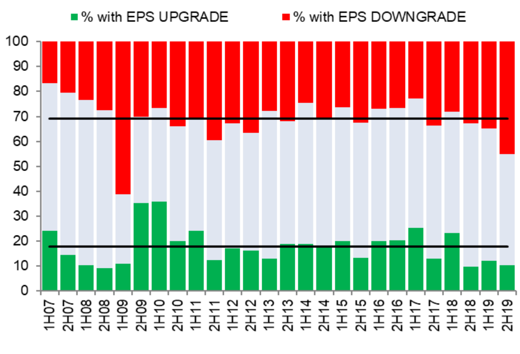
Monthly Comment – August 2019
Alphinity Concentrated Australian Share Fund

Volatility Returns

Market comment

Our attention in August was split between big-picture offshore activity (escalating trade war between China and the US, ongoing Brexit, bond market activity, Hong Kong in flames and the Chinese military massing on the border, rising fears of possible US recession and so on) and the massive local data dump that is Reporting Season. While markets were roiling around the rest of the world, most Australian listed companies updated the market as to how the six months to 30 June had panned out. This unusual confluence of hard-to-anticipate macro events and individually significant company information resulted in some wild swings in absolute and relative returns during the month. It panned out however with the market (ASX300 including dividends) falling 2.3%, the first monthly fall of 2019. This took the market back to the level at which it was in mid-June; it remains up a little more than 20% since the start of January.

The $A continued its recent slide, falling from mid-68s against the $US to the mid 67s. Despite this, Australian shares still finished in the middle of the pack globally in $A terms. Every major market except Canada's fell in its own currency, although the soft $A converted that into gains for some. The worst was Argentina which was down 55%; Switzerland provided the best return but only +2%, and that was all from currency moves.



Reporting Season was arguably the most disappoint-ing since the Global Financial Crisis (GFC) a decade ago, as this chart from Goldman Sachs suggests. Only around 10% of companies had earnings upgrades of more than 2.5%, but 45% had downgrades of more than 2.5%. Resource companies generally delivered the best results, followed by Health Care.

So the year to June 2019 won't go down as a great one for corporate Australia, notwithstanding some decent returns that were made from the share market overall. Macro forces have been very powerful. A big swing factor was the bond market, with yields falling even further to the lowest levels ever seen in a number of developed markets – Australia included – and deeper into negative yield territory in Europe and Japan.

The concept of negative bond yields is difficult to grasp: it makes no sense for people to be willing to lock up their money for an extended period of time with the guarantee of getting back less than they invested, no return at all to compensate for either the time-value of money or the erosion of value caused by inflation, which admittedly is low right now but is unlikely to be that way forever. Australian and US yields haven't gone negative yet, and our ten-year bond yields of 0.9% and US ten years at 1.5% stand out globally. The corollary however is that assets which are able to provide a positive yield have become more attractive, and this goes some way to explaining strong equity markets this year.

Commodity prices were mixed during August. Signs of increasing economic stress in China send our main bulk commodity, Iron Ore, 25% lower. Coal prices also fell but only by 4%. The price of Oil fell about 5% and base metals were generally slightly soft – the exception being Nickel and Cobalt which both rose sharply. Gold, the "fear" trade, did reasonably well in the month rising 8% in $US and more than 9% in $A.

Portfolio comment

The Fund performed essentially in line with the market in the month of August. The companies which contributed most to performance were blood fractionator and vaccine producer CSL, gas explorer Beach Energy, and global wine group Treasury Wine Estates; not owning milk and infant formula play A2 Milk was also positive. On the opposite side of the ledger were resource plays BHP Group and Iluka Resources, while not owning supermarket retailer Woolworths hurt a little.

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)	-2.5	4.5	5.1	12.7	9.7	12.8	11.1
S&P/ASX 200 Accumulation Index	-2.4	4.2	9.0	11.4	7.9	11.0	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

The Australian reporting season confirmed what most were already expecting – slowing global and domestic economic activity is making earnings growth increasingly difficult to come by. While this has been the case for most of the year it hasn't stopped equity markets from rising strongly as interest rates collapsed. How markets will react in coming months, should earnings keep coming under pressure, remains to be seen but August served as a sobering reminder that bad news will not always be seen as good news, on the premise that central banks will come to the rescue.

