Quarterly review

March 2016

Market environment

The first trading day of 2016 set the tone for what was to follow in share markets in the first few weeks of 2016. When Wall Street opened January 4, the Dow Jones Index dropped 276 points or 1.6%. By the end of the week, the Dow was down some 1,100 points or 6.2%, its worst start to a year ever.

Royal Bank of Scotland (RBS), a major global bank, told clients to "sell everything". A long-time bear Albert Edwards, a global strategist at Societe Generale best known for his prediction of a coming 'Ice Age' for financial markets, warned that the U.S. stock market could fall 75%.

The bears definitely had a lot of ammunition to make their case. Chinese stocks were crashing and there were fears that China's economy would follow suit. Oil was in freefall. Bank stocks were tanking. The U.S. dollar was climbing, delivering a big hit to earnings of U.S. multinationals and emerging markets. Global markets became turbulent and wildly volatile. The Bank of Japan pushed borrowing costs into negative territory for the first time. And if that was not enough, Wall Street feared the Federal Reserve was on the verge of making a big mistake and hiking short-term interest rates too soon and too much in 2016, following their initial rise in December 2015.

As you may recall, we wrote to you in February pointing out we were holding higher levels of cash than normal during this turmoil, with the risk that if the market rallied strongly from here, we may miss out. Preservation of wealth took precedence. And, in fact, the market did rally strongly from late February, lead by the US, as investors came to realise that the health of the U.S. and global economy, while hardly stellar, was not as dire as first thought.

The turnaround in sentiment stemmed from 1) the Federal Reserve Chair, Janet Yellen, pleasing markets by holding fire on further interest rate rises, citing awareness of growing risks abroad, and 2) the oil price stabilising, after falls of nearly 30% in 2016 alone and 80% from its highs. Additional stimulus measures from the European Central Bank, steps by China to steady its economy and currency swings, plus solid economic data in the U.S. further allayed fears.

Domestically, the Australian sharemarket followed the fortunes of offshore, but with financial stocks i.e. the banks being clear underperformers for a variety of reasons (rising bad debts, regulatory issues etc.). And, despite the start to the quarter, mining and energy stocks ended up being some of the best performers, justifying our investment in Rio Tinto late last quarter and BHP early March.

Our portfolio did though underperform, firstly, because we did not participate as much in the rally back and secondly, owing to some disappointing first half results amongst some of our smaller cap stocks, in whom we retain faith but which can be volatile, plus our publicised exit from Slater & Gordon.

Portfolio activity

In the last quarter, we added the following stocks:

- **QBE Insurance** (the well-known commercial insurer with global operations but whose business has struggled in recent years, given premium pressure, amongst other things, in the insurance market. Whilst conditions remain challenging, we are encouraged by the work to date done to reduce volatility in its earnings, the many levers at QBE's disposal to deliver cost savings as well as attractive valuation).
- **Aveo Group** (an evolving retirement village and aged care operator, which is in the process of streamlining its business, with the strategy of providing a seamless continuum of care through co-locations of retirement villages with aged care facilities; the funding of which is taking place from the sale of surplus land to needs. Demand for such is well supported by ageing demographics, with the group held in high regard by industry bodies).
- **Vita Group** (an IT/telecommunications retailer, operating successfully some 100 Telstra branded stores under a long standing master agreement, with strong performance being generated on the back of the staged NBN rollout and now extending its skill set into Small Business/Enterprise channels via assumption of management of certain Telstra Business Centres. Vita's first right of refusal in buying underperforming stores and the growing IT demands of both consumers and business provides an attractive proposition).

In addition, we also added to holdings in **Yowie** (after securing a long term manufacturing agreement) and **Seek** (following its first half result evidencing encouraging uptake of its new products).

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During the quarter we removed, apart from Slater & Gordon, the following:

- **Greencross** (given issues with its WA operations, where it had bought a competitor, and the growing likelihood that a proposal to buy the company, which had boosted the price, would likely not succeed).
- **Henderson Group** (upon concerns that the first half result might show funds inflows being impacted by market conditions, coupled with possible additional costs relating to changing UK regulations, where its headquarters resides. Such concerns were proven to be justified).
- **Ansell** (at a loss, following a significant downgrade to its earnings guidance on the back of another year evidencing a lack of organic growth but this time in tandem with manufacturing cost pressures and a flagged significant rise in its tax rate).

We also reduced our positions, largely either from a profit-taking and/or risk mitigation perspective, in **Amcor, Burson, Challenger, Commonwealth Bank, Ramsay Healthcare** (following changes in French hospital funding arrangements), **Telstra** and **TPG Telecom**.

Commentary

The first quarter of 2016 has been extremely volatile and could be best characterised as a tale of two halves – six weeks of overwhelming gloom followed by six weeks of benign optimism – with an unusual theme – the oil price and sharemarkets moving in lock step, whereas the reverse is the traditional norm; all of which translates to a challenging growth environment which we have commented upon previously.

The events of the quarter left us with the following thoughts that:

- Low investor conviction levels as to the direction of economies and in turn markets ensures volatility will remain high;
- Not only will central banks maintain very accommodative interest rate policies but are also contemplating further unconventional strategies to boost growth, with the return of inflation and interest rates to 'normal' levels hard to envisage in the foreseeable future;
- Such low (or negative) rates may actually be hindering rather than helping global growth with China's recent unexpected pick-up in growth a welcome offset to a US 'flat spot';
- Most countries/regions are desiring currency devaluations as a channel to stimulate growth;
- Against a backdrop of a resilient economy, poor investment sentiment as well as low or even non-existent earnings per share growth expectations, Australia's listed market is reasonably valued and more likely to move up over time on present settings, just on 'less bad news' alone; and
- In light of this, we have added proportionately more to our larger cap stocks, as these tend to be the companies to which investors flock first, when sentiment does improve.

Our Quote for the Quarter

– with an eye to the forthcoming Federal election

"It is dangerous for a national candidate to say things that people might remember."

Eugene McCarthy, US Congressman and one-time challenger for the Democratic Nomination for the US Presidency in 1968.

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