Breaking Free in 2017

2017 has been a relatively smooth year for global financial markets, with investors largely shrugging aside ongoing drama in the Trump administration, tensions on the Korean peninsula, Brexit uncertainty and several natural disasters, which the insurance industry believes will end up making 2017 the most expensive year for the industry on record. Overall volatility in global markets was subdued, global growth and corporate earnings improved, liquidity was ample and central banks remained supportive, unwilling to 'rock the boat' by tightening aggressively.

The Australian market and portfolio strategy

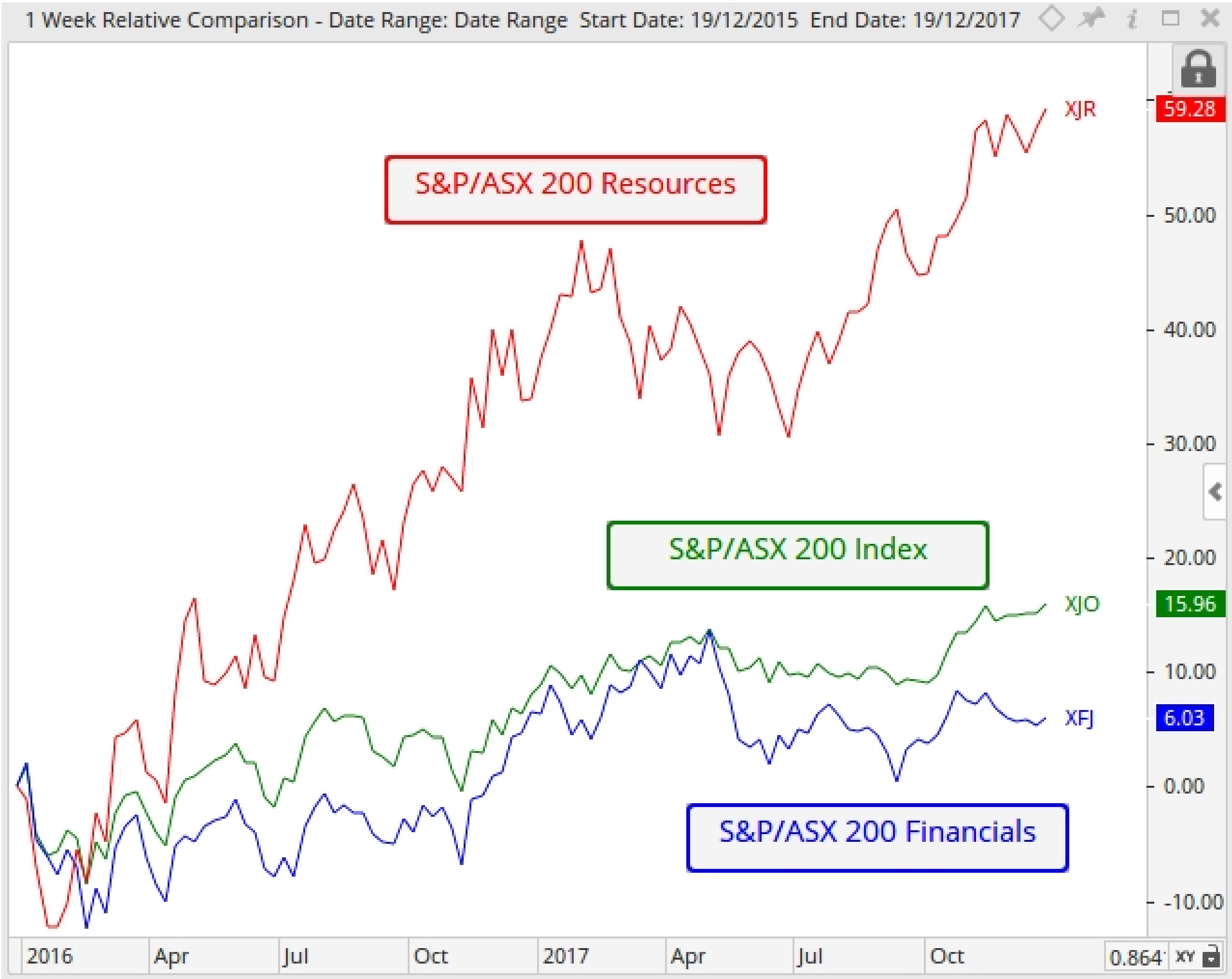
It has been a good year for world stock markets with the All Country World Index hitting new highs. Some of the biggest contributors were US equities, with the major indices there logging up numerous new records over the course of the year, and Japanese equity indices hit levels not seen for two decades. Emerging markets were strong performers, playing catch up after underperformance in prior years.

