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ASSET PARTNERS

Alvia Asset Partners Investment Team Insights

March 2018 Quarter

March quarter review:

Volatility bites back after a sanguine 2017

After a dreamy period for US investors, Q1 produced a quarterly negative return for both equities and bonds with S&P500 and Barclays Aggregate Bond Index slipping into the red for the first time since Q3 2008.

Given equities and bonds historically act inversely of one another this isn't common. This generally only occurs in high volatility environments – such as what we have experienced (see VIX below).

Junk bond funds recently experienced the second-biggest weekly outflow on record. Investors withdrew $6.3 billion, bringing total outflows over a five-week period to a record $15 billion.

Remember it was only until recently that European junk was yielding less than U.S. Treasuries…we all knew this had to end at some point.

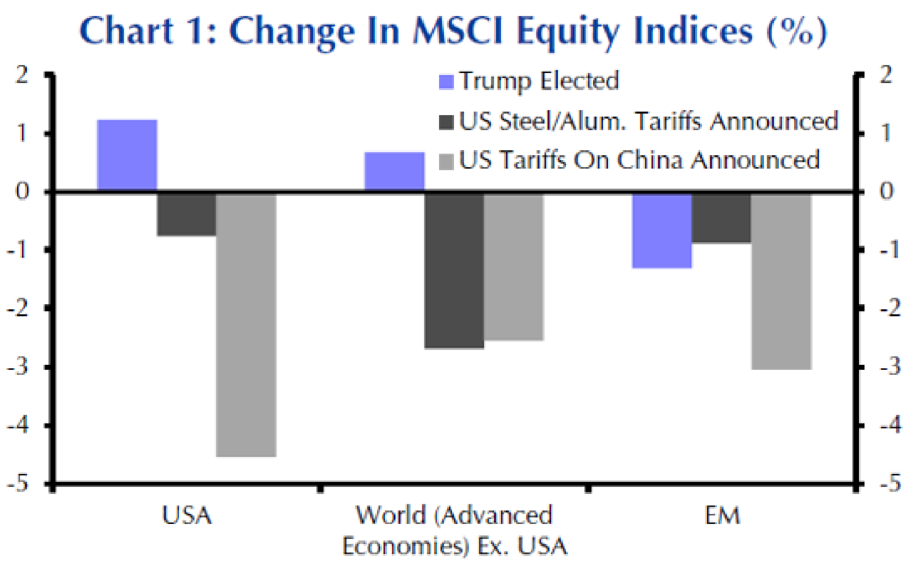
And where did this volatility come from:

- Effectively it all started with a 0.3% m/m gain in US core consumer prices, which in three-month annualised terms means core inflation climbed to a six-year high of 2.9%.
  - The market cared because it may force the Fed to raise rates faster than expected, chocking sentiment and business activity.

Tariff tantrums:

- Both Trump and Xi Jinping got their 'guns' out flexing but the result was soft.
- Trump announced $50bn of tariffs on Chinese goods last month. As expected, it focused on a wide range of high-tech goods.
- Chinese responded with equivalent 25% tariffs covering $50bn worth of imports from the US, including soybeans, motor vehicles and aircraft.
- Despite appearing significant if implemented in full, the macro impact of both sets of tariffs will be light.
- Worst case outcome so far: 0.1% GDP on China, 0.3% GDP on US.

US markets felt it most!



Sources: Bloomberg, Capital Economics

What about little Oz...

- We expect minimal impact for Australia/NZ in the near term.
- Long term we are more exposed than most to increased protectionism given our reliance on exports of scale to China and the US. However, we crude materials would need to be targeted before our apple cart was upset.

Is it over for Markets?

- Market timing as we all know it is a mug's game. Peter Lynch sums it up beautifully:
  "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."
- Timing is uncertain but it always pays to be cautious (i.e. review your asset allocation and hold some cash).

