alphinity INVESTMENT MANAGEMENT

Monthly Comment – November 2019
Alphinity Concentrated Australian Share Fund

Gathering Pace

Market comment

November is almost like another reporting season with any number of opportunities for companies to update investors on their performance for the first four months of the financial year: conferences, investor days, capital raisings, new company listings, the odd takeover and of course Annual General Meetings. And the updates came thick and fast, gathering pace into the end of the year. Sometimes good, sometimes bad, and generally with a sharp share price reaction, often out of proportion with the magnitude of the news.

The result was a surprisingly good market return of a touch over 3% (ASX300 including dividends), in the upper half of global market returns in $A. The $A fell by 2% during the month, flattering offshore returns. A few did better, with New Zealand topping the charts at a whopping 7%, the US just behind with 5.5% and a few European bourses (which still includes the UK for the moment) doing 3-5%. Asian markets generally struggled, most were positive but only just.

2019 looks like being a colossal year for the share market. It's obviously not over yet, December is still to come, but it would have to be pretty bad to make much of a dent in the 26% lift in overall share prices that has taken place since January. We are pleased to have added a decent increment to that 26%. And the news as we head into December is potentially positive, as chatter around a US-China trade deal appears to be getting louder. Arguably the pressure is more on the side of the US: its President is facing an election in 2020 whereas China's doesn't have one any time soon, if ever.

Resource prices were mixed, as usual. Bulk commodities like Iron Ore and Coal were slightly firmer in $A terms although some base metals fell sharply: Nickel fell 17%, Lead 10% and Zinc 7%. Copper, which is generally seen as a leading indicator of economic activity, rose 3% over the month. The price of Gold fell by 3% and the various types of Oil were all 4-7% higher.

From a sectoral point of view the best returns came from the Technology sector, closely followed by Health Care and Consumer Staples. The only real laggard was the large Bank sector after further allegations of poor behaviour and lax systems hurt the only major bank that had, until now, largely escaped significant criticism during the Royal Commission last year.

The economy grinds along at a modest pace. While the Reserve Bank's three rate cuts this year are certainly having an impact in the housing markets of Sydney and Melbourne, the benefit is less evident in the broader economy. Wages are growing sluggishly; employment growth is only just keeping up with the increase in labour force participants; and inflation – except in the aforementioned housing market – is almost non-existent. Business confidence is only just positive despite decent trading conditions, according to the NAB Survey, but consumers still have a slightly negative outlook, according to the Westpac survey.

Geopolitics looks set to continue to impact markets even at this late point in the year. Climate talks in Madrid, the NATO summit in London closely followed by a general election in the UK and of course the aforementioned ongoing trade talks all have the potential to either delight or disappoint the rather skittish markets.

Portfolio comment

The Fund's performance fractionally lagged the market in the month of November. The companies which contributed most to performance were blood fractionator and vaccine maker CSL and flag-carrying airline Qantas; being underweight major bank Westpac, which was the subject of serious money-laundering allegations during the month, also added to performance. The only positions that detracted noticeably were gas transmission company APA Group and two banks, ANZ and NAB.

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)	3.0	5.9	28.2	13.6	11.8	12.8	11.5
S&P/ASX 200 Accumulation Index	3.3	4.8	26.0	12.7	9.9	10.9	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. **Source: Fidante Partners Limited, 30 November 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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Market outlook

Global growth rates continue to weaken even though some leading indicators are suggesting the worst might be behind us. A China-US trade deal should be welcome news to equity markets and should also be supportive of the (so far) tentative improvement in the global economic outlook. At the same time, low bond yields, the key driver behind this year's equity rally, are likely to move higher on increased growth optimism. These factors, one of which works in favour and one which works against further equity gains, remain finely balanced, in our view.

China's economy should get a boost from a trade deal with the US, but probably more important than that is whether the government will provide some additional stimulus next year. Our resource analyst Stephane is just back from being on the ground in China and his conclusion was that while there will no doubt be some stimulus it will probably not as big as in previous instances. While the Chinese government is keen to achieve an economic growth rate close to 6% next year, it is also mindful of not giving up on the progress it has made so far in reining-in excessive overall debt levels over the last three years. Some further increase in infrastructure spending is likely, which would provide further support to commodity prices, but a repeat of stimulus of the scale of its 2016 program appears unlikely.