Australian equities have gained, although the key indices have lagged many overseas markets. The All Ordinaries index is up approximately 6.4% year-to-date, while the A&P/ASX 200 index is up roughly 5.8%. It has been frustrating few years for investors in Australian stocks, with local equities largely range bound. That said, certain select stock and industry weightings have been rewarded, with the performance of the resource sector a notable highlight in 2017.

Still, towards the end of the year there have been some encouraging signs that the Australian market is breaking free from a long-entrenched range. The latter stages of 2017 have seen the ASX200 index (AXJO) climb back above the 6,000 mark, a level not seen in over a decade. While we set out somewhat higher targets for the benchmark, we had forecast this upward dynamic in our predictions for the year, expecting both the banking (AXFO) and resource sectors to play roles. As it turns out, the resources sector (AXJR) was the key.

Overall though, we believe the main reason Australian equities underperformed in 2017 was slower earnings per share growth than that seen in many other nations. We note too that the ASX200 index is not a gross index, as say compared to the NZ50 in New Zealand which hit new highs in 2017. This needs to be considered when making comparisons and Australia is also one of the highest yielding markets globally - investors in high yield stocks have in many cases still done well compared to parking cash in ultra-low deposit accounts.

Relative performance of the ASX 200 (AXJO), Financials index (AXFO) and Resources index (AXJR)



Australian banks are a major weighting in the key Australian equity indices (financials comprise 40% of the ASX200) and the sector has weighed on the broader market's performance due to some industry headwinds. Interest rates are still low from a historical context, limiting interest income. Besides still low interest rates, business activity has been muted and Australian banks have been in the regulators' crosshairs, negatively impacting investor sentiment for much of the year. The Federal government's bank levy will have an earnings impact, although ultimately a lot of the cost will be passed on to customers in our view.

The Royal Commission into the banking, superannuation and financial services industry was another knife thrown at the banks. The scope of inquiry is narrower than some had proposed, but will still likely be a drawn-out process over the next year or so. The initial cost to taxpayers will effectively be about $75 million as Royal Commissions are paid for by the government. The big four banks will foot hefty legal and advisor bills that ultimately are also likely to be passed onto customers. It has been speculated the big banks could face a bill of up to $150 million each, so this is a substantial sum.

The banks have become a political football in Australia, but are resilient and will cope with the latest headwind. After the initial bluster, our House View is that the Royal Commission will probably prove to be a minor factor in 2018 and 2019. The Australian banking system is among the strongest in the world and none had to be bailed out during the Global Financial Crisis. Significant checks and balances on the banking system are already in place and the sector has had to further strengthen its buffers against adverse conditions in the future.

APRA's bank capital requirements ended up being less onerous than expected, which gave some support to banking stocks. ANZ for example has already met the "unquestionably strong" 10.5% common equity tier 1

(CET1) capital ratio threshold as at 30 September 2017, well ahead of APRA's 2020 deadline. The impact from the rise of disruptive 'Fintech' competitors in Australia on the banking sector to date has been limited, but is something to watch.

One side impact of the levy being imposed by the government on the big four, will potentially be some 'levelling of the playing field' for the regional banks. This should bode well for **Bank of Queensland** which we have also recommended several times during the year, and which has out-performed the sector in 2017.

