ALVIA

Asset Partners

Alvia Asset Partners Investment Team Insights

June 2018 Quarter

Executive summary:

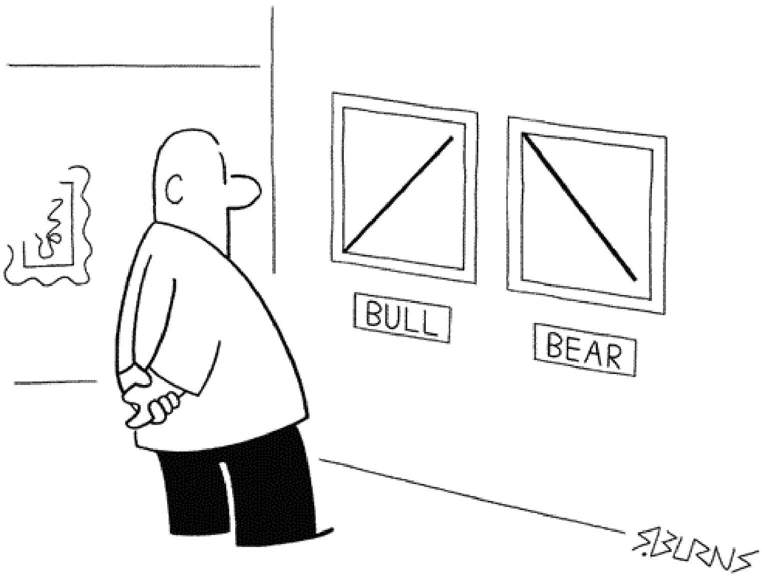
In this quarterly we firstly take time to reflect on the arguments for the bull and the bear, noting that it is invariably hard to ever predict the next cycle turning point, we remind ourselves that is about 'the time in the market, not timing the market' and to always have enough cash to take advantage of opportunities if they present themselves. As we know, history doesn't always repeat, but it does often rhyme.

The technology sector couldn't have been any hotter this year, valuations have been driven to new highs, and all we do here is ask 'what happened to real price discovery'? The obsession with FANGs will come to an end as good time stories tend not to translate to the bottom line. We take this chance to look at what it takes to generate returns over the long term.

Another key theme keeping everyone (mainly China) on their toes was 'what will Donald do next?' his twitter handle has certainly kept a few investors upa at night, but the fact is, no one quite knows how a trade war would play out. However, where there is uncertainty, there is opportunity – we state how would we are positioning ourselves if we had to own one company and the left field idea that trump has created.

As investors, we often get asked 'what keeps us awake at night? We take this opportunity to look at inflation and where it may be heading, the private equity market and the multiples being paid, the private lending market and the business's coming out of the woodwork – we saw five in the space of a week! These represent our current concerns in the market, apart from valuations in general (we test Elon on his ability to grow into a $400 share price at Tesla).

Bringing it home, we outline our concerns for both the Australian housing market and the accumulated debt in the system, which is magnified by a decreasing savings balance. The obvious thought here is, will this manifest into the equity market. A small number of growth darlings appear to be driving the ASX200 (CSL, Cochlear, TWE, A2M). It appears to us that growth is the flavour of the year, leaving a sour taste for the value managers, could this be the top? We anticipate that in time this will revert. Our quotes of the quarter will provide some rational thinking to some not so rational investing.



June quarter review:

Quarter thoughts

"Bear markets are the authors of bull markets, and bull markets are the authors of bear markets"

The Bull: there is a lot of cash in the system - more than global GDP, 100 trillion.

The Bear: there is more debt than ever before in the system.

The Bull: the US economy is literally booming at full employment and that should translate to earnings

The Bear: markets are a leading indicator, best performance has been generated from high unemployment – see graph below.

Very few will inevitably get the timing right for the next bull or bear market, and we for one, are not going to try and time the market.

If we believe we are going into a bear market and move to cash, we could miss out on the end of a bull market.

If we believe we are going into a bull market and are fully invested, we could be down 30% before we asked what happened.

At Alvia, we always remind ourselves that it is about *'the time in the market, not timing the market'*. We aim to always have enough powder (cash) dry to take advantage of opportunities. Valuations will always come first.

History may not repeat, but it does often rhyme

For every investor who has learned from past mistakes and experiences with various market environments, there are 3-4 who are stuck **fighting the last war who have become prisoners to their memories of past markets.**

- *A young investor from the 1930s would assume the stock market was the last place you would ever place money and that great depressions were part and parcel of the normal business cycle.*

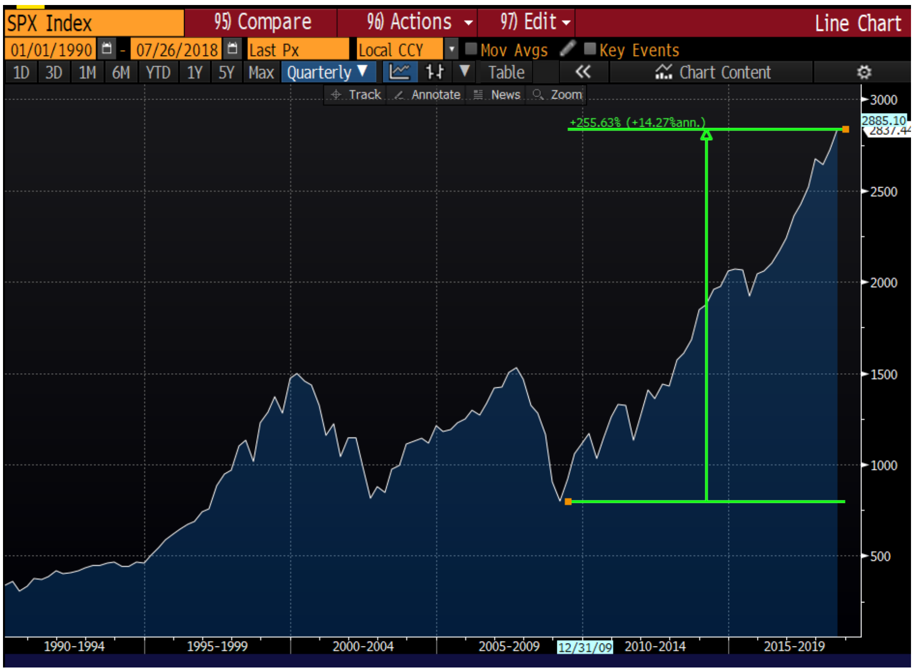
- *A young investor from the 1940s would assume World Wars and the resulting face pealing inflation were normal.*

<u>And</u>

- *A young investor from the 1990s learnt to presume that a 20% annual return was a serviceable expectation.*

- *A young investor who lived through the 2000s would assume enormous market crashes and recessions occur regularly and that technology is the only investible sector.*

How many investors "called" the 2008 crisis only to miss out on the ensuing recovery? A lot.



