

Touchstone Index Unaware Fund Performance update

As at 31 October 2016

Performance

	1 month	3 months	6 months	Since Inception**
Fund	-2.84%	-2.09%	+0.30%	+5.18%
Benchmark*	-2.17%	-3.20%	+3.59%	+8.89%
Value added	-0.66%	+1.11%	-3.29%	-3.71%

Performance figures are net of fees and expenses.

*S&P/ASX 300 Accumulation Index

**Inception date is 4 April 2016.

Market Review

The Australian equity market, as measured by the S&P/ASX 300 Accumulation Index, weakened by 2.2% in October. Once again international events were the main influences on the market. Specifically uncertainty over policy settings by global central banks and the forthcoming US election continued to fuel caution.

Domestically, news from the company AGM season proved to be on the whole disappointing with few positive comments regarding current trading. Many companies warned of softness in the first quarter with full year earnings dependent on a stronger second half.

The US equity market also fell in the month, with the S&P500 declining -1.9%. While the third quarter company reporting season in the US was a little better than expectations and signalled the return to modest growth by US corporates, it was largely overshadowed by the uncertain outcome of the US election in November. In addition, the likelihood of an interest rate increase by calendar-year-end also weighed on the market. While the US Federal Reserve kept rates unchanged in the month, it signalled that the scope to increase rates had "continued to strengthen". In the UK, the FTSE gained +0.8% in the month notwithstanding the turmoil in its currency. In China the Shanghai Comp also advanced (+3.2%) aided by economic data which showed GDP growth of +6.7% for the third quarter in a row.

Major bond markets declined heavily over the month over concerns that key central banks have reached the limits of their monetary policy stimulus. In the US, heightened anticipation of a rate rise saw the US10-year Treasury bond yield rise to 1.82% from 1.59% in the prior month, the highest level since May. Other international bond markets also pulled back in the month with the 10-year German Bund yield rising to 0.16% (from -0.12%) despite the ECB reaffirming its plans to maintain QE at current levels. The UK 10-year Gilt yield rose by 49bp to 1.14% after stronger economic data dashed expectations of further monetary stimulus from the Bank of England. Locally, our bond market also posted a heavy decline,

with the Australian 10-year Bond yield rising 44bp to 2.34%.

The Australian dollar generally rose against most major currencies in the month but was largely unchanged against the US dollar (USD), ending the month at \$0.761. October was also notable for the move in the British pound which fell to 31 year lows against the USD on concerns over a 'hard exit' from the European Union.

Australian economic data was mixed in October. Retail sales, building approvals and trade were better than expected but were offset by weaker than anticipated housing finance approvals and a fall in the September labour force data. Jobs data remains mixed in that while the rate of unemployment remains low at 5.6%, the employment data remains soft, falling by 10,000. Headline CPI for third quarter rose by 0.7% qoq (+1.3% yoy) which although stronger than market expectations (due to a jump in fruit and vegetable prices), remains below the Reserve Bank of Australia (RBA) target level of 2-3% for an eighth consecutive quarter. The RBA (with a new Governor at the helm in Philip Lowe) left the cash rate unchanged at 1.5% at the October meeting.

Commodities were mainly weaker over the month with the exception of coal and iron ore. Oil peaked at \$US53.68/bbl during October and subsequently weakened after a failure of any definitive agreement by major oil producers on production cuts. At month end it finished lower by 2.9% to \$US48.50/bbl. Gold also continued to retrace from the previous month, falling 3.0% to \$US1,277/oz. On the plus side, iron ore ended the month at its high of \$US64.38/t (+15.3%). Once again coking coal was a strong performer, rallying by circa 8.7% in the month to \$US255/t. Coal has been very strong over the last three months (+150%), as Chinese domestic coal production cuts and genuine supply tightness lifted the price from what were quite depressed levels previously.

In terms of sector moves, Materials (+1.3%) and Financials (+0.7%) were the strongest performers both domestically and globally. Within the Materials sector, resource stocks were strong performers, retracing from their lows in early calendar 2016. Resources have now risen 10.8% over the last six months significantly outperforming the market. Fortescue Metals (+11.1%), Alumina (+8.2%) and South32 (+6.6%) were the standouts in the month.

The rotation away from interest rate sensitive sectors to less defensive or undervalued cyclical sectors continued in October. To this end Property Trusts (-7.9%), Telcos (-4.4%) and Utilities (-3.0%) were all weak. In addition, "expensive defensive" sectors such as Healthcare (-8.3%) and Technology (-6.5%) were also weak (consistent with overseas performance).