In August, most sectors saw earnings expectations lowered further for FY20 with Healthcare, boosted by a solid outlook from powerhouse CSL, the only sector that saw earnings expectations upgraded. It is also one of only two sectors for which earnings expectations are higher today than they were three months ago. (Resources is the other sector with earnings expectations higher but those were slightly reduced in August.) While many stocks with exposure to the Australian consumer have performed well since the federal election in May, only a few pointed to an improved earnings outlook at this point. The impacts of tax cuts, interest rate cuts and the rebound in the largest housing markets should become clearer over the next couple of months, especially as tax rebates hit consumers' pockets in full.

Much has been written lately about the record premium being paid for growth stocks: some are expecting an imminent resurgence of value stocks while others point to structural changes underway in the economy, not to mention lower interest rates for longer, as reasons that growth stocks will continue their ascent.

Our view remains that share prices will ultimately follow company earnings and that earnings expectations changing for cyclical or other reasons will be the catalyst for improved relative performance. It was interesting to note that, while some previous high flyers were dumped by investors in August when elevated earnings expectations were not met, the majority of poor-performing stocks in August were actually stocks that have been challenged both from earnings and share price perspectives for some time. At least for now, the view that value stocks will start outperforming appears difficult to sustain.

We are currently facing a confluence of global macro factors, which for some time have been pointing to a slowing or maybe even contracting global economy; and a domestic economy which is growing at its slowest rate since the GFC albeit with the hope of some degree of positive impact from recent stimulatory measures. When combined with interest rates at levels which may continue to see equity markets supported by investors searching for yield, the outlook continues to be complicated.

Portfolio Outlook

While we didn't expect the August reporting season to provide all the answers, it still confirmed what matters most to our investment process: that earnings surprises, positive or negative, are still driving share prices. We had some strong winners, including CSL, Beach Energy and Santos, and some other that disappointed. But they all had one thing in common: changes to the market's expectations of their future earnings explained the majority of the company's subsequent share price performance. We would, as always, have liked to have more of the winners and fewer that saw earnings expectations lowered, but we take comfort from the fact that the factors on which we have built our investment philosophy and process continue to work from a market perspective, even in these unusual times. We have found that earnings revisions typically keep going in the same direction for an extended period of time so there's still time to make adjustments to the portfolio taking into account the new information received in August.

While the macro factors discussed above will continue to influence the overall market direction and provide support/challenges for different sectors of the market, it is individual company performance that still matters the most. We saw this earlier in the year when Fortescue Metals strongly outperformed both the market and its larger iron ore producing peers when the discount for its lower-grade ore reduced significantly. The August reporting season provided another clear illustration of this in the Energy sector, where our holdings Santos and Beach Energy solidly outperformed despite a weakening oil price and sectoral challenges. Strong cost discipline, production and reserve upgrades – all factors controllable by the companies – resulted in increases to future earnings expectations. We look forward to reporting on further developments in coming months.

Top five active overweight positions as at 31 Aug 2019	Index weight %	Active weight %
CSL Limited	6.2	4.6
Santos Limited	0.7	3.3
Macquarie Group	2.2	3.0
National Australia Bank	4.3	3.0
Transurban Group Stapled	2.2	2.5

Asset allocation	31 Aug 2019 %	Range %
Securities	97.5	90-100
Cash	2.5	0-10

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BTW

We are quite bullish about the prospects for electrification of land transport in coming decades. Once the problems of limited battery life, recharging availability and time to recharge are solved, as they will eventually be, electric vehicles (EVs) make a lot of sense and have the potential to make the world a slightly better place. Of course any environmental benefit EVs might bring will depend largely on how the electricity used to charge them is generated, but there is so much going on with renewables that, given time, there is a good chance of that problem also being solved, even in Australia.

Norway became a wealthy country on the back of its vast oil reserves, and in the 1990s its government set aside a large part of state oil revenues to create a sovereign wealth fund which will provide support for its economy when the oil runs out. That fund has become enormous, containing more than $US1 trillion at present. (Australia did the same in 2006 when we were running large budget surpluses; although the Future Fund only had a total of $60 billion contributed in the first couple of years, strong investment returns have grown it to more than $A160 billion at present.)

Notwithstanding the fossil fuel-intensive source of its assets, Norway's Fund recently decreed that its assets would not be invested in companies producing fossil fuels. While some commentators decried this as hypocrisy, we feel that it is quite an understandable and justifiable stance to take. When a large source of your wealth originates from oil and there is a good chance that demand for oil will decline in the not-too-distant future, it probably doesn't make much sense to get extra exposure through investing in it as well.

