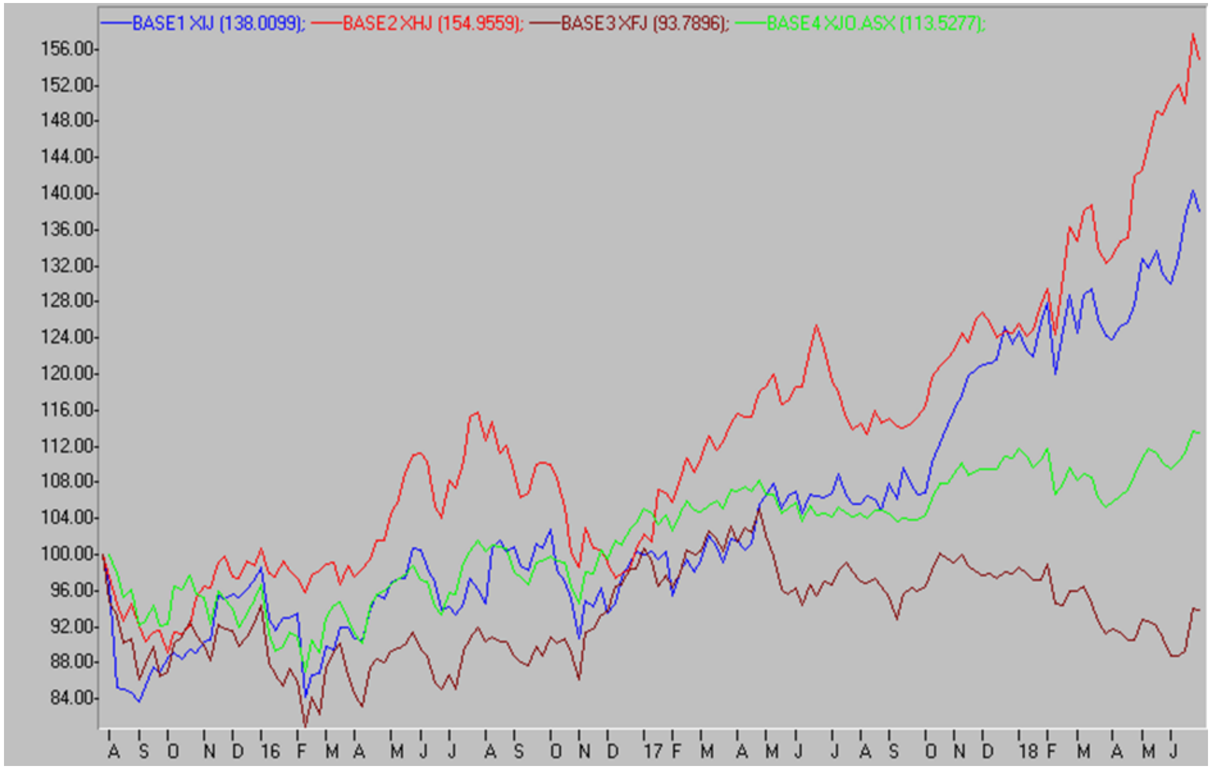
Monthly Investment Review

June 2018

Value vs Growth

- A narrow range of companies and sectors experiencing very strong returns.
- Outsized returns for IT, healthcare and those exposed to China.
- Traditional companies have struggled - Telstra, banks, hospital groups.
- Digital disruption improving emerging companies growth vs. traditional industries.

