Tribeca Alpha Plus Fund – Class A Units

GRANT SAMUEL FUNDS MANAGEMENT

Tribeca Investment Partners

MONTHLY FUND UPDATE

31 December 2018

Performance

At 31 December 2018

	1 month %	3 months %	1 year % pa	3 years % pa	5 years % pa	7 years % pa	10 years % pa	Since inception[1] % pa
Class A Units[2]	(2.80)	(13.79)	(11.22)	2.87	8.62	10.91	10.73	7.64
Benchmark[3]	(0.12)	(8.24)	(2.84)	6.69	5.63	9.61	9.00	5.41
Value added	(2.68)	(5.55)	(8.38)	(3.82)	2.99	1.30	1.73	2.23

1. Inception date: 18 September 2006
2. Returns are based on end of month redemption prices and calculated after the deduction of ongoing fees and expenses but before tax and assume distributions are reinvested.
3. S&P/ASX 200 Accumulation Index

Past performance is provided for illustrative purposes only and is not a guide to future performance.

Fund facts

Top 10 holdings	Portfolio%	Index%[1]
CSL Limited	9.7	5.6
Aristocrat Leisure Limited	5.5	0.9
Star Entertainment Group Limited	5.3	0.2
ANZ Banking Group Limited	5.2	4.7
Qantas Airways Limited	5.1	0.7
Origin Energy Limited	5.0	0.8
National Australia Bank Limited	4.9	4.4
Tabcorp Holdings Limited	4.7	0.6
Commonwealth Bank of Australia	4.7	8.5
Bluescope Steel Limited	4.4	0.4

Portfolio characteristics	Portfolio%	Index%[1]
Communication Services	-6.3	3.3
Consumer Discretionary	13.1	4.1
Consumer Staples	3.2	8.0
Energy	12.1	5.4
Financial-x-Property Trusts	21.6	32.6
Health Care	12.4	8.9
Industrials	17.7	8.0
Information Technology	2.7	2.1
Materials	22.0	18.2
Property Trusts	1.4	7.4
Telecommunication Services	--	--
Utilities	-1.0	2.0
Cash	1.2	--
TOTAL[2]	**100.0**	**100.0**

[1] S&P/ASX 200 Accumulation Index

[2] May not total due to rounding

Commentary

To the disappointment of many investors, the "Santa Rally" did not take place this December with global equity indices trending sharply lower. The S&P/ASX 200 outperformed its global peers, finishing down 0.4% to 5646 points. The S&P/ASX 200 Accumulation Index was down 0.12%, while the fund lost 2.80%, leaving an underperformance of 2.68%.

The S&P 500 lost 9.18%, marking the worst monthly performance since 1931. Trade tensions, oil prices and a slow down in global growth data spooked investors with renewed fear of a possible US recession in 2019. The US 10 year yield dropped below 2.7% while the FOMC continued with its 25bp hike. Amid this volatility, the Australian market was relatively unscathed, helped by capital management initiatives from the large resource companies.

The best performing sector was Materials, up 5.31% supported by capital management, followed by Utilities, Health Care, Consumer Staples and Property Trusts. The worst performing sectors were Communication Services, Consumer Discretionary, Financials ex Property Trusts and Information Technology.

The fund's performance was primarily impacted by stock selection across Materials as buy backs supported BHP and Rio Tinto while mid-cap miners were sold off aggressively. Our overweight position in Energy also detracted with the correction in the oil price.

