Touchstone Index Unaware Fund

Performance update

As at 28 February 2017

Performance

February 2017	1 month	3 months	6 months	Since Inception**
Fund	+3.16%	+6.18%	+7.81%	+16.16%
Benchmark*	+2.18%	+5.79%	+6.94%	+18.43%
Value added	+0.98%	+0.39%	+0.87%	-2.27%

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 200 Accumulation Index, posted a solid gain in February of 2.3%. The market took its lead from rising international equity markets and from the domestic reporting season. While the reporting season was lacklustre in terms of themes, the market pulled back from its intra month high as some sectors such as Resources and Energy saw profit taking following their recent gains.

International equity markets were stronger in February. The US market led global markets higher as it posted 12 consecutive days of new highs before breaking its record run on the final day of the month. The S&P500 advanced by +3.7% over the month aided by continued enthusiasm for President Trump’s plans to cut taxes, the prospects of increased infrastructure spending and the potential for financial deregulation. In addition, a stronger corporate earnings season and signs of an improvement in the US economy bolstered equities in the month. Other markets were also higher with the FTSE 100 rising by +2.3% despite the continued uncertainty of the Brexit execution. The German DAX30 +2.6% and French CAC40 +2.3% also reversed the falls of the previous month. Asian markets also rose, albeit the Japanese market rallied by a more modest +0.4%.

The Australian Dollar rallied again for the second consecutive month against the US Dollar, ending the month 0.9% higher at $0.766 (from $0.759). The Reserve Bank of Australia left the cash rate unchanged at 1.5% in the month.

A lacklustre yet benign interim reporting season during February saw some profit taking from intra month highs, in particular Resources and Energy, and also drove small downward revisions to industrial earnings for FY17. Consumer Staples (+6.2%), Property Trusts (+4.1%) and Financials (+4.1%) were the better performing sectors, reversing much of their losses from the prior month. In addition, Healthcare (+3.9%) was a strong performer, mainly on stock specific news. Resources (-3.4%) and Energy (-2.1%) both had pullbacks from their recent rally post the US Presidential election, notwithstanding the former posting results largely in line with expectations and significantly higher than the previous year. Telcos (-3.1%) were also laggards in the month following some disappointment with the result from Telstra (-3.6%), despite the company reiterating guidance.

The company reporting season saw a number of disappointing results and/or trading outlooks across a wide group of companies. The most prominent disappointment during the reporting season came from Brambles (-10.6%) the second in consecutive months from the blue chip. In addition, Primary Healthcare (-12.0%), Ardent Leisure (-22.1%), Blackmores (-11.3%) and Ansell (-10.5%) also disappointed in the month. Notable upgrades came from Costa Group (+24.1%), Downer EDI (+13.4%), Qantas (+10.0%), Goodman Group (+9.1%), Charter Hall (CHC) and Super Retail Group (+8.3%).

The key themes that emanated from the domestic reporting season were as follows:

- In general top line revenue remained soft for Industrials while the Resources sector benefited from rising commodity prices
- While conditions in Western Australia remain soft due to weakness in resource demand, activity in the eastern states remain buoyed by the strong building cycle
- Building material companies and developers pointed to an elongation of the current housing and construction cycle whilst retailers exposed to the housing market also benefited
- Specialty retailers and discount department stores remained weak
- Resource companies posted results which were better than expected and some surprised with capital management (RIO) or stronger dividends (BHP). The contactors were a beneficiary from the improvement in demand for mining and infrastructure
- Outside mining, business capex remains mixed but in general weak
- Overseas cyclicals posted mixed performances with CSL, Resmed, Treasury Wines, Amcor and QBE delivering improved numbers. However Brambles, James Hardie and Ansell posted disappointing results, and
- Costs remain a focus but there were few announcements of major new cost out initiatives.

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Top 5 Shareholdings

Company
National Australia Bank
Wesfarmers Limited
Telstra Corporation
The Star Entertainment Group
Westpac Banking Corporation

Performance Review

The Fund outperformed solidly over the month, advancing by +3.2% versus the benchmark return of +2.2%, aided by a number of key positions which performed well over reporting period.

The Fund benefited from its holding in Costa Group (+24.1%) which rose after posting strong growth in earnings of 36%. Confidence in the outlook saw management raise full year profit guidance for the second time from “at least 15%” to “growth of approximately 25% for the full year”.

Our two large positions in the REITs sector, namely Charter Hall (+11.9%) and Goodman Group (+9.1%) delivered solid returns in the month after posting increases in 1H17 operating earnings which were ahead of market estimates. Each company also upgraded earnings guidance for FY17. CHC upgraded its post-tax FY17 EPS guidance to approximately 12% (from 7% previously) while GMG also upgraded guidance from 6% to 7.5% growth.

Conversely, our holding in US based James Hardie Industries (JHX) fell in the month (-5.7%) after the company reported 3Q17 results which were below market expectations. The weakness was due to plant ramp-up costs as well as manufacturing inefficiencies as the company is adding significant capacity in its North America Fibre Cement division. Importantly the 3Q17 result did not show any weakness in demand for fibre cement which enjoys both increasing demand from firming US housing activity and incremental market share gains. Whilst disappointing, we believe that FY17 should be considered a transition year, with FY18 shaping up to be very strong, driven by continued US housing market growth and margin expansion due to normalising production costs.

Telstra (-3.6%) was also weaker after reporting a disappointing headline 1H17 result. However the miss was largely driven by higher tax and depreciation and amortisation charges. Importantly underlying EBITDA of $5.4bn increased +2.4% yoy and was largely in-line with expectations despite increasing competitive pressures. As a result, Telstra’s FY17 EBITDA guidance of “low-to-mid single digit growth” was maintained. Whilst Telstra faces challenges to its core earnings from the loss of high-margin fixed line revenues, we believe the downside risks for investors is limited given the company’s appealing valuation, defensive earnings stream and high dividend yield.

Market Outlook

As highlighted in our last report, we believe the optimism which has swept equity markets since the election of US President Trump in November last year will dissipate as markets look for evidence of delivery on promised policies. Political risks also remain elevated globally, with France, the Netherlands and Germany facing elections in 2017. In addition, the details of the UK Brexit are yet to be finalised.

For markets to rally further in the short term, much will depend on what policy measures are actually implemented over the year ahead.

As such we remain cautious on the sustainability of our market’s advance. While the February reporting period was broadly uneventful, the broader company earnings cycle (ex resources) needs to improve in order for the market to justify current valuations before extending gains.

Touchstone’s takeaways:

- Revenue growth remains difficult – tight cost management takes on added significance
- Highly geared capital structures are riskier in this environment, even with low interest rates
- Heightened geopolitical uncertainty.

Downside protection remains at the fore of our investment decisions.

Contact details

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