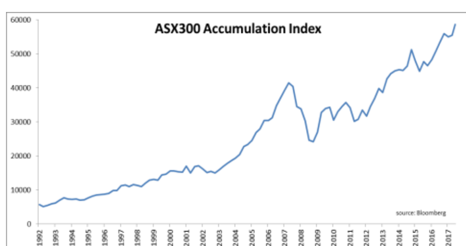
Monthly Comment – November 2017
Alphinity Concentrated Australian Share Fund

Towards 6000

Market comment

The Australian share market (ASX300 including dividends) had another upward move in November, rising by a little over 1%. The ASX 300 price index flirted with and briefly exceeded what was referred to by the press as the "psychologically important 6000 level", its highest level since prior to the financial crisis almost a decade ago. In our view there's nothing important about 6000, psychological or otherwise. It's just another round number. The prices of the individual stocks you own is what matters and at any point in time there are stocks trading at lows as well as highs. In any case, it makes much more sense to look at the Accumulation Index which includes dividends, as these are a crucial factor in asset class returns. The ASX300 Accumulation Index passed its previous peak years ago and is now trading almost 50% higher than that.

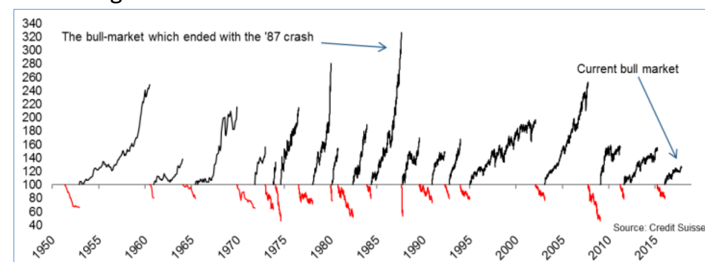


Bank stocks struggled in November after a subdued reporting season and in the lead-up to the announcement of a Royal Commission into the finance industry, with a particular focus on a number of scandals that have involved the Banks in recent years. While the Royal Commission is unlikely to have a meaningful financial impact on these massively profitable organisations, the market is concerned that it could be a significant distraction to management, and that it may result in unhelpful regulatory changes that crimp future upside. Telecom stocks performed poorly when further delays to the NBN, which will hit Telstra earnings, was announced. Energy and IT stocks however performed well for the month.

The $A softened a little in November. The whole world expects short term US interest rates to rise in December, whereas our monetary authorities have made it clear that there is no appetite to tighten in Australia any time soon. A fall in the interest rate differential between the two countries could create a negative bias for our currency.

Resource prices in $A terms were mixed, as usual. The bulk commodities involved in steel making, Iron Ore and Metallurgical Coal, were very strong, rising by close to 20% for the month. Thermal coal and base metal prices were much more subdued, moving only modestly. Energy prices rose somewhat as often happens at times of political tensions, and there are plenty of tensions around the world at present: the Middle East, the Koreas, the South China Sea – it is somewhat surprising that equity markets are as robust as they are. Having said that, providing nothing flares up uncontrollably, the outlook for 2018 appears to be coordinated economic growth in all of the big economic blocs, which is generally supportive for equity markets.

We were intrigued to see the chart below from our friends at Credit Suisse. It shows Australian bull and bear markets over the past 70 years, measuring the magnitude of gains and losses in each instance. For instance the 1987 crash was preceded by a more than trebling in the market; the current bull market is so far only up 26% from its trough in February 2016, suggesting that there could still be further gains to be made before the market peaks and turns down. While you wouldn't want to bet your house on this sort of analysis, maybe the market has the potential to keep going on for a while longer.



Portfolio comment

The Fund underperformed the market a little in November. The best contributions were from positions in Westpac, Origin Energy and not owning Telstra. On the negative side were our holdings in National Australia Bank, Aristocrat Leisure and not owning major miner BHP.

Performance[1]	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Since inception % p.a.
Fund return (Net)	0.8	5.6	15.1	11.1	12.7	10.4	11.1
S&P/ASX 200 Accumulation Index	1.6	5.7	14.6	8.7	10.6	8.6	9.1

[1]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.
[2]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.
[3]Numbers may not add due to rounding

Alphinity INVESTMENT MANAGEMENT

Monthly Comment – November 2017

Alphinity Concentrated Australian Share Fund

Market outlook

After six months of flatlining, the Australian equity market has had an impressive burst over the last couple of months. This looks justified at a headline level as the global growth outlook has strengthened further, commodity prices are higher, the Australian dollar lower and interest rates broadly unchanged. Dig a little bit deeper however and the picture is more complex. The rally has to a large extent been driven by the most expensive stocks getting even more expensive, rather than by rises in cyclical stocks which stand to benefit the most from stronger global growth and commodity prices. Some of the high-multiple stocks are also positively leveraged to the retreat in the Australian dollar but the same can be said of many cyclical companies. This leaves us to conclude that sentiment and liquidity have played significant roles in the buoyancy of the market. These factors are not to be ignored as they are important drivers of market returns, but they are also more difficult to predict in terms of strength and durability. We would therefore caution against becoming too optimistic at this point in time.

