

Touchstone Index Unaware Fund

Performance update

As at 31 August 2017

Performance

August 2017	1 month	3 months	6 months	1 year	Since Inception** p.a.
Fund	+0.11%	-0.53%	+1.77%	+9.72%	+12.62%
Benchmark*	+0.75%	+0.99%	+2.43%	+9.54%	+14.70%
Value added	-0.64%	-1.51%	-0.66%	+0.18%	-2.08%

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, ended August with a modest rise of 0.8% despite volatile intra-month trading. Trading was dominated by the domestic reporting season which proved to be more disappointing than the market initially expected. Resources were the strongest performers aided by firmer commodity prices, better operating efficiencies and strong cashflow generation which enabled higher dividend payments. Conversely, Financials weakened, weighed down by a pullback in CBA following allegations that it may face substantial fines for alleged breaches of its anti-money laundering obligations. The weakness extended to all bank shares as the incident has provided more impetus for a Royal Commission into the Financial sector.

Domestic economic data was mixed in August with business conditions once again showing upside but the consumer still weak. Employment data for July continued to show an improvement with the unemployment rate falling to 5.6% (in line with expectations), from 5.7% in June. The RBA made no change to the cash rate of 1.5% for the 11th consecutive month.

Commodities continued to rally in August with some supply constraints and better economic data from China underpinning their advance. Iron ore (+7.1% to \$US78.9/t), copper (+6.6%) and nickel (+15.5%) all rose strongly. Coking coal was also strong in the month, rallying +16.4%. Gold (+4.1%) continued its rise as investors sought safe haven assets as geopolitical tensions rose in the month. Oil (Brent) was largely flat at \$52.80 as the crude markets gradually tightened over most of August on North Sea field maintenance and falling inventory levels.

The Australian Dollar (AUD) was largely unchanged in August but remained firm against the USD (\$0.795), helped by firming commodity prices and weakness in the latter currency.


Notwithstanding the lacklustre company reporting season, the Australian equity market ended the month largely flat with Resources (+5.5%) and Energy (+5.7%) the main outperformers. Resources were buoyed by a lift in earnings and cashflows on the back of stronger underlying commodity prices and focussed capex. Conversely, the Telcos sector (-7.4%) was dragged lower by Telstra, which declined after management outlined a new dividend/capital allocation policy at their full year result release. The early implementation of a new payout ratio policy from FY18 onwards disappointed the market. The Retail sector (-6.5%) was also weak despite some reasonable profit results. Investors were nervous regarding the cautious outlook from Trade Me (-17.6%), while The Reject Shop (-12.7%) and JB Hi-Fi (-11.1%) were also among the bigger losers in the month.

In general, the August domestic company reporting season proved a little more disappointing than the market expected with the number of downgrades to consensus earnings significantly outnumbering upgrades. As such, the earnings per share growth outlook for FY18 is now forecast to be in the low single digits (from strong double digits in FY17). While much of the decline in earnings for FY18 is due to the expected pullback in resources earnings, the reporting season has resulted in the expectations for industrials also being reduced.

Some of the key themes which emanated were as follows:

- There were few major earnings upside surprises in the season but those which disappointed or provided cautious outlook statements were dealt with harshly
- Top line revenue growth was modest outside the Resources sector
- Many corporates faced margin pressures from increased competition, higher cost pressures (notably wages and utilities). In addition, lower interest costs are no longer the tailwind as per previous years.





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A number of companies announced further cost-out initiatives to counter the increased pressures

- Dividends and capital returns were a focus of the period. In a twist from the norm, it was the Resources sector which provided the main lift in dividends. In contrast, the traditional high payer Telstra adopted a lower payout policy going forward. In addition, the lack of capital management from AGL, Suncorp and AMP also disappointed, whilst infrastructure operator Transurban also surprised with a lower than expected FY18 forecast distribution
- Building material companies in general pointed to an elongation of the current housing and construction cycle, whilst retailers exposed to the housing market also benefited
- Companies reliant on consumer spending (other than housing) pointed to softer trading conditions or increased competition. Initiatives to counter the imminent rollout by Amazon of its full suite of retail services in the Australian market was a focus of management discussions
- Resource companies, as anticipated, reported much stronger profit growth due to the rebound in commodity prices. Together with the focus on cost cutting and capex reductions, the companies reported a significant strengthening in cashflow which enabled higher dividend payouts. The sector was one of the better performers in the month
- Overseas cyclical posted solid growth but the strength of the AUD is now a headwind to the outlook with the AUD currently at a two year high versus the USD
- Guidance by management in the main remained cautious. In general, management commented that the subdued trading environment was likely to persist in the second half of this calendar year.

