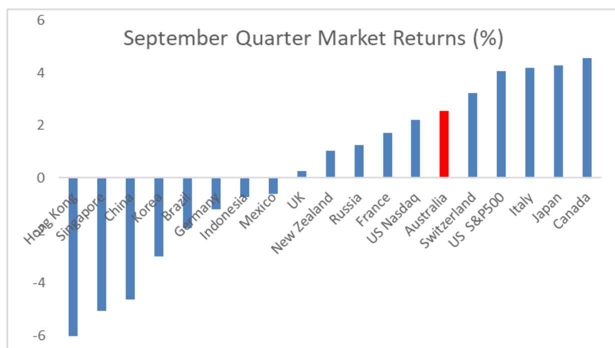
alphinity INVESTMENT MANAGEMENT

Quarterly Comment – September 2019
Alphinity Australian Share Fund

Springing Back

Market comment

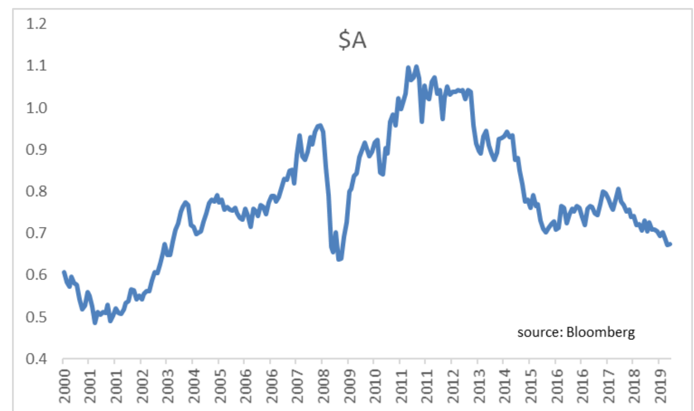
The September quarter benefited from modestly rising markets despite the return of volatility. There were three distinct periods: the market (ASX300 including dividends) initially continued the previous quarter's strength, peaking at the end of July before suffering mildly from globally-induced panic which lasted only two weeks, sending the market down by about 7%. The upward trend resumed in mid-August and continued until the end of September, resulting in a net return of +2.6% for the quarter. This was in the middle of the pack of major global markets in $A, quarterly returns of which ranged from down 6% (Hong Kong) to up 4.5% (Canada).



September didn't finish well for the leaders of the US and UK, both of whom suffered significant setbacks. The final week of September saw impeachment proceedings started against the US President, then the UK Supreme Court went decidedly anti-rogue when it determined that its roguish PM's pro-roguing of parliament was illegal, requiring Boris to rush back to the UK from hobnobbing with his US counterpart and resume parliament. The trade difficulties between the US and China waxed and waned with lots of chat but no real sign of resolution, but obviously the US President thought things were going so well with that one that he expanded the war to take in the world's next biggest economic zone, Europe. There is no sign of resolution to Hong Kong: the issue that initially sparked the rebellion seems to have been dealt with, but the protesters have used the movement to reach for more demands. It is hard to see how it will end gracefully for either side.

A graceful conclusion to Brexit also needs to be sorted out soon as it is supposed to be all wrapped up by the end of October. Considering the amount of uncertainty, it is amazing that the UK share market was able to come up with a positive return for the September quarter, if only just.

The $A continued on its downward path, falling by 4% from just above US70c at the end of June to 67.5c at the end of September. This is not great for any upcoming overseas holidays but is a great boon to our exporters, whose products become a bit cheaper in foreign currencies, and for companies with offshore operations, whose earnings are now worth a bit more. Monetary policy was a major part of that: the Reserve Bank of Australia cut short term rates to 1.25% from 1.5% in July, and the subsequent cut to 0.75% on October 1 was widely anticipated. The $A is now at its lowest level in a decade, a long way from the $US1.10 it reached in 2011 but still much better than the sub-US50c point it reached in 2001.



Commodity prices were mixed as usual: in $A terms the prices of two most important bulk commodities for Australia, coking coal and iron ore, fell by between 19 and 14%; thermal coal however was 3% higher. Precious metals were strong, with Gold up 8% and silver up 15%; other movements of note were Nickel which rose by 42% and Cobalt by 29%. Tin however fell 12%.

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)	1.8	1.4	9.5	12.3	9.4	11.5	10.0
S&P/ASX 300 Accumulation Index	1.9	2.6	12.6	11.9	9.6	10.9	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. **Source: Fidante Partners Limited, 30 Sep 2019.**
^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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Portfolio comment

The Fund's performance was a little below the market in the September Quarter. The companies which contributed most to performance were gas explorer Santos, global wine producer Treasury Wine Estates, gas explorer Beach Energy; not owning diversified resource company South 32 also added value. These were more than offset by performance headwinds from resource exposures BHP Group and Iluka Resources; being underweight gold producer Newcrest and not owning property developer Lendlease also hurt a little.