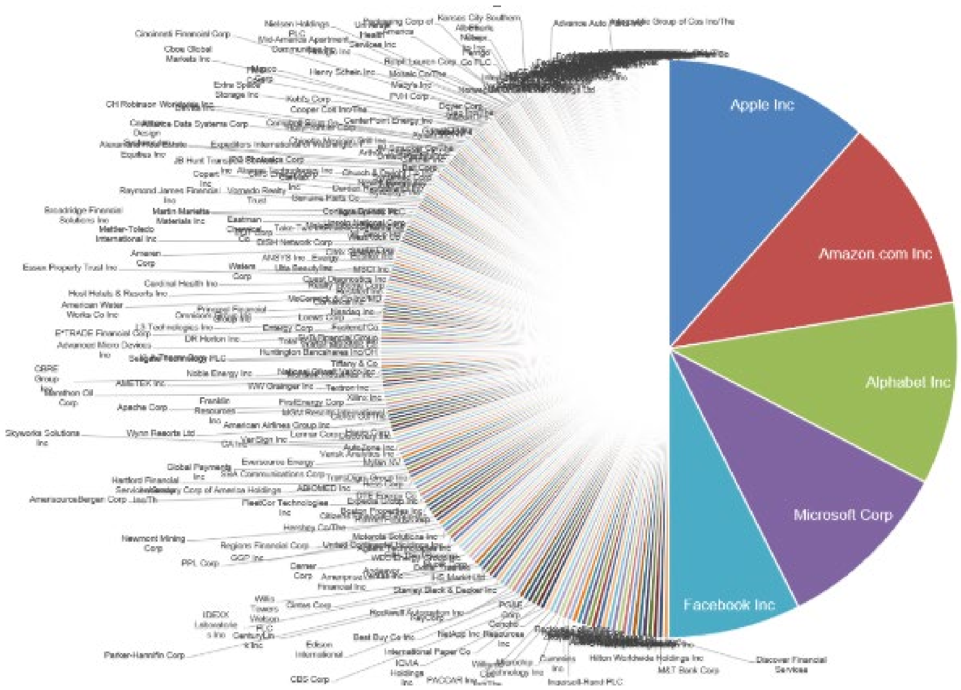
What happened to real price discovery? – Everyone is crowding in "defensive" technology

We would like to make a few simple points;

1. The crowding effect:

The extent to which the entire market is dependent upon the usual suspects now borders on the absurd. See below – the passive ETF industry is surely exacerbating this risk.

At some point you need to contemplate the investment decision you are making when buying an ETF. You are making the active decision to buy based on market capitalisation and **thus momentum not valuation** so be careful.



Source: The Reformed Broker

2. In saying this, those that have bought the market have done very well;

Stocks most responsible for the market's gain this year

Company	Percent of S&P 500 YTD returns ▲	Percent of Nasdaq 100 YTD returns	YTD percent change
Amazon	35	41	49
Netflix	21	21	117
Microsoft	15	15	19
Apple	12	12	13
Alphabet	8	8	11
Facebook	8	8	16

CNBC

3. The FANG hysteria

A few weeks back, USA Today suggested that college students should plow the money they make from summer jobs into FANG stocks.

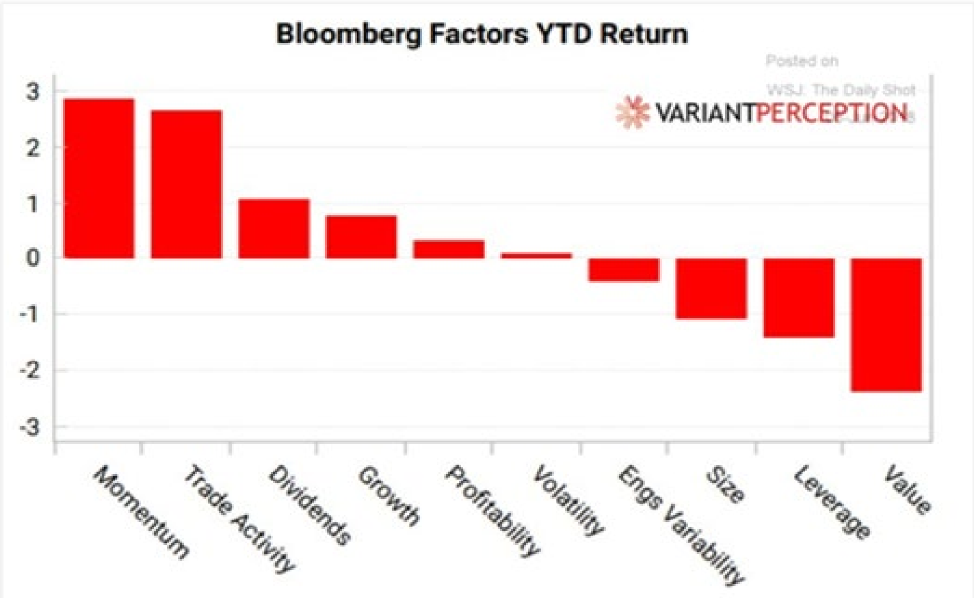
The article quite literally says that this strategy is a good way to "build a small fortune".

A $10-per-hour summer job slinging eggs or saving lives at the beach [is] enough seed money to build a small fortune in a short period of time ... in four FANG stocks.

Momentum over value names continue to handsomely outperform – which does concern us.

Why does this concern us? Because it means investors are placing 'faith' in a good story over the fundamental valuation and this historically has never ended well. **Remember the Nifty 50.**

Momentum has been first, value last – **this will not last!**



4. Stories are great for toddlers – but not for investing in.

Humans are by our very nature, story-loving animals, and we create stories to help us make sense of what is going on around us in the world, and many times, those stories are wrong. Thus forecasts based on stories are hugely problematic, they make us feel good but add very little value.

We mistake noise for signal and then formulate a good story over the short term and thus the process is largely meaningless.

Over the very long term however – all that is left in the absence of a 'story' is the context of history, **the mean and valuation**.

Therefore at KPW we believe in learning from history, being mindful of the mean and making decisions based on valuation.

We will use Amazon and Berkshire Hathaway as our example:

AMZN (the #1 story stock) is up 50% for 2018.

BRK (The #1 fundamental valuation story) is down 5%

	Amazon	Berkshire Hathaway
Market Capitalisation	$874 B	$490 B
Free Cash Flow	$6 B (145x)	$34 B (14x)

Ps. BRK also has $115 B in cash as a war chest, AMZN has only $20 B.

We prefer to own the fundamental (BRK) over the story (AMZN)

Our main point is that this is not normal, tech is not the only sector available – **it's just the sexiest!**

