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Alvia Asset Partners Investment Team Insights

December 2018 Quarter

2018
A Year of Normalisation

<u>Paper losses and a cut to hubris</u>

Well the transition from the 3rd quarter to the start of the 4th quarter felt like an abrupt metamorphosis, from Jennifer Aniston to Bill Crosby. How quickly investor euphoria has been exchanged for deep despondency.

What happened?

Stocks started to correct on September 17th without much relief. Sentiment has shifted and as per history boredom has given way to worry, worry has given way to fear - let's see if panic kicks in. We are doubtful of a fully-fledged panic driven selling event but it could happen. The non-fundamental/non-earning 'bubble' basket has literally vomited all over itself – hopefully this spells the end of the loose money momentum driven speculation. **This is not investing, this is hope based fantasizing.**

We have also seen a touch of indiscriminate selling – this tends to happen as professional investors (fearful of reprimand) choose to '**act**' as if they are doing something in an attempt to hide large portfolio blemishes rather than avoid facing the review wraith of their potentially flight investor base.

Career preservation kicks in and less courageous professionals crystallise outliers and migrate to the index rather than hunting down outlying opportunities – so be kind to your truly active managers and reward the mischievous (aka the non-index huggers) that are truly concerned with compounding absolute returns via active management. These are the ones willing to put your portfolio before their desk jobs.

What about me?

You aren't alone in feeling paper loses. You are an in fact in fine company with barely a single asset class registering a calendar gain (bar cash and local bonds). However appropriate asset allocation has significantly reduced the anguish for balanced investors – as per its design.

Let's be honest we all know a sell off was warranted so don't be glum as long as you don't/didn't act on it – or only acted appropriately it means very little. It's actually quite healthy and normal, the period of low volatility that we had experienced is what was abnormal. It's easy to forget that volatility and corrections are the norm. They are an unpleasant but a regular part of the landscape. On average, you could expect a 5% correction every 51 trading days. You could expect a 20% correction every 630 trading days. **Don't get angry just get used to it!**

We've gone more than 2,400 days without a 20% correction. This was due and it was clearly noted.

All this noise… GFC V2and all that…

Please don't engage with the media during such times (there are plenty of studies to highlight how destructive this is to portfolios). We all know the headlines: "Stocks plunging," "Markets tumbling" and "Bloodbath in stocks."

Engage your brain, not your heart.

*Be pragmatic **(enjoy Christmas with the family)** and ignore it.*

Example 1.

Headline: Let's be honest About Gold: It's a pet rock - *Timed to perfection!*

Example 2.

Everyone is getting hilariously rich (on bitcoin) and you're not - *Timed to perfection!*

When pullbacks and corrections do occur, the media/commenters will overreact. As investors, we should welcome this—because volatility is when opportunities present themselves for the brave.

Easy for you to say, but what about my 'red' portfolio?

When we think about risk, the first thing to recognize is for most people, risk really boils down to the loss of purchasing power over time, or a lower quality of life.

It isn't necessarily about market volatility, when prices go down, the wiring in people is not to invest more, and it's often to invest less. When prices go up, people get more excited. That is an old story and one of the most important risks out there.

There's a simple truth:

Lower prices may help increase future returns and decrease risk.

If you were investing yesterday at higher prices than why not today at lower prices?

But what about trade/trump/…..?

There is always a reason to be fearful and the current trade debate is the current "attention-grabber" we think this is a great example of the headlines distorting the reality.

Trade disputes are always bad, because once you introduce tariffs, you introduce friction— which basically means money is taken from businesses and consumers and transferred over to the government. Not ideal but absolutely nobody knows the outcome or can predict its underlying impact on long term asset prices.

Without bad headlines there wouldn't be opportunities and price/value distortions and yes, volatility is tough. But this is first time in a while that we have been thrown multiple opportunities at once - this is a great time to carefully deploy capital due to indiscriminate selling – i.e. selling that drags down quality franchises irrespective of fundamental value.

