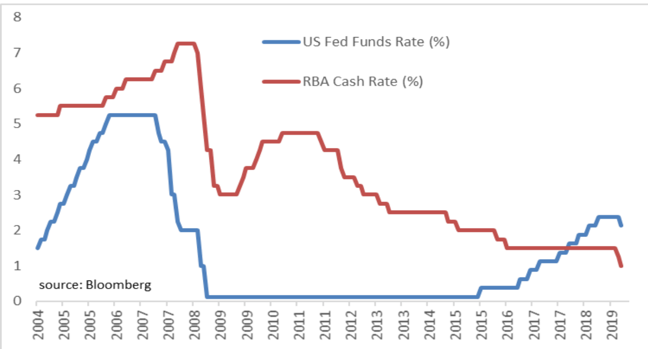
Monthly Comment – July 2019
Alphinity Australian Share Fund

Bonds and Boris

Market comment

Markets marched higher for another month, July's 2.5% rise being the seventh consecutive monthly increase this year. The Australian market is now 23.4% higher than the level at which it started the year, and this Fund has outperformed even that. Many other markets around the world also rallied as their bond yields fell to the lowest levels in history. Australian short term interest rates were lowered again in July to 1%, three year bonds are now yielding well under 1% and ten year bonds only a little over 1%. These moves challenge the paradigms under which markets have been operating for decades and combine to make equities, which offer dividend yields several times those levels, look reasonably cheap even despite recent rises. The $A continued its grind lower, finishing July about $US0.685.

The month finished with the first cut in US short-term interest rates in more than a decade. Yes, hard as it is to believe, the last time US lowered rates was in 2008 in the aftermath of the Global Financial Crisis. As the chart shows they stayed at zero until tightening started at the end of 2015, from where they progressively rose to 2.5% late last year, before the US President started agitating for cuts. The US Federal Reserve Bank (Fed) finally gave in to White House pressure and begrudgingly cut by 0.25%, although it also warned markets against expecting too many more to come. With the US economy generally appearing to still be in moderately good health despite the trade stuff going on, it was a curious move for the Fed to make and possibly speaks more about one loud and powerful voice than economic considerations.



Not many equity markets went up much in July. Australia, US and New Zealand all rose a few percent while Asian and European markets were generally flat to down a couple. Year to date has been good for shares generally, with most Western markets up in the mid-teen to mid-20% range and Asian markets up a little less. Korea is the only market we follow that has fallen year to date, it is -2%.

UK stocks fell, hampered by its currency in the wake of political developments in that country. There was a certain air of inevitability about Boris Johnson ascending to the highest elected position in the UK. Having achieved that long-held ambition he now faces the task of actually implementing the messy situation he was instrumental in instigating in 2016, Brexit, and only has a slender majority in Parliament to work with. He now has just three months to negotiate with his own colleagues and/or the EU to get the separation achieved on terms which are acceptable to both. Trying to unscramble the European egg is a social experiment we are glad we don't have to live through. While it may end up being the right thing for Britain in the long term, the short and medium terms could be very messy indeed.

Commodity prices were, as always, mixed. The improvers of note were Nickel +17%, Steel +16%, and Iron Ore +6%, while going the other way were Metallurgical Coal at -8%, Tin -6% and Zinc -2%. Precious metals were firm in $A terms, with Silver up 8%, Platinum up 6% and Gold rising 3%.

Portfolio comment

The Fund underperformed the market a little in July, although it still delivered a decent positive absolute return. The companies which contributed most to performance were wine producer Treasury Wine Estates and gas producer Woodside Petroleum, while those that detracted were mineral sands producer Iluka Resources and companies we didn't own such as infant formula exposure A2 Milk and gold company Newcrest Mining.

