Alphinity INVESTMENT MANAGEMENT

Quarterly Comment – March 2016
Alphinity Wholesale Concentrated Australian Share Fund

Strange Days Indeed

Market comment

After starting 2016 poorly, the market recovered somewhat in March with a return of almost 5% (ASX200 including dividends), bringing the deficit for the March quarter to only -2.7%: disappointing but not the end of the world. It was one of the better performers in $A of the major markets we follow: Chinese shares in Shanghai fell 19% in the same period, the US S&P500 by 7% and most European countries were lower (-5 to -11%). It was resource-heavy markets that did well in the March quarter: South Africa was +2%, Canada +5%, Russia +10% and Brazil up an amazing 26% (although even after that move Brazil's market is left 12% lower than it was a year ago). Most peculiar.

Commodity prices were mostly higher in the March quarter raising questions about whether this is a temporary blip within the established downtrend, or a fundamental change in the prospects of resources. This is a critical question to establish and we have been spending a lot of time and effort on working out the answer: to move from our present underweight resources position might prove to be a mistake. But the $US price of Iron Ore, an important export, rose by 23% over the quarter, gold was up 16% and Brent oil was up 8%. Base metals were mixed, zinc and copper rising 13% and 4% but nickel and lead fell 4% and 6% respectively.

Banks proved tricky during the quarter. Commonwealth Bank was the only one to announce a half yearly result in February, and quite a good result it was too, but all the banks were rocked by the announcement by ANZ that it needed to provide an extra $100m or so for potential Bad and Doubtful Debts in its commercial lending book. While this only represents a small fraction of the roughly $7 billion ANZ will likely make this year the market took it as a harbinger of doom, the first crack in the dam wall of a highly leveraged economy, and sold all the banks off sharply: as a sector Banks fell 13% in the quarter. By contrast Metals & Mining, which takes in most non-energy resource companies, rose by 14% in the same time period and Energy companies were up 8%.

The global currency markets did strange things in the March quarter not helped by some prevarication at the US Federal Reserve (Fed) which, at the first sign of financial market instability

appeared to turn hawks into doves and put some doubt around the tightening bias it had announced just before Christmas, sending the $US sharply lower. The $A was consequently quite strong during the quarter making a big turnaround from its mid-January lows when it dipped below US69c. It finished the quarter just under US77c.

Should this currency move be sustained it could prove troubling for some Australian exporting companies which have only just started to breathe a currency-related sigh of relief. We have a number of positions that would benefit from a lower currency, including Aristocrat Leisure, Treasury Wine Estates, Macquarie Group, James Hardie and Resmed, but we also make sure there are strong operating factors driving earnings upgrades – we are not just hoping for a lower dollar. However it does feel as if the balance of probability from this point is for the $A to trend lower over time as US economic growth appears to be likely to well outstrip Australia's at least for the near future.

Portfolio comment

The Fund underperformed the market a little in the March quarter. While there were obviously a number of stock specific impacts it was largely macro factors that impacted: primarily a bounce-back in some resource stocks that had been underperforming. The best contributions were from health insurer Medibank Private, global winemaker Treasury Wine Estates, global industrial property developer Goodman Group, and not owning major bank ANZ. Holdings that detracted were global investment bank Macquarie Group, domestic retailer Super Retail Group, which produced a disappointing result towards the end of the month, and major bank Westpac.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	4.2	-3.3	-6.7	7.5	7.7	9.5
S&P/ASX 200 Accumulation Index	4.7	-2.7	-9.6	5.4	5.7	7.4

*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.
^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

After a first quarter which unusually included both a broad-based sell off due to global growth concerns and a strong market recovery led by cyclical stocks, we would expect the equity market to pause until a clearer picture on the direction of the global economy emerges. We suspect that, at least in terms of overall economic growth, the picture is not too different to before: growth will be positive but remain below trend.

These days it seems we live in a world of high speed connectivity, not just online but also in the economic world. The rally in cyclical stocks was triggered by the USD weakening against most currencies, including the AUD. The lower USD led to a rebound in many commodity prices and, in turn, the shares of resource companies. Of course the initial cause of the USD weakness was a combination of concerns over the US economy, China and global financial markets in general.

With equity markets now having recovered somewhat, high-risk bonds well off their lows, China stabilising and economic data in the US improving it seems logical that attention in coming months should turn to when the Fed will make its second step towards "normalising" interest rates. If this is the case, renewed USD strength later in the year would not be surprising, especially as both Europe and Japan have in the meantime moved to negative interest rates, further increasing the interest rate differential. Should the market go full circle, commodity prices would likely then come under renewed pressure followed by share prices in the sector.