We assure you that we are positioned durably for this scenario across all asset classes and whilst your equity portfolios are down on paper – your asset allocation has worked for you during this period. **Effective asset allocation is the only true risk management tool** and this will never change. It provides the only effective means to compound wealth through all cycles - be patient, act only when necessary and let your asset allocation work for you.

We love fear because it bites at everyone but only really hurts those without the fortitude to resist unnecessary action – **yes your equity portfolios are worth slightly less on paper but without liquidation it only really impacts your BBQ bragging rights over Christmas.**

In summary:

- Diligent asset allocation will always hold your emotions in check and should never be replaced by a greed induced concentration or fearful overreaction.

- The more you find yourself upset right now the more you need to focus on asset allocation.

- Focus on the portfolio on the whole – don't pick out the winners and the losers it's the end portfolio result (absolute) that matters.

- Heavily weight real history over forecasts – **don't try to predict the weather/ you will end up wearing a skivvy in the middle of summer and look ridiculous.**

- Stories are for putting toddlers to bed – not for your investment portfolio. Own real businesses not pitch decks ☺

The Devil's in the Detail

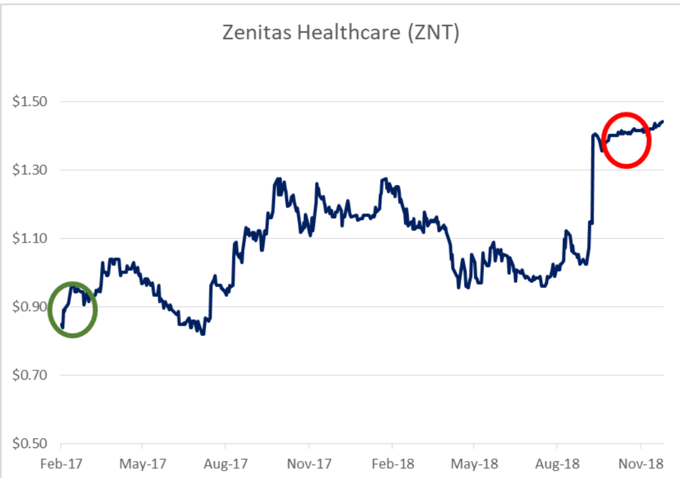
The highs and lows of the year – *some examples*

Fixed Income

Bond	Purchase Price	Yield	Sell Price	Annualised IRR
Heartland Bank	$104.5	5.91%	$105.25 (Plus Interest)	6.81%
NABHA (Hybrid)	$78	3.6%	Still holding (current price $84)	9.2%

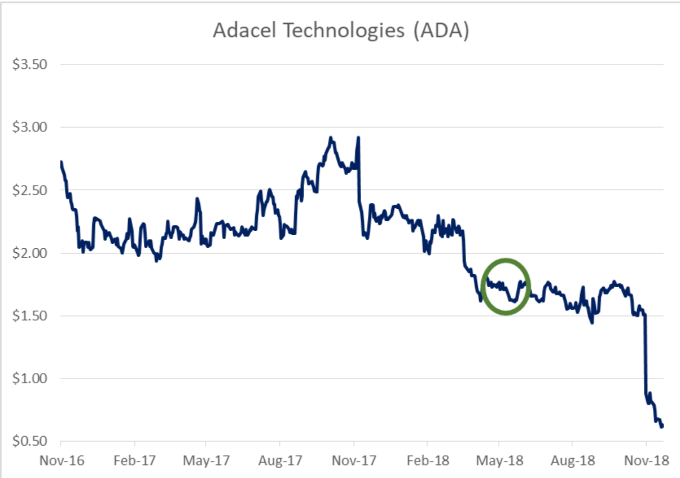
Australian Equities

Thematic:	Oil price.
Why we bought:	Cost out. Reduced debt.
Why we sold:	Oil price rebound. Takeover bid.
Why we are holding:	
Simple return:	105%