On the other hand, cyclical sectors such as Resources, though more volatile, continue to look attractively valued and still have solid prospects for further positive earnings revisions as commodity prices remain above consensus expectations, which should support overall market levels. Interestingly, the recent rally in oil prices has seen the Energy sector join the Metals & Mining sector in having upside to market earnings expectations should current prices endure. This is a situation we haven't seen in this sector for several years. Our view (and increasingly the market's) has for some time been that oil prices are capped by the US shale sector's ability to quickly respond to higher prices with increased production. There are some tentative signs that US production growth rates are moderating despite higher prices. If sustained, this will have interesting consequences not only for the energy sector but also more broadly for inflation and ultimately interest rates.

The overall Banking sector reported slightly disappointing full year results in November. While the repricing of mortgages did contribute positively, and should further boost earnings in 2018, other factors offset. The banking Royal Commission will also dampen sentiment towards the sector and distract management, even if the financial impact is ultimately likely to be modest. Mid-single digit returns for this sector looks like a reasonable prospect in the absence of increased loan losses, of which so far there are still very few signs. This may also be a fair expectation for the broader equity market in 2018

Top 5 active overweight positions as at 30 Nov 2017	Index weight %	Active weight %
National Australia Bank	5.0	4.4
Macquarie Group	2.0	4.2
Rio Tinto	2.0	3.7
CSL	4.1	3.1
Atistocrat Leisure	0.9	3.0

Portfolio Outlook

The conundrum of strengthening economic growth prospects at the same time as some less economically-sensitive sectors are outperforming poses a challenge to portfolio construction. Stocks with operational upside relative to expectations typically tend also to have valuation upside as they are generally priced on underestimated earnings. However, given the PE expansion seen for many of these companies, this is not the case today. So should one just follow the momentum because the market seems to be happy to keep buying these stocks? With no disrespect intended to our peers, that feels a bit like the "greater fool" strategy – i.e. hoping there will be a fool around willing to buy at an even higher price than today when we want to sell. Perhaps the trend can go on for a little longer but it dramatically increases the risk of severe correction if earnings disappoint. And even without any earnings disappointment, stocks can only go up by more than earnings for so long.

Bond yields have been reasonably steady since the sharp rise after the election of Trump as US president a year ago, which probably explains some of the strength seen in this segment of the equity market. Interest rates may stay low for some time but with global growth on more solid ground and some of the transitory factors holding back inflation receding, it seems to us that that the direction for bond yields is more likely to be upwards. This is likely to be most damaging for those long duration stocks which have been so much in favour.

On the other hand, the earnings upside and reasonable valuation in the Resource sector continues to stand out to us – a rare trait in today's equity market! So far the story has been about strong cashflows, low capex and, as a result, dramatically strengthened balance sheets. Over the next 12 months however we expect medium term production growth profiles will increasingly come into focus as current mines gradually deplete. Companies which are able to identify new projects, internally fund them without stretching their balance sheets, and successfully bring them to market are likely to be well rewarded. We believe Rio Tinto and Oz Minerals are two portfolio holdings with those characteristics. The rejuvenated board of BHP is also making encouraging statements about improved capital discipline and while implementing this in practice will take some time, the strength in the oil price has made also the "Big Australian" a more interesting investment proposition.

Overall, we believe the portfolio has a good balance between stocks which are positioned for an improved macro environment and somewhat higher interest rates, and stocks with internally generated earnings growth which should prosper regardless of broader economic trends. Reliance Worldwide, Aristocrat Leisure, Link Administration, Medibank Private, Treasury Wine and Costa Group are some of the holdings in this type of company.

Asset allocation	30 Nov 2017 %	Range %
Securities	98.4	90-100
Cash	1.6	0-10

![Alphinity Investment Management]

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BTW

We've written before about the automotive disruptor Tesla, which is using Silicon Valley thinking to try and upset one of the most traditional of heavy manufacturing industries, car-making. Last time (June 2017) we discussed the way the market was valuing this massively loss-making company at a premium to established and profitable manufacturers with a century of history. Since then Tesla's shares have come down a bit, from $US380 to around $US320, after it announced successive delays to production of its more mass-market Model 3, a vehicle on which the company has taken 400,000 deposits but so far struggled to deliver more than a handful.

