell well short of the overall market.

Compared to offshore markets the ASX300 performed pretty well, increasing by 11%. We didn't do as well as China – a big relief rally there on hopes of a resolution to the trade war with the US sent its shares up an incredible 26% although over the year to March it returned just under 1%. NASDAQ in the US, with its large exposure to technology stocks, was the next best, up 16%, and the resource-heavy Canadian market rose 14.6%. Most European markets made solid gains of between 6 and 11% while the US S&P500 made 12.8%. Japanese shares returned a meagre 7% but plucky little New Zealand made an impressive 12.5%. The UK market was surprisingly resilient at +11% despite the living nightmare that Brexit has become for Britons. This can largely be explained by the make-up of its index: a large proportion of the FTSE100 constituents are global

companies which happen to be domiciled in the UK. Oil exposures Royal Dutch Shell and BP; drug companies AstraZeneca and GlaxoSmithKline, consumer companies Unilever, Diageo, Reckitt Benckiser; British American Tobacco; resource companies like Glencore and the dual listed pair BHP Group and Rio Tinto: this handful of companies makes up about half the FTSE100 but only a modest portion of their collective revenues come from the UK itself. March 29 was supposed to be Brexit date but it was pushed into April at the last moment: even so any ructions in the domestic economy when it finally does occur may have less impact on the UK equity market than one might have expected.

Commodity prices were relatively strong in the March quarter. Oil rose sharply, 25-30% depending on the type, and Iron Ore was up 15%, driven by renewed confidence in the Chinese economy after some indications of easing trade tensions between it and the USA. Metallurgical Coal, used in steel-making, was up 2% but the price of Thermal Coal, which is used for power generation, fell by 10%. Industrial metals Copper, Zinc, Nickel and Tin were also up sharply but precious metals Gold and Silver were largely unchanged.

Portfolio comment

The Fund outperformed the market nicely in the March quarter thanks to exposures in a range of sectors, demonstrating the potential of a portfolio of companies in an earnings upgrade cycle. The best returns came from positions in a diverse list of companies including global industrial property specialists Goodman Group, gas explorer Beach Energy, global diversified resource company Rio Tinto, domestic waste company Cleanaway Waste Management and global asset manager Macquarie Group. All of these companies exhibited positive earnings surprise during reporting season and had consensus upgrades as a result, which drove their share prices to new heights. There were no holdings which detracted by a significant amount in 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)	0.7	12.1	11.6	11.7	7.2	10.7	10.5
S&P/ASX 300 Accumulation Index	0.7	10.9	11.7	11.4	7.4	9.8	9.6

*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 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

The Australian equity market is currently dominated by two distinct earnings trends: upgrades for Resource companies and downgrades for pretty much everything else. These trends have been in place for some time – the beleaguered Bank sector is now in its fourth year of having earnings expectations gradually but consistently scaled back.

The Resource sector upgrade cycle started about three years ago and many of those companies are currently in a virtuous circle of growing earnings at a faster rate than expected by the market and generating strong cashflows in the process which strengthens their balance sheets. In past cycles this trend has typically ended with over-investment followed by falling commodity prices, but so far in the current cycle companies have shown unusual expansionary restraint, instead focusing on returning cash to shareholders. With China's economy showing clear signs of improvement on the back of yet another stimulus program which will further tighten the global iron ore market, this situation looks as if it will last for some time. While the Resource sector on longer-term metrics is now closer to fair value, a strong short- to medium-term earnings outlook should be supportive.

On the other hand the Australian Bank sector is in a vicious cycle in which earnings growth has stalled for several well-known reasons: low credit growth, increased compliance costs and, since the Royal Commission, sharply rising remediation costs. Dividends have so far been resilient but increased capital requirements, particularly in New Zealand, have added further pressure. At this point only ANZ has reduced the share of its earnings that is returned to shareholders in dividends but some other banks are at risk of having to do the same. It will be interesting to see if recent senior management changes will be the catalyst for this to occur in the upcoming bank reporting season. Some of this has probably already been priced in to some individual securities but it highlights the risk of buying stocks purely with a yield focus.

The cooling housing market and the building construction downturn that is well underway means that while most domestically-exposed building materials companies appear cheap, they are also likely to continue to struggle due to continued earnings risks. Even though some are also exposed to the east coast infrastructure boom, signs of actual earnings leverage has so far been absent. Many consumer stocks will also feel the impact of the flow on effects from the negative housing wealth effect.

Other than in Healthcare and the smallish Technology sector, which are both enjoying solid growth rates, further market advances this year may need to rely on continued commodity price strength and multiple expansion in the rest of the market. This is not an impossible scenario given the collapse in long-term interest rates and the potential for lower short-term rates, but is a less solid scenario than one driven by broad based earnings growth.

Portfolio Outlook

We remain comfortable with the portfolio's positioning, which reflects a combination of exposure to Resource companies which are set to benefit from China stimulus, particularly iron ore, as well as some more defensive portfolio holdings. We own all three iron ore majors: BHP, Rio Tinto and Fortescue. These companies represent much of what we look for in our investments: a series of earnings upgrades with significant potential for more, strong quality attributes such as free cashflow and profitability, and solid valuation upside remaining even after their recent strong performance.

We acknowledge that this sector is cyclical and that we therefore need to be mindful of any signs of a turn in the cycle, but equally we know that there are always risks that need to be managed in any sector or company. We continue to like mining services companies Seven Group and Monadelphous as well, as another way to benefit from increased activity levels across the Resource sector. In contrast, we have further increased our underweight to the Bank sector during the quarter, also for reasons discussed earlier.