Back in Australia, the economy is still sputtering despite three rates cuts and some tax relief. Maybe we shouldn't be all that surprised that the reaction so far to even lower rates has been muted (other than in house prices in the major cities): after all, Europe has had nil or even negative rates for some years now. Perhaps it's just another indication that while wage growth remains weak, the average Australian would rather pay down debt than increase spending. Many equity markets – including our own – have posted stellar returns in the year to date, resulting in valuation metrics that are well above long term averages. It is becoming increasingly clear that we will need evidence of an improved earnings outlook to maintain this positive share price momentum. A US-China trade deal might provide the catalyst, but we are likely to have to wait well into the new year for it to show up in company earnings.

Portfolio Outlook

For much of the year – or even longer – market participants have been fretting over whether they should be positioning for a stronger economy or for a continuation of the current subdued macro environment, especially given the arguably cheaper valuations of some of the more cyclical stocks.

As discussed above, we remain fairly cautious on the economic outlook around the globe, and especially here in Australia. However, we continue to find that sectors or companies that provide earnings leadership through positive changes to their more immediate outlook are outperforming regardless of what category of stocks they happen to be classified as.

We have identified a number of these sorts of companies over the course of 2019 and remain confident in our ability to do so as we move into the new year. Whether those stocks will have a more cyclical tailwind or not remains to be seen, but we are exiting 2019 with a portfolio with a mix of structural earnings growing companies in the Healthcare and Industrials sectors, an overweight to global cyclicals through the Resource sector. We are also starting 2020 with an underweight to the bond yield-sensitive REITs sector and also an underweight to Banks, for both cyclical and structural reasons, which has been working well for us for some time.

Top five active overweight positions as at 30 Nov 2019	Index weight %	Active weight %
CSL Limited	7.0	5.5
Macquarie Group Ltd	2.4	4.2
Santos Limited	0.8	4.0
BHP Group Limited	6.2	3.8
National Australia Bank Limited	4.1	2.7

Asset allocation	30 Nov 2019 %	Range %
Securities	96.9	90-100
Cash	3.1	0-10

Source: Fidante Partners Limited, 30 November 2019.

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BTW

We're often a little bemused by the power of index compilers, those people who by default seem to have ended up running a large part of the financial markets. In theory, the benchmark should measure the aggregate movement of all companies in a particular market. While we do use indices – for instance our Australian Funds use the S&P/ASX 200 and 300 and our Global Equities Fund uses MSCI – we've always considered them to be a tool for estimating exposures rather than an objective in themselves. However it seems that many people have become bewitched by the commonly-stated belief that "you can't outperform the market" so therefore a "cheap" index fund, run by computers and an index, will do better than having people like us making hard decisions about allocating your capital.

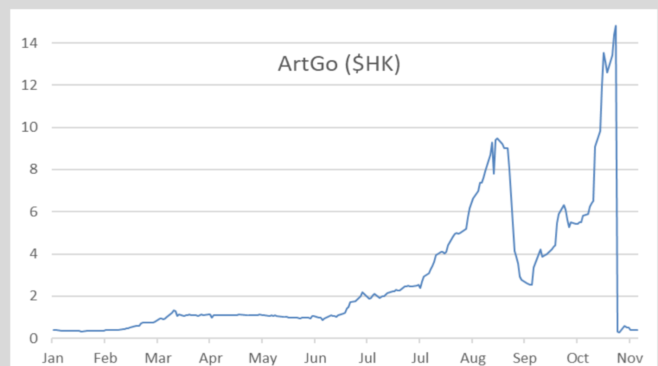
That idea has a lot of currency in the US, where most of the studies postulating that view are performed. The underperformance of US active funds is quite legendary, but this is patently not the case in Australia where some (although certainly not all) fund managers have good records of consistent outperformance over many years. We humbly submit Alphinity's own record, over more than nine years now in our own name and many more in a previous guise. The funds we manage have provided solid increments of excess return, beating the index consistently even after fees, in a risk-conscious manner. While the magnitude of outperformance may sometimes appear small in numeric terms, as a proportion of total return it is quite meaningful, and when you compound that excess return over a number of years you would have ended up with a much better experience than you would have received from an index fund over time.

