alphinity INVESTMENT MANAGEMENT

Monthly Comment – January 2020
Alphinity Australian Share Fund

Catching a Cold

Market comment

19th Century Prussian diplomat Metternich once said, "When America sneezes, the world catches a cold". Considering the geopolitical changes in recent decades we can now extend that saying to China, literally. A lot of bad stuff was going on here and around the world in January but you would never know from the Australian share market. Despite dreadful bushfires scorching large parts of our country and sending plumes of smoke around the world, impeachment proceedings in the US and the outbreak in China of what is feared could become a global pandemic, the ASX300 (including dividends) followed on from its strong rise in 2019 adding a further almost 5% in January to an all-time high.

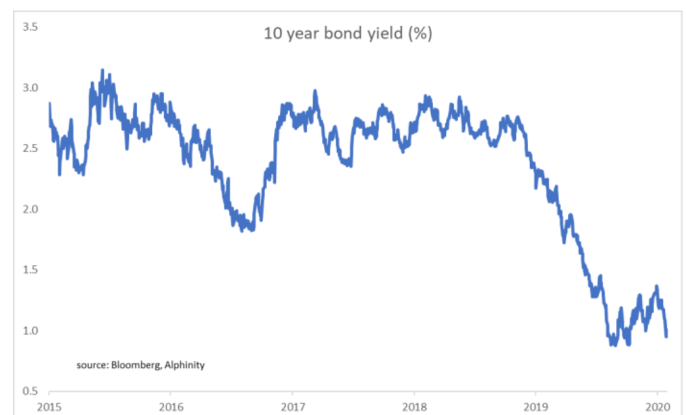
The $A sold off sharply during the month, falling almost 5% against the $US and 3% against the Euro. The US market was virtually unchanged in its own currency but up 5% in $A. Asian markets were generally soft as the virus increasingly seemed to infect bourses as well as bodies: HK-listed Chinese shares were off 8% in $HK but only 3.5% in $A terms. China's domestic markets in Shanghai and Shenzhen were fortuitously closed for the final week of the month due to Lunar New Year holidays, limiting their January falls to very modest levels. European markets fell modestly in Euro terms but with the soft $A that became 1-3% increases.

The evolving crisis in China had a noticeable impact on resource prices. Oil was off 6-9%, depending on the type, and Gas in the US traded down a massive 13%. The weak $A cushioned the price falls of a lot of other commodities but Gold bucked that trend, rising 8% in the month in $A terms to an all-time high. Bond yields have again become topical, with yields falling sharply (i.e. prices rising) in January back towards recent lows of under 1% (see chart). They fell further in the early part of February as hype around the impact of the coronavirus on global economic activity built. In a virus-impacted month like January the "fear trades" of gold and bonds worked quite well.

Although the Australian market was so strong, the number of companies that performed well was quite narrow: it would have been very easy to underperform this month. If you'd had a strict value tilt, for instance, you could easily have missed out on the three biggest sectors as most of the companies therein could be considered "expensive". The companies that did well in January were mostly in the Healthcare, Technology and Consumer Staples sectors, while Utilities, Energy and Materials stocks (other than Gold) lagged, still making positive returns but only just.

Portfolio comment

The Fund outperformed in January, in excess even of the strong market rise. The positions which contributed most to performance were blood fractionator and vaccine maker CSL, supermarket operator Woolworths and building products manufacturer James Hardie. Wine producer Treasury Wine Estates was the biggest detractor after issuing a profit warning late in the month, followed by airline Qantas, largely on fears that the coronavirus might dent international travel, and insurer IAG which not only felt the effect of property loss from bushfires but also a nasty hail storm which hit Sydney during January.



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)	5.3	5.9	26.0	12.9	9.4	10.3	10.4
S&P/ASX 300 Accumulation Index	4.9	6.0	25.0	12.4	9.4	10.0	9.7

*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 January 2020.**
^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

History suggests that pandemics such as the Novel Coronavirus tend to have a sharp but relatively brief impact on global economic activity. There is of course never a good time for such events but the timing of this one is potentially precarious for global equity markets which had been rallying on expectations of better economic growth in 2020. Those growth expectations, which in our view already looked quite optimistic, have now clearly been pushed out a by quarter or so.

Of course, if we again look to history as a guide to the future, China is highly likely to stimulate its economy when it feels the crisis is under control to regain lost momentum. Indeed, the Peoples Bank of China, its central bank, has already eased monetary conditions in various ways. Fiscal stimulus is likely to follow as soon as the virus is deemed to be under control. The Australian Government, already under pressure from the bushfires, might also use this virus event to loosen its purse strings.

Another impact of the growth scare from the Coronavirus has been another collapse in global bond yields, which has benefitted the valuation of companies whose earnings growth is less tied to economic growth. So even though we can't help being concerned about market multiples that are well in excess of longer-term averages, the market might prove yet again to be resilient to poor corporate profit growth. After all, the low interest rates support valuations and make equity alternatives traditionally thought to be safer, such as bonds, continue to look unattractive.

