Monthly Comment – October 2019
Alphinity Concentrated Australian Share Fund

Meandering

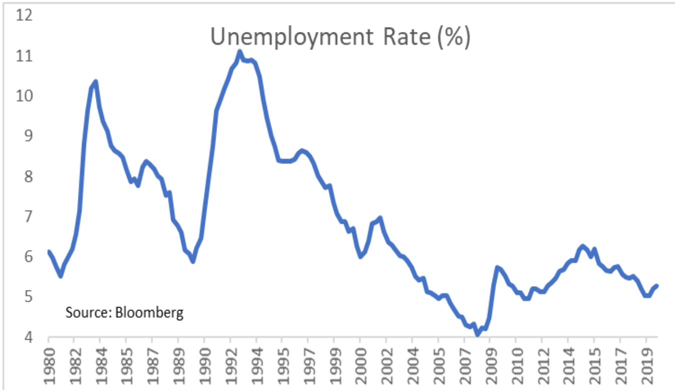
Market comment

The month of October has a reputation for market disasters. The most notorious New York stock market crashes in 1929 (-35%) and 1987 (-33%) both took place in October, and there was another, smaller event in October 2008 (-22%) after Lehmann Brothers went bust and sparked fears of economic Armageddon. Of course plenty of market hiccups have taken place in other months but with the biggest having happened in October some market historians get nervous at this time of year. We're pleased to report that while our market did fall in October 2019 it was by no means a crash. The Australian market (ASX300 including dividends) traded up and down through the month, ending less than half a per cent lower in October. That's only the second down month of the ten so far in 2019, not a bad outcome considering the amount of uncertainty and negativity the year started with, and it highlights the risk involved in putting too much trust in anybody who makes definitive predictions about the direction of the share market.

The month was bookended by short term interest rate cuts: in Australia on the 1st and in the US on the 31st. Bond yields in both countries swung wildly with the mood changing from tweet to tweet. Australian ten-year bonds traded between 0.8 and 1.2%, finishing towards the higher end of that range, while the US equivalent ranged between 1.5% and 1.9%. US bonds finished the month at 1.7%, rallying after the commentary accompanying their rate cut was taken to suggest that another cut was not imminent.

The $A rose by 2%, back into the US69s, but even so most global markets in $A terms did a bit better than ours, the exceptions being Canada and New Zealand, both of which fell by 1-2%. The European bourses did the best, most rising 2-5%, and even the UK was up a couple of per cent, buoyed by possible progress towards resolution of Brexit and the likely avoidance of a "no deal" exit from the EU after a UK election was called with that as a condition. The US had a small rise, but it was offset by our stronger currency resulting in a zero return for $A investors. Most Asian markets were a couple of per cent higher.

The Australian economy continues to amble along, with conflicting indicators of economic performance. Business and Consumer Confidence are both quite soft and wages growth continues to be tepid, but employment growth continues to be reasonable, particularly full-time employment. The recent tick-up in the unemployment rate (below) reflects more people being engaged in the workforce (the participation rate) rather than actual job losses.



The housing market, which has endured two years of negativity, appears to be picking up strongly in the larger cities, but the strength is not particularly deep with most demand being in the inner rings and for houses rather than apartments. However there are increasing indications that this starting to spread to the outer rings which is contributing to slightly better building approvals statistics.

Commodity prices were generally lower in October. Oil was off about 3% but there were much bigger moves in the bulk commodities most important to Australia: the price of Iron Ore was down 10% in $A terms along with further evidence of softness in the Chinese industrial production. Thermal Coal, which is used for electricity generation, was 6% lower while Coking Coal, used in steelmaking, was flat. Gold was also flat as were most base metals other than Nickel, which fell by 5%.

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)	0.7	0.3	18.6	13.9	10.7	12.4	11.2
S&P/ASX 200 Accumulation Index	-0.4	-0.9	19.3	12.6	8.5	10.5	9.3

*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, 31 October 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 outperformed the market nicely in the month of October. The companies which contributed most to performance were blood fractionator CSL, gas explorer/producer Santos, and not owning either gold producer Newcrest or major bank Westpac. The only detractor significant enough to warrant mentioning was our position in another major bank, ANZ.

Market outlook

Global financial markets have responded enthusiastically to what looks increasingly likely to be the first phase of a trade deal between the US and China in addition to some progress, or at least some new developments that provide hope for progress, in the ongoing saga that is Brexit.