Quotes of the quarter:

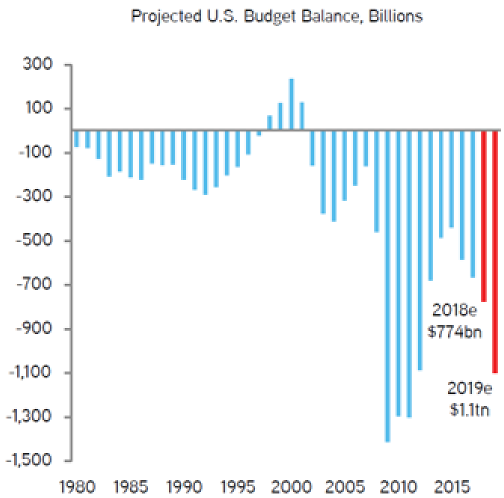
"Successful investing is having everyone agree with you…later" – Jim Grant

"[Those holding cash] are going to feel pretty stupid" – Ray Dalio, Feb 2018

"Still overweight equities, but watching the zombies*" – Chris Watling

Macro events driving the US bus:

1. The market is coming to terms with the transition from US monetary policy expansion to tightening at the same time that US fiscal policy is becoming increasingly expansionary - this is historically unique. Trump is certainly prepared to spend (below). **We think this is short term positive for markets but long term creates a whole other set of risks.**



Data as at January 2018. Source: www.cbo.gov/publication/52801.

2. US transitioning from increased reregulation post GFC to deregulation. Traditionally this is positive for earnings and hence equity markets initially**. Reagan era provides historical context**.

3. Nationalism over globalism agendas becoming more mainstream (again led by US). This is certainly a short term risk to all markets and something to be mindful of. Trade has become relatively free and we now need to contemplate are more protectionist program over the near term.

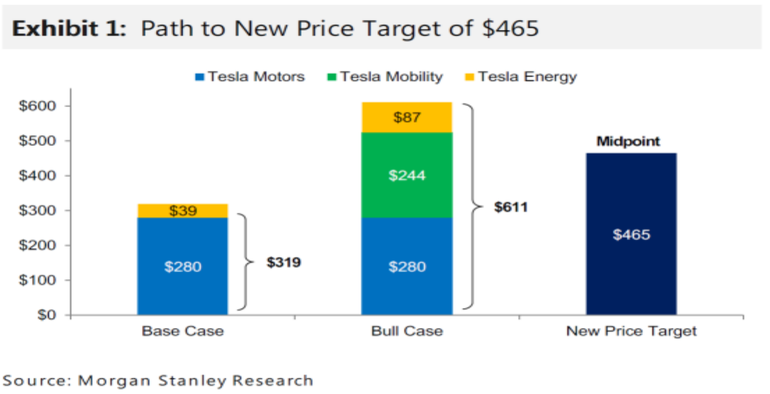
How's that revenue multiple going?

Pockets of irrational exuberance - tech hype

- Despite a recent sell off, we can't recall a time in my investing career where 'extrapolation/recency' bias and loose valuation techniques have become so prolific, especially in the tech sector.
- Technology is brilliant and we don't question its revolutionary impact on society (especially the last two decades) however the continual hysteria around disruption is over the top and highly selective.
- Yes, Uber has created a platform to ensure that we can travel more pleasantly at a cheaper price point, but do remember that we are still hunting down the cure for the common cold.
- Our point here is that Uber whilst disruptive to the taxi industry is hardly peak technological innovation and although it improves our lives ever so slightly (mainly using existing technology) it's not revolutionary.
- Despite everyday reading stories of human displacement and flying cars please check your bias when you contemplate the Uber of (insert noun here) that somebody is selling you in a branded T-shirt.
- Please check the valuations if it is based on idealism and world disruptive qualities – we assure you the market will test these lofty forecasts at some stage.
- The enabler of loose valuations? Very good markets and very loose monetary policy has provided rocket fuel for complacent valuation methodology – enabling all asset prices to creep. More to benefit the tech names (pre IPO/listed).
- The flip side of this equation is that such complacency has enabled unprofitable companies a long term play with other people's money without their financial models being truly tested. The art of selling a great story masking the underlying fragility of their businesses. Remember at some point profits become important!

Example 1. Tesla

At some point this 'finger in the air' style of valuation makes way for reality. Perhaps interest rate normalisation is the trigger of normality. ***Tesla Mobility is a business division that doesn't exist yet but is apparently worth $244 to the Tesla share price!***



Example 2. Dropbox – comparables vs valuation

How is this rational? Apparently sexy sells…

Company	Ticker	Return on Invested Capital (ROIC)	NOPAT Margin
Microsoft Corporation	MSFT	27%	23%
Alphabet, Inc.	GOOGL	31%	22%
Apple Inc.	AAPL	144%	20%
Open Text Corp	OTEX	10%	17%
Amazon.com Inc.	AMZN	6%	2%
Dropbox, Inc.	DBX	-4%	-5%
Box, Inc.	BOX	-35%	-31%

Dropbox also got away with giving founders and early investors more voting rights (10X) at IPO.