The upcoming February reporting season should shed some light on the impact of the bush fires on domestically-exposed companies, although we expect that most companies will say that any fallout from the Corona virus is "too early to tell". Aggregated earnings growth has stabilised somewhat so far in 2020, although this appears to have been driven by a handful of large companies rather than being an indicator of any broad-based improvement: the ratio of company downgrades compared to upgrades remains firmly negative. We don't expect this trend to have changed meaningfully by the end of February.

Asset allocation	31 Jan 2020 %	Range %
Securities	96.6	90-100
Cash	3.4	0-10

Source: Fidante Partners Limited, 31 January 2020.

Portfolio Outlook

The Australian equity market has already had plenty to deal with, even just a month into 2020. Pleasingly, your Fund has so far fared relatively well despite this environment of increased uncertainty. With the macro environment fluid, we think it's as important as ever to focus on company fundamentals, rather than making big picture decisions.

We have taken some profits in some of our best performers over the last 12 months. These stocks cover a range of both defensive and cyclical industries, and our cautionary move should not be interpreted as us expecting a major shift in earnings leadership or performance. In the Energy sector we exited Beach Petroleum and also somewhat reduced our holding in Santos. The management teams of both companies have done an excellent job over the last few years in building enviable growth profiles. However, with great performance comes increased market expectations and Beach in particular will have to work hard to meet management targets for FY20.

Other noteworthy adjustments include trimming our positions in iron ore producer Fortescue and health exposure CSL after exceptional performance of both companies. Fortescue has continued its industry-leading cost and production performance and all indications suggest that CSL has done the same. CSL remains one of our largest positions but after such a strong run we feel it's prudent to lock in some of the gains. Wine maker TWE was also reduced after a disappointing earnings update with further risk from industry oversupply in the US and demand uncertainty in China.

The February reporting season will provide further insights into which companies are best navigating the current environment. We enter February with a portfolio we believe has strong prospects for positive earnings revisions and, therefore, investment performance, but additional adjustments will no doubt need to be made over the next few weeks. We look forward to discussing our conclusions from the busy period ahead in our next monthly report.

Top five active overweight positions as at 31 Jan 2020	Index weight %	Active weight %
CSL Limited	7.3	2.5
Santos Limited	0.8	2.3
Macquarie Group Ltd	2.4	2.2
BHP Group Limited	6.0	1.9
APA Group	0.7	1.8

Source: Fidante Partners Limited, 31 January 2020.

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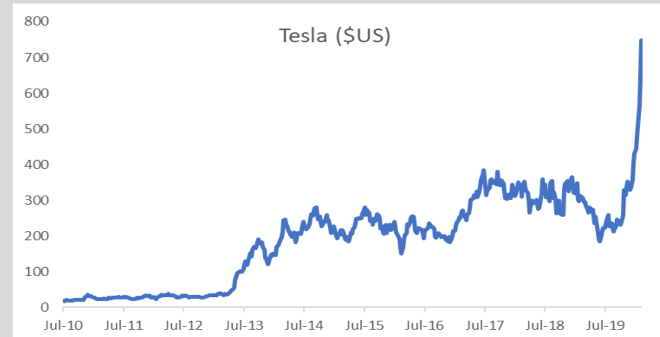
BTW

We have mixed feelings about Tesla and its founder Elon Musk. Tesla is undoubtedly a disruptor in the automotive industry, and Musk is undoubtedly a visionary who will likely be remembered as one of the most influential people of our time. He not only co-founded a payment platform which he sold for billions of dollars, he parlayed that fortune into several other even greater fortunes – Tesla, SpaceX, Hyperloop, Neuralink and others with multibillion-dollar potential – and is busily re-making the car industry. We hesitate to use a man's assets as a measure of his worth, but Musk on that basis is "worth" around $US30 billion. Impressive.

On the other hand, Musk the individual appears to be a thin-skinned narcissist who was willing to trash the character of one of the rescuers of the Thai soccer team trapped in a cave in 2018 when that person rejected Musk's rather unrealistic offer of help. He is also an alleged stock manipulator that same year, while smoking marijuana during a radio interview, he let slip there was about to be a private equity bid for Tesla at a steep premium to the then share price. The bid possibly never existed, and that episode resulted in him being sanctioned by the powerful US Securities and Exchange Commission and forced to give up his position of Chairman of the company. (As an aside, the person who took over from him is an Australian, Robyn Denholm, who resigned last year from her position as CFO of Telstra to take up that position.)