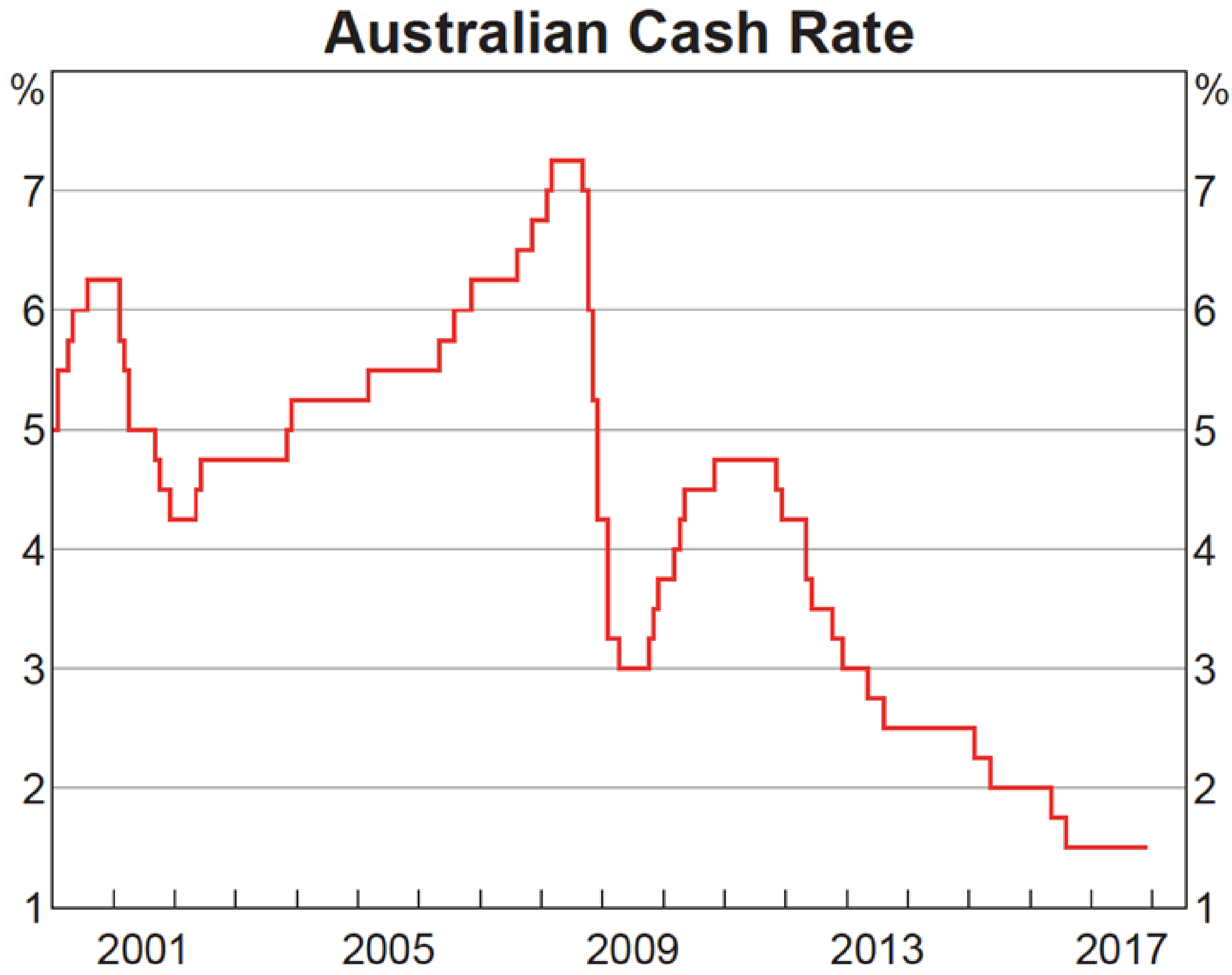
Looking ahead, we continue to believe the banks can outperform, with the impact of the Royal Commission likely to be overshadowed by higher bond yields over the next year or two. This should lift the sector globally.

Another sector we expect to benefit from higher rates over the next couple of years is the insurance sector globally, which will see higher investment income on their 'floats.' There is almost certainly going to be upward movement in premiums as well after the raft of natural disasters in 2017.

QBE Insurance has disappointed after another profit warning, but will benefit from the sector drivers discussed above and we believe there is significant value on offer for patient investors at current levels. A new CEO could bring some positivity to the investment story, especially as it seems much 'kitchen sinking' has already been done.

Still on the financials 'page' and we have remained positive on the financial platform stocks, **Praemium**, OneVue and **Hub24**. These have performed well and enjoy a supportive backdrop. The Australian superannuation industry is already one of the largest in the world and continues to have solid growth prospects. The platform companies have scope to capture more share in a still fragmented market and operating leverage is high. Funds under administration (FUA) are on the up.