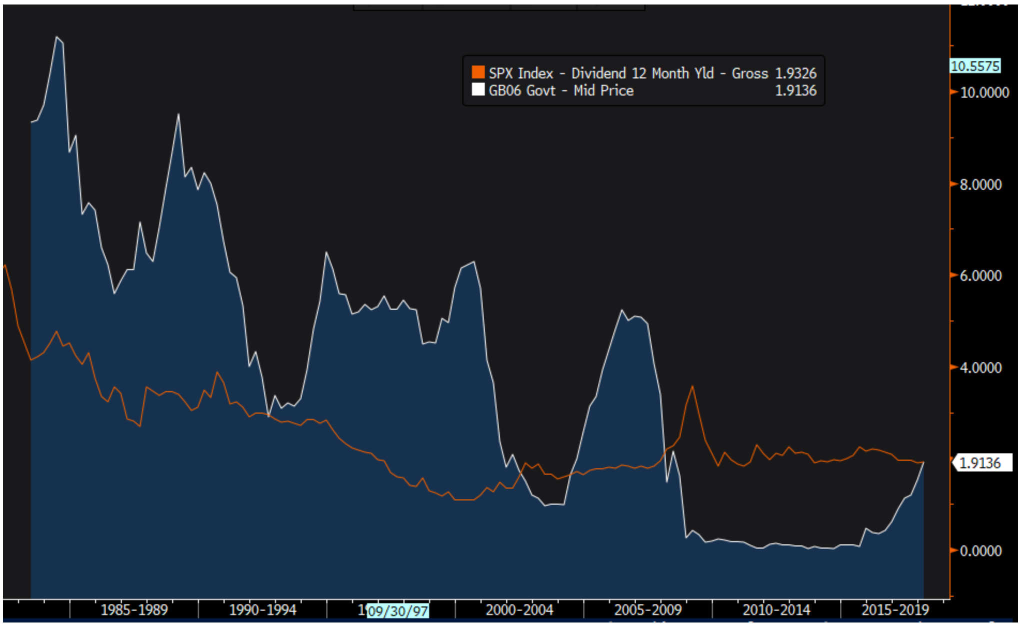
Listed at 10bn now 12.8Bn.

Sold on a revenue basis with an after tax profit of -$55 million, net margin of -5% and a return on capital of -4%.

Can someone please explain how you can't make money from 500million users? Exactly how much scale do you need?

PS – We own Apple and hopefully get a chance to own Google one day!

Chart of the Quarter – S&P 500 yield



10 year US treasury yield (White), S&P500 dividend yield (Orange).

What does this mean?

The yield provided by 10 year US treasuries just surpassed the underlying dividend yield of the US market. Meaning that treasuries now offer an income yield alternative to equities with less risk. This removes the lack of alternative flight of capital to equities.

Earnings yield however still hold a good gap (**equity risk premium**) to the 10 year yield despite the 10 year climbing.

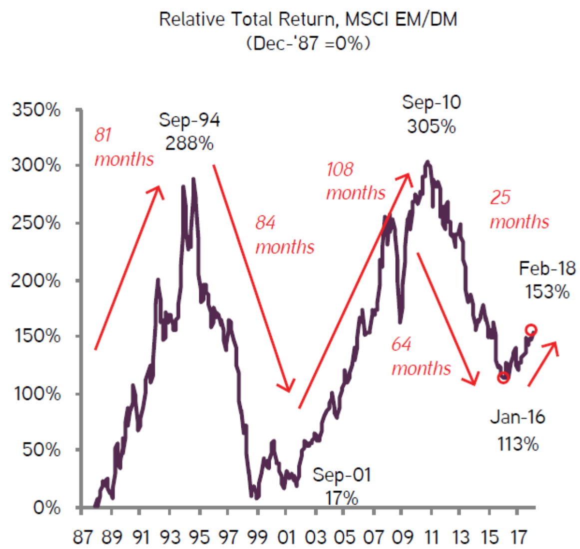
This means equity investors are still receiving compensation for taking equity risk.

What are we looking at?

1. **Emerging markets on a relative value basis.**
    - In the context of a portfolio it's irresponsible to ignore EM as a whole when constructing a global portfolio.
    - We are currently reconsidering our positioning however we are very conscious of heightened volatility.

Tide turning for EM? Party over for US equities?