At a stock level, positive attribution came from underweight positions in TPG Telecom (TPM) (the ACCC released a statement of issues in relation to the TPG/Vodafone merger and delayed its final decision until March), Domino's Pizza Enterprises (DMP) (AGM commentary suggested weak trading performance so far despite reiterating full year guidance), Seek (SEK) (further weakness in the Seek job index with a softening economy drove consensus downgrades) and Wisetech Global (WTC) (dagged lower by the sell-off in the NASDAQ as investors rotated into defensive sectors) and overweight positions in Star Entertainment (SGR) (strong AGM update and better Sovereign room trading) and Downer EDI (DOW) (won the Parramatta Light Rail construction contract which builds confidence in the earnings outlook for FY20/21). Negative attribution came from overweight positions in Afterpay Touch Group (APT) (impacted by global tech sell-off while earnings continue to track strongly), Lynas Corporation (LYC) (Malaysia political uncertainty continues with government imposing new licencing requirement inconsistent with recent government report), Worleyparsons (WOR) (sold off as oil prices fell sharply on the back of fear of weakening global growth), Seven Group Holdings (SVW) (fell as part of the risk-off move) and Aristocrat Leisure (ALL) (negative momentum in a risk off market) and underweight positions in BHP Group (BHP) (further buyback supported share price despite fall in risk assets).

Outlook

Markets remain under pressure as the withdrawal of central bank liquidity has driven risk premia higher and set off a cycle of panic. Historically, the equity market has been a good predictor of recessions, although it does give plenty of false positives. The equity market doesn't possess a separate consciousness that forecasts the economy, rather it is a very sensitive barometer of liquidity conditions. As liquidity tightens, either due to policy action by central banks or as counterparty risk increases as credit quality deteriorates, it is reflected quite rapidly in equity prices. The market also moves around freely with animal spirits so bear markets can give a false lead on an impending recession.

The current situation is unique in that there is a contraction in liquidity, but it is unclear to what extent it is influencing financial markets compared to the real economy. Actions by central banks since the GFC have been unprecedented and extraordinary in their efforts to stimulate the economy below the zero bound on interest rates. The US Federal Reserve, the ECB, Bank of Japan and the Bank of England have increased their balance sheets by over US$14 trillion. The impact of this on financial markets has been clear with real bond yields being suppressed and flow on effects to narrower credit spreads and higher multiples for high growth and low volatility equities. The impact on the real economy is far less clear beyond the assumption that higher asset prices and wealth effects have stimulated consumption and that lower borrowing costs have boosted investment, and there is considerable debate about this.

Our expectation for some time has been that the withdrawal of QE would have a significant impact on markets and that a lot of its effects would be reversed. That is, bond yields would move higher and PE dispersion within the equity market would contract. There is no precedent for this shift in policy though and the impact has turned out to be somewhat different. We did see bond yields move higher and technology shares come under pressure through the middle of the year, although the subsequent loss of momentum has compounded upon itself to create a bear market. There are two likely reasons for this. Firstly, the order of QE unwind has been led by the US which has caused the USD to strengthen. This has created some disruption in emerging markets and pressured growth. It has also seen Japan and the EU maintain policies to flatten yield curves which has acted as a restraint on the US yield curve as well. Secondly there has been plenty of political policy uncertainty, particularly around US-China trade relations. These traditional signs of a recession with a weaker equity market and flattening yield curve, combined with policy uncertainty have driven further selling of risk assets. Relative pricing within equities has reflected a broad risk off tone with cyclical earnings being sold down heavily to the extent that the market is now discounting a shallow to moderate recession.

The question moving forward is to what extent QE withdrawal impacts the global economy and what has already been priced in? There was certainly some evidence of slowing growth globally through the second half of 2018. China slowed, mainly due to policy tightening around shadow banking, wealth management products and the property sector in 2017. The trade war with the US also had an impact with slowing auto sales following the impost of import duties on foreign autos. The European manufacturing sector decelerated, partially as a result of slowing demand from China, but also as tightened vehicle emission standards impacted the auto sector. There was also an inventory cycle moving through Europe as white hot growth at the end of 2017 normalised through 2018. The US has been quite robust with the consumer being boosted by tax cuts, and employment and business spending all solid. It is only recently that the surveys for US manufacturing have pointed to slower growth and this is largely due to the sharp fall in the oil price. Over the last decade the US has become a net energy exporter and movements in the oil price now have a significant impact on shale oil investment and the broader US investment cycle.