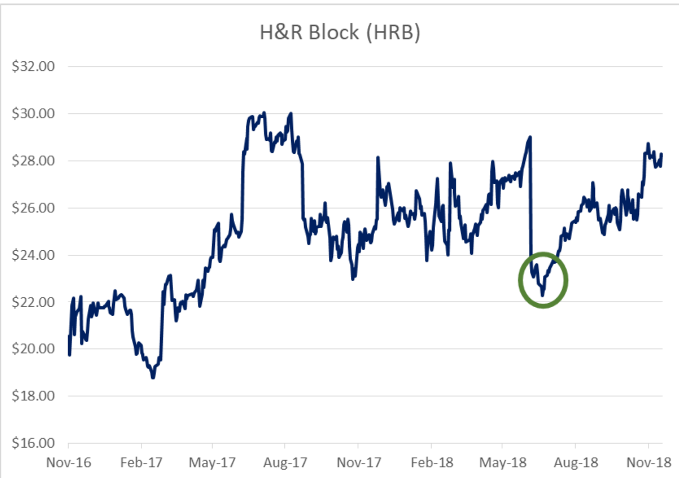
Thematic:	Allied healthcare.
Why we bought:	Sound management. First allied health roll up.
Why we sold:	Takeover by private equity.
Why we are holding:	
Simple return:	62%

Thematic:	New game technology, duopoly market.
Why we bought:	Value proposition, unique licence for South America.
Why we sold:	Issue with country traction, opportunity cost.
Why we are holding:	
Simple return:	-39%

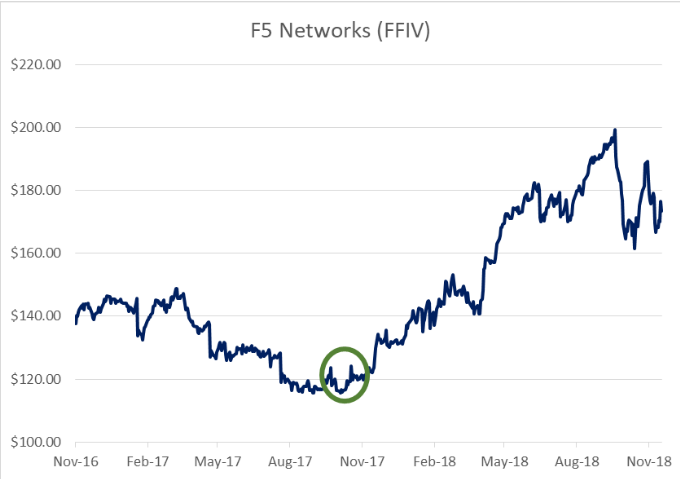


Thematic:	Increasing air traffic.
Why we bought:	Sold off on less profit due to paying tax.
Why we sold:	
Why we are holding:	We believe the market misinterpreted announcement.
Simple return:	-50%

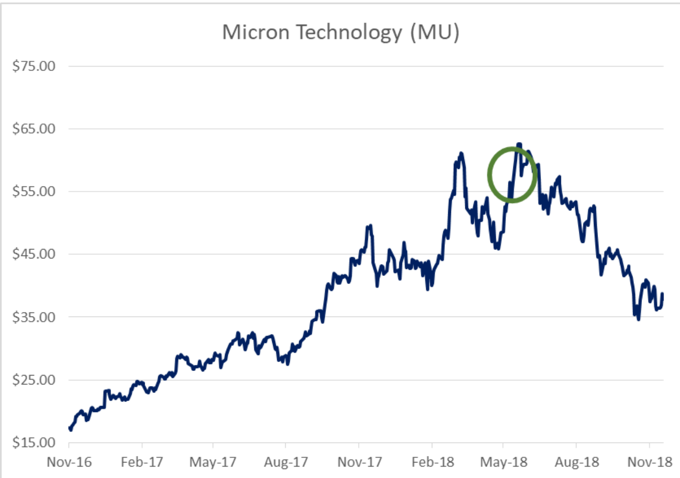
International Equities



Thematic:	Changing tax system = more people seek help.
Why we bought:	Trump "I'll put HRB out of business".
Why we sold:	
Why we are holding:	Fundamentally cheap for world's largest franchiser of tax professionals.
Simple return:	28%