It Has Been a Long, Hard Road in EM. However, We Now Believe a Structural Turn Is Occurring

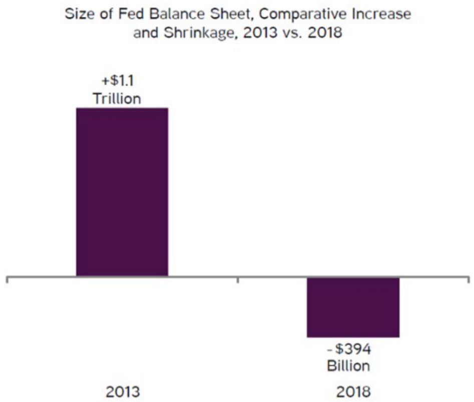


Data as at February 28, 2018. Source: MSCI, Bloomberg, Factset, KKR Global Macro & Asset Allocation analysis.

2. Cautious but more to come from the US market (it's all relative).

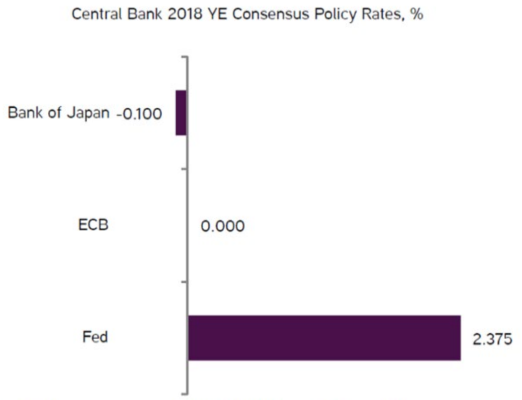
- Despite its newly introduced fiscal party the US government's balance sheet is steadily repairing itself and is much further down the track to normalisation it is than its major capital counterparts. Figure 1 and 2.

The Fed Balance Sheet Is Expected to Shrink by $394 Billion in 2018 (Compared to a $1.1 Trillion Increase in 2013)



Data as at January 2018. Source: Cornerstone Macro.

The Fed's Path Towards Normalization Is Now Way Ahead of Europe and Japan



Note: Fed rate represents KKR Global Macro & Asset Allocation estimates. Others are consensus as per Bloomberg. Data as at February 23, 2018. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

- We also believe that despite lofty headline valuations, earnings will do the heavy lifting (perhaps more than expected) as a result of tax cuts. see figure below.

The Recent U.S. Tax Cuts Offer a Significant Upside Boost to Corporate Earnings Growth

BASE CASE	$/SHARE	Y/Y % CHG
GMAA 2017e EPS	$132.10	
Revenue Growth	4.5%	
Earnings Growth	8.0%	
Baseline GMAA 2018e EPS	$142.7	
Adj. for Tax Rate Change	$13.80	10.4%
Adj. for Buybacks / Repatriation	$2.60	2.0%
Adj. for One-time Tax on Foreign Profits	-$4.20	-3.2%
Adj. for Interest Deductibility	-$1.00	-0.8%
Total Adjustments	$11.20	8.5%
Pro-forma GMAA 2018e EPS	$153.90	16.5%

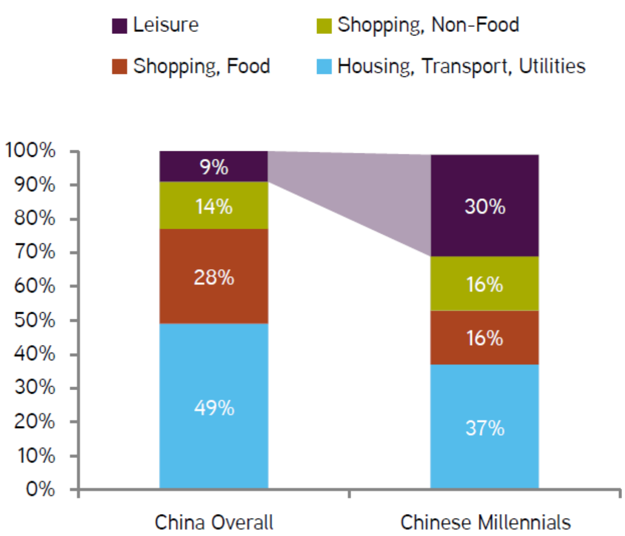
Data as at December 31, 2017. Source: KKR Global Macro & Asset Allocation analysis.

3. Chinese millennial developments

- We dislike using the word 'thematic' but this is something to consider.
- The millennial demographic of China certainly embrace the leisure spend – We would suggest Australia as a tourism exporter will benefit from this trend.

