MARKET COMMENTARY JANUARY 2015

Executive Summary

- Equity market cycle maturing, but still has some distance to run. Earnings and interest rates remain supportive.
- Deflation, lower interest rates, a growth boost from lower energy prices supportive of financial markets
- The USA remains most attractive developed market, though Europe to benefit from QE, while Asia is most attractive emerging market.
- Prospects of continuing $US strength, subdued global growth diminish prospects for commodities.
- In Australia, yield and defensive plays are very expensive, though supported by prospect of lower interest rates.
- The substantial divergence between stock and sector performance make stock selection the key determinant of investment outcomes.

Review of 2014:

The December quarter was a tough time for most markets. Volatility increased significantly. Oil (WTI) fell from $95 in late September to $53 at year end. The $A/$US declined from 93.3 to 81.8. The broad based measure of commodity prices, the Thompson Reuters CRB Index, declined 18% for the quarter. US 10 year bonds traded in a range of 2.5% down to 1.86%.

Although the ASX200 index outperformed most comparable benchmarks during the month of December, it lagged for the quarter (2.2% against MSCI World of 2.9%) and the 12 months (1.1% against MSCI World of 7.7%).

Given market moves of this magnitude, stock and sector selection has been the key determinant of investment outcomes. For the quarter, the Healthcare sector rose 13.9%, Telecom up 11.9%, Property up 9.8%. In contrast, Energy declined 17.8% and Materials down 6%.

In summary, the key to performance in 2014 has been a bias towards yield, defensive, low risk, combination of growth plus income. Underperformance has been concentrated where bias is towards capital growth, value, high risk, contrarian strategies.

The Global Market Cycle Maturing

With the US equity markets hitting consistent record highs during 2014 (as well as strong performances in Japan, India and China) valuation risks are on the rise. Factors supporting this strength include:

- Growth by acquisition in a low growth world an increasingly important corporate strategy
- Global M&A activity reached a 7 year high in 2014.
- US IPO's reached highest number and value since 2000.
- Increased level of margin lending in the US.
- Internationalisation of Chinese capital providing new source of demand for global equities.
- Solid growth in corporate earnings, high profit share relative to wages.

So while we are in the latter stages of a cyclical bull market, a number of other factors suggest to us that it does have further to run. These include:

- Third year of US Presidential cycle typically the strongest market .
- High levels of on-market buybacks reducing equity supply.
- Continued downward pressure on interest rates in much of the world, in part driven by deflationary forces. Equities attractive in deflation times.
- Solid growth in earnings in the USA, Europe, China, Japan in 2015. (Citi has EPS growth of 8.2%, 8.9%, 7.8%, 10.5% respectively).
- While not cheap, valuations are reasonable in the context of solid earnings growth, declining inflation and low interest rates.
- Favourable monetary policy settings that remain supportive of growth.
- Positive boost to growth flowing from lower energy costs.

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Review of Investment Strategy

In our October market commentary, we remained positive towards Healthcare, Infrastructure, Financials and companies with significant overseas earnings. It is fair to say that this served us well during the December quarter. Those key metrics of predictable yield with growth, companies earning revenues in non $A, and limiting exposure to resource companies contributed positively to performance.

Two calls made in October detracted from performance. One related to our positive view on the Energy sector based on the upcoming start up of major LNG projects. The sharp decline in oil prices has suddenly diminished the attractiveness of several projects.

The second call to detract from performance relates to "growth by acquisition". Despite some compelling growth prospects, the market has chosen to price such companies at significant discounts compared to those generating organic growth.

Generally, portfolios biased towards the "yield" trade have performed strongly over the last 12 months. Those more highly exposed to growth have done less well, reflecting the challenges of delivering growth without strong support from income in a low growth world.

Prospects for 2015

As we enter 2015, it is difficult to see any sudden changes to the outlook that warrant wholesale changes to our current investment strategy. We are mindful of the fact that many of the stocks we hold appear fully valued. However we own them because they have sustainable yield and growth characteristics, somewhat independent of the economic cycle. Healthcare, Infrastructure, parts of the Financial Service sector are examples of this.

Our deliberate approach of biasing stock selection towards companies generating a significant part of their earnings from overseas have been highly beneficial to performance. The likes of CSL, Brambles, Fox, Amcor have all made very positive contributions to performance during 2014. We continue to see this group as capable of delivering superior growth, assisted by a lower AUD.

Domestically, our core holdings are based around defensive sectors-Consumer Staple, Telecoms, Utilities, Healthcare, Property Trusts. We have avoided cyclical sectors such as building materials, insurance, discretionary retail (other than Flight Centre).

Exposure to Resources and Energy remains minimal. We have acknowledged that the appreciating USD is in a long term uptrend, while commodities in aggregate are in a long term downtrend (most likely along with the AUD). So the primary focus is on long term, sustainable growth, strong balance sheet and being a lowest cost supplier with realistic growth options through the cycle. While we have cut our position in Santos, we have maintained holdings in Woodside, Oil Search and BHP that comply with our stated investment parameters, as they also provide us with some countercyclical exposure to a potential recovery in the oil price.

We look forward to catching up with you soon to discuss your portfolio and address any change of circumstances or issues that we might be able to help you with.

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