

Touchstone Index Unaware Fund

Performance update

As at 31 May 2017

Performance

May 2017	1 month	3 months	6 months	1 year	Since Inception** p.a.
Fund	-1.45%	+2.31%	+8.63%	+11.89%	+16.10%
Benchmark*	-2.74%	+1.43%	+7.30%	+10.80%	+17.18%
Value added	+1.29%	+0.88%	+1.33%	+1.09%	-1.08%

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, fell by -2.7% in May and underperformed most major equity markets in the month. The Federal Budget was a focus and while its major policy initiatives were in line with expectations, the announcement of a Bank Levy to be imposed on the major banks was a negative surprise. As a consequence the banking sector, already under pressure from a lacklustre interim reporting season and rising concerns over the outlook for the residential property market, suffered a significant pullback in the month. Soft retail spending combined with a number of profit downgrades also saw sharp declines in the retail sector.

In contrast, most major international equity markets were stronger in May as better corporate earnings and signs of a steady global economy boosted the markets. The broader US S&P 500 ended the month higher (+1.2%), with the main strength coming from technology companies. European markets were aided by favourable market reactions to the French Presidential election with both the German DAX30 (+1.4%) and French CAC40 (+0.3%) trading higher. The UK market closed at record highs, advancing +4.4% in the month with export orientated companies buoyed by a weakened UK pound. In contrast, the Chinese Shanghai Composite posted another fall in May of -1.2% as regulators clamped down on shadow banking and speculative trading. The Chinese market was also adversely impacted by a downgrade to China's sovereign credit rating by Moodys late in the month.

Commodity price declines and doubts about the strength of Australia's economy weighed on the Australian dollar in the month. Australian economic data releases pointed to further weakness in the consumer and housing markets. Consumer sentiment fell a further 1.1% mom in May to 98, the lowest level since January 2017. In addition retail sales for March were also weak with the rise of +2.1% yoy, the slowest pace of increase in four years. The value

of construction work done fell 0.7% to \$46.4 billion qoq. Residential construction was the biggest drag in the latest releases falling 4.7% per cent in the first quarter of the year, in a further sign the housing boom may have peaked. The wage price index showed Q1 '17 wages growth of 0.5% qoq which saw the annual growth rate at a record low of 1.9% yoy. While the consumer remains under pressure, the NAB Monthly Business Survey posted another strong result for April, with both business conditions and confidence improving. Also in May, the RBA made no change to the cash rate of 1.5% for the eighth consecutive month.

Over the month the Australian equity market was pressured by a large decline in the Bank sector (-9.8%), with the Retail (-9.3%) and Healthcare (-2.4%) sectors also weak. Industrials (+4.7%), Telcos (+3.4%) and Energy (+1.5%) were the better performers in the month. The Bank sector was the main focus of the market in the month, impacted by subdued interim earnings releases (weak revenue growth but aided by low debt charge) and concerns that the current housing boom may have peaked.

The Retail sector also underperformed, impacted by the softer sales environment, on-going concerns regarding the likely entry of Amazon into the Australian market, a number of company downgrades including Orotan (-26.2%), Automotive Holdings (-21.2%), AP Eagers (-7.2%), Myer (-22.1%) and RCG (-27.7%) and an increasing number of corporate failures in the sector over the last few months including Marcs & David Lawrence, Topshop, Herringbone, Agent Provocateur and Kit and Ace.

The other main stock specific news in the month came from Vocus Group (-16.3%) which lowered its EBITDA guidance for the second time this financial year. In addition Pact Group (-12.7%) and Sigma Pharmaceuticals (-34.8%) both downgraded earnings guidance.



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Monthly performance update

As at 31 May 2017

Top 5 Shareholdings

Company
National Australia Bank
Telstra Corporation
Wesfarmers Limited
Insurance Australia Group
Goodman Group

Performance Review

Over the month the Australian equity market declined by -2.7%. Pleasingly the positioning of the portfolio shielded our performance from the worst of the market pullback in the month, with the Fund declining by -1.5%.

Our large underweight position in the Banking sector was a major contributor to performance. Specifically not holding either Commonwealth Bank (-8.9%) or ANZ Bank (-12.2%) assisted returns following their large falls in the month. We continue to remain cautious on the sector given the weak revenue growth and on-going capital requirements. However, our concerns have been tempered by the material price decline in the sector during the month. As such we are seeing some valuation upside emerge as these issues begin to be priced in.

Treasury Wine Estates (+8.5%) was an outperformer in May. The company is a beneficiary of a weaker Australian dollar, has strong earnings growth prospects and is one of the few companies in the consumer sector that is unlikely to be impacted by the arrival of Amazon.

Conversely, James Hardie Industries (-13.6%) detracted after it reported 4Q17 earnings that were below market expectations. We believe the majority of factors behind the decline in US margins in FY17 are largely transitional and associated with enhancing the company's long-term earnings growth prospects. We expect earnings to improve in FY18 and beyond, driven by continued US housing market growth and margin expansion due to normalising production costs.

APN Outdoor Group (-14.8%) declined following the decision by the company to terminate merger discussions with oOh! Media after conceding the deal was unlikely to obtain regulatory approval. Our investment thesis in APO as a standalone business remains unchanged, namely it is expected to generate strong earnings growth over the forecast period and still trades on relatively undemanding valuation metrics.

Market Outlook

Over recent weeks, our market has digested a number of softer economic releases and corporate downgrades thereby weakening the outlook for the year ahead. A highly indebted consumer sector has led to softness in spending and this appears to have accelerated over the last quarter. Slowing wages growth, rising costs due to out of cycle interest rate increases by the major banks, and increasing utilities, insurance and petrol prices have added to this burden. This has been highlighted by the number of companies within the consumer discretionary sector which have trimmed their earnings expectations and has extended to previously stronger parts of the market such as car sales.

Despite the recent pullback in May, we remain cautious on the Australian equity market. Growth expectations for the broader market (excluding resources) remain modest yet may still prove to be optimistic. In addition, the recent decline in commodity prices also limits the ability for resources companies to upgrade.

Furthermore risks remain elevated globally. International financial markets have continued to rally, some to ever increasing highs, yet global growth appears to have plateaued while political uncertainty in terms of policy settings and geopolitical risks generally remains high.

Our thesis remains unchanged that given the heightened uncertainty, the market remains very vulnerable to an exogenous shock. As such we remain cautious and have reflected this in our portfolio positioning.

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

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