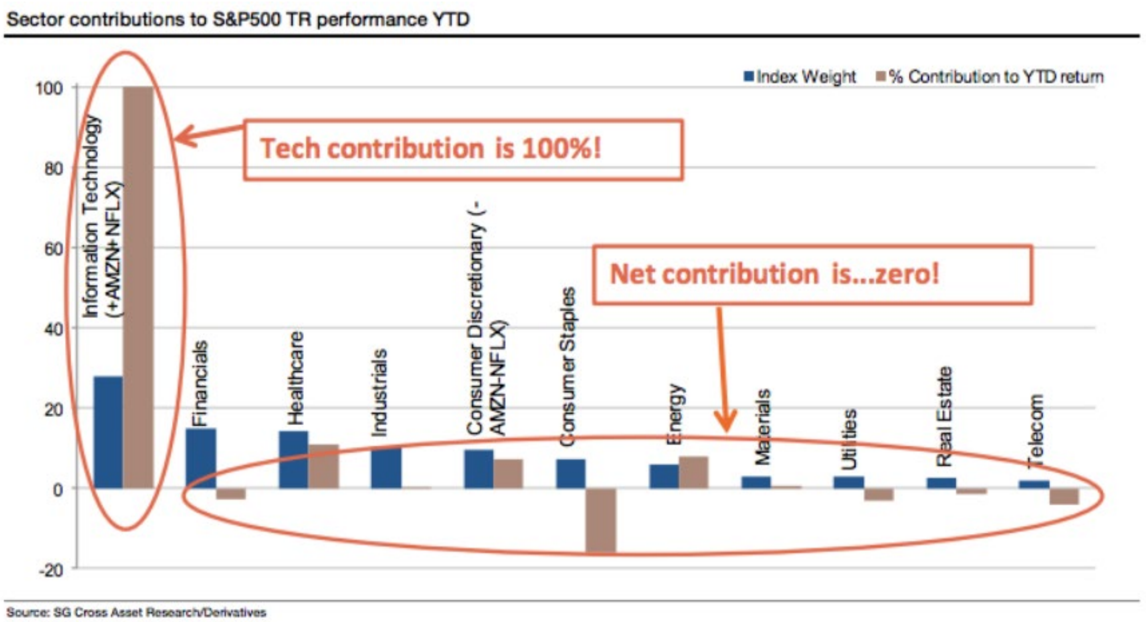
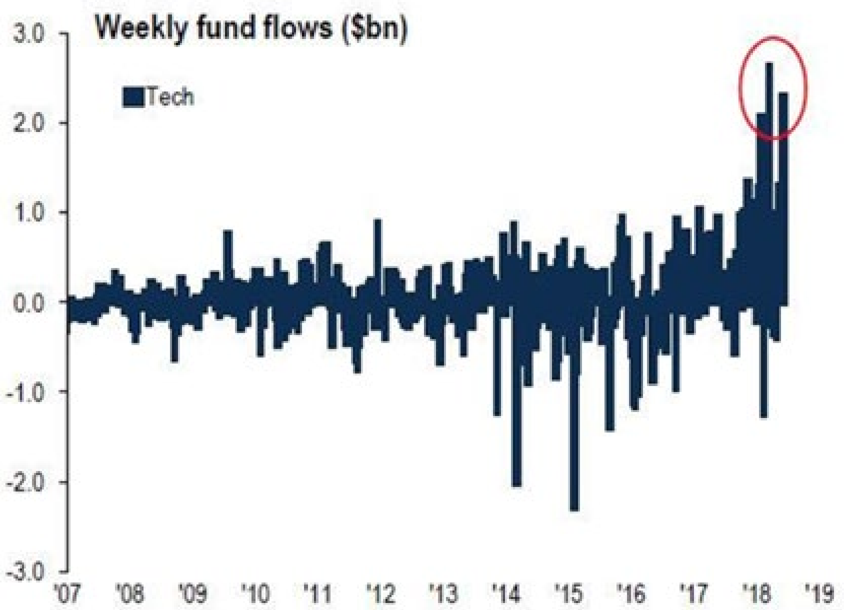
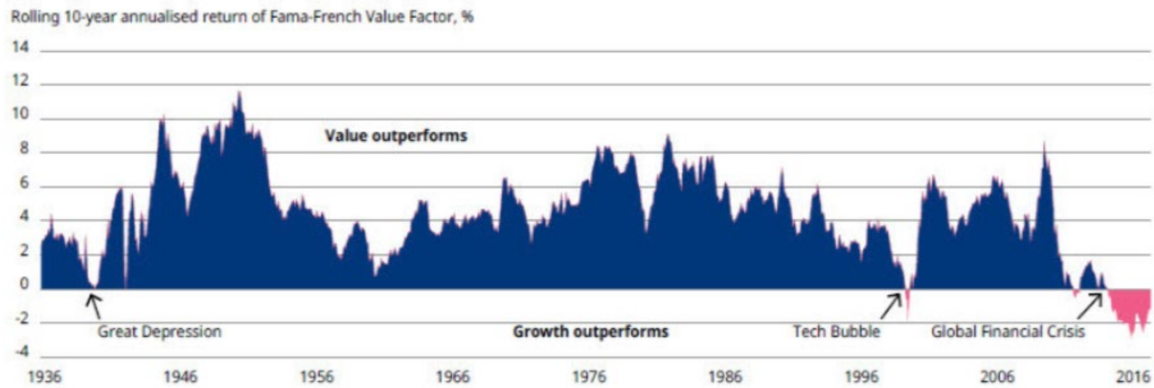


Chart 3: 2nd-biggest ever week of tech fund inflows



Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

Value has nearly always outperformed growth – until recently



Past performance is not a guide to future performance and may not be repeated.

Source: Kenneth French's Data Library and Schroders. Data from July 1926 to December 2017.

15 Largest S&P 500 Companies	
Stock	**2018 Returns**
Apple (AAPL)	11.82%
Microsoft (MSFT)	20.20%
Amazon (AMZN)	50.07%
Facebook (FB)	14.78%
Berkshire Hathaway (BRK)	-4.19%
JP Morgan (JPM)	1.06%
Google (GOOG)	11.21%
Exxon (XOM)	0.65%
Johnson & Johnson (JNJ)	-8.40%
Bank of America (BAC)	-2.03%
Visa (V)	21.53%
Wells Fargo (WFC)	-6.30%
United Health (UNH)	16.23%
Chevron (CVX)	0.46%
Intel (INTC)	12.22%

Returns through 7/11/18

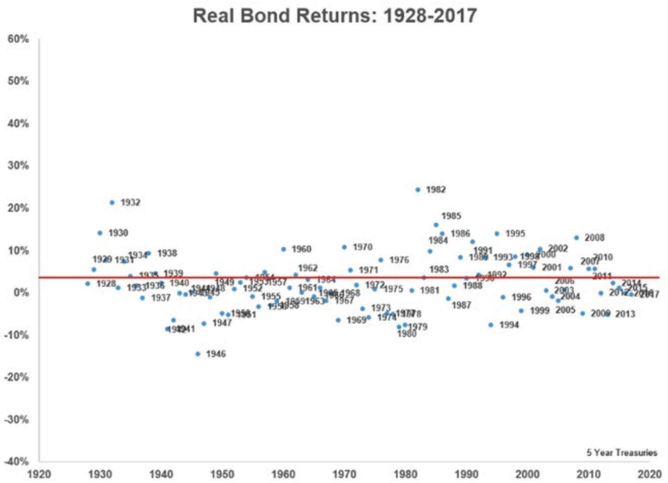
What actually generates returns over the long term?

Asset allocation and some patience – Stay rational, don't get emotional.

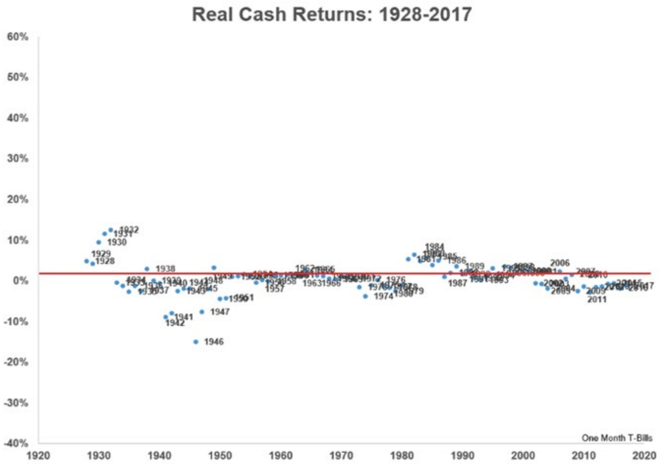
Here are the S&P 500 calendar year returns shown as a scatter plot:

The red line is the average so you can see how wide the fluctuations are from year to year.

And here are after-inflation bond returns using 5-year treasuries:



Even bonds give you a somewhat bumpy ride around the long-term averages.



It may be surprising to some to see so many slightly negative years but that's what happens when there's above average inflation, even when rates were in double-digit territory in the late-1970s and early-1980s.

Source: A Wealth of Common Sense – Ben Carlson

These graphs provide a nice visual of the risk-reward relationship that exists in these various asset classes. When looking at all three next to each other, most investors probably wonder why they would ever accept the insanity of the stock market when they could take the relative calm of the bond or cash return stream.

