

February 2018 — Over the Horizon Market Commentary by David Offer

February 2018 may become known as the month that the US share market's record breaking bull run ended. During the month, the Dow Jones index fell 1,120 points or 4.28% to close at 25,029. It was the US share market's worst month in over 2 years. From the US market's record January peak of 26,617 points to its low point in February of 23,360 points, the US market was off 12.2% at its worst.

The Australian share market, having not experienced the significant upside that the US share market has enjoyed in recent years, fared significantly better. The All Ordinaries Index closed down 29 points or -0.5% at 6,117 points. Including dividends, we managed a small gain of 0.2% for the month. Not a bad effort that was in part due to a reasonable interim reporting season as corporate Australia reported, on balance, better than expected half year results.

Our share market will continue to be influenced by global events and the main show in town is a strong US economy putting upward pressure on US interest rates and therefore interest rates globally. All eyes will be on the US Federal Reserve meeting later this month scheduled for March 20-21, when it is widely tipped that US rates will rise by another 0.25% to 1.75%. This is expected to be the first of three or four rate rises for this calendar year.

As global interest rates march higher, this will open up alternative investments to growth assets such as shares. As such, it is likely that investment volatility will rise this year with risks to the downside, particularly for more expensive global share markets like America. Respected fund manager Hamish Douglas of Magellan Financial Group suggests that if US rates rise more swiftly and forcefully than expected, resulting in a jump in yield in long term US debt (his illustration being a 4% yield on US 10-year Treasury Bonds compared to the current yield of 2.8%), then a fall in global share markets in the range of 20 – 30% is within his 'range of outcomes'.

It is worth noting that a 30% fall in the US share market from January's high would see the US share market back at 18,631 points. This is almost the same level that the US share market traded at the day after Trump's presidential election win. At that time, we felt that subsequent strength in the US share market post the US election may reflect the commencement of the third and final leg of the bull market in US equities; otherwise regarded as the 'euphoria' or 'froth' component. This is the gain share markets tend to give up when a bull market rolls over.

We would be delighted if the US share market did head back to these levels (Dow Jones sub 20,000) and assuming this occurred in the second half of the year, we would again start to view US equities as fair value and an acceptable risk return proposition. Particularly as US businesses would have enjoyed two years of strong profit growth in the intervening period post the US election.

As such we continue to position for stormy seas with lower than long term average weightings of equities within portfolios. We are also building exposure to investments that offer the potential for upside (or at least outperformance) during times of falling markets.

One example that is now in many portfolios is listed investment company **VGI Partners Global (VG1)**, a listed investment company (LIC).

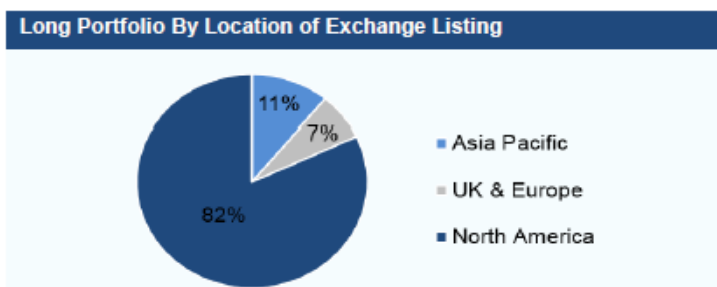
VG1 provides investors with access to a concentrated global investment portfolio of shares. VG1 is an actively managed fund that should outperform during periods of share market weakness through a willingness by management to short sell shares as well as hold a large percentage of the portfolio in cash when deemed appropriate. Since 2009, VG1's investment performance in its equivalent unlisted fund has averaged a compound rate of return of 14.6% net of all costs while maintaining an average cash weighting of 28%. VG1 is managed with a focus on capital preservation. As a result, while investment returns have lagged slightly during market up months, returns have been extremely favourable during months when the market has fallen.

VG1 listed late September at \$2.00 in line with its Net Asset Backing (NTA). After reaching a recent high of \$2.25, VG1 is now trading back in line with its NTA of \$2.06. As such we are happy to once again start adding to this investment through on market share purchases. Current key information on VG1 is below;

Month End Exposures	
Long Equity Exposure	49%
Short Equity Exposure	(15)%
Gross Equity Exposure	64%
Net Equity Exposure	34%
Cash Weighting	66%

Top Five Long Positions	
1. CME Group Inc.	8%
2. Colgate Palmolive Co.	5%
3. Mastercard Inc.	4%
4. Medibank Private Limited	4%
5. The Coca-Cola Co.	4%
Total Top 5 Long Positions	25%