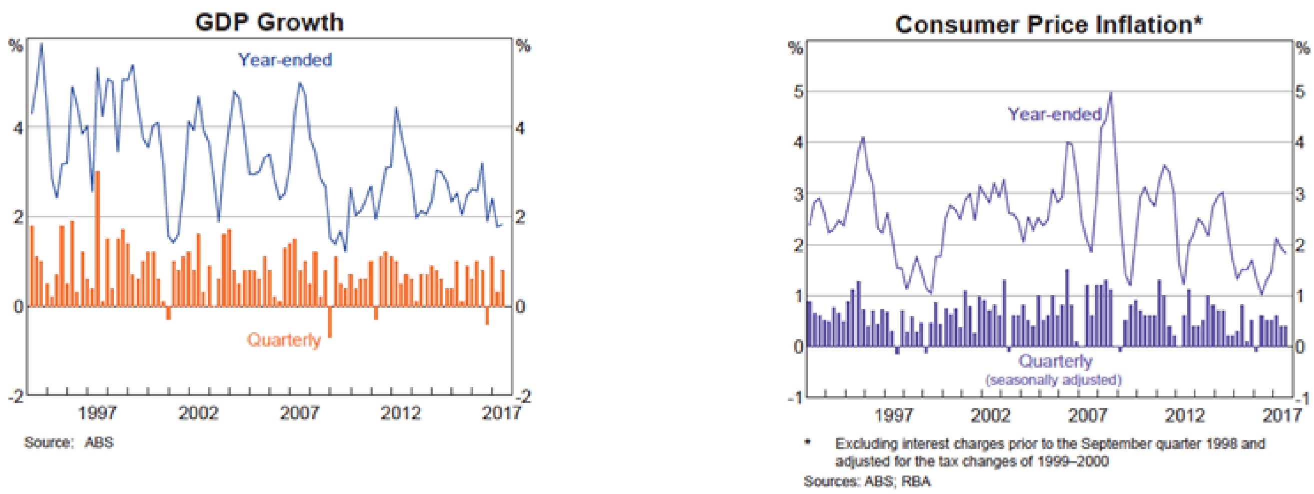
As we had anticipated, the Reserve Bank of Australia (RBA) stayed on the side lines in 2017, with the benchmark interest rate of 1.5% unchanged since August 2016.



Source: RBA

Sluggish wages, apathetic inflation and concerns over the strength of the Australian dollar won out, despite stronger domestic data emerging in the latter part of the year.