Top 5 Shareholdings

Company
National Australia Bank
Westpac Banking Corporation
Wesfarmers Limited
Insurance Australia Group
QBE Insurance Group

Performance Review


The Fund underperformed the market over the month, advancing +0.11% versus a benchmark return of +0.75%. Performance was adversely impacted by a pullback in a number of key positions.

Our positions in insurance companies QBE and IAG also detracted in the month. QBE (-10.1%) fell following its half year result as management provided cautious commentary, suggesting that full year earnings would come in toward the lower end of the range previously provided. The share price is now down more than 20% since issues in the Emerging Markets (EM) business were first highlighted last month. This is a disproportionate reaction with the division only contributing 10% of the group earnings. QBE is now trading at more than a 20% discount to global peers. While the previously announced losses in EM were disappointing, there is no change to our investment thesis. The drivers for an earnings uplift are in place and the company has now initiated a \$1bn buyback.

IAG (-3.9%) also weakened after its FY17 NPAT release included a small number of abnormally large commercial losses which surprised the market. The stock fell following the release of the result, due in part to excessive market expectations, after the company updated the market in late June. While the company had previously upgraded expectations for reserve releases, the market had assumed that the underlying result was also very strong. In addition, management continued their practice of being conservative in their outlook comments.

The Fund benefited from not holding Commonwealth Bank of Australia (CBA). CBA fell heavily (-6.9%) after AUSTRAC initiated civil penalty proceedings in the Federal Court against CBA “for serious and systemic non-compliance with the Anti-Money Laundering and Counter Terrorism Financing Act”. Potential implications include material penalties, on-going brand damage, higher costs and further scrutiny from regulators, politicians and the community. During the month it was also announced that Managing Director and CEO Ian Narev, would retire by the end of FY18. This was subsequently followed by the announcement of a number of Board changes by the Chairman. At month end, APRA also announced an inquiry into CBA’s governance, culture and accountability.

Our holding in Treasury Wine (TWE) rebounded strongly from last month’s pullback. The company has guided analysts to 25% EBITs margins (from the current 19%). This should underwrite continued double digit growth in earnings for the next five years. As a result of the stronger outlook TWE rebounded strongly and ended the month up 20%.



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Wesfarmers (+7.7%) continued to strengthen as it posted another solid result with the Bunnings and Kmart businesses continuing to be resilient despite a tougher consumer environment. Cashflow was another highlight which supported the full year fully franked dividend of \$2.23 (+19.9%). We expect the operating businesses will continue to perform well. In addition, with the coking coal price continuing to be strong, we see the potential for the sale of the Resources unit which would provide a positive catalyst for the share price.

Market Outlook

The Australian equity market posted a credible performance in August in the face of what was a relatively soft earnings season. Outside the largely anticipated rise in resources earnings, growth was modest. Concerns regarding the strength of the consumer, rising input costs and increased competition will continue to weigh on the outlook for earnings growth. As such the estimates for FY18 market earnings have been tempered as economic growth remains below trend and the scope for large scale 'cost out' or capital management appears limited. More recently, the rising AUD will also be a headwind for US dollar earners. For resources, we continue to anticipate that commodity prices will decline from current levels, tempering their profit outlook. Against this backdrop, valuations remain high and vulnerable to a pullback.

We reiterate our comments from last month that risks remain elevated globally. International financial markets have continued to rally, some to ever increasing highs, yet uncertainty in terms of policy settings, interest rates and geopolitical risk 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

For more information, call 1800 895 388 (AU) or 0800 442 304 (NZ) or visit touchstoneam.com.

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

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