Market outlook

The Australian and global equity markets continue to oscillate between worrying about slowing economic growth and anticipating the positive impact on equity valuations to come from reduced interest rates and, potentially, the positive impact of the lower rates on the trajectory of economic growth. Significant monetary stimulus across the globe in 2019 has been the primary reason behind strong equity market returns year to date. The US Federal Reserve Bank's change in heart, going from raising short term interest rates as recently as December last year to cutting rates in July and again more recently has been matched by two rate cuts by the Reserve Banks of both Australia and New Zealand, not to mention the reversion to quantitative easing by the European Central Bank.

Not only equity markets have responded to lower interest rates: other asset classes have too, and possibly the most important for domestic investors has been Australian house prices – at least in the largest markets of Sydney and Melbourne. While stabilising house prices is welcome news, strong price rises are less so and highlights one of the challenges for policy makers: that most or all of the positive impact from lower interest rates has so far been seen in higher asset prices rather than better economic growth. A US-China trade deal could also perhaps be the catalyst for an improved growth outlook, as could fiscal stimulus in Australia or China if it were to take place. At this stage however, equity returns continue to be strongly and uncomfortably linked to interest rates and the paucity of attractive alternative investment prospects outside equities.

Top five active overweight positions as at 30 Sep 2019	Index weight %	Active weight %
Santos Limited	0.7	2.7
Macquarie Group Ltd	2.3	2.4
CSL Limited	5.8	2.0
APA Group	0.7	1.8
BHP Group Limited	5.9	1.5

Portfolio Outlook

The Australian equity market is trading well above long term averages and, from what we can see, this has been largely driven by low interest rates rather than any signs of a positive inflection point in corporate profit growth. While any truce in the trade war has the potential to reduce growth concerns, we believe a relatively defensive stance for the portfolio is warranted. The question in the current environment however is: what is defensive? Growth stocks which are trading at close to record multiples? Bond proxies which have attractive dividend yields compared to bonds, but only because those bond yields are at very low absolute levels? Or are cyclically-challenged companies defensive as they generally trade well below cycle averages? The answer, in our view, is that we should continue to focus on owning companies and sectors that are providing earnings leadership.

In the current environment of very low aggregate earnings growth and multiple headwinds facing many industries, being an earnings leader is increasingly a relative proposition: those companies which can even just meet the market's earnings expectations are likely to stack up well against the rest of the market. They aren't all defensive companies however, for example three of the portfolio's strongest performers in recent months have been high-growth company Treasury Wine Estates, healthcare company CSL and energy exposure Beach Energy, all of which have very different industry environments and earnings drivers. While CSL, as a reasonably defensive company, has arguably benefited from stable or growing demand for its products, the key differentiator between it and other companies in its sector has been its continued market share gains and product innovation. The importance of management in the success of both Treasury Wine Estates and Beach Energy is perhaps even more significant given the challenges in their respective industry environments and the poor performance of some of their peers.

So, while from an overall perspective we are relatively defensive, we need to remain focused on identifying companies with superior management, able to manage industry challenges and take best advantage of opportunities that arise. We remain confident that applying our investment process will keep uncovering these opportunities.

Asset allocation	30 Sep 2019 %	Range %
Securities	98.1	90-100
Cash	1.9	0-10

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BTW

WeWork, the co-working office space company, was in the news this month and not for the best reasons. Until now a private company, it was attempting to conduct an initial public offering (IPO) of its stock so its shares could be traded on one of the US stock exchanges. That seems to have been pulled for now as indications of what the public might be willing to pay for it was well below the $US50 billion or so the offerors thought it was worth.

We first came across WeWork during a research trip to New York in 2015. We met with the company not as a potential investment but for insights into an emerging trend in the property industry. We met in one of their workspaces, a funky restored industrial space in Soho, and found a buzzing atmosphere filled with lots of (mostly) young people working on laptops and drinking coffee. The concept wasn't that new – serviced offices have been around for ever. What WeWork offered was a millennial take on that concept.

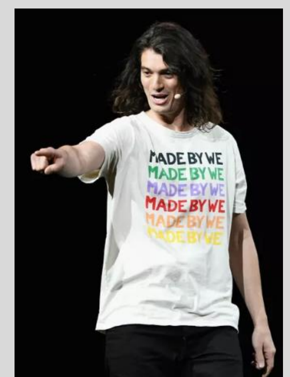
The idea was that rather than working from home, workers rent some space fairly cheaply on a casual basis and take advantage of the better environment and professional facilities WeWork offered. You could rent a seat at a shared table for $US350 a month (at the time), or a more secure single-person office for $US1000 a month. Larger office spaces for multiple people were also able to be rented without the hassle or commitment of a long-term lease. The main attraction however was being part of a network. People with a spot in New York could turn up at another WeWork office anywhere in the world and use the facilities. But even more than that, being in a group of like-minded people provided business opportunities. Someone needing a certain professional skill could just shout out "any lawyers in the room?" and go on to do business together.