Chinese Millennials Save Less, and Allocate Three Times More of Their Income to Leisure

Spending Breakdown China Overall vs. Chinese Millennials

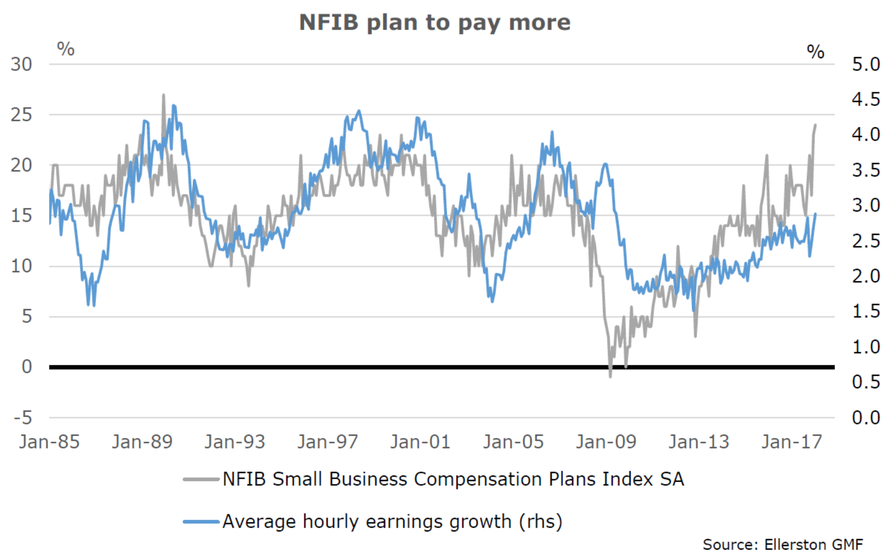


Data as at December 31, 2016. Source: Goldman Sachs Global Investment Research.

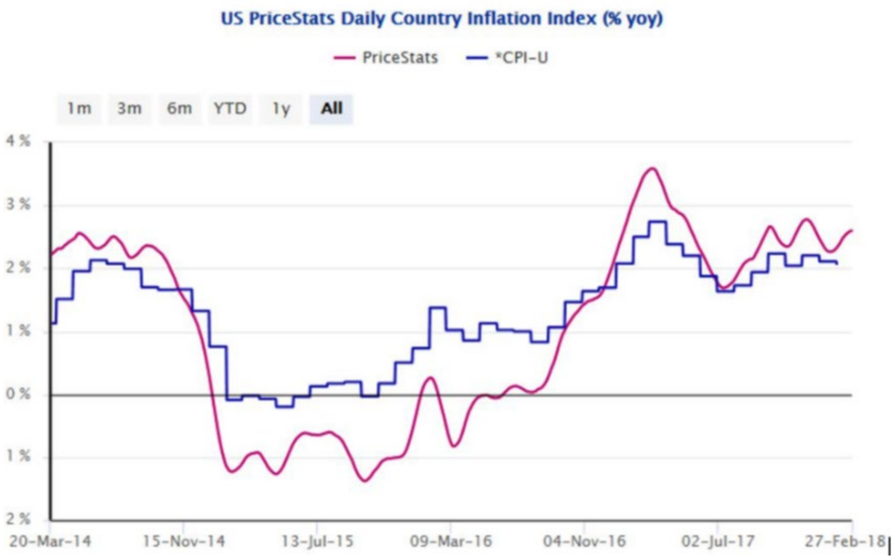
4. Fed watch

- Well flagged that Fed has been very accommodating with a growth mantra.
- The accelerator has been firmly pushed until now, as they gently try to restrict the expansion without choking growth.
- The plan is to steadily diffuse heat should it arise – a fine balancing act.
- Trump's fiscal expansion however may throw a spanner in the works. Tax cuts alone have caused a 0.4% GDP uplift – without accounting for the increase in spending (likely worth another 0.4%).
- Hence we are dealing with a contradiction with Fed trying to gently slow and government wanting to speed up a fully employed system.
- Concern here is that the fed is forced to move more quickly? We could see 8 rises over the 18 and 19.
- Prices are beginning to rise – consumers are paying more and it won't be long before real wages follow suit as it's apparent that employers are already considering pay rises. See figure 1 and 2 below.

Small business to pay more?



Will inflation follow?



What's the impact?