These fluctuations are explained by the fact that stocks have returned a little more than 7% above the rate of inflation while bonds and cash have real returns of 2.2% and 0.5% respectively.

If you want more predictability in the short term, you have to learn to live with lower long-term returns. And if you want higher long-term expected returns, you have to learn to live with more volatility in the short term.

Trade War Chatter...

It is very hard to formulate an opinion of the risks around trade wars. Obviously any impact on globalization is negative for markets and Australia but the current reactions are largely kneejerk in nature.

A lot of the fiery rhetoric emanating from Washington should come as no surprise. The president heavily campaigned on the idea of reducing uniform unfair Chinese trade policies and levelling the trade playing field.

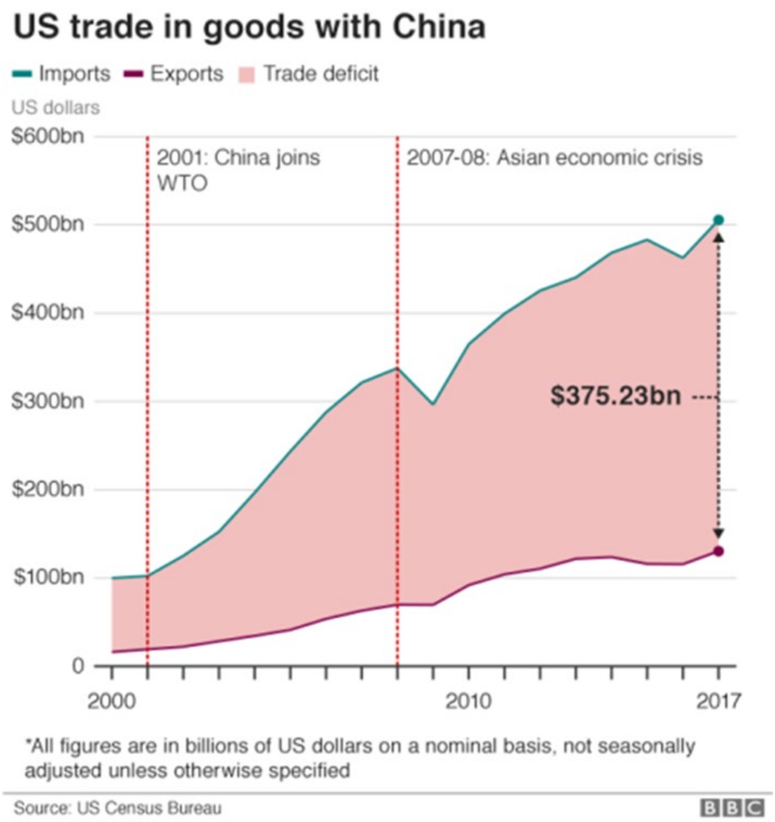
It took about a year and a half before the president actually pulled out the tariff guns. The first $50 billion tariff salvo has been launched by the Trump administration against China, and an additional $200 billion in tariffs has been threatened.

So far, Trump has enacted tariffs on imported steel, aluminium, solar panels, washing machines and other Chinese imports.

It's important to understand, we are in the very early innings of tariff implementation and trade negotiations. Therefore, the scale and potential impact from tariffs and trade wars should be placed in the proper context relative to the $20 trillion U.S. economy (annual Gross Domestic Product) and the $16 trillion in annual global trade.

Stated differently, even if the president's proposed $50 billion in Chinese tariffs quadruples in value to $200 billion, the impact on the overall economy will be minimal - less than 1% of the total.

Even if you go further and consider the US $375 billion trade deficit with China for physical goods (see chart below), significant reductions in the Chinese trade deficit will still not dramatically change the trajectory of economic growth.



China fighting back via a Yuan devaluation

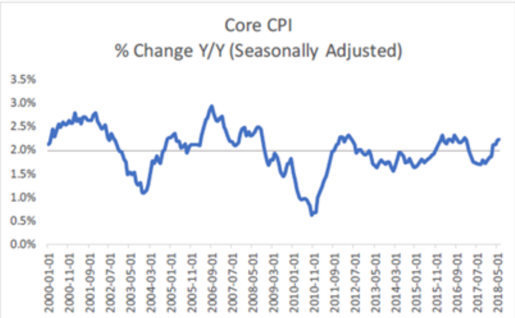
- Currency depreciation largely mitigates any tariff that the US put in place – worth watching this space.
- Trump is trying to jawbone the USD down.

What keeps us awake at night?

1. Inflation

It has started to creep and the yield curve is flattening. A great signal of business cycle risk. This will lead to margin crimping.

Core CPI
Core CPI (CPI less energy and food) is Slightly Above the Average Since 2000



U.S. Treasury Yield Curve
The Yield Curve Has Flattened Significantly in 2018 vs. Few Years Ago

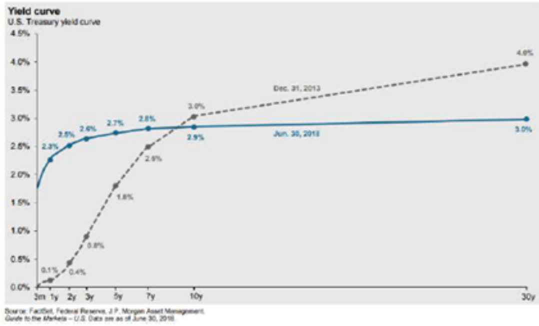
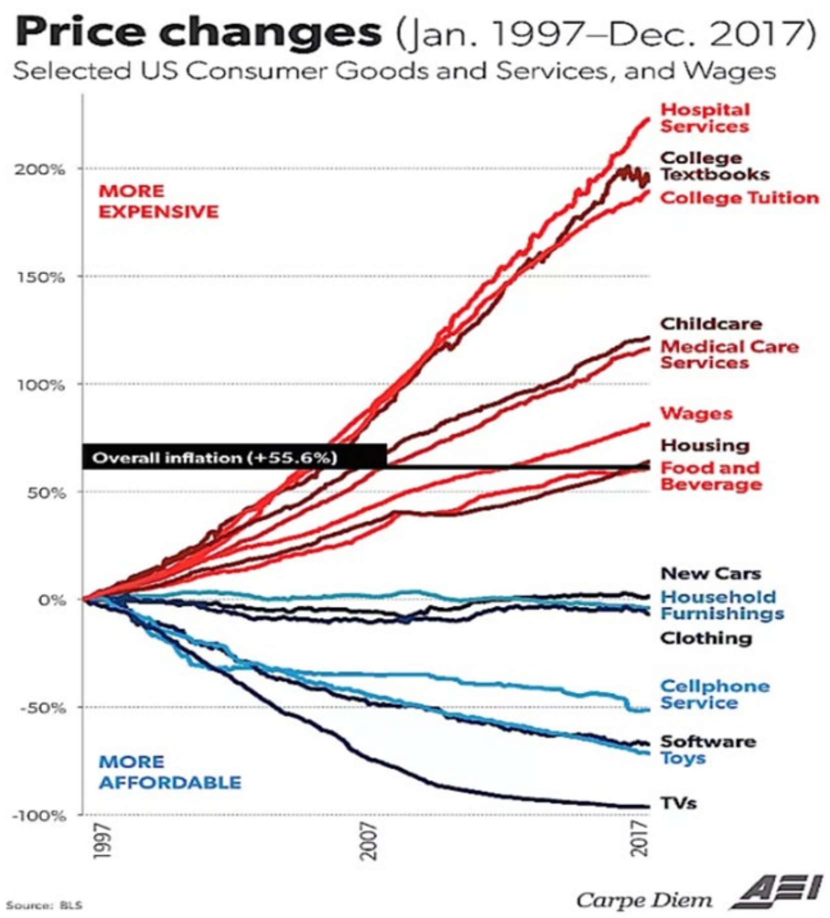


Chart 5. US inflation is expected to rise over the coming quarters.

