2018 Review 18/12/2018 **FAT-AUS-903**

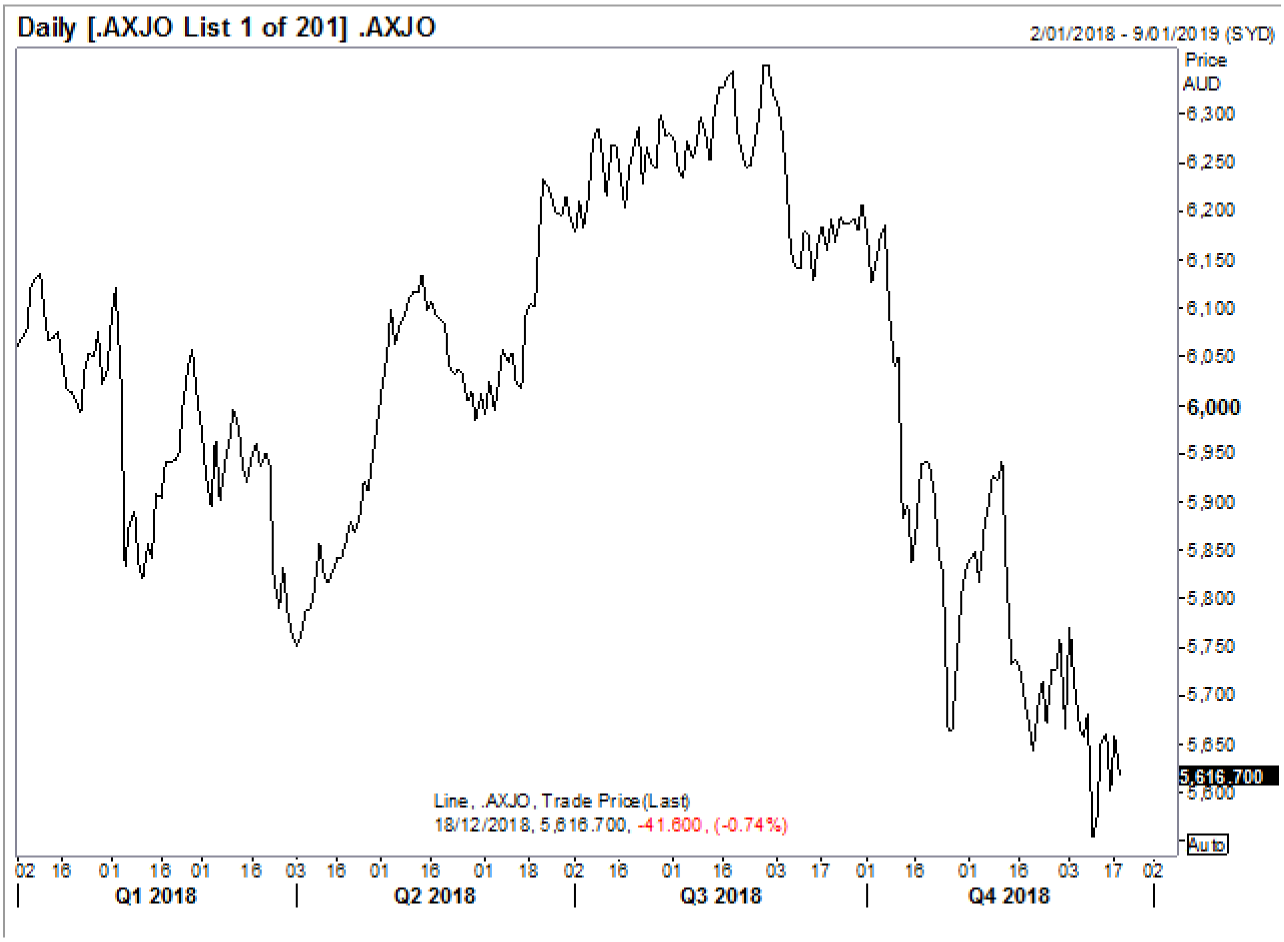
Battered and somewhat bruised

2018 has certainly been a challenging year for markets, and one where volatility increased significantly at times. For Australia, a reasonable start to the year came to an abrupt end in February, as investors globally fretted about higher rates of interest as the Federal Reserve in the US got underway with its tightening program.