An important caveat however is that after more than two years of analysts chasing falling commodity prices, a significant positive gap between spot commodity prices and analyst forecasts has opened so far this year. This is especially the case for iron ore, in which we would expect sizeable upgrades over the next few months even if current prices are not fully sustained. It's still too early to tell where prices will settle and it's unlikely that this is the beginning of a new resource upcycle, but we may have seen the bottom in share prices for those resource companies with sustainable cost positions and balance sheets. We are less enthusiastic about the prospects for the Energy sector where expectations of a price recovery still look too optimistic to us.

While the lower USD has been good news for commodity prices, the consequent rise in the AUD will negatively impact the value of non-resource companies' overseas earnings when they are translated back in to AUD, and this translation impact has been one of few positive drivers of company earnings for the broader Australian equity market. In other words, a weaker USD/stronger AUD is both a positive and a negative for the market.

Asset allocation	31 March 2016 %	Range %
Securities	98.1	90-100
Cash	1.9	0-10

Finally, the outlook for the Bank sector has also become more mixed. It's increasingly clear that bad debts are coming off cyclical lows. Losses are still modest but the deterioration in the credit quality cycle is another headwind for the banks in addition to already anaemic pre-provision earnings growth and stretched dividend payout ratios. After a solid rebound in bank share prices since late February the sector looks set to at best contribute to the broader pause in market returns that we expect or potentially renewed weakness if required loan provisions turn out to be worse than forecast when the bank reporting season gets underway in May.

Portfolio outlook

Despite the Fund lagging its benchmark somewhat during the March quarter we were encouraged by its solid hit rate in the most recent reporting season, in which the majority of our larger positions delivered strong results which led to positive revisions to earnings forecasts. While the quarter was dominated by the rally in resource stocks, we expect that the underlying operational performances of companies will start to be reflected in share price performance over the course of the year.

That's not to say that we dismiss what may have been the bottoming in the Resource sector, and we do expect that there will be significant positive earnings revisions for some resource companies in the current quarter. We have partially closed our underweight to the sector in response to this by adding to our iron ore exposures (Rio Tinto and Fortescue Mining) as well complementing these holdings with a new investment in last year's BHP Billiton spin-off South32. Importantly, our investment case for South32 is not primarily based on expectations of significantly higher commodity prices but is instead driven by sharply-improved earnings profile and cash flow generation from the large cost-out program announced by company management.

However, given the fact that most drivers of the recent rebound in commodity prices, such as modest fiscal stimulus in China and some delay in the US Fed's path to interest rate normalisation, so appear to be rather short-term in nature we think would be premature to make more significant changes to our sector allocations. With most medium term indicators still suggesting that economic growth will remain sluggish, we believe that having the portfolio skewed towards quality and reliable earnings growth should achieve the best outcome over time.

Top 5 active overweight positions as at 31 March 2016	Index weight %	Active weight %
Westpac Banking Corporation	7.6	5.9
Commonwealth Bank of Australia	9.6	4.3
Goodman Group	0.8	4.1
Sydney Airport	1.1	3.9
Aristocrat Leisure	0.5	3.4

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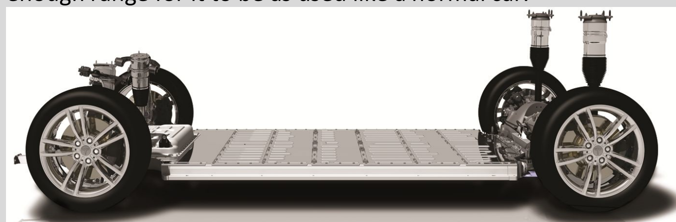
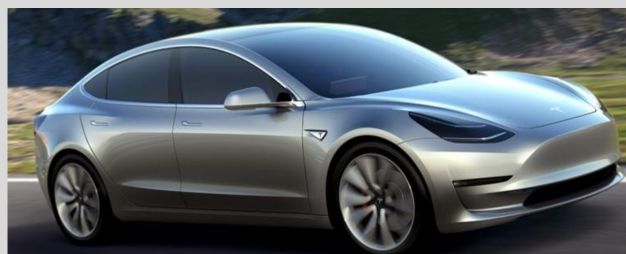
BTW

Tesla Motors is in one sense an insignificant carmaker. Established by billionaire PayPal founder Elon Musk, it is the only car manufacturer based in Silicon Valley. In 2012 it started making a large luxury car the Model S, cheekily implying that it is one better than the iconic Model T Ford that started mass car ownership a century ago. Up to the end of March it had made in total about 120,000 cars. In 2015 it produced just over 50,000 cars, which would constitute about two days' production for one of the big manufacturers.

Tesla is an incredibly significant carmaker in most other ways. Using the classic disruptor model Silicon Valley loves, it makes a slickly-styled product that in most ways is a massive advance on traditional cars. Electricity is clean (potentially – depending on how it is generated), markedly more efficient (>80% of the energy is used to drive the car versus 20-35% for a typical internal combustion engine), its features are able to be upgraded on the run, its mechanical components are much simpler (see photo below of a Model S sans bodywork) and provided the software is properly programmed, it should require much less maintenance yet be more reliable. Its advantage over the myriad other electric cars attempted through the ages lies in its batteries, which allow enough range for it to be as used like a normal car.



