Quarterly Comment – December 2019
Alphinity Concentrated Australian Share Fund

2020 Vision

Market comment

What a year. In December 2018, when the markets were crumbling all around us, who'd have thought that 2019 would turn out to be such a good year for share market investors? Remember back then the US Federal Reserve Bank was still tightening interest rates despite the sage advice of its President that it should be easing? And the Trade War between the US and China seemed to be getting out of hand, providing a real threat to global economic growth? And Brexit uncertainty was going on and on, seemingly without end? Who would have put money into equities in such circumstances?

As is often the case, when the news was at its worst was exactly the time to put money in: as the old saying goes "it's always darkest before the dawn". The ASX300 (including dividends) ended up returning about +24% for the year. Why such a big move? It's much easier to predict market moves after the event (see BTW over the page) but sometimes just taking away some of the negatives is enough for the market to become positive. The best sectors to be in in 2019 were Health Care and Information Technology which returned 42% and 35% respectively, followed by Consumer Discretionary with 28%. Financials was the laggard with Banks returning a paltry 3%, Insurance 15% and Real Estate 17%. Consumer Staples returned only 18% after suffering a sharp downturn in December.

Some global markets did even better than ours, we were about middle of the pack (see chart). The best major market in $A terms was the technology-focused US Nasdaq which returned close to +40%, and quite a few exceeded 30%. The laggards were Korea (+6%), Singapore (+11%), and Hong Kong (+14%). But it's a pretty good year when even the worst markets are largely up. Argentina's was the stand-out: its market was actually 35% higher in its local currency, it's just that the Argentinian Peso halved in value over the course of 2019.

The $A started the year at US70.5c and finished virtually unchanged at US70.2c, although it went as high as 72c in January and as low as 67c in September. Commodity prices had some big swings over the course of 2019, not least the bulks which are so important for Australia. Iron Ore was up more than 22% over the year, which was great for our major miners, although the price of Coking Coal used in steel making was down 13%. The price of Thermal Coal, used in power generation, fell by 33% but Oil rose by between 23% and 35%, depending on the grade. Gold was also strong in 2019, rising by 19%, and base metals moved only modestly other than Nickel which was up by 32%.

Portfolio comment

The Fund performed well in the December quarter and for the whole year. The companies which contributed most to performance were blood fractionator and vaccine maker CSL, global asset manager Macquarie Group and flag-carrying airline Qantas. Not owning major bank Westpac, which was the subject of serious money-laundering allegations during the quarter, or Gold miner Newcrest also added to performance. The only positions that detracted noticeably were two other major banks, NAB and ANZ, and being underweight Rio Tinto.

Across the whole of 2019, the best contributors were CSL, iron ore miner Fortescue Metals, gas producer Beach Energy, property developer Mirvac and Macquarie Group as well as not owning Westpac or South 32; worst contributors were data administration company Computershare, ANZ and NAB and logistics facilitator Brambles.

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)	-2.2	1.4	26.2	11.1	10.8	11.9	11.1
S&P/ASX 200 Accumulation Index	-2.2	0.7	23.4	10.3	9.0	10.0	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 December 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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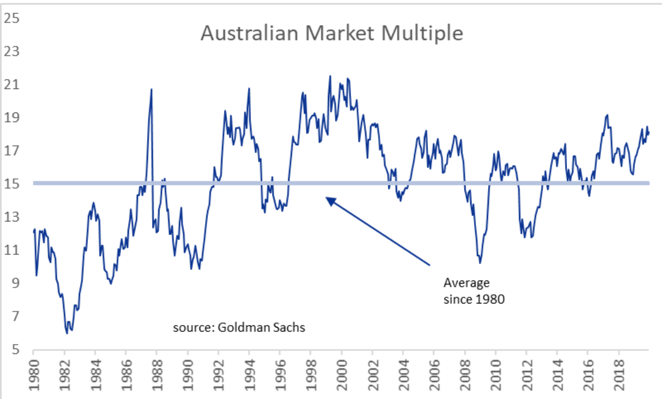
Market outlook

Global equity markets ended 2019 at another high. The first phase of the US-China trade deal and increased certainty around Brexit after the Conservative Party's solid win in the UK election have increased optimism about the potential for stronger economic growth in 2020. This contrasts with the noticeable economic slowdown that took place during 2019, when global manufacturing was effectively in recession.

With equity market returns well ahead of earnings growth over the last 12 months many bourses ended the year trading at valuation metrics well above long-term averages. Of course, the prices of various other asset classes are also above long-term averages: Australian government bond yields at 1.4% are not far from historic lows and property prices – residential and commercial – are also at or close to new highs. Maybe it isn't surprising that equities were bid up too.