A 'calm' returned to the markets from the start of April, with the ASX200 enjoying a period of relative prosperity through to the end of August. This saw the index surpass 6350, and attain levels not witnessed since prior to the GFC. After a lost decade, it would almost seem that the tide was set to turn firmly up.

But it was not to be, with offshore headwinds coming with some gusto as Donald Trump set his sights on US trading partners, and in particular China, with a host of aggressive tariffs. This has taken its toll on the markets, which have cast their view that such moves are set to send the world into another recession. As the year draws to a close, this has led to investors continuing to tread with some caution, in what is traditionally a strong time of year.

ASX200 - 2018



The distress in Europe (with Italy and Brexit) has also been something of a side-show, but also at times contributed to investor angst. The impacts are arguably less relevant to Australia, but Italy's budgetary woes and the prospect of the UK falling out of the EU with no deal have also added to a list of items for the markets to 'worry' about (when do they not!).

Australia of course has had its own domestic risk factors to contend with. The Royal Commission has taken its toll on the financial sector, and as regulation and costs are set to rise. An overblown housing market has also unsurprisingly started to correct, with concerns over how far this will fall, and the toll it will take on heavily indebted consumers, and their spending, a key driver of the economy.

But after a "bruising" year and three months of straight declines that has not been rivalled since the GFC, investors are tired. We would argue that sellers are exhausted, and that markets are therefore prone to an upward dynamic.

Many investors have subsequently cashed up and deleveraged, following the substantial decline since September, with liquidity now built up on the side-lines. The corporate sector is also likely to be very active in terms of initiating or reinstating buybacks and we have seen this emerging in recent weeks. This in our view, structurally sets the market up for a rally.

We believe that there is still upside risk in equities, given that valuation support is significant. Looking at the S&P500 (a bellwether for global indices), the key US benchmark is on a forward PE of 14 times, the growth outlook has slowed but is not in decline, trade issues are being negotiated, and the Fed seems prepared to take a more dovish stance in 2019.

The Australian index has certainly not performed this year, down around 12% from a high point back in August. The issues surrounding trade have played a large part in the correction witnessed, but this also means that the Australian market should rally strongly on a trade resolution, and reap gains on any further positive language from the US and China. Recent events in our view provide strong evidence that both sides want to 'settle,' with China reducing auto tariffs, and Donald Trump signalling he is prepared to intervene in the Huawei saga.

If further progress (and post the G20) on the trade front, the ASX200 should be in for a reasonable lift given the value that has emerged. The index is now trading on less than 14 times earnings, and offers a yield of around 6%.

The widely pervasive bearishness and extreme pessimism often typifies a turning point and we possibly have seen this already in Asia, with China and Hong Kong not reacting as much to negative news.

Growth may be showing signs of slowing, but still remains positive. The March 1 extension granted to the Chinese, provides a window to resolve the trade dispute. The Federal Reserve has reacted to the market volatility and trade uncertainty, and pivoted away from the three rate hikes flagged for next year, signalling that a neutral outlook could be justified sooner than was widely expected.