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)	2.4	8.7	9.9	12.2	8.4	12.3	10.3
S&P/ASX 300 Accumulation Index	3.0	8.6	13.2	11.6	8.6	11.6	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 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

Another month, another record low for Australian interest rates and a record high for the Australian equity market. Global financial markets continue to be driven by central bank policy and the odd Trump tweet. During the month both the Reserve Bank of Australia and the US Fed cut rates as expected, citing weaker economic growth. Thus far, investors have been comfortable to continue to pay more for equities despite a deteriorating earnings outlook.

We think this has more to do with the lack of alternatives in other asset classes than traditional equity investors gaining confidence in the market outlook. The recently concluded US second quarter reporting season saw earnings expectations for the current year pared back even further, to the point that only 2-3% growth is now expected. This trend looks set to continue in the second half of the year as even this modest growth profile requires a sizeable improvement over the next two quarters, especially in US manufacturing. The escalation of the stakes in the US-China trade war in recent months is likely to add further pressure.

The Australian equity market, while influenced by some unique features such as the Federal election outcome and the earnings bonanza in Resources, have followed global markets with the strong returns in the first seven months of the year predominantly driven by a re-rating of the market rather than surprisingly good earnings growth.

The August reporting season will, as always, be an important test of the earnings outlook for the year ahead. Global and domestic trends suggest that earnings expectations will probably be even lower at the end of the month. How investors react to that – i.e. if bad earnings news will continue to be good news for the equity market or if bad news finally becomes bad news – remains to be seen. However, with two rate cuts already delivered and equity market valuation metrics looking full the arguments for further gains are looking increasingly exhausted.

Top five active overweight positions as at 31 Jul 2019	Index weight %	Active weight %
Santos Limited	0.7	2.0
CSL Limited	5.6	1.9
QBE Insurance Group	0.9	1.6
APA Group	0.7	1.5
BHP Group	6.5	1.4

Asset allocation	31 Jul 2019 %	Range %
Securities	97.3	90-100
Cash	2.7	0-10

Portfolio Outlook

Slowing global growth, contrasting with hopes of an improvement in the market outlook coming from the dual stimulus of lower interest rates and tax cuts, as well as ultra-low interest rates in much of the world and the ongoing debate about the sustainability of the record high valuation premium for growth stocks: these factors all combine to form a potent cocktail for investors to digest. We don't profess to have all the answers to these big picture questions, but we do remain confident that our focus on earnings leadership and our search for those companies that are able to deliver earnings better than market expectations will allow us to identify stocks that will do well in different macro outcomes.

With Australian bond yields setting ever new record lows and a domestic economy which, in our view, is unlikely to improve meaningfully, the more defensive infrastructure names are looking increasingly attractive. Aurizon and Transurban are two such reasonably new additions to the portfolio. These are both companies which have defensive earnings streams from their rail and toll road operations respectively, and they also have not just sustainable but growing dividends. Management of both companies continue to impress in finding ways to add shareholder value: Aurizon through a simple group restructure which will enable several years of share buy-backs; and Transurban through moving to 100% ownership of Sydney's M5 toll road, increasing the company's cashflow supporting its dividend growth.

While we've added these defensive companies to the portfolio, we have also retained our exposure to Resources, Iron Ore in particular. Despite the Iron Ore price having come back somewhat from recent very high levels, we continue to perceive quite a tight demand/supply outlook, with further upside to earnings expectations over the coming 12 months. Stephane is heading to Brazil in September to get a firsthand understanding of the severity and likely longevity of the supply constraints presently impacting the world's second largest Iron Ore producer.

In the meantime however is the August full year reporting season, where most of our companies will provide financial and operational updates. There is always a rich seam of insight to be mined from this period, and we will be using it to confirm – or possibly disprove – the investment theses around which our company holdings are based.

