Quarterly Comment – June 2019

Alphinity Australian Share Fund

Winter Wonderland

Market comment

As the weather turned chilly here, relations between the leaders of the two most important economies in the world, US and China, also grew increasingly frosty. This sparked a hasty revision of the game-plans of global monetary authorities, pivoting back to an easing stance. This was particularly noticeable at the US Federal Reserve Bank (Fed), which had been an inflation hawk and was raising interest rates as recently as late 2018. The Fed seems now to have turned quite dovish and, according to those supposedly in the know, could drop short term US interest rates imminently.

The irony is that the move to dovishness probably implies a full-blown trade war which would not be a great outcome for corporate earnings and therefore company valuations. However the prospect for lower rates set the US market alight, helping the S&P500 to finish the quarter at new all-time highs. The month closed out with the G20 meeting in Japan, and a degree of rapprochement seemed to be in the air.

Our market (ASX300 including dividends) rose for the sixth consecutive month, lifting 8% for the quarter and an astounding 19.8% over the first six months of 2019, leaving the ASX300 Accumulation Index at another all-time high. Of course the six months before that was poor: July to December 2018 saw our market fall by 8%, but even so equity returns for the financial year to June were an appealing 12%. As usual, there was a wide range of outcomes for other countries' markets, from -14% (Turkey) to +27.5% (Switzerland). Australia shaped up well in a global context.

The $A trended down for the quarter, meandering between $US0.69 and 0.72 and finishing a fraction above $US0.70 despite the lowering of official cash rates during the month to a new record low 1.25%. The $A is now ~5% below its level of June 2018.

There was a fairly constant progression of profit warnings from companies in a number of industries during the quarter, especially those exposed to the domestic consumer, and while the share market reaction to many of these was quite savage, our portfolios traversed this tricky environment largely unscathed. Most commodity prices fell, the exception being those related to steel-making. Metallurgical Coal held its value, unlike its counterpart used for electricity generation which fell 23% over the quarter, but the big winner was Iron Ore, which jumped almost 40% over the quarter. This was a result of a combination of factors: Chinese stimulus boosting demand for steel, falling Chinese Ore stockpiles, and supply disruptions due to weather in Australia and the ongoing fallout from the terrible tailings dam collapse in Brazil earlier in the year.

Other commodities were mostly soft: Oil fell slightly but Gas was down 12%, Aluminium was down 5%, Copper down 7%, and Zinc -14%. Gold was a rare bright spot, rising 10%.

Portfolio comment

The Fund performed strongly in June and outperformed even the very strong market over the quarter. The companies which contributed most to performance were iron ore miner Fortescue Metals, health insurer Medibank Private and pipeline company APA Group; not owning diversified miner South32, shopping centre operator Scentre Group and energy company AGL was also positive. On the opposite side of the ledger global asset manager Macquarie Group, security app Life 360 and global insurer QBE all detracted, as did not owning gold miner Newcrest. With the market up so much, our modest holding of cash was another headwind to performance.

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)	4.7	8.4	9.1	13.7	8.8	12.6	10.2
S&P/ASX 300 Accumulation Index	3.6	8.0	11.4	12.9	8.9	11.8	9.4

*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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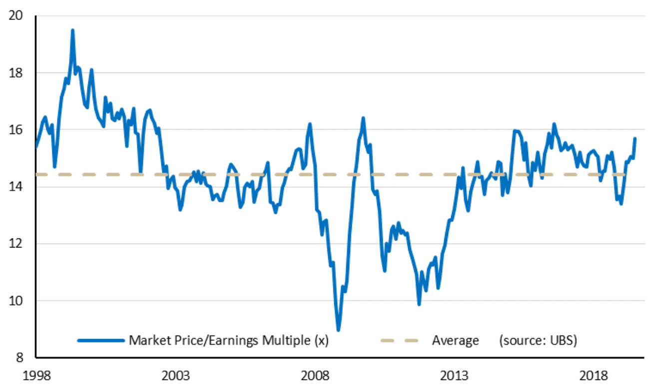
Market outlook

Bad news is sometimes good news. Global equity markets continued to move higher despite economic growth and corporate earnings growth continuing to slow. While one might argue that the markets are being forward-looking and focusing on the potential boost to economic growth from easing monetary conditions around the world, that is probably too optimistic an interpretation. Instead, it is more likely that ultra-low interest rates have renewed investors' search for yield and further reduced the discount rates they are applying to long-duration equities.

That is not an illogical reaction, but it is one that is difficult to be fully comfortable with given the lack of support from an earnings growth perspective, and also one that is subject to future investor sentiment shifts in the interest rate outlook. Perversely, if the current environment were to apply, a breakthrough in the US-China trade war, which would be undeniably positive for global economic growth, might actually have a negative impact on financial markets as it would make future interest rate cuts viewed as less likely.