WeWork's own business model is a bit more challenging. It secures office space, fits it out and then rents out to lots of people at a much higher rate. It expanded very rapidly, a process that was paid for by numerous rounds of fund raising from its financial backers and became one of the biggest renters of office space in the world. WeWork and its ilk supposedly account for almost 2% of all Sydney office space, 4% of New York's and more than 6% of London's.

The leases WeWork commits to are generally long – averaging fifteen years in the US – and the cost of the funky fit out is quite high but the tenants they sign up are generally very short commitment, generally month to month. While the demand is strong this is not a problem, the issue will come when there is a significant economic downturn: if people stop coming in WeWork's revenues fall but its multi-billion dollar rent commitments would remain. This is a company with extremely high leverage to the business cycle.

Then there was the issue of financial performance and price expectations of the vendors. Companies in start-up phase are rarely profitable and investors generally understand that, but those coming to IPO are generally well down the path to profitability. WeWork is not: after nine years it is hardly a start-up anymore and it now has tens of billions of dollars' worth of lease liabilities. It does have substantial revenues – $1.8 billion dollars in the most recent full year (2018) but reported a loss of $1.9 billion dollars that year and a further $700m loss in the first quarter of 2019, suggesting the pathway to profitability has not yet been mapped.

So why did the vendors think it might be worth $50 billion? Largely because that was the price they had been putting money in at. Funding large operating losses is a costly business, so WeWork has been raising capital consistently ever since it started. The most recent investor was Japanese tech giant Softbank which initially bought in during 2017 and now owns a third of the company. Softbank alone has already contributed more than $7 billion and had committed to putting in a further $1.5 billion in 2020. The most recent tranche was at a price that implied a valuation for the whole company of over $40 billion. Prior investments were at a lower level but in order for Softbank to break even on its investment it would need a total valuation of about $25 billion.



The problem is that the market wasn't even willing to pay $20 billion for WeWork and it may even have needed to be below $10 billion for an IPO to get off the ground. The IPO process was pulled at the end of September and founder and CEO Adam Neumann (pictured, in happier days) was forced out of the company.

Where to from here? WeWork is cutting costs under new management and trying to establish a more viable financial case to IPO at some point in the future. But the combination of long-term lease liabilities and month-to-month tenants is one that may not sit very well with a lot of investors contemplating a fairly uncertain economy.

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Traveller's Tale

Stephane went to Brazil in September. No, it's the wrong time of year for Carnivale and he wasn't touring the fleshpots of Ipanema Beach. This trip was purely for research purposes, he was off to a gritty industrial area in the state of Minas Gerais.

Minas Gerais translates as General Mining, an unromantic name but one that accurately represents the major economic activity of the state. It is where most of Brazil's iron ore is mined, and where two horrific mining accidents recently occurred: the collapse of dams in Mariana (known as Samarco, a joint venture between BHP and Brazil's mining giant Vale) in 2015 which resulted in 19 deaths and significant damage to infrastructure and the environment; and in Brumadiñho (owned by Vale) in January 2019, in which an incredible 248 people lost their lives; a further 22 are still unaccounted for many months later. These dams contained tailings, a slurry made up of water mixed with the residue of mining. The second tragedy led the Brazilian government to immediately halt ore production at a number of mines with similar types of tailings dams; this effectively removed 90 million tonnes of annual supply from the market – about 5% of the total market – just at a time when Chinese demand turned significantly stronger, pushing up the iron ore price from $US75 per tonne to $125.

Stephane's aim was to meet with producers and government representatives to understand the pace at which production at these mines could return, if at all. He arrived at the view that production would resume faster than the market is currently expecting, which potentially has implications for our positions in companies like Fortescue Metals, Rio Tinto and BHP.

After a government review of all the country's upstream dams it has been decreed that all will be closed down by the mid-2020s. Alternatives are actively being explored, with more robust dams construction being an obvious but much costlier one. But there are other alternatives.

Stephane visited Brazilian mining company CSN's Casa de Pedra mine (pictured) which has been in operation since 1913. There he was interested to learn about the process of "dry stacking" by dewatering the tailings, as water is the main source of instability and risk in a dam. CSN is leading the way on dry stacking, using a process developed by Italian engineers.

Existing tailings from Casa de Pedra is being removed and reprocessed in quite an economic manner. Those tailings actually contain very high amounts of iron ore: in the early days they didn't recover as much ore as today's techniques would, so the slurry is still quite iron-rich. The residue is then stored as dry piles in a much safer way. The industry is paying a lot attention to this technology as it has the potential to bring great improvements in safety, not just to the miners themselves but also to the surrounding communities, and at the same time potentially increases profits – that's a win for everyone.

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