Quarterly review

December 2015

Market environment

The last quarter was dominated by commentary and conjecture around the much-anticipated-and-finally announced first US Federal Reserve interest rate increase since 2008.

Judging by the local market's reaction as well as those of offshore markets, it was one initially of relief as it was taken to confirm the US Federal Reserve's confidence in the US economy's self sustaining recovery whereby the stimulus previously provided could now be gradually withdrawn. All the major markets (US, China, UK, Germany, Japan) rallied as a consequence from the UK's 3% to China's 16%.

Against this backdrop though, commodities, and the most discussed one, oil, continued their descent, despite the precipitous falls over the prior quarter. As commodities are generally priced in US Dollars (USD), the rise in the USD against most currencies (circa 1-3%), with the exception of the AUD, also exacerbated the falls. There is a long-standing negative correlation between the USD and oil price.

Such falls continue to be attributed to concerns over China's slowing economy and general increases in supply across most commodities, with these an interesting juxtaposition to the sanguine perspective adopted to the US interest rate increase.

Local energy companies, such as Oil Search and Origin Energy, were notably impacted.

Domestically, headlines were centred on the housing market, a significant contributor to GDP growth in recent times, with the debate very much focussed on whether the peak for this cycle had passed. This was seen in greatly reduced auction clearance rates in Melbourne and Sydney in particular and moderating housing finance approvals, albeit the latter partly as a result of increased investor lending restrictions imposed by the banks. Whilst this seems to be the case, building approvals remain at high levels suggesting the bubble will not burst but deflate gradually.

Our portfolio moved much in line with the market, despite our positioning being justified i.e. underweight resources/energy and financials in general, with the underperformance of certain stocks, generally of a smaller nature, impacting.

Portfolio activity

In the last quarter, we added the following stocks:

- **Bega Cheese** (a long established processor, manufacturer and distributor of dairy and associated products in the Australian/New Zealand markets, best known for cheeses under its Bega brand, which has a high level of contracted volumes, underpinning a consistent returns profile not typically associated with agricultural investments, as well as importantly providing a strong exposure to growing infant formula demand in Asia).
- **iSignThis** (a technology company capitalising on increasing global compliance requirements under AntiMoney Laundering & Counter Terrorism Funding legislation, where entities are obliged to identify parties to certain online financial transactions eg foreign exchange, with the verification method developed, a step change from the current static, paper-driven process, with it not only real-time, low cost and user-friendly but also patent protected).
- **IVE Group** (a domestic diversified marketing services and print communications provider, which has been an industry consolidator, where scale is paramount to service large organisations. It has a deeply experienced management team, a stable, high quality and reliable revenue stream and with a product/service offering distinct from the production of mass circulation catalogues and magazines, which has characterised the space).
- **Rio Tinto** (the well-known miner, noted principally for its iron ore, with its fall in price, coupled with its ability to not only invest at this point in the mining cycle, whilst its competitors struggle, but also pay a healthy dividend without straining its balance sheet, make it a logical contrarian play at a time when resource stocks are out of favour).

In addition, we also added to holdings in **Ansell** (where earnings expectations are low and the negative impact from currencies has largely passed), **Ramsay Healthcare** (following reiteration of its earnings guidance), **Billabong** (where the long term story has not changed, despite flagging a subdued 1st half effected by currency) and **Commonwealth Bank** (our top-rated bank).

In turn, during the quarter we removed the following:

- **Capitol Health** (at a loss, despite (for some) taking profits on this stock on various occasions, following a review of its earnings and cognisant of the regulatory uncertainty from a number of government reviews into healthcare, all with the aim to rein in costs in areas such as diagnostic imaging).
- **National Australia Bank** (at a loss, given question marks about the sustainability of its current dividend, reduced growth expectations and less value likely to be achieved from exiting the UK than at first anticipated).

We also reduced our position in **Japara Healthcare** (at a profit), **Covermore** (cognisant of foreign exchange being a temporary drag on earnings, given ability to ultimately reprice for this), **CSL** (at a profit) and **Bega** (following an unexpected price spike in the Xmas/New Year period without any news).

Our Quote for the Quarter

"Whenever you find yourself on the side of the majority, it is time to pause and reflect."

Mark Twain

Commentary

As we enter 2016, we do so cautiously, holding (and building) slightly higher levels of cash as well, conscious that, despite the rally in the last quarter of 2015, challenges lie ahead:

- **Financial conditions globally have tightened.** Low US rates previously have encouraged an increase in offshore USD borrowings, which now, with the USD appreciating, are harder for countries and corporates to service.
- **Lower oil prices are hurting more than helping global growth.** Questions are being asked as to when the famed "second round' effects of lower prices putting more money into consumers' pockets and aiding spending will eventuate.
- **China potentially exporting deflation to the world.** The clearest mechanism available to Chinese authorities to manage their economy's gradual transition is the currency and further devaluation seems likely to smooth this process but in turn it will put downwards pressure on global inflation further, which central banks have been at pains to stimulate.

With this in mind, we continue to believe:

- **Central banks will maintain very accommodative policy** and the US will probably delay further interest rate increases in view of recent volatility, though increasingly questions will be raised as to monetary policy's effectiveness given its lacklustre impact on global growth to date.
- **Global growth will remain sub-trend,** with China's continued slowdown impacting us.
- **Volatility** should be taken as a **given**.
- **Australia's listed market is becoming less reflective of the changes underway in the local economy,** with a large part of the market comprised of banks and mining/energy companies at a time when they represent a declining share of the domestic economy.
- Those companies with offshore earnings, notably those with revenues in US dollars, and those with defensive qualities paying secure dividends, should remain in favour.
- Noting the above two (2) points, stock selection skills are more important than ever.

www.accordius.com.au

Accordius Pty Ltd • ACN: 128 900 603 • AFS Licence No. 321955
Level 24, 333 Collins Street, Melbourne, VIC 3000 • GPO Box 2985, Melbourne, VIC 3001
Telephone: +61 3 8623 3378 • Fax: +61 3 8678 1235 • Email: information@accordius.com.au

ACCORDIUS
Your personal funds manager