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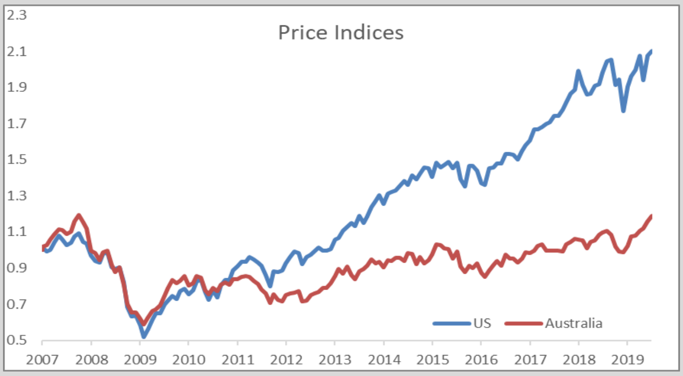
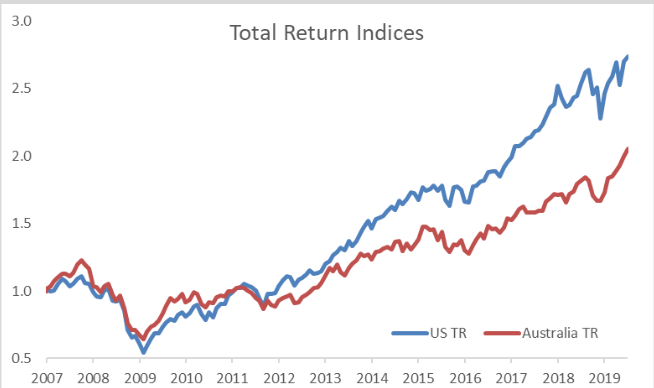
BTW

There was a frisson of excitement, mostly in the media, about the share market (ASX300) reaching its all-time high in July. The prior high was in November 2007, almost twelve years ago, just as the cracks were starting to appear in the global financial system. The chart below shows the US (S&P500) and Australian (S&P ASX300) markets based to a common starting point at the peak. The US passed its previous high in 2013 and gone on to double since then. Why has Australia done so poorly?

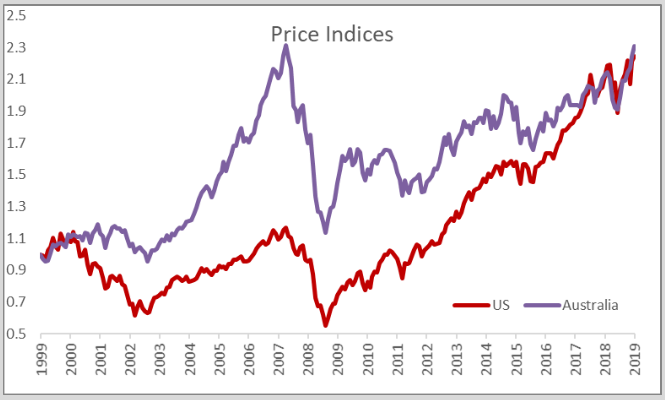


There are a couple of factors at play here: for a start the indices most people tend to look at only take into account one element of share market returns, movements in share prices. The other very important element of returns, dividends, are ignored in the most-quoted indices. S&P also publishes "Total Return" indices which include the reinvestment of dividends: we always refer to these as they give a more accurate picture, but they are often ignored by less insightful commentators.

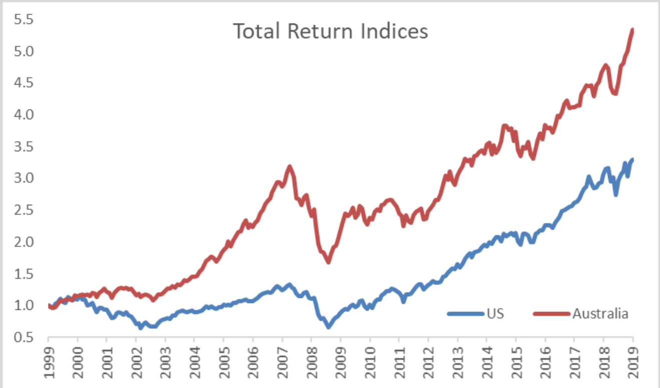
Dividends matter for Australian shares much more than for the US as Australian companies tend to pay out more of their earnings in dividends. The yield of the S&P500 is below 2% while here it is around 4.5%. Compound that difference the years and it makes quite a difference. If you look at the chart below you can see that from a total return perspective Australian shares still underperformed US shares, but by a much smaller magnitude, rising 2 times versus 2.7 times. Much of the difference can be attributed to some of the large, highly valuable US tech companies we just don't have.



