Monthly Comment – May 2019
Alphinity Australian Share Fund

Miracle in May

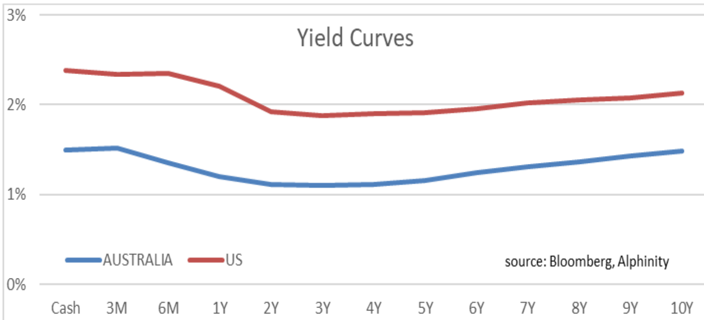
Market comment

Election day came and went and we were as surprised as anyone at the result. Even newly reelected Prime Minister Morrison couldn't believe it, describing the result as a miracle. How could the polls have been so wrong? How could a government which had so recently demonstrated such division and dysfunction prevail over an opposition with stable leadership and a big policy agenda? Labor did indeed have some courageous policies, a little too courageous it turned out.

Global politics didn't get any better. UK Prime Minister May survived May but becomes only a caretaker in June, with the search underway for a replacement amongst a rather spotty group of alternatives. The trade war between the US and China escalated somewhat with the meeting that was supposed to take place between the two Presidents in June looking doubtful. While a breakthrough to resolve many of the issues could take place at a tweet, the longer it goes on the greater the risk there is to global economic growth. At the same time the European economies seem to be weakening again and Italy is again at risk of a multi-billion Euro fine from the EU for violating deficit restrictions, although levying a fine would just seem to make the deficit situation worse. Australia, even with all its issues, still looks like a safe haven of stability and common sense.

There weren't many equity markets able to report positive returns in May, in $A or in local currencies, and those that did had a bit of a resource flavor (Australia, Brazil and Russia). Our own +1.8% return represented the fifth consecutive positive month this year and was a new all-time high when dividends are included. We compared well with China (-6%), the US (-5%), most of Europe (-4 to -6%) and the UK (-4%). Japan's share market lost 3% in $A but that was helped by a strong Yen, and New Zealand just scraped into positive territory. Why did Australia do so relatively well? There was no single factor: iron ore prices certainly helped; the unexpected Coalition victory maybe removed a few risks in areas such as tax and industrial relations; the likelihood of lower interest rates was positive too.

Our share market outperformed despite the $A which snuck below the US70c mark that has effectively been its floor for the last decade and a half. It was not helped by the Reserve Bank of Australia: it virtually promised an interest rate cut during the month which it delivered at the start of June, cutting the cash rate by 0.25% to 1.25%, the lowest rate we've ever had. The yield of ten year Australian Government bonds also finished the month at levels we have never before seen, a touch under 1.5%. At the end of May the whole Australian yield curve was well below that of the US, an unusual event.



Commodity prices were quite soft but the most important one, Iron Ore, held up quite well: stockpiles of ore in China were low and supply continued to be disrupted, largely as a result of Brazil's woes. The price of Iron Ore rose 14% in $A terms but pretty much every other commodity was lower. Energy prices were particularly soft, with the different types of Oil down between 10% and 15% in the month.

Portfolio comment

The Fund lagged the market in May, with a few positions which had recently performed well taking a step back. These included global asset manager Macquarie Group, global insurer QBE Insurance, global wine company Treasury Wine Estates, gas producer Santos and global administrator Computershare. Against that, positions in iron ore miner Fortescue Metals and health insurer Medibank Private added value, as did not owning steel maker Bluescope Steel.

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)	1.3	4.3	7.9	11.0	7.4	12.2	9.7
S&P/ASX 300 Accumulation Index	1.7	5.0	10.9	10.6	7.8	11.3	9.0

*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 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

Australia really does seem to be the lucky country. With our market having rebounded for most of the year, along with global markets, Australia defied the downdraught from the escalating US-China trade war that hit most international bourses in May. The sharp share price rises in Banks, Consumer Discretionary, Building Materials and other sectors leveraged to the domestic economy that took place in the aftermath of the election suggests investors' outlook for these sectors has improved markedly following the vote.

While we tend to agree with the positive sentiment, we do harbour some doubts as to whether the current rally will be particularly durable. After more than a year of pretty much one-way negative news flow for the housing market, within the space of a few weeks we have seen adverse changes to negative gearing taken off the agenda, the banking regulator reducing the required interest rate buffer for borrowers and now, at the start of June, a rate cut by the Reserve Bank. All are clearly helpful for a residential property market that was, at least anecdotally, already showing signs of stabilising.