Leading and lagging sector returns



Source: IRESS

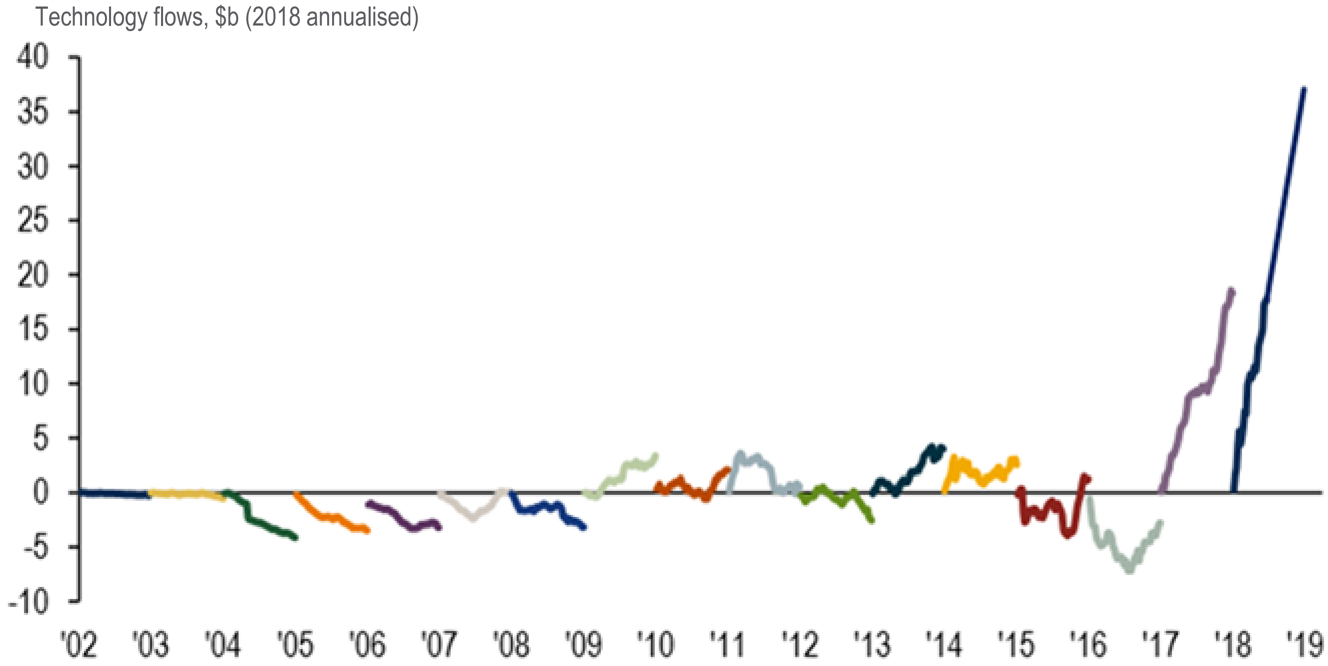
12 month share price performance

	% Gains/Loss
Afterpay Touch Group (ASX:APT)	218
The A2 Milk Company (ASX:A2M)	176
WiseTech Global (ASX:WTC)	123
Bellamy's Australia (ASX:BAL)	123
CSL (ASX:CSL)	38
REA Group (ASX:REA)	36
Treasury Wine Estates (ASX:TWE)	35
Commonwealth Bank of Australia (ASX:CBA)	-7
Brambles (ASX:BXB)	-8
AMP (ASX:AMP)	-27
Ramsay Health Care (ASX:RHC)	-27
Telstra Corporation (ASX:TLS)	-35

Source: DNR Capital

Liquidity finding a home

- Low interest rates and QE means the world has been awash with liquidity.
- Liquidity chasing parts of the market with growth prospects.
- Tech space has been a big beneficiary.
- Quant strategies support these sectors with good momentum and low historical volatility creating a positive feedback loop.



Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

Valuation gap widening

- Valuation gap between technology, health, China exposed companies vs other sectors continues to widen.
- IT and healthcare have clear growth profiles but on a healthy ~29x earnings.
- **Question is:** are these multiples justifiable and what could change them?

S&P 500 Value Index versus the S&P 500 Index

Source: Bloomberg

Australian sector valuations spread widening

	PE 1 year fwd	P/ Book	Growth
Resources	14	1.6	5%
Financials	11	1.5	2%
IT	29	5.3	15%
Healthcare	29	6.0	12%

Source: DNR Capital

Are the crowded trade multiples justifiable?

- We are concerned that these trades are becoming crowded, some caution is warranted.

- We see a number of **warning signs**, namely:
  - aggressive valuation assumptions using low risk free rates.
  - new valuation techniques such as price to sales.
  - heavy use of vague addressable market assumptions to increase the terminal value.

- Factors that could cause the market to reassess valuations include:
  - The potential for inflation to rise given a changing political climate. This will impact the terminal value in valuations.
  - As growth stock multiples extend, confidence increases along with earnings expectations. Those that disappoint will be treated harshly.
  - Opportunities emerging with companies that have addressed their competitive position, rebased earnings and are at lower valuations.