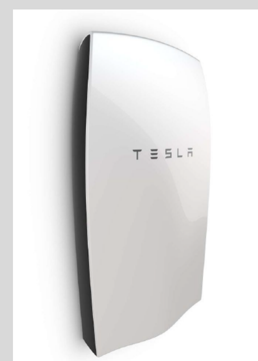
Tesla was in the news in March when it released its third model, a sleek compact car imaginatively named the Model 3. Up until now its cars have been the playthings of the rich: six figure price tags mean you needed deep pockets to buy either the Model S or the Model X (a SUV with "falcon-wing" rear doors, soon to be sold in Australia). The Model 3 is set to sell at a much less prohibitive price point – around $A60,000 – putting it within the reach of many more people than before.



Tesla took a leaf out of Apple's book by releasing teasing details in the lead up to a big show-biz style announcement on 31 March, the difference being it was taking orders on a much more expensive piece of equipment than Apple tends to sell, and the delivery date was not today or next week, it was for the end of 2017. But the showmanship worked, Tesla took more than 180,000 orders, each with a $US1000 deposit on the day. This would be impressive for any product, but for a high-value car no one has ever driven, it is an astounding achievement. What would many other carmakers, most of whom are struggling with overcapacity, give to get several years of production assured so far in advance of delivering its first car? Not to mention $US180 million of free financing…

What the Model 3 will do is put a rocket under the efforts of the major car-makers to get competing products available, which will no doubt drive up quality and features and drive down the price. That should be good for us all.

So will Tesla change the world? It's certainly trying to, and not just by making cars. Its Powerwall home battery pack (right) is using the same technology to try to disrupt another industry, power generation and distribution, potentially allowing households to store electricity it has generated itself or bought from the grid at off-peak rates, for use at peak times. Full marks for your vision Elon Musk!



Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size	$12.3M
APIR code	HOW0026AU

Fees	
2014/15 ICR	1.00%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions payed) above the Performance Benchmark
Buy/sell spread	+0.20%/-0.20%

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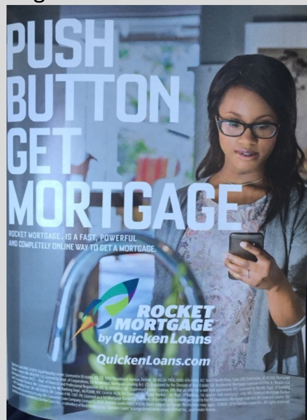
Traveller's Tale

Shane went to the USA in March mostly to see building materials companies and, with a schedule that included six cities in five days, he spent a lot of time on planes. Flying within the US is never a pleasant experience and although for some it may have been made slightly more bearable by the introduction of in-flight Wi-Fi (for a fee of course), our frugal traveller chose to get at least some of his entertainment from the well-read in-flight magazines. While skimming through one such magazine Shane found some of the advertisements a little surprising, especially considering that many parts of the US are yet to recover from the housing-lead recession not that long ago. One was for Rocket Mortgage, and there is a very slick video explanation of its product at https://youtu.be/dg5K9DMK3to.



Rocket Mortgage was launched in November last year by Detroit-based Quicken Loans with the promise of being able to get a mortgage in just a few minutes using your smartphone. How could that be possible? Are our friends in the US of A suffering from amnesia? Are we already back to the pre-GFC housing bubble situation in which anyone with a pulse (and even a few without one) could get a housing loan far too easily?

Its recent ad, which was shown during the Super Bowl, (https://youtu.be/RRDxDgHu5pU) inflamed this perception. It includes the rather bubble-like comment that Rocket is "further stoking demand as our tidal wave of ownership floods the country with new home owners".

Shane's initial panic subsided a little after some digging: the technology isn't actually an app that approves a loan but rather a website built for mobile devices. At the end of the process applicants are only pre-qualified, not actually approved, for a mortgage. Behind the scenes the technology moves the traditional on-line application process significantly forward by pulling together data from a range of public and proprietary databases to automatically verify the information provided, removing much of the role of a old-style loan officer. Property information is matched against tax records, local assessments and historical data. Employment history is verified using the applicant's social security number, whilst asset and credit information is instantly checked against bank accounts and credit reports, eliminating the need for applicants to send in reams of documentation. Interest rates, payment options and fees also work off live market data allowing the applicant to also lock these in on the spot.

So rather than feverishly trying to reignite the housing bubble as it first appeared, Rocket Mortgage is simply another example of disruptive technology that has the potential to win business by making consumers' lives a little bit easier. But we do think their claims should probably be more carefully stated!

Alphinity Investment Management

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