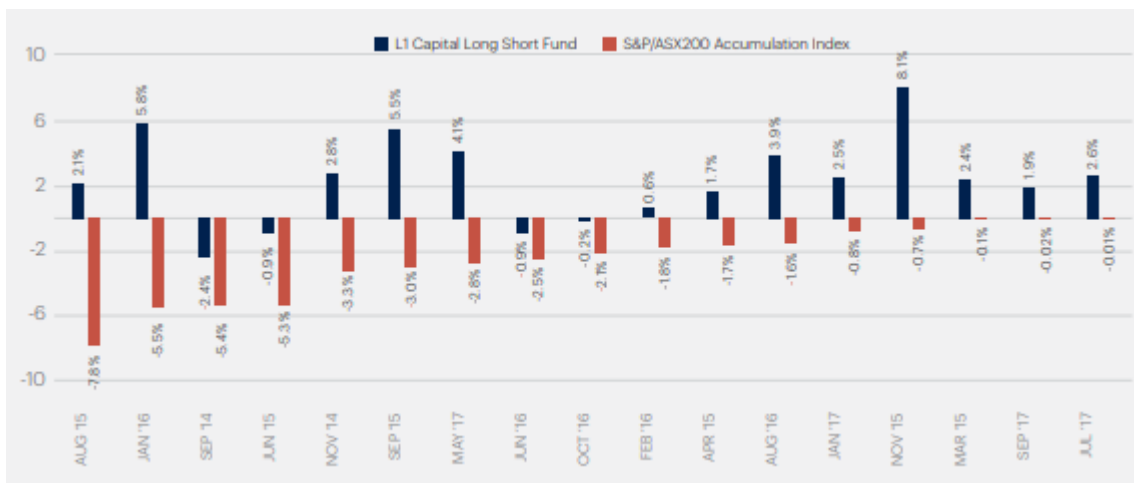
Net Currency Exposures	
USD	100%
% Portfolio NAV Un-hedged to AUD	100%



Another opportunity presently available as a new float is the **L1 Long Short Fund (LSF)**, also to be listed as a LIC.

The unlisted version of this LIC, which is closed to new investors, has returned 36.9% per annum since commencing in September 2014. *Please note that while we expect solid returns from the LSF, we do not expect the past rate of return achieved as being sustainable going forward.*

The LSF investment objective is to provide a strong, positive risk-adjusted return while seeking to preserve capital over the long term. LSF has a mandate to invest in Australian and NZ Securities and up to 30% in Global Securities and will generally hold 60 – 70 positions (both long and short) at any one time. Of particular note is how the equivalent unlisted fund has performed during down months, as illustrated in the following table.



Finally, we also have a small allocation in a new hybrid issue by Commonwealth Bank, the **CBA PERLS X**. These notes are offering an initial yield of 5.22% per annum, which is a premium to the recent Westpac hybrid issue (which we declined on the basis of insufficient return), and have an expected term of 7 years. Like all hybrid securities, the CBA PERLS X will be tradable on the ASX.

With respect to the LSF and CBA PERLS X offers (our office has an allocation of \$5 million in the LSF and \$2 million in the CBA PERLS X), we are presently reviewing portfolios and will be in touch if we consider either of these opportunities an appropriate investment for you. However, in the interim, please do not hesitate to contact our office if you would like more information. As both these investments are new floats, should you wish to participate, there will be no cost to do so.

As a concluding comment, I am sure that you have heard of Australia’s Federal Labor Party’s recent policy announcement concerning the cessation of refunding of unused franking credits for individuals and entities that incur a low rate of tax. We find this announcement extremely concerning as, contrary to Labor’s suggestion that this policy will predominately impact the rich, it will be everyday Australians that rely on franking credit refunds to help meet their annual income requirements that will be the hardest hit.

We view the policy as not well thought out. From a Federal Government perspective, it will increase the reliance on government Age Pension longer term. From an economic perspective, there will be adverse implications as a large number of Australians will be forced to tighten their belts and reduce discretionary spending. From an investment perspective, there will be an uneven playing field as different types of assets will be treated differently for taxation purposes. For example, fully franked shares will be at a disadvantage as distributions are paid after tax whereas property investments and bank interest are paid out before tax.

As such, we think it is likely there will be some modification by Labor to their proposed changes to imputation as they currently stand, with one potential scenario that franking credit refunds continue but the amount of refund is capped in value.

Also required for this policy to take effect is a Federal Labor Government victory at the next Federal election in 2019 and successful passing of this yet to be formed proposed legislation in the Senate. If Labor was successful at the next election, it will still take time for this policy to be enabled even if it successfully passed the Senate and as such we expect franking credit refunds will apply for at least the 2017/18 and 2018/19 financial years. Nevertheless, we will continue to monitor the situation and will start to factor into our thinking that franking credit refunds are unlikely to continue indefinitely in the current manner.

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