Source: FRED, Vertium

US inflation over 10 years

- It's our view that inflation has been depressed for a number of number of reasons (productivity advances thanks to technology, industry consolidation (keeping wages down) and labor arbitrage (Chinese cheap labor relative to US).
- However this wage dynamic is changing – add tariffs to the mix and inflation risk is heightened i.e. can US manufacturers absorb production input increases or do they pass them on? Could car prices actually increase… Despite not increasing in 10 years (see below).



2. The non-bank lending business model

Providing credit (commercial and non-commercial) is quite specialised and fraught with risk.

Major Banks are withdrawing from the market for a reason…

The 5th largest bank of Mum and Dad has been tapped – now we are seeing a plethora of non-bank lenders filling the void.

Recent failed float of Prospa is an interesting case study.

Prospa is the type of fintech that is supposed to prosper from tighter bank lending conditions to SMEs, but the company canned its IPO at the last minute. ASIC is demanding all lenders review their Unfair Contract Terms… What was unfair? **How about charging 41.3%….**

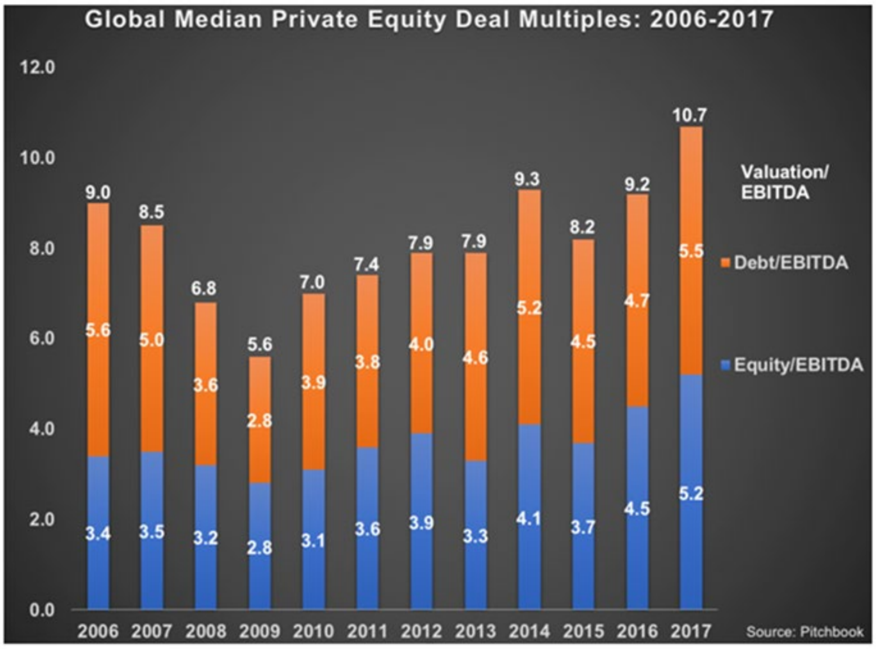
"Page 44, footnote 11 on their Annual Percentage Rate (APR): **"We use a factor rate in our pricing discussions with customers because we believe the total interest dollar cost and the total payback of the loan is (sic) the most relevant to our customers … At 31 December 2017, the weighted average APR (on a gross loan basis) of our portfolio was *41.3%*."** That's not a typo, it says 41.3%."

3. The private equity market

We recently caught up with a global private equity group, as we chatted about the current market conditions we probed on current valuations in the market.

"Well, 12x is the new 10x… we don't expect to sell any asset at the same multiple we buy it at"

<u>Excess cash in the system is washing into unlisted assets, driving up the multiples.</u>



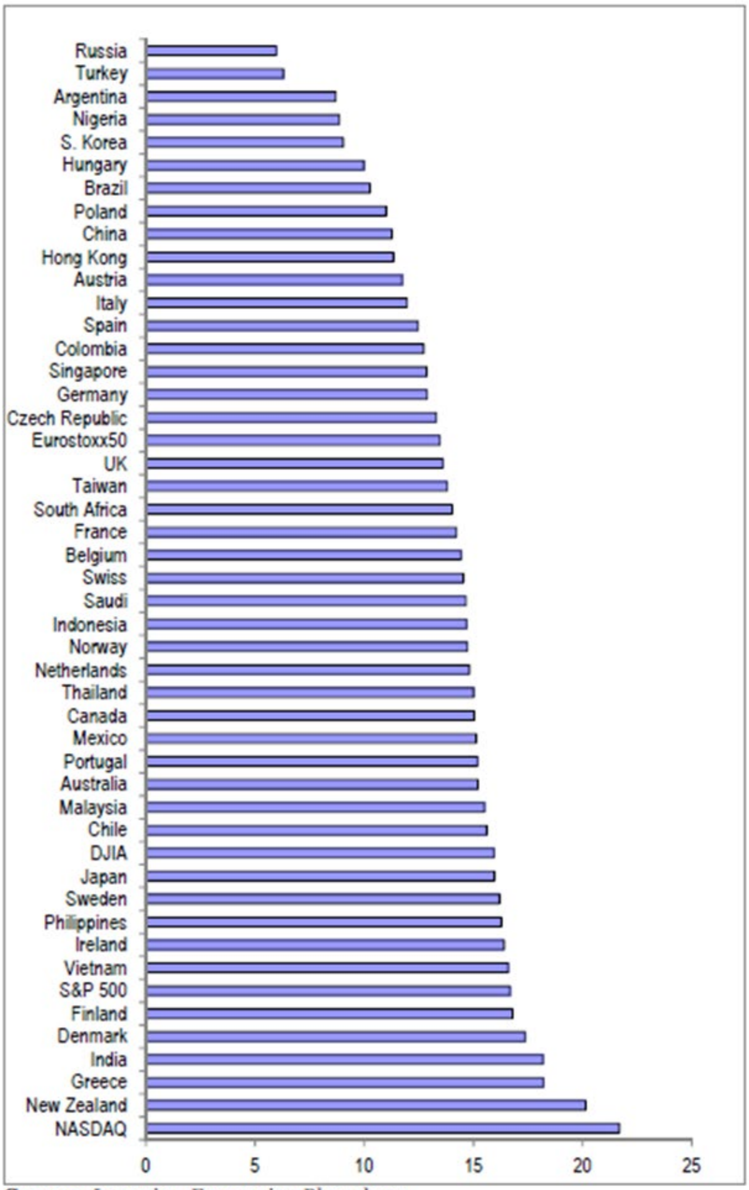
A yard stick approach to valuations

The Equity Risk Premium (ERP) has often been a useful yardstick of equity valuation because it takes into account the prevailing level of interest rates.

The ERP is the premium that equity investors require to compensate them for taking on the higher risks inherent in equities compared to bonds. Put simple, it is the assumed difference of returns.

Clearly, it's been risk on for the NASDAQ and risk off for emerging markets.