At close to 16 times earnings for the year to June 2020 the Australian equity market is now trading well above long term averages, as the chart below shows. With short- and long-term interest rates at record lows at the same time as earnings expectations continue to be pared back, the Australian market is fairly typical of equity markets around the world. Other than for some Resource companies, whose earnings expectations still appear too low, additional gains in our equity market probably continue to rely on further multiple expansion driven by money flows and investor sentiment. These are factors that are inherently difficult to predict, and we are not comfortable relying on them.



Top five active overweight positions as at 30 June 2019	Index weight %	Active weight %
CSL Limited	5.4	1.8
Santos Limited	0.7	1.8
Goodman Group	1.3	1.6
APA Group	0.7	1.5
QBE Insurance Group Limited	0.9	1.4

Portfolio Outlook

A market environment in which much depends on the outlook for, or investor sentiment towards, interest rates is never one that is entirely comfortable for stock-pickers like ourselves. However, we have generally found that our focus on companies that can deliver earnings growth ahead of market expectations is effective in most market environments and has delivered solid outperformance in the long term. 2019 has been no exception, with strong absolute and relative performance year to date, including the month of June.

While the contributors to the Fund's performance has been well diversified, it is largely explained by strong stock selection in Resource (particularly Fortescue Mining and Rio Tinto) and Real Estate (Goodman Group and Mirvac) companies. These have benefited from favourable tailwinds in the form of Iron Ore prices and interest rates respectively, but each has also outperformed its peers for stock-specific reasons. In the case of Fortescue it has been the sharp improvement in the ore price it has been able to achieve; for Goodman and Mirvac it has been strong execution of their respective industrial and office property strategies that has been the key differentiator.

In the current environment in which negative earnings news has been far more prevalent than positive news, it has also been important to avoid the long list of companies making profit warnings. We've counted more than 50 company announcements in the last couple of months where earnings expectations have been trimmed. While the reasons have been quite varied, a weak Australian consumer and cooling construction market has been blamed by many. Of the companies downgrading, the Fund's only exposure was to cautious comments by Wesfarmers relating to its Kmart and Target discount department store businesses. Other than Wesfarmers, the Fund's exposure to the Australian consumer is limited.

We remain comfortable with our overall portfolio exposures although we have trimmed positions in some of the stocks mentioned above following strong performance. In fact, we have increased conviction in our key energy exposures Santos and Beach Petroleum. This conviction is not so much based around a particularly strong view of the oil price as we are neutral regarding that sector. Rather, we see production and resource upside for both companies primarily from their assets in the Cooper Basin.

Asset allocation	30 June 2019 %	Range %
Securities	95.8	90-100
Cash	4.2	0-10

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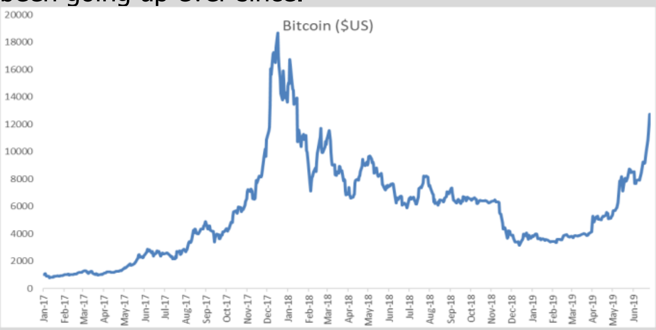
BTW

We've written a bit about cybercurrencies over the years, in particular noting the vicissitudes of the most famous, Bitcoin. Bitcoin came close to hitting $US20,000 per coin in late 2017 before falling below $4000 early this year. On the first of April it took off and at the end of June was trading above $10,000 again. The initial spike on April 1 was probably caused by an April Fools joke claiming that Bitcoin had received a form of official approval from the US Securities and Exchange Commission (SEC), days after the SEC expressly ruled that out. Ironically, if the story had been true the writer might have been liable for charges of market manipulation, but as it is the SEC doesn't regulate Bitcoin. In any case, for whatever reason Bitcoin has been going up ever since.



Now Facebook is trying to get into the act. It announced in June that it was setting up its own cyber currency, Libra, to add to the panoply of coins already available. This one has differences however: it has the imprimatur of one of the most powerful companies on the planet, and it will be backed by Real Money.

There are a few things wrong here: for a start the name Libra is already used in many markets for a product that would probably not sit well with the etymological sensitivities of many Americans. After all, if one's culture feels compelled to refer to toilet paper as "bathroom tissue", we're not sure they'd be too happy associating feminine hygiene products with their cyber currency. We prefer the name someone suggested, Zuckerbucks, after Facebook founder Mark Zuckerberg.

