

Quarterly review

September 2016



Market environment

With economic data on the whole pointing to a still grinding recovery coupled with supportive monetary policies by central banks globally, investors' risk appetite seemed to return during the September quarter, following the initial negative (and understandable) reaction to Brexit.

The sum result was that volatility in financial markets subsided, commodity prices edged higher (from very low levels) and corporate debt spreads narrowed; the latter being a good indicator of investors' preparedness to assume some additional risk for return. All major markets posted positive returns for the quarter.

Whilst a calm of sorts descended upon markets, the major talking point last quarter seemed to be a growing recognition amongst policy makers that, since the Great Recession, designated as the period of general economic decline since the GFC up until the early 2010s, they had overestimated the effectiveness of monetary policy and at the same time underestimated the effectiveness of fiscal policy. Growth, despite being generated by monetary policy, has fallen well short of forecasts. Similarly, fiscal tightening to repair budgets etc., has probably done more harm than good.

A consensus, amongst policy makers, is arising that negative interest rates are not working and instead turning on the fiscal tap e.g. higher spending on infrastructure is probably preferable. Problem is politicians control the purse strings. So with Japan currently embarking on this path, signs of success will likely be required here to see this considered more generally. Such discussions at the same time are making the likelihood of a US interest rate rise less data dependent and more inevitable, with markets clearly bracing for this.

Locally, economic data released showed the headwinds from the mining bust moderating but with tailwinds from the housing boom fading. Growth domestically remained moderate, exemplified by the RBA cutting the cash rate again during August with low inflation and a high exchange rate featuring strongly in their decision making. The federal election passed without much reaction. Despite moderate growth, the lack of private business investment growth continues to detract.

In the context of the Australian share market, the performance of the Materials sector (mining and energy) was noteworthy. The rebound in commodity prices, in our eyes, is more an affirmation that some stabilisation has returned i.e. a mean reversion than the start of a new cycle. Our holdings in BHP and RIO benefited, though we are loathe to participate much further, questioning the sustainability of this recovery in the face of still tepid global growth. With interest rates globally 'bottoming', interest rate sensitive sectors such as Telecommunications, Utilities and Listed Property Trusts underperformed. This was mirrored in Spark Infrastructure and Sydney Airports. Any interest rate rises, in the current low demand environment, we believe will be very gradual.

This quarter also coincided with earnings reporting season, with the trend of cost out, capex cuts and acquisitions continuing to be the means to offset still weak revenue growth. Earnings outcomes, whilst mixed, provided some comfort though that a stronger base for growth is being formed, when that elusive growth eventually arrives.

Our portfolio, albeit up some 3.7%, underperformed for the quarter, mostly owing to certain companies, e.g. Medibank Private where uncertainty around government policy/funding has impacted. Despite this, we hold, recognising increasing government interference, given their long term investment merits.

Portfolio activity

In the last quarter, we added the following stocks:

- **Link Group** (the largest provider of fund administration services to Australia's superannuation fund industry and a leading provider of shareholder management analytics and share registry services which, following the acquisition of a competitor some 18 months ago, is positioned to extract substantial synergies over the next few years from migrating clients onto its platform in the process solidifying its position as a low-cost, high quality provider in the space); and
- **Mantra** (2nd largest accommodation operator in Australia with a large network of hotels, resorts and serviced apartments, operating under three (3) key brands, being Mantra, Peppers and Breakfree, with an attractive asset light model (does not own its properties) and in an industry (travel) where conditions remain favourable, driven by inbound tourism, increasing household wealth and thus far a constrained hotel supply response).

In addition, we also added further to our holdings in **IVE Group** (post a partial sell-down by the major shareholder), **Japara**, **iSignthis** (following a major contract announcement) and **Orora** (post its results and guidance for FY17).

During the quarter we removed the following:

- **RCG Corporation** (whilst only acquired in the previous quarter, we sold at a profit following a significant re-rating on the back of an acquisition of a competitor, with the price capturing all the potential upside, which still needed to be delivered, with a subsequent downgrade more than justifying our decision);
- **Vita Group** (at a profit, following a significant appreciation in price, with Vita's success in operating Telstra's branded stores being assumed ahead of time in the Small Business/Enterprise channel, which they are progressively moving into, despite the strategy still being refined and fully rolled-out); and

- **Programmed Maintenance** (at a loss disappointingly, given its recent purchase, following confirmation of guidance at their Annual General Meeting in July (four months into their FY) and then significant downgrade two months later for reasons which should have been foreseen earlier, undermining the confidence we had in management).

We also reduced our positions, from a profit-taking and/or risk mitigation perspective, in **Bapcor**, **Commonwealth Bank** and **Challenger**.

Commentary

Attention will remain squarely on the US as we enter the last quarter of 2016, with the US elections only a few weeks away along with a couple of US Federal Reserve meetings at which an increase in interest rates will be on the agenda. At this juncture, markets seem to be factoring in a Clinton win and an increase. Volatility is always likely however would be more so if these outcomes did not come to pass.

At the same time, market valuations locally continue to remain above long term averages. Whilst a return to more 'normal' bond yields globally would translate, as a rule, to a return to more 'normal' equity valuations, this might not impact as much in Australia where the Reserve Bank of Australia has still a bias to cut based on factors mentioned earlier (low inflation/high exchange rate). The problem still remains 'spotty' growth though, in Australia's context, an improvement in resources is a welcome relief.

With this backdrop, and despite the media's tendency to gloom, our focus remains on where pockets of growth exist i.e. the compositional nature of the market than any concern about the market per se but at the same time mindful of current consensus positions, held by the market, which may be wrong i.e.:

- commodity prices have risen to what are deemed to be unsustainable levels;
- inflation risk remains benign with limited upside to interest rates; and
- the AUD should depreciate over time against the USD.

It is always easy to follow the pack, and we continue to question these assertions in the context of your portfolio make-up as data comes to hand/events unfold.



Our Quote for the Quarter

(in deference to the press coverage our athletes' performances garnered following the Rio Olympics)

"Sport is the most important thing in the world that doesn't matter."

Anon.

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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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


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