This sort of analysis is vulnerable to manipulation by carefully picking the starting point you use. If you take a nice round 20 years for instance the picture looks quite different, and we present the next two charts on that basis, from the starting point of 31 July 1999. The first is the price index (i.e. not including dividends), and it surprisingly shows an almost identical return from both markets, a little more than doubling over 20 years. How can that be? Probably because it captures the US tech-wreck of the early 2000s and the recession that took place after the attacks on the World Trade Centre in New York, both of which had much smaller impacts on Australian shares. That starting point proved hard to recover from so even though their post-Crisis recovery has been stronger, the US only just managed to catch up to our shares' returns.



Including dividends makes things even more stark: Australia outperformed substantially, more than quintupling rather than just trebling. That's effectively just that extra few per cent a year in dividends compounding over 20 years.



As is often the case, there are many ways to torture data until it confesses. These numbers ignore the effect of currency, but we note that the $A was worth $US0.65 in July 1999, which is not all that far away from its July 2019 level of $0.685. Admittedly it fluctuated widely (and wildly) over the past 20 years, moving between $0.485 in March 2001 and 1.10 in July 2011, but when we ran the numbers it didn't make a material difference to the outcome.

Traveller's Tale

Being in control of billions of dollars isn't always as glamorous as it might seem. For instance, Bruce recently ventured to the far western suburbs of Sydney looking at landfills. They were rather nice landfills, but landfills all the same. One chilly morning he boarded a bus with a bunch of others and went to visit two recycling and landfill sites operated by listed company Bingo Industries, a competitor of portfolio holding Cleanaway. One site was newly constructed, all shiny and clean, as yet untarnished by any actual waste. The other was one Bingo recently bought at Eastern Creek. It was large and well-established and didn't smell as bad as one might think.

Bingo specialises in disposing of commercial, construction and demolition waste and has been a beneficiary of the residential building boom (now sadly over) and infrastructure boom (still well under way) that has been taking place around Sydney. Bingo does not take in household organic waste which is why its landfill didn't smell too much. This also means it doesn't have some of the gas emissons issues many landfills have to deal with. It was impressive to see large truckloads of waste coming from the demolition of houses or roads or whatever come onto the site, and being emptied onto a big conveyor belt where it was sorted into reusable materials. Timber would go off to one part of the site, glass to another, brick and concrete elsewhere, and so on, where they would be further sorted and processed into reusable form. There is quite a degree of manual handling involved but is being automated as much as possible.

Timber mostly gets mulched and re-sold through garden centres; brick and concrete is broken up into various sizes and sold as road base or aggregate to make back into new concrete. Metal goes into a big pile and is taken off to be melted down and re-used. Similarly, glass is recycled and even though they don't see much plastic, whenever possible it is also sent off for recycling. Bingo is able to re-purpose, re-sell and enable the re-use of about three quarters of the waste that comes through its gates. There will always be some things that can't be salvaged which still ends up in landfill but the big benefit is their ability to keep out the majority of what they take in. Bingo aims to get this to 80% and beyond. It's not glamorous stuff, but it is essential to the effective operation and development of our society.

For further information, please contact:
Fidante Partners Investor Services | **p:** 13 51 53 | **e:** info@fidante.com.au | **w:** www.fidante.com.au
Fidante Partners Adviser Services | **p:** 1800 195 853 | **e:** bdm@fidante.com.au | **w:** www.fidante.com.au
Alphinity Investment Management | w: www.alphinity.com.au