The fall in the oil price is also somewhat of a monetary phenomenon and a victim of circumstance. Through much of last year the oil price trended higher with evidence of stronger demand growth, rational investing in US shale and increasing speculative positioning. This reached a peak with expectations that Trump's new sanctions on Iran would cause a shortage, however a range of exemptions saw the market caught long. The Saudis and Russia were pumping hard to meet an expected shortfall and speculative positioning was very long. The oil price has fallen sharply as speculative positioning was aggressively reversed as the market went into oversupply in the short term. With OPEC+ agreeing to production cuts the oil price is now stabilising and is likely to recover as speculative positioning normalises. This is a very different situation to 2015 where the Saudis were trying to stop US shale taking market share and were willing to push prices lower. This period did impact US manufacturing via the energy sector, but even this was a slowing of growth rather than the recession that is being priced by markets.

Whilst there are some financial market indicators pointing to trouble for growth we think these are being influenced more by QE normalisation than the real economy. The US yield curve has flattened as the Fed has raised rates at the short end while the BoJ and ECB have been buying bonds at the long end which spills into global markets. US investment grade credit spreads have also widened, but this is also a likely return to more normal levels after being suppressed by QE. The US Senior Loan Officers Survey points to commercial lending standards still being eased and shows no impending credit event. Real cash rates are near zero to negative around the developed world and with solid employment growth and a functioning banking system the deleveraging event that will cause a serious recession is not apparent. Since the GFC most of the increased leverage in the world has been in the government sector, with the exception of a few countries like Australia where household leverage has increased significantly. As such, it is difficult to see a recession in the US without a significantly higher level of the yield curve forcing deleveraging by the government and fiscal austerity.

With falling prices for risk assets the Australian equity market has reacted predictably if not consistently. Defensive assets and cash like proxies have generally outperformed. The irony of this is that the stocks that were some of the biggest beneficiaries of quantitative easing and the suppression of real yields have been the best performers during quantitative tightening as markets have panicked about growth. Anything with a cyclical flavour, including industrials, consumer stocks, mining and mining services have been heavily sold down. The major exception to this was the big miners BHP and Rio Tinto who have significantly outperformed not just other miners, mining services companies and the market as a whole, but many defensive stocks. The inconsistency of this cannot be explained by franking credits alone and is indicative of how technically driven and disconnected from fundamentals the market has become. In essence, we have had a very technical driven sell-off triggered by the withdrawal of central bank liquidity which has seen many stock prices disconnect from fundamentals. We have taken the opportunity to build increasing positions across these stocks.

The portfolio is now positioned with a significant value tilt. This is partly due to exploiting the disconnect between price and fundamentals for many stocks as well as the increased volatility in the market turning down some of our momentum factors as part of our process. We have increased positions across Energy, Materials, Capital Goods and the Industrials sectors and reduced holdings across Telecommunications, Utilities, REITs and maintain an underweight to Banks. The portfolio now has a 12 month forward PE of 12.2 compared to the market at 15.1 times and an EV/EBITDA of 7.9 compared to the market at 12.3 times while earnings growth is above the market and earnings momentum and gearing are broadly in line.

While we remain sanguine around the prospects for global growth we are more concerned around the outlook for the Australian economy and particular the housing sector. Ongoing credit tightening post the Royal Commission is pressuring house prices which will lead to weaker housing construction and flow on effects to retail and consumption. It is difficult to get excited about the attractive valuations in the banking sector with this backdrop as they are cycling low bad debt charges and face higher regulatory capital, funding and compliance costs. Stopping us from becoming too bearish though are a lower AUD boosting tourism and still strong terms of trade and growing LNG exports boosting national income.

For more information about the Tribeca Alpha Plus Fund – Class A Units, please visit www.gsfm.com.au.

Important information