While both short term and long-term interest rates remain supportive of equity markets, a pick-up in corporate earnings growth both in Australia and globally is increasingly becoming required to sustain the record long run of positive equity market returns. Some of the leading indicators, such as global purchasing manager indices, are beginning to suggest that a degree of optimism is perhaps warranted, and a US presidential election year is typically associated with positive economic growth – or at least not having a recession.

Following the stellar returns in 2019 that were arguably anticipating some of these things, the fact is that any real improvement to come from the US-China trade deal or Brexit (assuming it is a positive) is likely to still be many months away. So even though comparisons to the poor conditions of last year will become increasingly easy, we enter 2020 as we left 2019, feeling increasingly in need of evidence of improved earnings growth before markets can move meaningfully higher.

Portfolio Outlook

The year 2019 provided the usual number of challenges and opportunities for the portfolio but overall results were pleasing, both from a relative performance perspective and from the unusually strong absolute returns. While the current fairly elevated valuations and fairly modest extent of expected earnings growth make us cautious about the short-term overall market outlook, we still remain optimistic about being able to keep identifying individual companies that can deliver an earnings trajectory ahead of what the market is currently expecting. We believe this will remain a more reliable way to add alpha to portfolios than trying to pick the broader macro outlook which, as always, has a large number of hard-to-predict elements to it.

The portfolio remains well-diversified but with a small overweight to non-gold Resource companies (primarily BHP, Fortescue Metals and Oz Minerals) and an underweight to the major Banks, where we see further challenges to earnings. Other high conviction calls remain health exposure CSL, financials company Macquarie Group and energy producer Santos – these are all companies for which we expect further upward earnings revisions. Over the last few months we have increased our positions in building materials manufacturer James Hardie, explosives company Orica, medical device maker Fischer & Paykel Healthcare and hospital operator Ramsay Healthcare.

While from different industries and possessing different earnings drivers they have, in our view, one thing in common – underestimated earnings growth and the potential for continuing upgrades. We expect these companies will keep outperforming as the market becomes increasingly aware of their potential.

Top five active overweight positions as at 31 Dec 2019	Index weight %	Active weight %
CSL Limited	7.0	5.0
Macquarie Group Ltd	2.4	3.9
BHP Group Limited	6.4	3.8
Santos Limited	0.8	3.7
QBE Insurance Group Limited	1.0	2.5

Asset allocation	31 Dec 2019 %	Range %
Securities	97.6	90-100
Cash	2.4	0-10

Source: Fidante Partners Limited, 31 December 2019.

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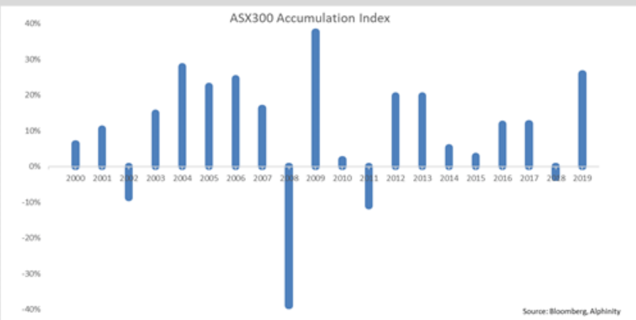
BTW

A frequent theme in our publications is the inherent difficulty in predicting the magnitude and direction of movements in equity markets, particularly over periods as short as a year. It's much easier to predict the market after the event and we point to our quarterly report from December 2018, at the end of a year during which the market had dropped 3% (thanks to a nasty -8% in the final quarter), when we concluded: "Each year has its own unique conditions and characteristics so we can't at this point predict with great confidence what 2019 will bring. The first days of January were decidedly weak with a profit warning by Apple and poor manufacturing data in both China and the US, although this was followed by very strong US employment data. With the Australian share market starting the year at the lowest earnings multiple since 2006, there would need to be some pretty significant earnings disappointments ahead for the market to be lower again at the end of this year."

As it happened there were earnings disappointments for some companies in 2019 but if you managed to avoid most of those, as we largely did, you would have had a pretty good year. We didn't expect the market to be up by almost a quarter last January but that just proves our point: if anyone tells you with certainty what is going to happen to the market you should take it with a very large grain of salt. We try to focus on the fundamentals, the earnings and valuations of individual companies, and let the overall direction of the market look after itself.