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The domestic AGM season provided little support to the market with comments on first quarter trading typically being cautious on the current trading environment and indicating a skew toward the second half in order to meet earnings expectations. Notable profit warnings came from Bega Cheese (-25.6%), Healthscope (-28.0%), the Reject Shop (-29.5%), AMP (-13.5%), Carsales.Com Ltd (-10.8%) and Coca-Cola Amatil (-6.9%).

The main corporate news came from a number of mergers and takeovers announced in the month notably Tabcorp and Tatts Group, UGL by CIMIC and the announcement of a merger between Henderson Group and US based Janus Capital. Other major corporate news came from the detention of Crown Resort employees in China on suspicion of gambling crimes. Crown fell heavily on the news (-16.9%) which also negatively impacted other gaming stocks such as Star Entertainment (-17.1%) and Sky City (-16.2%) in New Zealand.

Lastly, theme park operator Ardent Leisure (-27.1%) fell heavily following four fatalities at its Dreamworld theme park on the Gold Coast.

Top 5 Shareholdings

Company
Westpac Banking Corp
National Australia Bank
Wesfarmers
Star Entertainment Group
Telstra Corp

Performance Review

Over the month the Fund fell by -2.8% versus a market decline of -2.2%. The Fund was adversely impacted by the pullback in a number of key positions.

Notably the -17.1% fall in Star Entertainment (SGR) was the biggest individual detractor to performance largely in response to the news from Crown Casino (as outlined earlier in this report). Investors were concerned about the potential for a contagion to other domestic casinos thereby impacting their VIP derived revenues. In late October SGR provided a trading update and stated they were not experiencing any impact to the VIP business (14% of group EBITDA and ~10% of valuation). In addition, SGR noted they were very positive about the rest of the financial year. We remain comfortable with our position given its strong growth outlook with a solid balance sheet and very attractive valuation.

APN Outdoor (-13.6%) also fell in the month in spite of strong outdoor advertising data for the industry released in October. The negative momentum may have been driven by a large institutional shareholder reducing its

exposure in the stock. We believe that APO offers exposure to high quality assets, strong growth prospects in the digital outdoor media advertising market underpinned by a quality management team and an attractive valuation. Subsequent to month end, the company has upgraded its profit guidance.

Our holdings in select "yield sensitive" companies such as Charter Hall (-8.0%) and Goodman Group (-6.7%) were weak over the month falling in sympathy with the bond market. CHC was further impacted by the poor reception of the initial Long WALE REIT IPO, largely due to macro factors driving a rotation away from the sector at the time. The Long WALE REIT (CLW) was later restructured and launched on 8 November. We remain comfortable with CHC and GMG as they have high quality management, relatively low leverage, particularly compared to other rate sensitive sectors such as Infrastructure and Utilities (which are generally very highly leveraged) and offer relatively stable growth prospects with an accompanying high yield. Further supporting our fundamental thesis, post month end CHC announced a large upgrade of ~9% (pre-tax earnings), driven by strength in its funds management operations.

Not holding Commonwealth Bank of Australia (+1.4%) also hurt performance. However this was negated by our holding of other banks and financial stocks, which we believe have better growth prospects and more compelling valuation metrics, notably Westpac (+3.3%), NAB (+0.5%), QBE Insurance (+7.5%) and Insurance Australia Group (+0.7%).


Pleasingly our cash position was a positive contributor over the month. We took the opportunity to deploy some of the Fund's cash as the market fell in the month and as such the average cash position was around 11%, down from 12.5% previously.

We will reduce cash weightings at times of market pullback and/or when we see specific opportunities emerging. However, we believe the Fund is well positioned in light of extended financial asset valuations in general and given the heightened geo-political and economic uncertainty going forward.

Market Outlook

The recent company AGM season has reinforced our view that the outlook for the market for the remainder of the calendar year remains challenging given economic growth remains soft and many areas of the market are facing subdued demand conditions. While valuations have eased from their extreme levels across some areas of the market, the company earnings cycle needs to improve in order to justify current valuations. In addition, the political landscape is changing and markets can no longer ignore the emergence of geopolitical risks globally.

To this end, the US Presidential election has just been declared with a shock win to Donald Trump. Markets must now grapple with significantly increased uncertainty



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as the president-elect settles on his new policy agenda in the next few months. We remain cautious as to the flow on implications for forthcoming European elections in 2017.

Touchstone's Takeaways:

- i. Revenue growth remains difficult – tight cost management takes on added significance
- ii. Highly geared capital structures are riskier in this environment, even with low interest rates
- iii. Highest level of economic and geopolitical uncertainty and corporate earnings risk since GFC

We will seek opportunities to deploy our cash holding however downside protection remains at the fore of our investment decisions.

Contact details

For more information, call 1800 895 388 or visit touchstoneam.com

The Fund is managed by Touchstone Asset Management, a Bennelong Funds Management boutique.

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