Thematic:	Growth in IoT (cloud acceptance)
Why we bought:	Exceptional quality, no debt. Strong track record of capital management.
Why we sold:	
Why we are holding:	Fundamentals remain intact with upside in our valuation
Simple return:	50%



Thematic:	Computer chip usage expansion
Why we bought:	Large semi-conductor producer, exceptional fundamentals.
Why we sold:	
Why we are holding:	Huge discount to intrinsic valuation. Chinese tariffs have been a market concern.
Simple return:	-30%

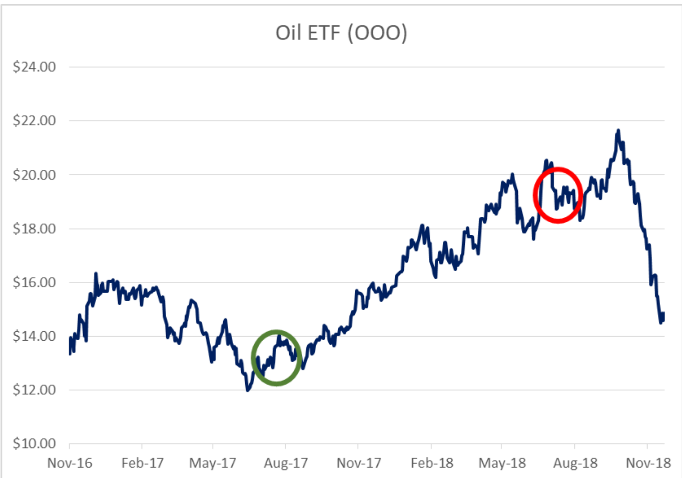
Thematic:	Revaluation of assets, changes to tax reporting.
Why we bought:	Strong management, diversified business.
Why we sold:	Started to reduce position, closer to our intrinsic value
Why we are holding:	Strong business fundamentals
Simple return:	22%

Property

Thematic:	Ageing population.
Why we bought:	Undervalued assets, strong management team, different products to standard players.
Why we sold:	
Why we are holding:	We decided to double our holding via Aus. Eq. Port – current NTA 3.92.
Simple return:	-17.5%

Thematic:	Logistics.
Why we bought:	Undervalued assets in high demand areas
Why we sold:	
Why we are holding:	Currently under several take-over offers, great management team.
Simple return:	75%

Alternative Assets



Thematic:	Oil price trade
Why we bought:	Below long term average – mean reversion.
Why we sold:	Above long term average, increasing supply coming.
Why we are holding:	
Simple return:	40%

What to take from our examples above?

- Investing takes time.
- Very rarely do we anticipate our realisation of value to occur within one year.
- As value investors, we are often going to be too early to the party.
- It may look bad at first, but if the problem/cause is fixable it generally takes time to heal (just like a human body)
- We believe in watering the flowers and cutting the weeds.
- We are never going to try and 'time the market'. We cannot help and predict human emotion. It's about time in the market, not timing the market.
- In this market (slightly volatile, slightly uncertain), the value investing discipline becomes even more crucial. It helps us to find our bearings when reassuring landmarks are no longer visible.
- In a market downturn, momentum investors cannot find momentum, growth investors worry about a slowdown, and technical analysts don't like their charts.

  <u>But the value investing discipline tells you exactly what to analyse, price versus value, and then what to do, buy at a considerable discount and sell near full value</u>