Are the crowded trade multiples justifiable?

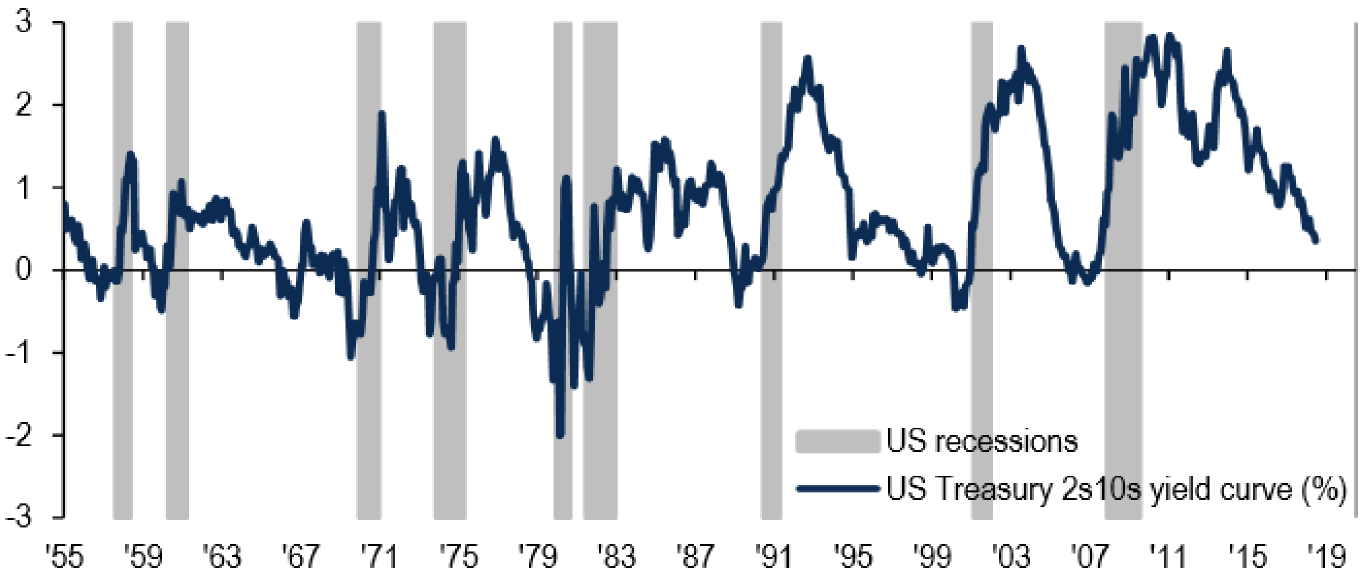
- Opportunities will be presented outside of some of the crowded trades.

- We caution and reiterate:
  - In time of rapid technology change, value traps are prevalent.
  - Some growth stocks continue to justify their valuations given their earnings growth.
  - Don’t throw the baby out with the bath water by exiting quality growth companies with a good line of sight on earnings.
  - The critical consideration is to retain valuation discipline.

Recession probability?

- Rising interest rates increasing concerns around next downturn.
- US yield curve flattening.
- Infrastructure spending increasing, oil and gas capex returning, and consumer wages in the US starting to rise.
- Australian economy holding up well despite a softening housing market.
- Trade wars provide reason for a little caution.

US Recessions and Yield Curve



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, Global Financial Data

Portfolio positioning

Key Considerations

- Valuation vs. growth – reduced exposure to growth names including REA and TWE.
- Inflation – we are underweight bond proxies.
- Household debt to GDP is elevated. We are underweight consumer stocks and banks.
- Corporate debt is low and capex is rising. We have an exposure to companies exposed to mining investment and infrastructure spending.
- Resource cycle remains sound particularly an exposure to higher spending by the majors.
- Interest rate differential to the US suggests A$ weakness. We are overweight offshore earners.

Recent changes

- De-rated quality: companies such as BXB which are quite defensive with valuation support.
- Improving quality: TAH which has regulatory tailwinds.
- Stocks with sustainable growth but at reasonable valuations. These include LNK and CYB.

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