Norway is quite aggressive in encouraging its citizens away from fossil fuels. It has large EV sales tax incentives and special treatment on road lanes and parking, while petrol is highly taxed. Norway has a lot of offshore wind power generation, combined with its hydro assets means pretty much all of its electricity comes from renewables. It also has an impressive array of charging facilities to support EV drivers. Although Norway's population isn't much bigger than that of Queensland, it is one of electric vehicle specialist Tesla's biggest markets and has become a priority market for other manufacturers trying to propagate EVs, like Nissan and VW. It has the largest per-capita fleet of true (i.e. non-hybrid) EVs in the world, and so far this year more than half of all car sales in Norway have been plug-in EVs.

Air transport however is more problematic. Government-owned airport operator Avinor aims to have electric planes in place for short-haul flights by 2030. The challenge for electric flight is that all of the battery technologies so far have been quite heavy, and when you are already trying to overcome gravity adding a bunch of extra weight is not helpful. Still, you never commercialise a technology without a lot of research and development, and inventors around the world are working furiously on prototypes of electric planes. Avinor bought a two-seater Alpha Electro G2, from Slovenian manufacturer Pipistrel, and invited a bunch of dignitaries to witness and take part in the plane's first flights in August. The first had Norway's Environment Minister on board and was a resounding success; the second less so.

There were two people on the second flight: another politician and the pilot, Dag Falk-Petersen, who is also CEO of Avinor. It was only a brief flight, but it didn't end well: shortly after take-off they were forced to make a landing on/in a lake for unspecified engine reasons; thankfully both were unharmed. The full reason has not been disclosed but it is amazing what a little thing like crashing into a lake does to public confidence: this is likely to set back the cause of electric flight some time. Falk-Petersen grasped that immediately: "I made a mayday call and looked for a place to land," he told a local broadcaster. "This is not good for the work we do."

Still, having no fatalities was a better outcome than the May 2018 electric plane fail when a prototype developed by German company Siemens, using experimental high-density batteries, caught fire ten minutes into a test flight and crashed into a Hungarian corn field, killing the two people on board. While the full story has never come out, Siemens continues with its development program: obviously it believes that the issue is solvable. Even so, considering the still early stage of development, it will probably be a very long time before we turn up to the airport and fly to the other side of the world on an electric plane.

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Traveller's Tale

Immediately after reporting season Stephane headed west. He went to a sustainability conference in London, then on to Germany for meetings with some of the largest European manufacturing companies including Daimler Benz (parent company of Mercedes) and BMW to find out how they are thinking through some of the challenges they face. He went to BMW in Munich and witnessed the incredible sight of 1500 robots (below) whirring away on the production line of that company's high volume 3 Series model. The robots are supported by about a thousand people who carry out maintenance and provide the necessary human eye and hand quality check touches. It takes only 37 hours from start to finish to make a 3-series car and, once recycling is accounted for, it only generates a tiny 160 grams of waste per car. BMW has an intense focus on reducing emissions during the production process: CO_2 emitted per car is down by 40% in the past five years to only 400kg.

Even more impressive however was his meeting at the Stuttgart headquarters of Mercedes the same day. That company's commitment to dealing with all sorts of issues like climate change, human rights, diversity, safety and other sustainability themes was remarkable. Mercedes has committed to be carbon neutral by 2039, and this covers its whole supply chain including the steel and aluminium used for its cars. It looks at the impact it is having on human rights across its entire value chain in a very methodical manner, not a simple feat considering it has 650 sites covering production, service centres and logistics, and 60,000 suppliers of materials that go into their vehicles. Whether it is cobalt for its batteries or plantations for the rubber it uses, Mercedes assesses not just its own suppliers but also its suppliers' suppliers, up to seven tiers below, seeing this as a question of morality and reputation. Where an issue is identified, the company's approach is to work with the supplier in question to rectify the problem rather than simply cutting the supplier out, to really drive positive change. It thinks about diversity more widely than just male/female and even has Daimler Pride Parades in several parts of the world. It has a website with full pay transparency to ensure there is no gender gap. It also provides childcare facilities and high levels of support to enable employees to come back to work after giving birth; the list goes on. Each topic he raised was addressed thoughtfully, pragmatically with a high moral and ethical code. It was so inspiring it almost made Stephane want to become a Mercedes car owner! He didn't order one though: he is firmly a Vespa man.

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