This year's softer rate of economic growth is now increasingly being viewed as a mid-cycle slowdown rather than the beginning of something more sinister, such as a recession. This could well be right, and equity markets are always forward looking and have a history of trying to look across the valley of negative earnings news if they think the other side is not too far away. We're just not sure that anyone really knows just how deep the valley might be and how long it might take for earnings to recover to current expectations. What we do know is that earnings revisions remain firmly negative, and that global earnings growth is at risk of going negative for the year.

Interestingly, despite the broader market rhetoric around the relative appeal of "growth" stocks versus "value", actual share price reactions continue to be largely correlated with good and bad company earnings news. This suggests to us that investor confidence in a broad-based earnings recovery remains fragile, and that individual company performance remains the most important determinant of share valuations.

After such strong equity market returns over the ten months so far of 2019, which has been driven largely by lower interest rates, elevated stock valuations suggest that a fair amount of good news is factored into share prices. Thus having a well-diversified equity portfolio which is not overly reliant on any particular macro thematic makes sense to us.

Portfolio Outlook

Considering the fairly sceptical view we have of the significance of recent macro events and the solid performance of the Fund so far this year, not just in October, we have not made many significant changes to the portfolio recently. Our focus on stock-specific drivers that can enable companies in which we've invested to deliver earnings better than the market currently expects provides us with the flexibility to invest widely across all market sectors. We've found that this approach has allowed us to maintain a portfolio with a combination of cyclical exposures as well as those with more defensive characteristics.

We've also found that the broader macro thematics, such as the potential for a US-China trade deal or a possible improvement in global growth, doesn't necessarily mean that we should make portfolio changes such as increasing our exposure to China or selling defensive holdings. In fact, we have been gradually reducing our Resource company holdings as the imbalance between demand and supply for iron ore appears to be easing, as steel production growth has moderated, and supply has improved.

Recent company research efforts have increased our confidence in explosives producer Orica and building materials company James Hardie. In both cases, while we believe industry conditions should remain supportive, the more important determinant of performance will be company-specific drivers such as product innovation and productivity programs rather than the debate between whether growth or value companies are in favour this week/month.

Top five active overweight positions as at 31 Oct 2019	Index weight %	Active weight %
CSL Limited	6.5	5.2
Macquarie Group Ltd	2.4	4.3
Santos Limited	0.8	4.1
BHP Group Limited	6.0	3.7
National Australia Bank Limited	4.6	3.2

Asset allocation	31 Oct 2019 %	Range %
Securities	98.1	90-100
Cash	1.9	0-10

Source: Fidante Partners Limited, 31 October 2019.

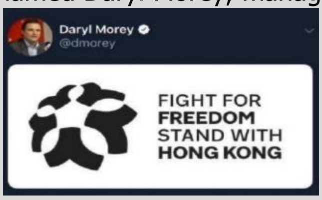
Monthly Comment – October 2019

Alphinity Concentrated Australian Share Fund

BTW

China is a little touchy about the way it is perceived around the world, and the trouble in Hong Kong this year seems only to have exacerbated its sensitivity. China has never been afraid of using its economic power to bring outsiders around to its way of thinking, as we saw a couple of years ago when a number of major global airlines were threatened with losing access to its market if they didn't represent Taiwan as part of China rather than the separate country it claims to be. But no one expected an ostensibly benign sporting group such as the US National Basketball Association (NBA) to fall foul of Chinese sensitivities and be punished in a very public and potentially damaging way. How did this come about?

The United States was forged in the 1700s fighting for relief from the yolk of British oppression, and that freedom-seeking culture has persisted over the succeeding centuries to the extent that it sends troops all over the world for decades at a time in the name of maintaining or implementing "freedom" – often whether the people involved want it or not. So when a chap named Daryl Morey, manager of the Houston Rockets basketball team, tweeted seven words in October "fight for freedom, stand with Hong Kong", no one in the US thought much about it.



But it sparked an incredible tweet storm in China. Even though Morey had no official position with the NBA itself, he is merely a team manager, China took great umbrage at this supposed assault on its sovereignty and banned the whole of the NBA from its TV screens. This was a problem because China is a huge basketball market, and the NBA was about to launch its 2020 season with a game in Shanghai only a few days later. It had two teams there (LA Lakers and Brooklyn Nets) waiting to play the first game, who suddenly bore the brunt of Chinese nationalistic anger. The Nets is owned by one of the founders of Alibaba, Joe Tsai.

