

# Quarterly review

June 2016



## Market environment

The final quarter of 2016 and the financial year itself concluded with markets bearing the mark of Britain's decision to exit the European Union, with conflicting signals. A late rebound in shares tempered by a renewed sense of caution in bonds. Most major markets though ended the financial year in the red, with the US the notable exception. Australia also managed to register a positive return.

Whilst the immediate reaction to Brexit resulted in a sell-off, the late rally in shares resulted from investors regaining their risk appetite in the knowledge central banks globally, concerned about the contagion from a now-likely UK recession, would have their back. In other words, they would do everything in their power to stimulate growth and a level of acceptable inflation. This was further supported by encouraging signs of economic activity in the US and Chinese stimulus, initiated in the 1st quarter, having its desired effect. Europe continued on its tepid recovery path.

But, as mentioned, bond yields in many countries plumbed historic lows, amongst fears growth in the overall global economy is still anaemic, with 'negative' yields a sign that investors are far from convinced the extraordinary monetary policies intended to aid growth are actually working. The Organisation for Economic Cooperation and Development (OECD) in fact worries that requirements placed on banks globally by regulators to make them more financially sound (one of which is to hold ever increasing levels of such assets) are counterproductive when those 'forced' holdings pay a negative return i.e. at a cost and thus inhibiting the role of the banking channel in helping the economy.

Australia, in the last quarter, had its own issues to contend with – a federal budget and a looming federal election. Outside of politics though, the general economic data revealed stable growth, marked by a large decline in business investment countered by rising exports and increasing consumer consumption. Our own Reserve Bank of Australia, on the back of lower inflation readings and subdued cost pressures in general, saw fit to cut rates in May, also comfortable that measures they had undertaken to regulate growth in housing were working.

Against this challenged backdrop, the commodity sector extended its recovery from the 1st quarter, with the safe haven appeal especially of precious metals in a low yielding financial environment an attraction. We continue to hold investments in BHP and RIO, taking some profits in the latter during the quarter, to capture some of this upside. A dilemma though exists here given the risk of 'underperforming' should lower quality companies, symptomatic of this sector, continue to 'go up'.

Banks in turn continued their underperformance. We still hold positions in CBA and WBC, given their compelling dividends. The sector globally however faces many headwinds, along with local individual issues e.g. greater political scrutiny, coupled with concerns of an over-heated housing market. These are unlikely to abate soon.

Our portfolio participated in the late rally but under performed marginally for the quarter, principally owing to some of our smaller stocks, which can be volatile but on the whole where news flow was positive, despite price action to the contrary e.g. CVO reconfirming its profit guidance but down 20%.

## Portfolio activity

In the last quarter, we added the following stocks:

- **Sydney Airport** (operator of Sydney Airport, where strong passenger numbers, both domestically and internationally, underpin performance, with the airport also set to benefit from a growing retail presence from its recent expansion plus first right of refusal over a 2nd airport).
- **ARB Corporation** (designer, manufacturer and distributor of SUV and light commercial vehicle accessories in Australia and to over 80 countries around the world. ARB's solid track record of performance, management quality and current strong demand for its products, given a number of recent model releases, warrant its inclusion).
- **Orora** (packaging products and services company, both in Australasia and North America, with ORA investing successfully into its business, where demand from its core FMCG (Fast Moving Consumer Goods) base is evident e.g. wine exports as well as expanding internationally through incremental acquisitions in defensive stable sectors).
- **RCG Corporation** (retailer and wholesaler of shoes both in Australia and New Zealand, with retail outlets such as The Athletes Foot and Skechers part of their store footprint. RCG have made a couple of sizable acquisitions recently, which provide platforms for further growth as a number of the global brands, to which they have licence rights, exhibit strong growth on the back of the 'athleisure wear' trend, with growth prospects underestimated by the market).

In addition, we also added further to our holding in **Yowie** (post a rights issue but selling down for a profit a short time later).

During the quarter we removed the following:

- **Lend Lease** (following concern arising around settlement risk attaching to apartment developments to which Lend Lease's exposure is significant, along with reducing possible Brexit risk (since substantiated) given the significance of its UK business to the group).
- **Bega** (sell down of our remaining stake at a profit against the backdrop of a very challenged dairy environment, where a variety of international events have resulted in longer lasting weak commodity prices at a time when significant industry investments have been undertaken to capture value-add opportunities, with Bega's price not reflecting this reality).

## Commentary

Despite the 'feel good' sharemarket rally year end, the recent Brexit decision likely reflects a rising anti-establishment trend and a consequent underestimation of political risk by investors, which arguably valuations are not allowing for. Market valuations as a consequence (represented by Price/Earnings Ratios) are now above long term averages thus leaving less room for error, as such a rise has not necessarily been associated with improved earnings prospects.

Once again, and without 'sweating the big stuff too much' ie. the economy because of its unpredictability, we are still left with the following thoughts that:

- focus must remain not on prices but on performance, with the ensuing commodity price pick-up seen in the recent period believed to be more a recovery from unsustainable levels, facilitated by select supply discipline, than a demand led expansion, hence likely to wane.
- interest rate settings will continue to be supportive for markets, with the US now on a more gradual path than previously owing to an increased eye to international events, along with additional measures i.e. helicopter money\* being contemplated.
- despite above, US remains a shining light and investment not only in companies with exposures to the US economy but also to the US dollar warrant examination (ORA being one).
- earnings growth is hard to find in the Australian sharemarket, given its pre-disposition to banks/miners, with greater need to allocate investments to mid-size/small companies in niche markets and to companies with defensive income streams and sustainable yields.

\*another form of quantitative easing being considered by global central banks.

- **QBE** (whilst encouraged previously by work done to deliver cost savings and thus growth in a tough insurance environment, the Brexit decision was a clear negative, given its exposure to Europe (some 1/3rd of its business) and possible changes in the regulatory environment likely impacting materially on its operations in the future).

We also reduced our positions, from a profit-taking and/or risk mitigation perspective, in **Japara Healthcare, Rio Tinto, Challenger, CSL, Carsales** and **Ramsay Healthcare**.



## Our Quote for the Quarter

*"Progress isn't made by early risers. It's made by lazy men trying to find easier ways to do something."*

Robert Heinlein, renowned American science-fiction writer.

Please note that the information in this publication is for general use only. We would be pleased to talk with you in regard to your particular circumstances should you wish to explore any particular aspect further. Any tax planning matters should be discussed with your accountant before proceeding.

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