Some positive re-rating, especially of the Banks, is therefore understandable. However we feel it is unlikely to be enough to significantly change the earnings trajectory of most sectors and stocks. Banks will in fact have negative earnings pressure from lower interest rates as margins get further compressed. While some of the more extreme downside scenarios now look less likely, the overall domestic economy will probably not re-accelerate much as a result. We don't want to be too negative: the continuation of recent years' trend of muddling through with modest GDP growth is certainly not a bad outcome. Having said that, high levels of household debt and only modest disposable income growth remain key challenges for any marked improvement.

In addition, the US-China trade war is becoming increasingly unpredictable. As we have learned, a breakthrough or a breakdown can happen overnight but it's quite possible that much of the valuable trust and goodwill between the warring parties has already been lost, and that the underlying incompatibility between both countries' ambitions is becoming increasingly clear. Given these circumstances, our market should at least have reason to pause for breath while waiting for either a resolution to the trade dispute, or more visibility that the improved sentiment is also supporting better earnings growth.

Top five active overweight positions as at 31 May 2019	Index weight %	Active weight
Santos Limited	0.7	1.6
CSL Limited	5.3	1.6
Goodman Group	1.2	1.5
APA Group	0.7	1.5
Computershare Limited	0.5	1.5

Portfolio Outlook

The collapse in bond yields since late 2018 and the steady rise in the premium paid for so-called growth stocks, epitomised by tech companies, continues to provide challenges for fundamental investors. Many are now calling for better days ahead for value stocks (i.e. companies with low Price/Earnings ratios). While it's hard to argue that many growth stocks are not looking stretched on almost any valuation metric, the same could have been said (and was said) six months ago or 12 months ago or even 24 months ago. The question is therefore not so much "will it happen?" as when or what will cause it to happen.

We don't have an answer to the "when" but would argue that the answer to "what" would be a meaningful shift in the macro economic outlook, either to the upside or downside. If economic growth were to accelerate, stocks that are trading on low valuation multiples due to investor nervousness about their earnings outlook should benefit from both better earnings and a multiple uplift. If it were a worsening economic outlook, it is likely that most of the damage will be done to expensive stocks with too optimistic earnings forecasts, even if their earnings still hold up better than their more cyclical counterparts that are already factoring in a fair amount of bad news.

However, if the economy continues on its current trajectory of slower but not recessionary growth, which in our view is the most likely, then it's difficult to see an overall shift in market dynamics. Alphinity's investment process is all about investing in stocks that we believe can deliver earnings growth above market expectations while making sure that we don't overpay for that earnings profile. We are happy to invest in either growth or value companies as long as their earnings are underestimated by the market, and this has proved effective in most market environments. Should we see a shift towards domestic cyclical companies or other value stocks having better earnings prospects we will gladly buy those companies. We're just not sure we are there yet.

In the current environment our main exposure to the cyclical part of the market remains in Resource companies. The sector continues to enjoy strong earnings upgrades as we have written about in previous reports. Valuations also remain attractive in the main. In other words, this is a sector that offers both positive earnings revisions potential and value. Opportunities in other parts of the market are more stock-specific but we continue to see earnings upside in companies we own such as Medibank Private, CSL, insurance broker Steadfast and mining services company Seven Group Holdings.

Asset allocation	31 May 2019 %	Range %
Securities	96.5	90-100
Cash	3.5	0-10

BTW

There's been a lot of talk about disruptors in recent years: companies that come into an estabished (usually highly profitable) market with a radically different offer that undercuts established players – sometimes on price, sometimes on service – and essentially pulls the rug out from under them. The established players are upset about this and complain loudly in an attempt to win sympathy and support from the public and/or or regulatory redress from the government and stop, or at least delay, the interloper.

Online retailing is a great example of this: who can forget the scenes in 2011 of retailing billionaires like Gerry Harvey and Solomon Lew trying to lead public rallies bemoaning the disadvantage at which they were being placed by international clothing retailers like Asos or electronics suppliers through eBay who were using the then-high $A (remember the days of parity with the $US?) and lack of GST being charged on international purchases? Strangely enough, the public didn't seem to mind buying products more cheaply than Gerry or Solly were willing or able to provide. It ended up taking years for GST to be imposed on international online sales, and a currency correction for local retailers to regain a degree of competitiveness, by which time the horse had bolted.