While generally pleased with the portfolio's performance in the first quarter of the year, and especially during reporting season in February, we have made some changes. These reflect in part lower bond yields due to slowing economic growth and lower inflation expectations, and part improving company-specific factors. We have recently added logistics facilitator Brambles to the portfolio. This company's earnings has disappointed the market for some years despite underlying structural growth in the usage of pooled pallets, with margin declines in its US business primarily due to ongoing cost issues. These cost factors now appear to have peaked at the same time as the company, for the first time in at least a decade, has been able to achieve some meaningful price increases.

We have also reinvested in Sydney Airport. We had sold out of this company on two concerns: that its traffic growth was normalising and that its changing tax status wasn't adequately reflected in consensus estimates of its future dividends. Together with the more realistic expectations, in our view, which are now assumed by the market (and, it should be acknowledged, a fall in bond yields that has surprised us) we feel that the company's prospects have improved such that we are happy to regain exposure to this company with strong prospects.

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Traveller's Tale

Stephane went to China in March, one of his regular trips to scope out what is going on in commodity markets. On this trip he also learned a fair bit about China's idea of the future of mobility when he met with the China Association of Automobile Manufacturers. China has heavily promoted the development and adoption of Electric Vehicles (EVs) through subsidies and regulation, but it is still unclear whether EVs really are cleaner than internal combustion vehicles when you take into account their entire-life value chain: mining the cobalt, nickel and lithium; the assembly of the battery; how the electricity is generated (whether coal, gas or renewables); and what happens to the battery at the end of its life.

China set a target of having 2 million EVs in operation by 2020, but he was most interested to learn that it is now shifting its attention towards hydrogen Fuel Cell Vehicles (FCVs). These use electric motors too but it is the source of the electricity that makes it different. Fuel cells are little power plants inside the car which generate electricity through an electrochemical reaction between hydrogen and oxygen from the air. The process doesn't involve high temperatures and is pollution-free: the only emission is water. Hydrogen can be stored in large quantities, can be distributed through pipelines and tanker trucks, but the big advantage over batteries is quick refuelling, as we've become accustomed to with petrol.

China's vision is to realise energy security by having its vehicles powered by multiple energy sources and with zero emissions, to improve local urban air quality and address climate change. It has set the target of having at least 50,000 FCVs on the road by 2025 and 1 million by 2030, and to reach zero emissions by 2050 through the use of FCVs and EVs. Hydrogen is the most abundant element on the planet. A major constituent of water, the process of separating it from the oxygen takes a lot of energy, and this energy can come from fossil fuels or renewable sources.

China is focused on using renewables. In addition to providing low carbon emission transportation and energy security, it believes that the development of FCVs will enhance China's technical innovation, global competitiveness and the sustainable development of its car industry. There are currently 12 hydrogen refuelling stations (below) and around 150 FCVs operating across China.

China is in a race with Taiwan, Japan and South Korea to make this technology mainstream. But Australia might also have a part to play by coming up with technology to more easily produce hydrogen. Last year our CSIRO and Australian iron ore company (and current Fund holding) Fortescue Metals announced that they were jointly working to commercialise the extraction of hydrogen from ammonia using a chemical catalyst and membranes. Ammonia itself often comes from processing natural gas which would still make it a fossil fuel, but the CSIRO is also working using solar energy to produce hydrogen.

There is still a lot of H_20 to go under the bridge, including a large amount of safety testing, before we're all driving cars powered by hydrogen but it is encouraging to see so much activity going with the aim of creating a better, hopefully cleaner future.

Top five active overweight positions as at 31 Mar 2019	Index weight %	Active weight
Macquarie Group	2.4	2.5
Goodman Group	1.3	2.0
CSL	5.2	1.8
Computershare	0.5	1.5
APA Group	0.7	1.5

Asset allocation	31 Mar 2019 %	Range %
Securities	93.7	90-100
Cash	4.9	0-10

BTW

The large amount of liquidity that has been sloshing around the world's financial system since the Global Financial Crisis a decade ago has contributed to a boom in the prices of many assets: stocks, bonds, property, precious metals and collectables like stamps, art and classic cars. Cheap, almost free, debt has driven the price of many of these items to very high levels. Now it seems that even pigeons have joined the boom.

We were startled by the news reported by the BBC during the month that Armando, a five-year-old prize-winning Belgian racing pigeon, had been sold to a Chinese pigeon fancier for the sum of €1.25 million. That's about $A2 million. For a pigeon. It wasn't just any pigeon though, the auction house that sold him, Pipa (or Pigeon Paradise), described him as the best Belgian long-distance pigeon of all time – a huge claim in a country famous for its pigeons.

He's also been described as the Lewis Hamilton of pigeons, after the Formula 1 driver. Armando won his last three races: the Ace Pigeon championship, the Pigeon Olympiad and France's illustrious Angoulême. Pipa's CEO said "In our wildest dreams, we had never hoped for a price like that. We hoped for around €400,000 to €500,000, and we only dreamed of €600,000." The price was pushed up by a bidding war between two pigeon fanciers from China. The previous record price for a pigeon was a paltry €376,000 (~$A600,000) although apparently a common racing pigeon typically sells for closer to €2,500. €2,500 still seems like a lot for a member of a species often described as a rat with wings and notorious for soiling public statues all around the world.

The new owner plans to put Armando out to stud, and a well-cared for pigeon can live as long as 20 years. Being five years old his racing days are now largely behind him but, in any case, his new owner would be unlikely to let such a valuable property roam free: he would most likely end up flying back to Belgium. If Armando has the stamina and his new owner can get the genetics right, maybe in a few years China will be the next region famed for its long-distance racing pigeons.

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