"Disruptor" is an over-used term in the markets but one that fits Tesla nicely. It took a hundred-year-old, well established heavy industry and turned it on its head by applying new technology and a different way of thinking to deliver personal transportation in a better way. While battery technology, charging and cost are still limiting factors, it is hard to argue that owning a vehicle with many fewer moving parts, lower maintenance requirements and technology that is upgradeable over the air is not a better deal than traditional internal combustion engine (ICE) cars. The environmental benefits are complex: electric vehicles shift the pollution from where you are using the car to wherever the electricity is being generated, so if your electricity comes from renewable sources, there are genuine environmental benefits from operating the car.



So, what has Tesla done now to be worth mentioning? Its shares almost doubled in January and kept going in the early part of February, after announcing quarterly earnings that surprised the market on the upside. It also announced that it had built 112,000 cars in the fourth quarter, launched the new model Y (pictured opposite) earlier than expected and opened a factory in China. At the end of January, the company was capitalised at $US117 billion which is quite impressive when you consider the number of cars it produces (forecast to be around 500,000 this year) and the fact that it barely broke even in 2019. The profit it is expected to make in 2020 (likely $US1-2 billion) pales by comparison with most of the long-established and sometimes highly profitable automobile makers.

Tesla is now the world's second most valuable car maker. Its value exceeds the big three US car makers put together: that's General Motors ($48 billion), Ford ($32 billion) and Fiat-Chrysler ($20 billion). In 2019 each of these companies made several billion dollars in profit and they all trade on about 5 times earnings. Tesla's value even exceeds that of Volkswagen AG (€84 billion/$US91 billion): it makes 20 times as many cars a year across a number of brands. It still has a way to go to match Toyota, to which the market accords a worth of ¥25 trillion ($US230 billion), and each of those other carmakers are putting a lot of effort into building their own electric vehicles – we will see many more on the market in the next couple of years.

Passing Toyota would be another step towards a big payday for Elon Musk. In 2018 he agreed to take no salary for his work as CEO, instead be paid in options based on the revenue and market value of the company over time. Should its value remain over $100 billion for six months he will be eligible for shares worth $US346 million. There are a number of further tranches for milestones out to 2028 which, if achieved, could earn him upwards of $US50 billion: that's worth dancing about. It would require the company to be worth $650 billion in 2028 – but with Musk anything could happen.

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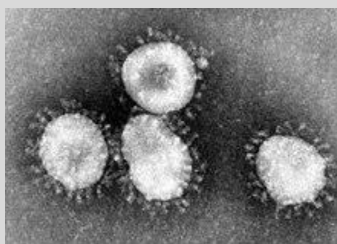
Non-Traveller's Tale

The so-called 2019 Novel Coronavirus (aka 2019-nCoV) was the story of the month – possibly the year – sparking mass quarantines within China and evacuations of foreign nationals from China. Comparisons are inevitably made with previous pandemics such as SARS (Severe Acute Respiratory Syndrome) which spread from China to Hong Kong and beyond in 2002-3 infecting more than 8000 people in 26 countries and causing 774 deaths (almost 10%); and the much more contained MERS (Middle Eastern Respiratory Syndrome), which spread from Saudi Arabia in 2012 infecting 2500 people and ultimately killing about 800.

This virus is apparently worse in terms of contagion, such that the number of people infected went beyond 20,000 fairly quickly, but thankfully the severity seems to be a lot lower, with quite a low death rate compared to the others: around 700 at the time of writing. We aren't minimising this, 700 is still a large number of lives and it will no doubt increase, but if it were killing 10% or 30% it would obviously be a lot worse. Most of the fatalities also seem to have already been in a weakened condition.

A "coronavirus" gets its name from its vaguely crown-like appearance. It is quite a generic thing, it really needs a catchy acronym for maximum effect. MERS and SARS, for instance, were both also coronaviruses. Most coronaviruses only infect animals. "Novel" just means new – it is a new type of coronavirus.



Authorities seem to have learned from prior pandemics: while there is some debate as to how upfront the Chinese government initially was about the existence and severity of the virus, it is fair to say it has done a lot better than it did with SARS, which it denied and obfuscated about before making adequate moves to contain the outbreak.

This time there are radical steps being taken, to the extent that many are wondering whether the cure might end up being worse than the disease. Shutting down entire cities, provinces, borders and industries is having global ramifications. If the closures are short-lived the ramifications should end up being limited. If they go on the world risks grinding to a halt, such is the extent to which Chinese manufacturing has become intertwined in the supply chains of most industries. China's economy is now about six times the size it was during SARS and represents close to 20% of global economic output.

One of the immediate effects is a lower propensity of people to travel. Leisure travel is obviously at risk: Australia and the US have both banned the entry of Chinese nationals without extenuating circumstances, putting a stop to China's outbound tourism and, to a great extent, our own inbound tourism for an as yet undetermined period. Business travel is also being hit, and our own energy and resources guru Stephane, who generally goes to China several times a year (we reported on his December trip last month), has had to curtail his plans for another visit in March. Great as his dedication to our investors is, he'd be no use to us or you ill (or worse)!

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