Another example is Uber. Taxi services have long been a sinecure in many countries, and Australia was no exception. The economic rent able to be captured by a taxi owner was significant, to the extent that a taxi plate became a traded commodity worth hundreds of thousands of dollars at times. People would buy plates, even for their super funds, then rent the licence for a hefty fee to the actual drivers, who were often impoverished and struggling to make a living after paying all their costs, despite the high fares imposed. The taxi industry was a protected species until Uber came along with its superior technology, better service, cleaner vehicles and, at least for a while, cheaper prices.

Uber first operated here on the edges of the law, much to the chagrin of taxi operators, but it eventually gained legal status and the government (at least in NSW) implemented a $1 surcharge on all taxi and Uber rides to compensate the owners of taxi plates, the values of which fell sharply when their monopoly finished. Uber was a force for lower transportation prices but some drivers who signed up with them feel that Uber might in fact be more of an enemy than a friend, as a casual discussion with an Uber driver might reveal. The Travellers Tale over the page gives an example of the outcome of such platform dominance.

Despite the prospect of taxi plate owners receiving a bit of money from the levy, Uber is still facing a class action from 6000 taxi and car hire owners in Australia. The lead plaintiff in the case recalled the day he realised his business was gone: he apparently waited for an hour for a fare one rainy Friday night after a game at the Melbourne Cricket Ground – something that is a little hard to believe – while Ubers were coming and going around him. When a passenger finally got into his cab she admitted "I would have got an Uber but my phone's gone flat."!

Anyway, Uber has now announced the launch of flying taxis, and Melbourne is supposed to be one of the first cities in which you can catch one (Los Angeles and Dallas in the USA are the others). Uber has apparently joined with Melbourne Airport, Telstra, Macquarie Group and shopping centre owner Scentre Group for this service, which could be under testing in 2020 and operating commercially in 2023.

Its unique vehicles seek to combine the best aspects of fixed wing aircraft and helicopters. We can't wait to be able to replace the sometimes hour-long schlep in a taxi (or Uber) from the CBD to the airport with the smooth, traffic-less hum of an electric air taxi.

But would Uber be a disrupter in this case? There is no established air taxi industry to attack, as far as we know, so maybe it just represents another nail in the coffin for the taxi industry, and disruption to Uber itself. We're yet to see its pricing though: if Uber's most recent effort at air transport is anything to go by we'll be on the roads for many years to come. During Melbourne Cup last year Uber offered a helicopter ride service from the CBD to Flemington Racecourse for which it charged $1000 one way, and Tullamarine is a lot further from the CBD than Flemington. It would need to be enormously lower than this in order to attract enough passengers to make Uber Air commercially viable.

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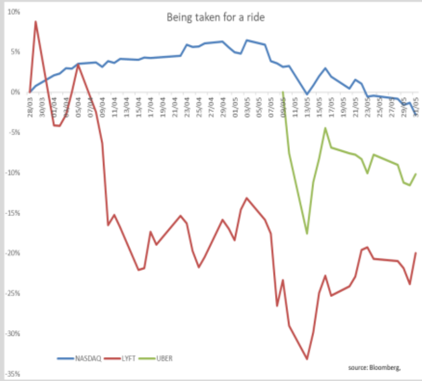
Traveller's Tale

Bruce travelled to the US in May to do some more research into developments in the consumer space, particularly the interplay between wine and cannabis. Probably the best thing about being overseas was that he missed the last week and a half of Australia's fairly tedious election campaign, arriving home the day before voting took place.

Election fatigue is a familiar concept in the US: that poor country seems to be in a perpetual election cycle and even then, still 18 months before the next Presidential vote is due, candidate jockeying has already been taking place for quite some time. California voted strongly against Trump in 2016, and there is obviously still a bit of resentment towards him, as evidenced by the bumper sticker below. This car's Napa Valley owner (and quite a few others) just want The Donald gone!

While in San Francisco he witnessed Uber drivers noisily striking outside the company's head office. They were upset about Uber's decision to arbitrarily cut the proportion of the fare that goes to them. It's not the first time their pay had been cut in this way and confirmed the fears of some such gig-economy workers that they are merely fodder in the ambitions of cool technology platforms. The protest took place only two days before Uber listed on the stock market.



Ridesharing peer Lyft listed in March and hasn't set any market records yet: at the end of May it was trading 20% below its issue price, worse even than the tech-focused NASDAQ index which was down only 3% over the same period. Uber hit the boards/screens in May and has so far shown a similar, albeit slightly less negative, trend in its listed life, lagging NASDAQ by about 6%. Both are making multi-billion dollar annual losses and neither is forecast to make a profit for many years, but the share prices are implying Lyft and Uber are worth around $US20 billion and $70 billion respectively.

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