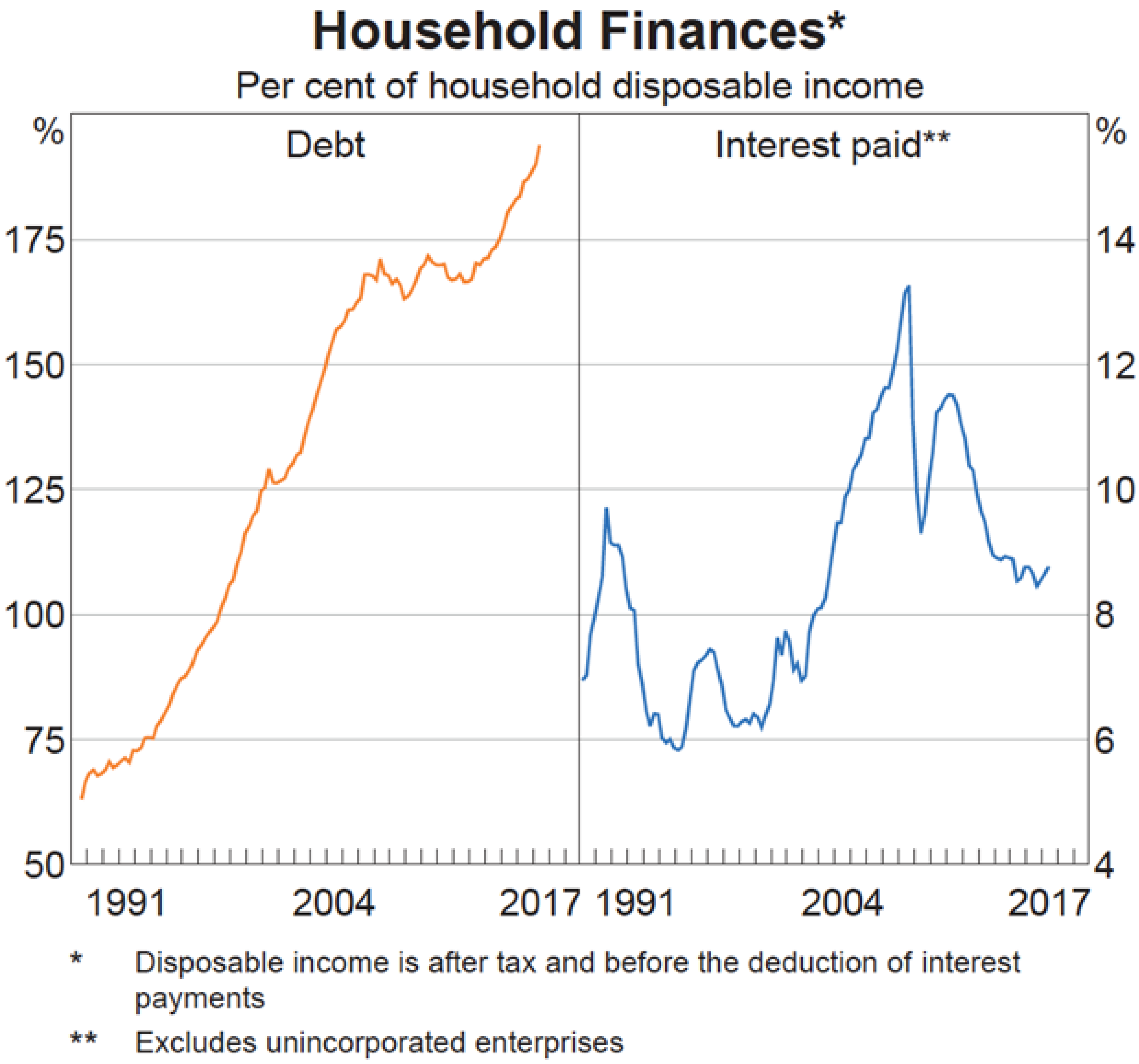
Australian GDP Growth and Inflation



Source: ABS, RBA

Minutes from the latest central bank decision also highlighted another key concern which is the high level of household debt, stating, “One continuing source of uncertainty is the outlook for household consumption.

Household incomes are growing slowly and debt levels are high."



Source: RBA

A reasonably strong job market should create some wage growth looking ahead and this combined with rising commodity prices could lead to inflation surprising to the upside. The ongoing revival in the resources sector over the past 18 months or so has supported the Australian economy and this is evident in the performances and share prices of many mining sector players. **We have over-weighted the sector since the lows seen last year and see more scope for gains ahead.**

Stocks in the sector we continued to recommend during the year such as **BHP** and **South 32** have been strong performers. Commodity prices pushed higher during the year and iron ore prices did not correct as the consensus analyst fraternity thought. As we anticipated, demand from China continued to be stronger than expected by the consensus view.

The decision of the RBA to sit on its hands regarding the cash rate capped Australian dollar strength during the year, which was positive for companies with overseas earnings. Besides miners, this was supportive for tourism-related stocks.

We backed accommodation provider **Mantra Group** with buy calls on several occasions and the value there was recognised by a $1.2 billion takeover offer from larger French competitor Accor in October, representing a premium to pre-takeover trading levels. Shareholders are set to vote on the deal in March 2018.

Agriculture has been another area we have recommended, as it benefits from any relative weakness in the Australian dollar and our proximity to Asia, where protein intake is rising and generally the appetite for Australasian agricultural products is increasing. **Elders** has been a standout, resuming dividend payments after an almost decade-long hiatus as its financial position has strengthened materially. Net profits more than doubled last fiscal year, driven by higher livestock prices and accretive acquisitions.

Elsewhere in the space, **Nufarm** looks well placed to benefit from M&A opportunities in the consolidating crop protection sector. The company has pulled the trigger on two acquisitions over the past few months, bolstering its portfolio considerably.