Fig 9ai: Standalone PE ratios – various country indices (based on 12m fwd EPS)

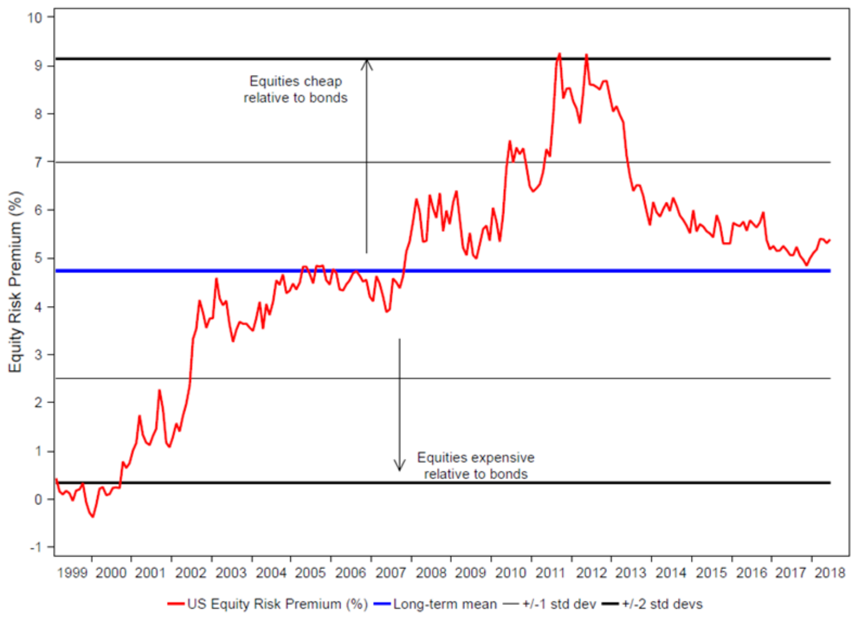


Source: *Longview Economics, Bloomberg*

Compensation for owning **equities vs bonds still exists** (question is for how long in the face of rate rises).

The GFC wasn't a valuation driven event. Compare today's (US) equity risk premium of circa 5.5 to 2001 at 0.

Fig 9ei: US Equity Risk Premium (earnings yield less real bond yield)



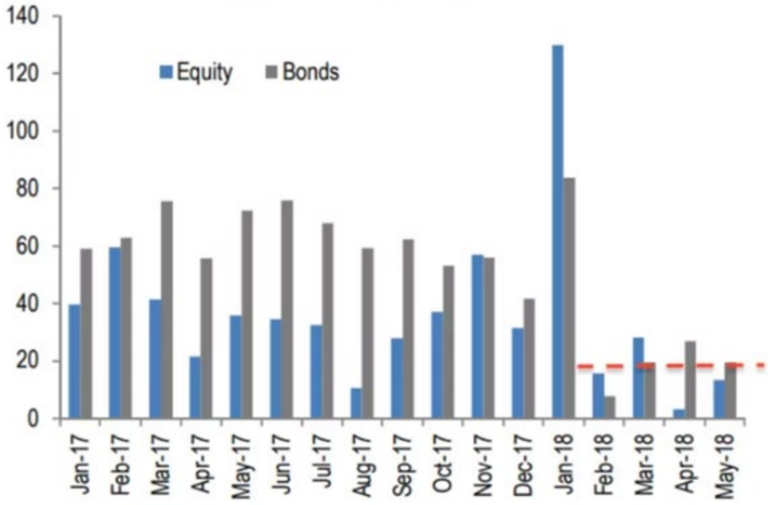
Source: Longview Economics, Macrobond

Equities and Bonds on the nose for 2018! Buy backs doing a lot of the markets heavy lifting.

Since the 8% January lift and subsequent draw down, asset flows have softened dramatically.

Figure 3: Equity and bond fund flows by month

$bn per month, Mutual Funds and ETFs globally

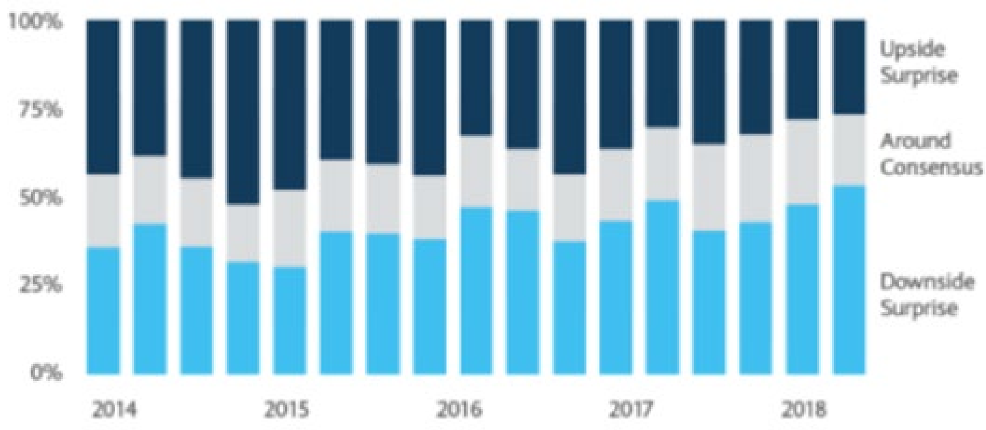


Source: Bloomberg, ICI, EPFR, J.P. Morgan.

So, what next? Growth expectations are low.

FIGURE 1

If there is a surprise in global growth in the next 12 months, it will be an...



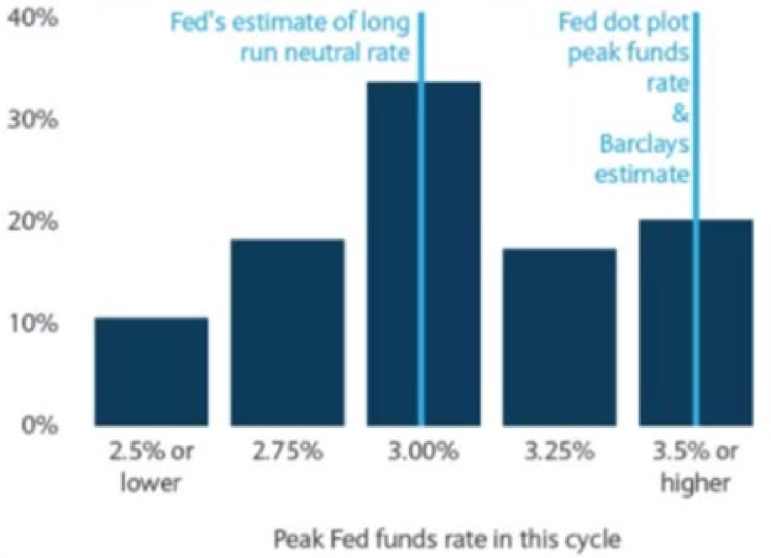
Source: Barclays Global Macro Survey

This leads many investors and analysts to doubt, for one reason or another, the feds ability to normalise policy.

Most people think that this rate rising cycle stops at 3%

FIGURE 5

At what level do you expect the fed funds rate to peak in the current hiking cycle (upper end of range)?



Source: Barclays Global Macro Survey

We all know the US fed story but what about the BOJ – quietly slowing.

The June number for the Bank of Japan's balance sheet was recently released and for the third month in seven, assets have fallen.

Almost 4 trillion Yen (around $34 billion US) disappeared from the balance sheet, the reductions have been small (just under 1%), but the distinct change in trend is important to note.

Japan's central bank has bought so many Japan government bonds, it now owns 46% of all outstanding debt of the government. In 2012, at the beginning of 'Abenomics', it only owned 12%. .

Because of the sheer size of the BoJ's portfolio, it may simply not be feasible for them to announce asset sales to the marketplace but it appears they are making some changes to policy irrespective of the 2% inflation target.

Quotes of the quarter

Cliff Asness

"The idea of a margin of safety, a Graham precept, will never be obsolete. The idea of making the market your servant will never be obsolete. The idea of being objective and dispassionate will never be obsolete."