It was exacerbated by the fact that the team associated with the tweet was the same team that had drafted the Chin's greatest ever basketball player in 2002, 2.3m (7'6") tall Yao Ming (pictured). This relationship had been the source of an enormous amount of goodwill for the Rockets in China over a long period of time, but that goodwill evaporated instantly with this tweet.

What happened next was a fascinating illustration of the conflict between America's commitment to freedom of speech and its commitment to money. While many people expressed support of what they saw to be a self-evident statement, there was an amazing amount of back-peddling from anybody associated with the sport. The NBA distanced itself from Morey and the views he'd expressed, which itself drew a new storm of abuse from the large number of Americans who sympathised with what Morey had said, or at least agreed with the principle of free speech.

Morey, after receiving some constructive feedback from a number of parties including the owner of the Rockets, the NBA and some legends of basketball like LeBron James, deleted his first tweet then tweeted some more, stepping back from its sentiments: "I did not intend my tweet to cause any offence to Rockets fans and friends of mine in China, I was merely voicing one thought, based on one interpretation, of one complicated event. I have had a lot of opportunity since that tweet to hear and consider other perspectives."

The NBA is obviously keen to keep access to the roughly 500 million or so people in China who watch NBA games each year. It had to come up with a nuanced message that both grovelled to China and stood up for free speech at the same time. As often happens, the outcome of sitting on the fence is that you end up with splinters in an uncomfortable place. It released an awkward statement: "While Daryl has made it clear that his tweet does not represent the Rockets or the NBA, the values of the league support individuals educating themselves and sharing their views on matters important to them". The Chinese language version of the statement added that it was "deeply disappointed by the inappropriate remarks". NBA boss Adam Silver said: "I'm sympathetic to our interests here and to our partners who are upset. I don't think it's inconsistent on one hand to be sympathetic to them and at the same time stand by our principles."

Notwithstanding the war of words, there will be a very tangible cost to the imbroglio: many Chinese sponsors of several basketball teams, not just the Rockets, have cut off their funding entirely which will cost the sport tens of millions of dollars. What can we learn from all this? Maybe it is just that Twitter has caused more problems than it has ever solved and should be banned.

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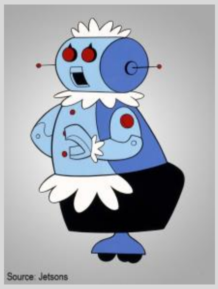
Travelling Tale

We haven't seen this ourselves, but we were intrigued by a story on CNBC about Chinese online behemoth Alibaba's take on the future of customer service in hotels: almost no interaction with humans at all! Alibaba's headquarters are in Hangzhou, a modest town of about 10 million people not far south of Shanghai. It has opened its first "hotel of the future", FlyZoo, next door to its head office. FlyZoo is keyless and cashless and operates with high degree of automation and robotics.

Check-in is done swiftly: your picture is taken and your passport is scanned. Chinese nationals don't even need to do that – they can just check in using the Alibaba app on their smartphone. There's also no door key: the doors are equipped with facial recognition so up you just walk up to it and it (hopefully) lets you in. Once in your room all controls, such as TV, lights and blinds, are carried out via voice recognition using TMall Genie, Alibaba's version of Alexa. We've all used voice recognition: what could go wrong? There are robotic butlers which will deliver things like bottled water or extra towels to your room, and drinks fridges placed throughout the hotel, which you need to use the Alipay app for.

The high level of automation extends to the public areas as well. You go to a bar and the drinks are mixed/dispensed by a robotic arm. And in the restaurant this rather cute R2D2-style waiter delivers food to your table.

The story didn't tell whether the food is also cooked by robots, nor whether Alibaba had been able to build robotic maids to clean rooms and make the beds, as was predicted by technology forecasters decades ago.



Why did Alibaba do this, other than because it is a massively profitable company that could easily afford to have a bit of fun? Its end-game seems to be proving that the technology works and then licencing it to global hotel chains. Large global chain Marriott was named as taking a close interest in the technology. For hotels, staffing is an enormous cost and anything the chains can do to reduce that cost would be appealing, providing that they can do it without annoying its paying guests, struggling to make themselves understood by Genie.

For further information, please contact:
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