Our call on **Telstra** proved wide of the mark in 2017, as the dividend was cut to a level below even bearish forecasts. The company also recently revised 2017/18 earnings guidance following the NBN Co announcement that it will pause sales of hybrid fibre co-axial (HFC) cables for six to nine months from 11 December 2017.

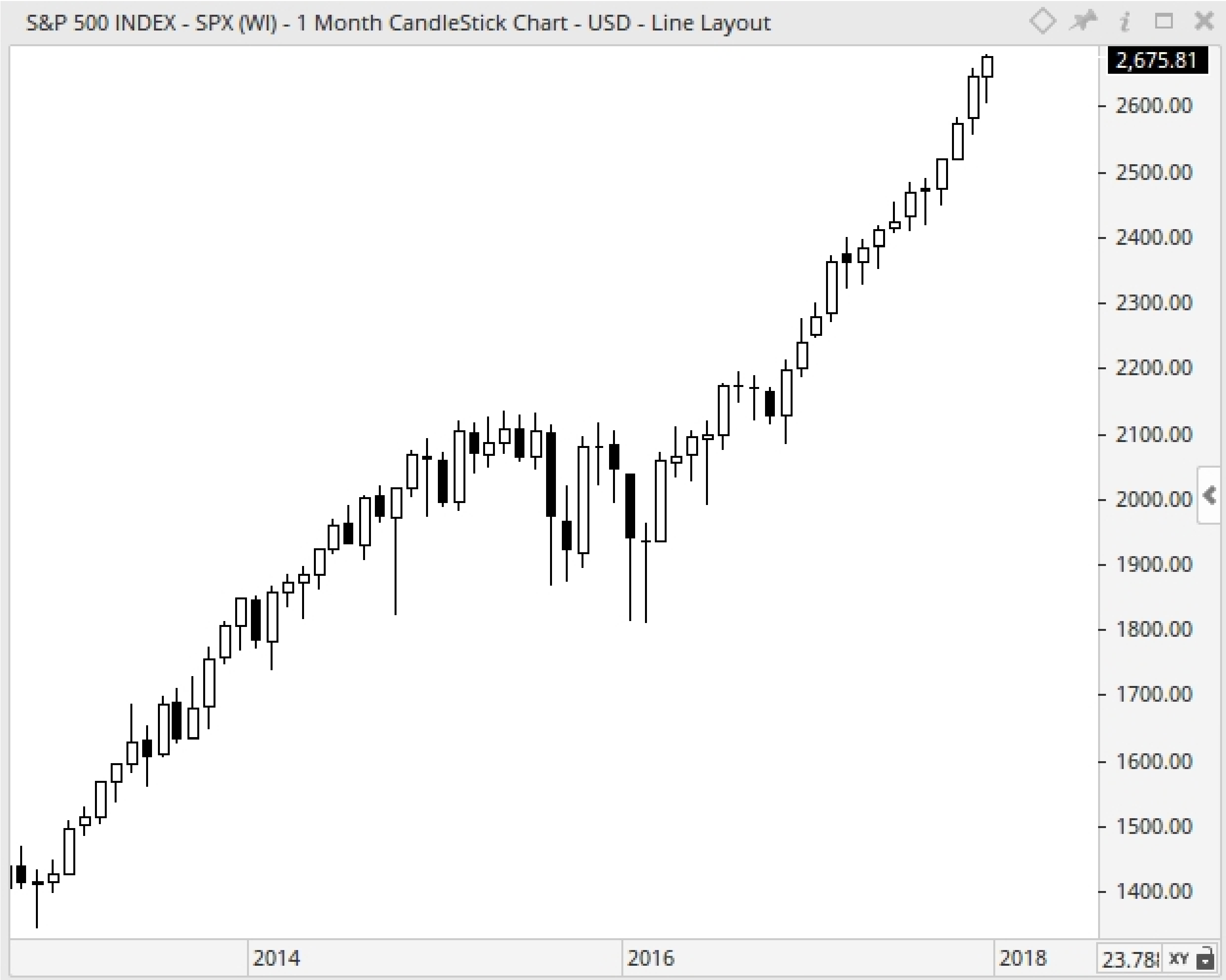
Telstra reaffirmed its recently reduced conservative dividend though and the news that the ACCC will not oppose the Foxtel and Fox Sports merger was positive, as was the decision from the same regulator to not force Telstra and Optus to share their mobile networks with competitors.