"A momentum investing strategy is the rather insane proposition that you can buy a portfolio of what's been going up for the last 6 to 12 months, sell a portfolio of what's been going down for the last 6 to 12 months, and you beat the market. Unfortunately for the case of sanity, that seems to be true."

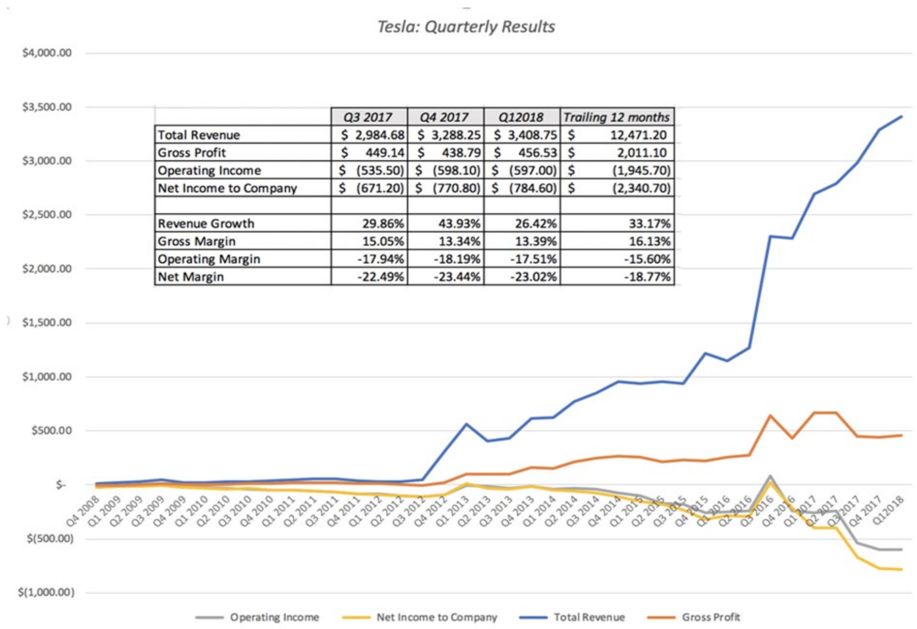
Let's not forget poor old Elon – own GM, short Tesla, despites its '[perceived] sexiness'

Company Name	Country	Enterprise Value	Market Cap (in US $)	Revenues	EV/Sales
Volkswagen Aktiengesellschaft	Germany	$278,738.14	$88,540.90	$286,698.30	0.97
Toyota Motor Corporation	Japan	$359,588.70	$199,925.40	$276,630.20	1.30
Daimler AG	Germany	$222,284.67	$74,886.10	$203,933.70	1.09
Ford Motor Company	United States	$197,755.18	$47,381.10	$159,589.00	1.24
Honda Motor Co., Ltd	Japan	$97,833.80	$55,062.50	$144,636.80	0.68
General Motors Company	United States	$150,481.24	$59,563.00	$144,421.00	1.04
SAIC Motor Corporation Limited	China	$58,738.24	$64,865.00	$143,679.50	0.41
Fiat Chrysler Automobiles N.V.	United Kingdom	$39,113.11	$31,680.30	$135,633.90	0.29
Bayerische Motoren Werke Aktiengesellschaft	Germany	$173,148.07	$63,385.00	$120,051.70	1.44
Nissan Motor Co., Ltd.	Japan	$100,563.30	$38,386.30	$112,529.30	0.89
Hyundai Motor Company	South Korea	$82,479.20	$24,185.80	$89,915.90	0.92
Peugeot S.A.	France	$18,532.66	$21,686.00	$78,302.10	0.24
AUDI AG	Germany	$26,607.63	$38,837.40	$72,199.80	0.37
Renault SA	France	$69,542.53	$25,133.00	$70,569.20	0.99
Kia Motors Corporation	South Korea	$16,874.60	$11,370.00	$50,168.10	0.34
Tata Motors Limited	India	$20,977.10	$14,310.90	$45,215.90	0.46
Suzuki Motor Corporation	Japan	$25,112.10	$25,328.10	$35,377.00	0.71
Mazda Motor Corporation	Japan	$8,872.60	$7,911.90	$32,710.60	0.27
Subaru Corporation	Japan	$16,866.90	$23,262.00	$32,062.70	0.53
BAIC Motor Corporation Limited	China	$5,675.83	$8,222.50	$21,925.60	0.26
Tesla, Inc. (2018)	United States	$70,781.58	$59,860.80	$12,471.20	5.68

Source: Musings on markets

<u>What it realistically needs to do to justify its narrative and $400/share price</u>

1. Increase revenues ten-fold over the next decade
2. Improve operating margins to match the most profitable auto companies
3. Invest more efficiently than the sector
4. Navigate its way through debt to safety



	Q3 2017	Q4 2017	Q12018	Trailing 12 months
Total Revenue	$ 2,984.68	$ 3,288.25	$ 3,408.75	$ 12,471.20
Gross Profit	$ 449.14	$ 438.79	$ 456.53	$ 2,011.10
Operating Income	$ (535.50)	$ (598.10)	$ (597.00)	$ (1,945.70)
Net Income to Company	$ (671.20)	$ (770.80)	$ (784.60)	$ (2,340.70)
Revenue Growth	29.86%	43.93%	26.42%	33.17%
Gross Margin	15.05%	13.34%	13.39%	16.13%
Operating Margin	-17.94%	-18.19%	-17.51%	-15.60%
Net Margin	-22.49%	-23.44%	-23.02%	-18.77%

Australian Housing Market

A recent conversation...

A friend: "I only buy property because it always goes up in value"

Me: "yeah, it has been a good 20 years, I don't know how it will look for the next 20"

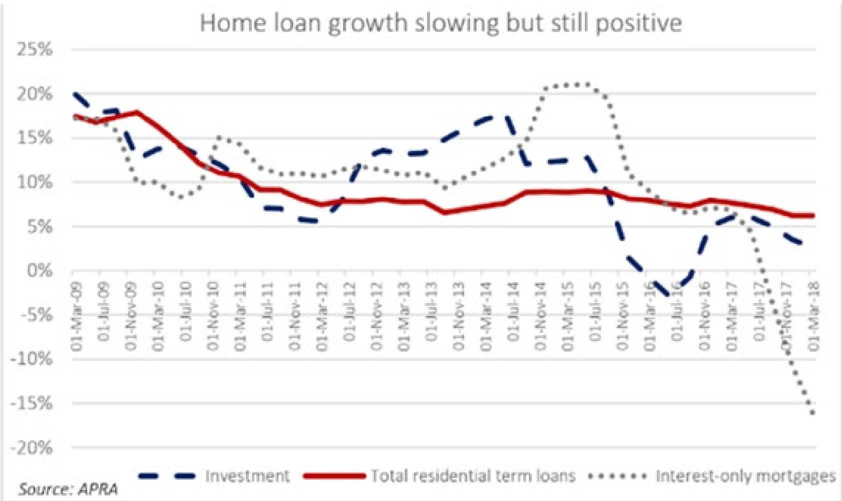
A friend: "nah, population growth always goes up"

Me: "what happens if that slows?"