The idea of "investing in the market" through index funds has a number of shortcomings. We all know of companies that have done really poorly, whose earnings and/or share prices have fallen significantly. If you invest "in the market" you are by definition buying some of those companies. Surely it would be better to avoid poor-returning companies and only invest in those with good prospects?

Investing "in the market" also precludes the important role the equity market has of allocating scarce capital to the most productive places. When you put money into an index fund it simply buys a proportionate number of shares in each company according to its size. If a company's weighting in the benchmark is large you end up owning a lot of that company whether it is a good investment or not. And the higher a company's valuation is, the more you buy of that company. We're not averse to buying a company with a high share price if our analysis shows that its prospects more than justify that price, but we certainly don't do it indiscriminately.

This piece didn't start out as a diatribe on index funds, it was intended to point to an unusual event that took place during the month. Hong Kong has been the site of a number of troubling things this year, but at least this one was not related to pro-democracy protests. Shares of a company we'd not previously heard of, marble producer ArtGo Holdings, had been booming this year. It had been on the boards in Hong Kong for ages after listing at $HK2.65 in 2013. It was a disappointing performer though, trading below the IPO level until this year. The shares finished 2018 at HK38c – that's about A7c – but started moving higher in February and finally made it to its IPO price in August. Happy days. It kept going on, with a few ups and downs along the way, but the really big move took place in November when the most prominent index compiler, MSCI, which is followed by most global investors, announced that ArtGo shares would be included in the market-leading MSCI World Index.

A whole industry has sprung up in recent years, revolving around front-running index changes. Index funds generally have strict rules about when they can make portfolio changes and often it is the day the index change takes place. Getting a few days or weeks notice is gold for share traders as they know there is a large group of forced buyers on the horizon. They piled into ArtGo at around $HK6.50 on November 7th and drove it as high as $15 by the time MSCI made its second announcement on the 20th.



The second was less positive. MSCI apparently looked closely at the company and received some lobbying from its clients and decided not to include ArtGo in the index after all. The share traders dumped them mercilessly with the result that ArtGo shares, which had closed at $HK14.80 on November 20th, traded down to HK30c on the 21st, a fall of 98%. Ouch.

Is there a moral to this story? Hard to say really but to us it illustrates just one of the potential pitfalls of letting a computer invest your money: you never know what you might end up owning!

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Traveller's Tale

Stuart spent a whirlwind week traipsing around the US in November – five cities in five days – researching companies in the health care sector and selflessly being away from his family for his birthday. He was actually in Atlanta that day visiting the US operations of Japanese company Takeda Pharmaceuticals. Together with Spanish company Grifols, Takeda is one of Fund holding CSL's major competitors in the global blood fractionation market.

Simplistically blood fractionation involves two steps: 1) collect blood from donors and extract the plasma (pictured) from it; and 2) fractionate that plasma into valuable products such as immunoglobulin.

Takeda's plasma assets have changed hands several times recently. They were originally spun out of US pharma company Baxter International in 2015 before being acquired by UK biotech company Shire in 2016. Shire itself was acquired by Takeda in January this year.

Periods of corporate activity like this often prove distracting to management, and this business was not immune. During the period of turmoil Baxter/Shire/ Takeda failed to invest in plasma collection facilities at the same rate as it had expanded its fractionation capacity. The result is that Takeda now owns an impressive-looking new fractionation plant but doesn't have enough of the raw material to properly feed it. Takeda is making positive strides to rectify the situation by running its existing collection centres harder, mostly through longer opening hours, and is urgently investing in new centres to grow its network. However, it will still take Takeda a number of years to catch up. This is positive for CSL, which continued expanding plasma collection centres while its main competitor was looking the other way.

Donors can donate plasma as frequently as twice a week. This is much more often than the once per quarter recommended for whole blood donations, as the plasmapheresis donation process just takes the blood, strips out the plasma and returns the donor's blood cells to their bodies. Unlike the situation in Australia, donors get paid roughly US$50 for their time. Some people have a perception that this attracts down-and-outs but that certainly wasn't the impression Stuart gained from being in the centre: people were well-dressed and generally were arriving by car on the way to or from work. The donors simply relax on comfy lounges enjoying the Wi-Fi while their plasma is collected. All the donors he witnessed spent their entire visit buried in their phones.

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