Clearly it would be unreasonable to expect >20% returns to happen very often; a better way of looking at things is over longer periods to strip out some of the volatility. Including the 3% fall in 2018, the two-year return of the ASX300 Accumulation Index (which includes dividends) averages out to be 9.5% pa. It was a 10.3% over three years and a little more than 9% over five years. In fact over the 20 years of the 2000s the index is up almost five times, which equates to just under 9% per annum. This includes 2008, the worst year of the Financial Crisis, when it fell 40%.



A market return of around 9% per annum makes intuitive sense: companies have generated on average 4-5% pa in earnings growth, you add 4-5% in dividends and you get to that number. It's really not a bad outcome in an economy in which inflation is almost absent and short-term interest rates have been cut to below 1%. There will always be years when the market move is much bigger or smaller than that but if you'd panicked and exited the market at the end of 2018 – which after that alarming final quarter might have been very tempting – you would have missed out on a lot of performance in 2019.

It's fair to ask how can the market grow earnings at a higher rate than the overall growth of the economy, but it's not really very different. Economic growth is generally forecast to be about 2% in real terms, which means 2% plus whatever inflation is, currently also about 2%. So if the nominal economy is growing at about 4% it would be reasonable to expect companies to achieve that much revenue growth, and some might get a bit of operating leverage on top (i.e. costs growing more slowly than revenues) which would improve the outcome a bit further.

You also need to remember that our companies are not tied to the growth rate of the Australian economy, most Australian companies also have exposure to offshore markets, and some are quite large exposures too. For instance, our second biggest company and the Fund's biggest position, CSL, derives most of its revenues from offshore, and so do the big mining companies. Against that however is our Bank sector where profits are under pressure and we don't expect them to achieve much earnings growth at all.

How will 2020 pan out? The normal caveats apply, but unlike the situation this time last year the market is not cheap. As the chart on the previous page shows the market is trading on about 18 times earnings: not the highest it's ever been but it is still much higher than the under 16 times it was a year ago. This reflects the fact that even though earnings growth in 2019 was fairly modest, companies' share prices on average were up more than 20%.

It doesn't necessarily follow that 2020 therefore will be a year of poor returns: earnings might still surprise positively and/or strong offshore markets could keep our market bubbling along. 2020 is after all a US election year and they generally turn out to be pretty good for equity markets. The current US President, despite his recent impeachment, sees the market as a symbol of his own success so he will be doing whatever he can, and pressuring the institutions of government to do what they can, to keep it on the up. Lots of swings and roundabouts but, everything else remaining equal, a high single-digit total return for equities in 2020 wouldn't be out of the question.

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Traveller's Tale

As part of our ongoing quest to obtain insights on the latest industry dynamics, Stephane travelled to Hong Kong, Shenzhen and Singapore in December to meet with LNG participants and China-exposed infrastructure and property players. His trip was initially meant to be just to Hong Kong and Singapore but Shenzhen was added at the last-minute when escalating unrest in Hong Kong forced organisers to shift a conference he was attending to a safer place, just across the border in mainland China.

40 years ago Shenzhen was just a fishing village with 30,000 residents, then China made it into a Special Economic Zone. As this picture shows it's now a thriving metropolis of about 13 million and was rated by Lonely Planet in 2019 as being the second-best city to visit in the world; Copenhagen was number one. It is an amazingly innovative place: this one small city (by Chinese standards) is responsible for more than half the patents granted to Chinese organisations. Telecom giants ZTE and Huawei are both based there, along with a large proportion of the world's semiconductor industry.

Stephane did conduct some meetings in Hong Kong. The impact of the demonstrations was not obvious to a brief visitor like him, other than the hotels being significantly discounted, restaurants being half empty and traffic being almost non-existent. The famous Hong Kong night life also seemed to be hibernating.

The contrast between the city-states, Hong Kong and Singapore, was striking. Singapore was buzzing and felt if anything strengthened by the destabilisation and unrest in Hong Kong. Some predict that Singapore will ultimately become the dominant financial centre in Asia as it does not have the same pressures resulting from a government conflicted between the ideals of democracy to which so many Hong Kongers aspire while trying to be faithful to those in Beijing who appointed them.

Singapore has had very stable government since it was created as a state in 1959. It has had only three Prime Ministers in that 60-year period, all from the same political party and two from the same family.

While it may not have the type of democracy we're accustomed to and has some laws and practices that seem quirky to those from the West (for instance its famous prohibition of chewing gum, possession of which is punishable by hefty fines) Singapore is far removed from the governing style of China and, for this reason alone, has a good chance of ending up being the financial capital of Asia. It will be the giant Western financial organisations who will ultimately determine which city wins out.

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