Then there's the issue of being sponsored by Facebook and backed by actual currencies. Until now the whole point of a cybercurrency has been that it is not owned by anyone or anything, it "belongs" to the users. The cybercurrency movement is deeply suspicious of governments and companies: Bitcoin was conceived to allow those in the know to avoid what they perceived to be rapidly-debasing fiat currencies in the aftermath of the Financial Crisis a decade ago, when governments around the world were pumping out vast amounts of liquidity in order to stave off financial armageddon.

So what is the Facebook proposal? It will sponsor a consortium of major companies, which so far includes names like Mastercard, Visa, Spotify, Lyft, Uber and Ebay, to join with it and promote Libra coins. The aim is to have Facebook's 2.2 billion users and customers of other consortium members use Libra for transactions or value transfers. It will still use Blockchain to administer coin transfers but Libra is unlikely to experience Bitcoin's wild price fluctuations as standing behind it will be the (supposedly) non-profit Libra Association based in trustworthy Switzerland which will back the coins with reserves in various major currencies and securities. Unlike Bitcoin, the number of Libra on issue will not be limited, it will expand as much as there is demand.

What could go wrong with this? If it stays at cottage industry level like all the other cryptos out there, nothing: Libra would just join them in irrelevance. But if Libra really takes off, and there must be a decent chance of that happening considering the might of its backers, Libra could prove a threat to central banks around the world. Libra users would have the ability to completely bypass their country's domestic banking system and therefore its central bank.

This might be a positive in some cases: a very large number of people in developing nations currently don't have access to basic banking services so Libra might – just as Paypal does in some markets – become a means of financial inclusion. It might also facilitate the transfer of value between people in different countries vastly more cheaply than the banking system currently allows and with less uncertainty than Bitcoin, which is expensive and slow to transact and can swing in value by 10% or more each day.

However the banking system is also a highly important piece of the efforts to fight money laundering and terrorism financing, so a widely-accepted and stable currency that exists outside that system would certainly work against that. And it isn't too much of a leap to foresee loans also being made outside the banking system, which would lead to the diminution of the power of a country's central bank to set interest rates and control liquidity conditions. So we'll keep a close eye on Libra, as no doubt will banks and central banks everywhere.

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Traveller's Tale

Andrew, as part of his coverage of banks and insurance companies, did a quick round-the-world trip in June meeting with a large number of companies and finance industry contacts and attending a large financials conference in Paris. We suppose if you have to sit through days of bank and insurance company meetings you may as well do it in a nice part of the world!

Paris was the centre of a lot of major events that week. There was the French Open tennis, won by our own Ash Barty and some Spanish dude; the opening game of the Women's Football World Cup; not to forget a few of the ongoing 'yellow vest' protest marches. But possibly the biggest of them all was the Paris leg of the BTS tour. If you haven't heard of BTS, also known as K-Pop mega boy band the Bangtan Boys, you probably don't have an early teenager. You could still get a ticket to the final of the French Open but there was no chance of finding one for the BTS concert, they are huge! Formed in 2013, the band took its name from the Korean expression Bangtan Sonyeondan, which apparently roughly translates to "bulletproof boy scouts".

So how big is BTS? After releasing its 'Map of the Soul: Persona' album in 2019 it became the first band since the Beatles to have three consecutive number one albums in the US. That's big. Korean firm Hyundai Research estimated that the band alone was worth US$3.67bn to the Korean economy in 2018. It reckons 7.5% of foreign visitors to South Korea are due solely to BTS.

K-Pop might conjure images of cheesy carefully manufactured bubble gum pop, but BTS isn't just seven pretty faces, they are also socially conscious. Their 'Love Myself' campaign and related fund raising advocating against violence to children and teenagers saw them address the UN General Assembly in 2018. BTS was even named in Time's 100 most influential people list for 2019. Perhaps even more important, BTS now holds the Guinness World Record for the highest number of Twitter engagements (an engagement occurs when a tweet recipient responds in some way, i.e. replies to it or re-tweets it. BTS recently had accumulated 422,000 engagements; the prior record holder was Harry Stiles, who we all know from One Direction, with barely a quarter of that). So, yes, these guys are big.

Despite his best efforts to get a ticket Andrew sadly missed out on seeing BTS when he was in Paris, it might have made all the meetings covering bank capital adequacy a little more bearable. Although for financials sector analysts, a briefing from a member of the Basel Committee on Banking Supervision is about as close to a BTS concert as you can get.

For further information, please contact:
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