Equities

- We think that from equities perspective the market copes with 7-8 hikes over the coming 2 years (that's a US cash rate of 3.5%). Hopefully the 10 year stays above the 3.5% circa 3.75%.
- Under this scenario we believe equities can cope and eek out 5-10% however you need be very selective on the bond side of the equation.

Bonds

- Don't be passive with fixed income now, it also time to consider your alternative positioning in your portfolio. Macro hedge funds should start to outperform.
- **You would very naïve to ignore the likelihood of inflation given the above.**
- **It's important to consider relative interest bills for the US government, corporates and also the home owner when the loans/treasuries/mortgages suddenly increase rapidly. This would certainly choke off 'animal spirits' rather quickly.**

5. US Housing

- US housing prices are back to where they were at the height of the housing "bubble." Given the above it would again be naïve to suggest that home sales (and prices) would not come under pressure as mortgage rates reverse. Unfortunately falling home prices have a particularly large impact on market psychology and the US economy.

US house price index

6. Old tech – continues to present value

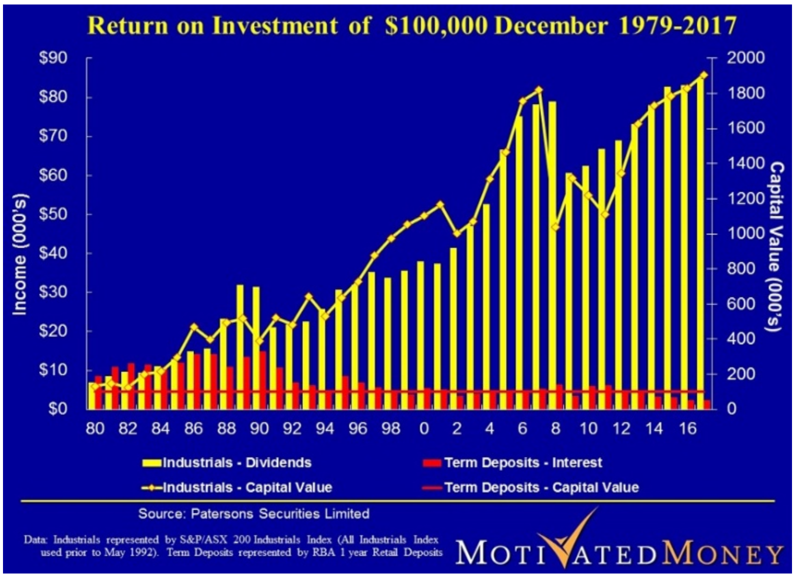
- We have benefitted from adopting the strategy of owning old unloved technology names such as Cisco whilst the magnetic pull of the FANGs has enabled these to be remain largely ignored
- See Cisco below versus Amazon on the basis of price paid for free cash flow. Cisco trades at 15.4 x whilst Amazon trades at a lofty 88.7x.

Our most asked Questions:

Q: Should we go to cash?

A: Hold some in balanced portfolio and stop trying to time it.

- We personally prefer the safety and security of the share market to risky assets like term deposits ☺ we can live with short-term volatility - over the next 50 years health permitting.
- It is our friend during accumulation phase as we inevitably buy more when the market provides an opportunity by becoming erratic and less when it is expensive. In retirement, I want income and for me, the volatility in the value becomes a non-issue. See figure below.



Q: When does the RBA follow the Fed's lead and increase rates?

A: Minutes suggest no change this year.

- Interesting views on gradual inflation and discussions around the threat posed by interest only mortgages (significant rollover from interest only to amortising loans coming in 2018-2020, putting the RBA in a difficult place.
- The ability for the average household to cope with higher mortgage rates appears limited.
- There was also reference to the concerns around trade war mongering.
- Need sustained wage growth to trigger a response.

Q: When is the Aussie housing market going to crash?

A: Likely due for a decent correction but it's a complex market.