While acknowledging the technical damage done to the share price we are of the view that Telstra is well placed to differentiate itself, as it becomes more focused on innovation in a converging environment. Recently, the company unveiled the new Telstra TV product. This allows users to access free-to-air television, catch-up services and subscription video-on-demand (i.e. Netflix, Stan) all on one device. Across the ‘pond’ we retain our positive investment stance on **Spark New Zealand**.

An interesting story to follow during 2017 was **Fairfax**, which we viewed as a high conviction buy early on. Two private equity players concurred and made bids for the company, although they eventually ended up walking away. While that meant our investment thesis took longer to play out, our view that the demerger of the online real estate arm, **Domain**, would unlock value has ultimately been realised.

Global macro

It was a tough year for equity bears, particularly in the United States with the aging bull run defying gravity. The S&P 500 has surged again in 2017, with gains of around 20% as of mid-December. The market has been supported by a growing economy, a tame Federal Reserve tightening cycle and tax reform prospects. Technology stocks have led the way in the US market for most of the year, and have still posted strong gains despite some profit taking in recent weeks.



The gains have come about notwithstanding a Donald Trump administration which has been beset by drama for most of the year, with the President cementing his reputation for inconsistency. Trump is within spitting distance of his first real win for the year though, with Congress expected to pass the new tax bill. It would be a welcome development for the Trump administration, which to date has failed to achieve much, even with the Republican party controlling both houses.

Japanese equities have been some of the strongest globally in 2017, with the Nikkei gaining roughly 18% year-to-date to hit levels not seen in over two decades. Positively, the stock market seems to be decoupling from the yen, which is a sign of significant strength. Investors have also shrugged off several scandals roiling several of Japan Incorporated's big names and some persistent structural issues, including the often referred to aging demographic in Japan.

There are good reasons for the recent rise in Japan's equities though, with GDP expanding for six straight quarters, the first time the economy has grown that long without a contraction in over a decade. Unemployment is at multi-decade lows, helping chronic wage and price deflation ease, although the Bank of Japan would like to see stronger inflation flow through. There is growing demand for Japanese products abroad, especially in neighbouring Asian countries as purchasing power grows and consumers like the reputation for quality of Japanese goods.

Another factor at play in Japan, is that after a long period of under investment following the bursting of the asset bubble, much excess capacity has been worked out of the system.

'Abenomics' have also been a tailwind and therefore we view the recent political events favourably, with Shinzo Abe poised to become the country's strongest leader in the modern era after his party's landslide victory in the October parliamentary elections.

Portfolio movements

We remained mindful of the need for prudent portfolio management during the year. We initiated sell or sell half recommendations 15 times in the Fat Prophets Australasian Equities Portfolio over the year, with capital gains having been reported on 12.

We have discussed in some detail the reasons for taking profits or losses on these stocks in a separate report (refer to the report titled 'Where we took profits and losses in 2017'). Needless to say, that in each instance, the decision to sell-half or all of each position was consistent with our adherence to the principles of fundamental value investing with a technical overlay.

On the other side, we introduced 3 new stocks to the Portfolio. **Domain Holdings** was the most recent addition, as it began life as a separate listed entity (ASX, DHG) in November. **Fairfax Media** (a stock we retain a buy rating on) shareholders received 1 share for every 10 Fairfax shares held.

Domain offers residential and commercial property marketing services through a variety of listing portals. In addition to advertising solutions, the company provides data and technology services to real estate agencies through CRM software, data and research subscriptions as well as other tools. Domain has also expanded into transactional services including home loan brokerage.

Having been demerged from Fairfax, Domain is free to be priced more in line with a new media company of its ilk, and not be weighed down by depressed sentiment towards the old media business. We don’t consider its valuation stretched considering competitor REA trades on a similar multiple – but with a much larger $10 billion market cap. Domain is smaller and nimbler and the number two player in the Australian online real estate market, but we believe this should allow earnings to grow faster. Although it is early days on this call, so far, so good.