A friend: "but that doesn't matter, because if we have inflation and property is a real asset, the property value rises with inflation"

Me: "that's only true if you can pass on the inflation cost"

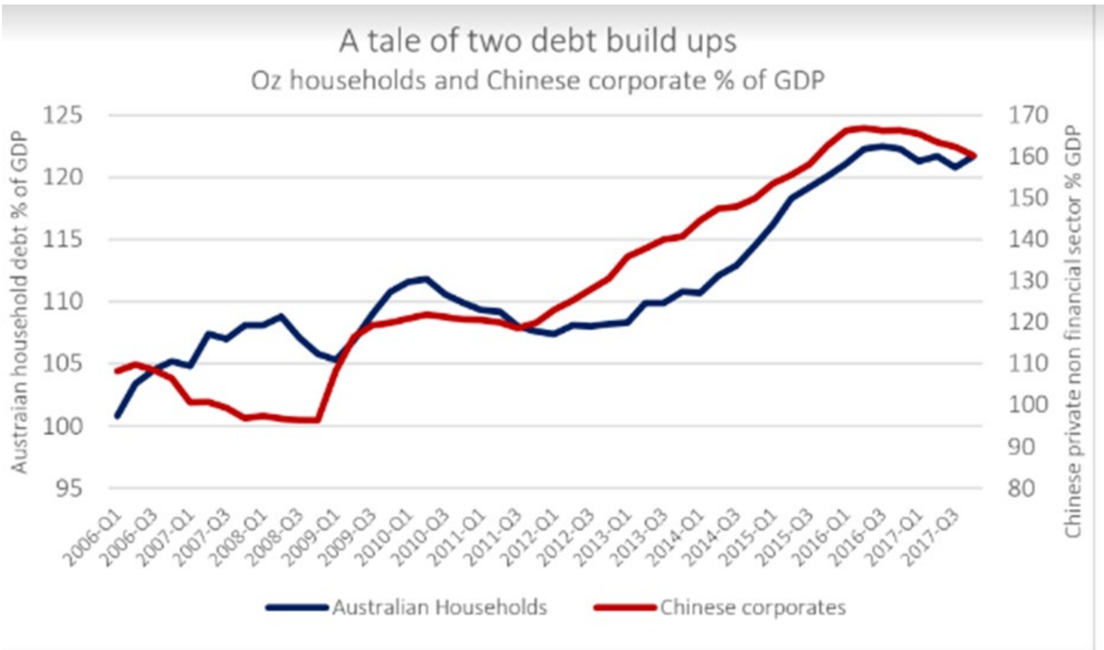
A friend: "property only goes up in value ok"



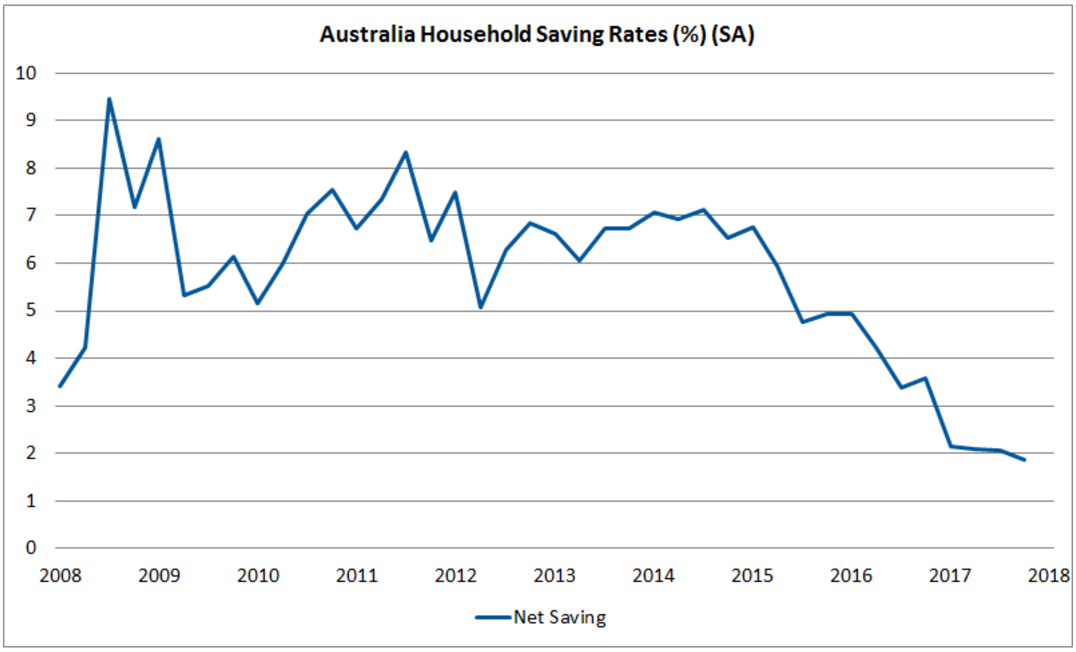
Banks determined to tighten irrespective of RBA and its clearly having an impact

To be frank, our households have too much debt and the RBA is inherently aware of this.

They are in a very precarious position whereby they know that any rate rises could result in any duress.



Our cash buffer has been severely eroded - therefore ability to weather interest rises is marginal.



Australian Equity Market

- A clear divergence in performance on a sector and style basis.
- Perceived growth really driving the market and valuation being disregarded;
- The big growth darlings as per below versus the ASX200 (Carsales, CSL, Seek, Realestate.com.au & Treasury Wines) – big divergence to ASX.

One Year Forward Rolling Price Earnings Ratios: Growth Stocks (16 June closing prices)*

Cochlear	38.5X
CSL	31.8X
Treasury Wines	28.6X
REA Group	34.9X
Seek	31.8X
Carsales	24.3X
A2 Milk	32.4X

*Source: Bloomberg consensus estimates

- Resources also leading the way

- Banks are being discounted significantly

Are we at the top?

Grantham's view

Euphoria's missing

- Jeremy Grantham says, "The lack of crazy euphoria in the market today may mean the market could bump along versus seeing a precipitous, sudden decline."
- In other words we're probably not going to have a rapid decline unless we have a material blow off i.e. rapid market expansion.

Best advice late cycle advice

- Don't take tips from anyone. I've never had somebody say to me, "Hey my friend recommended I buy this stock and now that I've quadrupled my money, do you have any advice?"
- Keep your speculative positions to a tight budget. Only buy what you're willing to lose.
- **Be wary of people – the late cycle tends to bring less credible people out of the woodwork.**
- Don't brag to your friends and family about how much money you're making. Your credibility will be tested at some stage.
- Take profits. If you buy something and it goes up 500%, it's okay to miss out on further gains.

CASH is a free call option on any single asset in the world. It never hurts to hold back some cash irrespective of opportunity cost.

Our latest positioning - If we had to own one stock until 2050, what would it be?

We were thinking about this as Josh was setting up a little portfolio for his daughter and because a friend asked him if he had to own a single company for the long (long) term what would it be?

Disney is our pick. It's currently a large allocation in our international portfolio and we believe it presents pretty decent value when you consider the breadth of its business. Compared to other content providers – its value is without question (see below).

It also helps that his 2.5 year old is obsessed with the characters (including Mickey Mouse) whom is older than her parents.

Valuation

Company Name	Ticker	P/S	P/S 5yr average	P/Cash Flow	P/Cash Flow 5yr average
Walt Disney	DIS	3.0	3.1	11.7	15.1
Comcast	CMCSA	1.9	2.1	7.8	8.8
Alphabet	GOOGL	7.2	6.3	21.6	18.2
Median					
Netflix	NFLX	14.1	5.9	N/A	N/A

Source: author's calculations, morningstar.com

A left Field Idea:

Similar to our Oil idea (via OOO ETF) a couple of years ago based on pure mean reversion and basic supply and demand dynamic.

It's hard to contemplate a more depressed agriculture market – trade tensions haven't helped conditions, it's hard to get much worse. What hasn't changed is demand which in fact is nearing 2010 highs (see below).

We recently took a small position in QAG (Agricultural ETF).

Broad Agriculture Discount

Unsustainably Low Ag Prices