- Sydney and Melbourne is very different to Brisbane and Hobart.
- However given the below the supply and demand dynamics it certainly make it difficult to see price increases until the supply is washed through.
- **Australian housing values did fall for the fifth straight month, however this is reflective of the recent interest-only crackdown on the demand side.**

Chart 3: Housing Demand & Supply (000s Per Year)

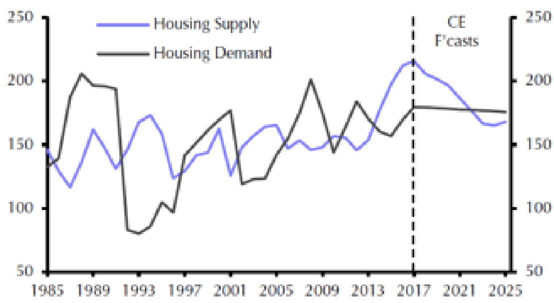
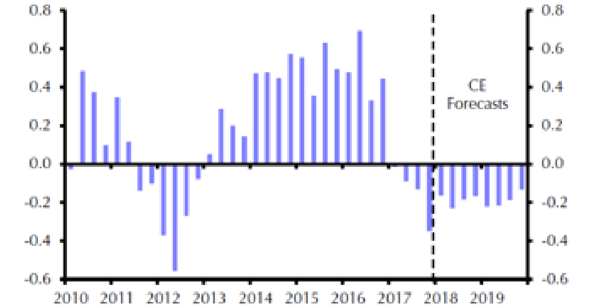


Chart 4: Dwellings Inv. Contribution to %y/y GDP (ppts)



Sources: Thomson Reuters, ABS, RBA, Capital Economics

Mr Buffet puts it succinctly

"*As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates*" **–** 2017 letter to Berkshire Hathaway shareholders, published 24 February 2018.

Q: Bonds v equities as rates rise?

A: Own both but be selective on both fronts

- Especially selective on the bond front at present (not all bonds the same).
- In a rate rising environment there is a threat of genuine negative returns from the bond market.
- This means that bonds may not provide the safety net that historically have – you would expect this to be the case in a rate rising environment.
- Long term bonds are not providing the compensation necessary to justify the risk – we favour corporates with floating rate profiles and inflation linked bonds

Rising rates will also impact equities – however the affect is normally delayed

How?

- Valuations are impacted as models are discounted more aggressively by a higher risk-free rate (10-year bond rate). I.e. a higher interest rate reduces the value of future earnings/cash flows.
- Higher interest rates will eventually slow the economy and normally cause recession. Almost every US recession has been caused by high rates. See figure below – arrows highlight recessionary events.

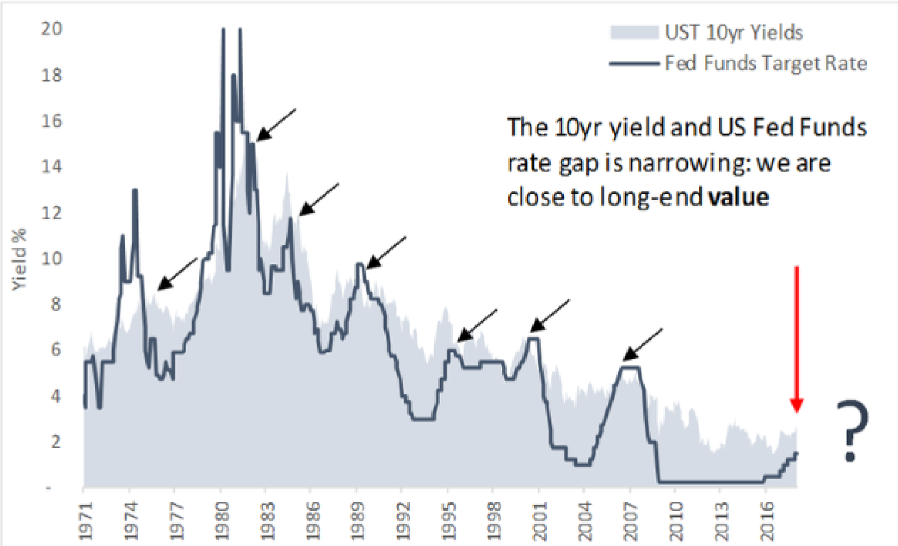


Chart: US 10 year bond yields vs US Fed Funds Target Rate (1971 – 2018)

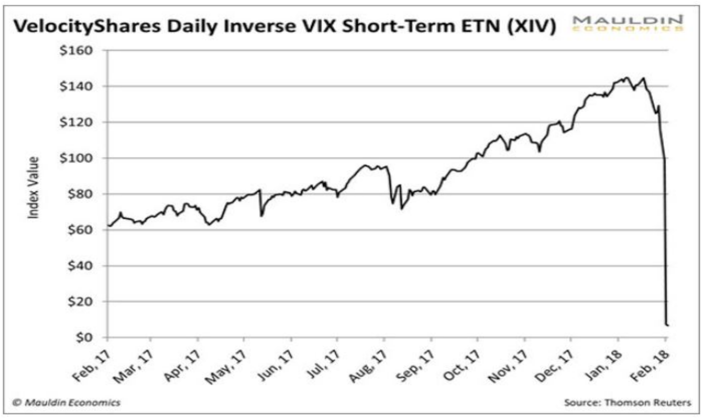
Alarm bells of the quarter:

Kodak… remember them? Who needs assets/earnings when you have 'Coins'

On 9 January 2018, Kodak jumped on the buzzword and launched its own cryptocurrency, *'Kodak Coins'* within days, Kodak's shares were trading 390% higher. Wow-wee!