Stockland Group (ASX, SGP), one of the largest residential property groups in Australia was added to the portfolio in July. In this name, we saw an “opportunity in adversity,” as sentiment had soured on the broader sector.

The company is focussed at the right end in our view, selling land rather than apartments, and targeting affordable housing and owner/occupiers. In retail, Stockland’s shopping centre properties are well positioned, with strong occupancies, and we believe that the fear and loathing over the likely disruptive impact of Amazon had gone too far, and created a value gap. Stockland has significant exposure to counter-cyclical assets in the retirement sector, as well as logistics centres, business parks, and office assets. Stockland is leveraged to the current residential boom, selling vacant residential land ready to build on**.** The company can promptly raise prices on land it is selling and settling, to benefit from the cycle in a timely manner.

Our other addition to the portfolio, **Estia Health**, was also introduced in July. We had scouted Australia’s large listed aged care operators for opportunities after a period of underperformance triggered by concerns over regulatory risks, government funding, and media exposes which had sullied the industry’s reputation. That some constituents have over-expanded aggressively had only compounded matters in some instances.

With Australians living longer, and the baby boomers set to retire over the next 15 years, the underlying thematic remains compelling in our view. Particularly as studies show that most will need to cash up equity in their own homes, and move into care to sustain themselves in their twilight years. Estia Health (ASX, EHE) ticked several boxes – the stock had halved in value since its IPO in December 2014, and we believed it was well positioned for a turnaround. Investors seem to have concurred with our view and the shares have been staging a recovery.

We provided updates on the Fat Prophets 'Income Portfolio' each quarter and the income yield since inception (as at 13 October 2017) in March 2012 of 21.8%, which is in addition to the capital growth of 21.2%. This makes for a total return of 42.3% since the portfolio was constructed in March 2012. Overall, we remain comfortable with the performance of the Fat Prophets Income Portfolio, noting that to date it has delivered on its mandate. That is to construct and maintain a concentrated basket of stable, well-managed, and financially sound companies that distribute strong, sustainable, defensive income streams.

Looking at the research portfolio more broadly, performance-wise the Australasian equities report continues to track well. This is also a reflection of the fact we get it right much more often than we get it wrong. The annualised return since inception on the Australasian Equities Report was 18.3% as at 30 September 2017, versus 7.8% for the All Ords over the comparable period.

The feedback from Members

If the results from our Member Survey for 2017 are any indication, our stock recommendations, in combination with the enhancements that we have introduced to our service in recent years, continue to be appreciated.

The daily email from Angus Geddes is a vital part of our communication with Members and a channel through which Fat Prophets provide clarity on our views on macro and micro-economic developments, and the implication for stock markets, in a timely manner. Consistent with our top-down and somewhat contrarian approach to stock selection, analysis of global events impacting markets featured prominently in 2017. The daily email was separately graded their year, and received an A- which is a testament to the value placed on it by the majority of Members.

Members also remain receptive towards our weekly fatWrap which summarises the ideas from across the Fat Prophets suite of research products. We continue to put a lot of thought into our covers, and design, so it is pleasing that feedback here remains positive.

Our weekly research webinars continue to be well received. These sessions give Members the chance to hear direct from our Head of Research Greg Smith, of our view on market events and developments. The forum style with a Q&A session at the end has also been a great way for us to engage with Members and the feedback here continues to be positive.

Our efforts on the Australasian Equities research service have been awarded an 'A-' grade from Members this year and we look forward to striving to further improve our offering for Members in the coming year. Work on our new website is underway, and this will be unveiled in 2018. We once again like to thank those Members that took the time to provide feedback for this review.

Until next year

We will be publishing our predictions for 2018 in the next report to be published on the 9th January 2018. As usual, these predictions will cover a range of topics. Signing off on 2017, we would like to once again thank all Members for their continued support, and wish all a safe and happy Christmas and a prosperous New Year.

Best regards,

Fat Prophets

Disclosure: Fat Prophets and associated parties declare an interest in Fairfax Media, ANZ Banking Group, QBE Insurance, Telstra, Mantra group, BHP, South 32, Domain, Nufarm, Elders, Estia Health, and Stockland.