This month Tesla started up the whole disruption thing again, this time targeting the trucking industry. You'd think that packing enough power into a battery to move a huge 35-tonne semi-trailer would be a challenge, but Tesla reckons it can do it. The not very imaginatively-named Semi Truck is highly aero-dynamic and in black it looks a bit like Darth Vader. It can supposedly travel 500 miles fully laden, which is enough for 80% of return truck trips in the US, and is able to travel uphill at 65 mph – a diesel truck will struggle to go 45. It has the very cool pop-out door handles from its cars, and screens and cameras instead of rear vision mirrors. The driver is positioned at the centre of the cabin, like in a racing car, rather than on the side. It has an automated mode which will bring the vehicle to a stop should the driver become incapacitated, and with that level of automation, no doubt there are plans to do away with the driver altogether one day.

The icing on the cake is that the cost to operate it should be much lower than a conventional truck – Tesla claims 85c a mile versus $1.51 for diesel – and the Semi Truck will have a million-mile warranty. Having individual motors on each wheel means the Semi Truck can be programmed not to jack-knife, a massive safety bonus. The plan is for the Semi Truck to hit the road in 2019, which on current Tesla form probably means 2021 or so.

But Elon Musk had another surprise at the Semi Truck launch. To the amazement of the Apple-esque audience assembled at the California site of Musk's other ventures, SpaceX and the Hyperloop, from the back of one of the semi-trailers rolled a completely unexpected new car model, the Roadster 2.0. The original Roadster was Tesla's first model, released in 2008. Tesla took the body of a two-seater Lotus and inserted its own electric drivetrain. It was a strange niche in which to launch a whole new breed of car and the Roadster only sold by the handful; it wasn't until the Model S in 2013 that Tesla found more broad appeal. The Roadster 2.0 however looks stunning and deserves to succeed on appearance alone, but its performance will also be pretty special. It can apparently accelerate from 0-60mph in under 2 seconds, has a top speed of 250 mph (400 km/h) and has a battery range of 620 miles (1000km). It will cost "just" $US200,000 or so, and you'll need to make a $50,000 deposit just to put your name on the waiting list. You could buy many of these for the $3m price of the only other car to provide a similar level of performance, a Bugatti, and it is powered by old-fashioned hydrocarbons. First deliveries are scheduled for 2020.

While Tesla shareholders are doing OK share price-wise this seems to be despite, not because of, the fundamentals of the company. Earnings continue to be challenged. Even the most optimistic analyst thinks Tesla will make a pre-tax loss of almost $US1.5 billion in the year about to end; the more bearish say the loss will exceed $2 billion. 2018 brings the expected losses back to just $83m at the more sanguine end of the range – still a loss of $1.6 billion for the bears – before maybe producing a $3.5 billion profit in 2019. Or a $700m loss if it pans out less optimally. You could drive a truck through that range!

Regardless of the coolness of its products and their impact on their respective industries, at some point Tesla has to stop bleeding cash. One press report recently said that the company is apparently burning cash at the rate of $US8000 a minute and will exhaust its current cash pile by August 2018. Considering the still-high share price and the company's dwindling reserves, Tesla could be putting its corporate hands out to shareholders for more before too long.

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Traveller's Tales

Bruce was in China recently seeing Goodman Group, a long-held position in the Fund's portfolio. Goodman is one of the world's biggest developers and owners of modern logistics facilities (a.k.a. big sheds). There has been massive demand for these as a result of booming global trade and changes to the supply chain caused by, among other things, online retailers.

But it wasn't all Amazon robots and JD.com shelves. One of Goodman's tenants near the airport in Shanghai is the Chinese importer of fine Italian automotive machinery. At this site he was intrigued to see, at the epicentre of this very communist yet also very capitalist country, hundreds upon hundreds of Alfa Romeos, Maseratis and Ferraris.

Apparently this was just part of one shipment out of many that come through Shanghai each year. The cars are taken off the boat and trucked to this warehouse, where they are given a thorough going-over to make sure that nothing had gone awry with the paint or interior during the voyage. This is followed by a test drive to make sure all is in order, to avoid disappointing the exacting buyers of such luxury goods. The cars are then test driven and wrapped in white protective covers for the final journey to the dealer. It was quite a sight to see workers in overalls taking Maseratis for a quick drive around the carpark.

The Chinese seem to have a penchant for Maseratis: we couldn't help noticing a press report in Australia recently along the same lines. It has become quite difficult in recent years to get large lumps of cash out of China – a fact that would resonate with apartment developers out there – as the Chinese government has a $US50,000 per person annual cap on foreign transfers. This however has not been enough to stop Chinese nationals buying Maseratis.

One Sydney dealer regularly sells the cars, which start at about $140,000, on UnionPay. UnionPay is a Chinese credit card which has become increasingly accepted in Australian stores and, it seems, high-end car dealers. "International students love their fast cars" she said. "Because they can't take out a private loan, they can get by with their UnionPay cards." She has sold Maseratis worth up to $300,000 to Chinese buyers, mainly international students and resident business executives who fund it using cash and UnionPay. Presumably someone at the other end pays the bill at the end of the month.

Alphinity Investment Management

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