Inverse VIX – ouch!

- In a similar vein to the cryptocurrency 'trillionaires' of yesteryear – numerous ETF product providers enabled momentum traders to bet on ever reduced level of volatility i.e. inversed VIX (remember extrapolation bias)..
- See below suffice to say it didn't end well and numerous Porches have sadly been repossessed. ☹
- That mean reversion is a killer…



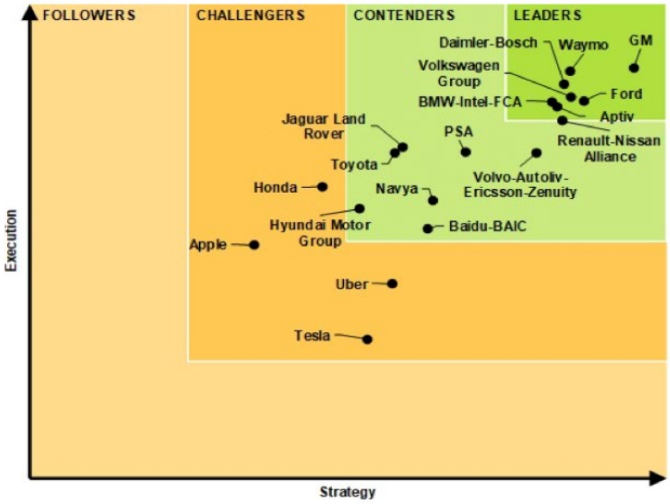
Our current ideas

Alternates

We like **Oil/Gold** when there is geopolitical weirdness occurs (nerve agents and trade escalations etc.)

A pair idea

Long GM and Short Tesla



At its current valuation of ~$38/share, GM has a price to book of circa 1 vs TLSA at 12.

For GM, the tariffs shouldn't pose any immediate problem, as the company has already negotiated its steel contracts for 2018. In the

Concerns around US auto sales overdone – down just 1.7% in 17. GM, largely offset by growth in China from 13.8% to 14.3%.

Does self-driving threat from Tesla really break GM?

GM actually looks poised to beat Tesla at its own game. A recent report from Navigant Research declared GM the leader in automated driving systems. (See figure above)

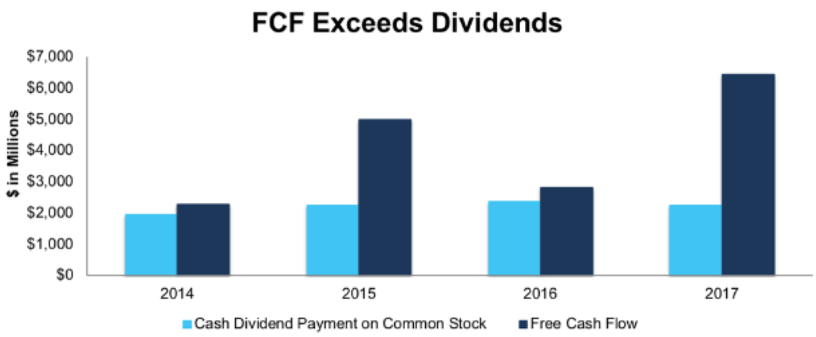
Should self-driving reduce car volumes – perhaps, but what about wear and tear and thus turnover? Plus, self-driving technology could increase the value of each car and deliver higher margins to manufacturers.

On the Electric Vehicle side - the Chevy Bolt outsold all Tesla models last October, and the company plans to launch 18 new electric vehicles in the next five years.

GM has generated a cumulative $16 billion in free cash flow over the past four years (see below), more than enough to cover its 4% dividend. Suffice to say you need profits to generate free cash flow

Sorry GM, Tesla managed to generate negative free cash flow of $7.4bn over the same 4 years.

Figure 4: GM's FCF vs. Dividends Since 2014



Sources: New Constructs, LLC and company filings