The Australian market and portfolio strategy

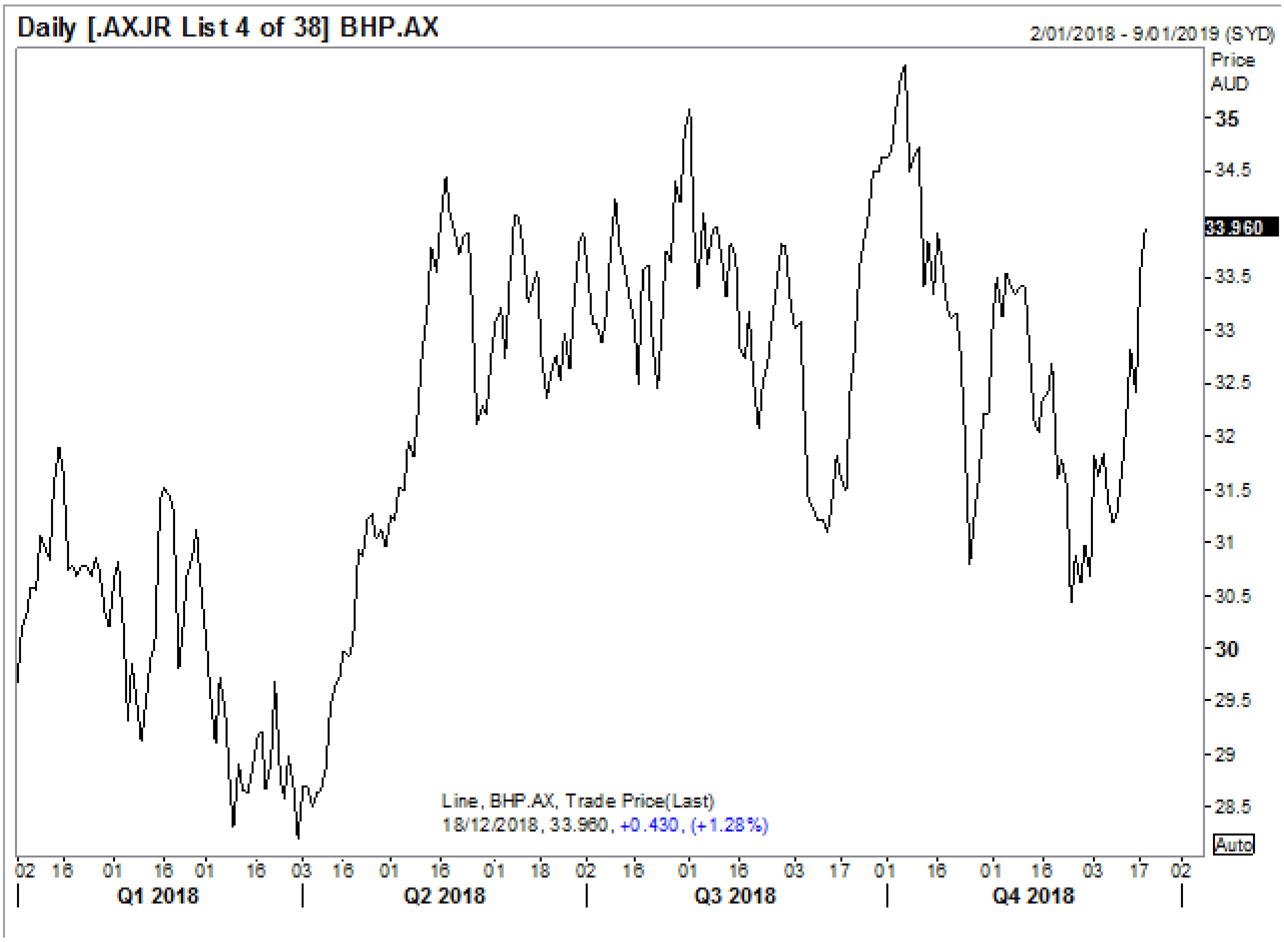
After a strong 2017 it was clearly not a great year for equities, although once again the US, despite being central to much of the volatility outperformed once again in 2018. The S&P500 is currently down around 5% for the year, while the NASDAQ has given up just 2%. This performance corresponds with declines of around 12% for the FTSE, and the European indices. These have fared though better than China, with the benchmark CSI300 index down around 22% for the year, as things stand. Elsewhere in Asia, the Nikkei in Japan held up much better with a loss of around 7% year to date.

Australian equities have also come under pressure, and are somewhere towards the median in terms of the negativity suffered. The All-Ordinaries index is down approximately 8% year-to-date, while the ASX 200 index is off around 12%. While ten-year highs were achieved during the year, on the 2018 performance overall, it continues to be a somewhat frustrating time for investors in Australian stocks. That said, certain select stock and industry weightings have performed better than others.

We were targeting for the ASX200 to push beyond 6000 (and beyond) in 2018 and this was playing out until August. A key driver up till this point was the resource sector, which has also been re-rated on the earnings outperformance we expected to come through; on high commodity pricing.

Amongst the diversified miners, **BHP** once again stole the show, and echoed a similar theme amongst peers of strong dividends, buybacks and impressive earnings results. We tempered our enthusiasm to the stock and peers **Rio** and **South32**, putting them back to holds later in the year. This has proved the right call, but we see the sector benefitting as inflation pushes through next year, and on our scenario of the world avoiding a recession.

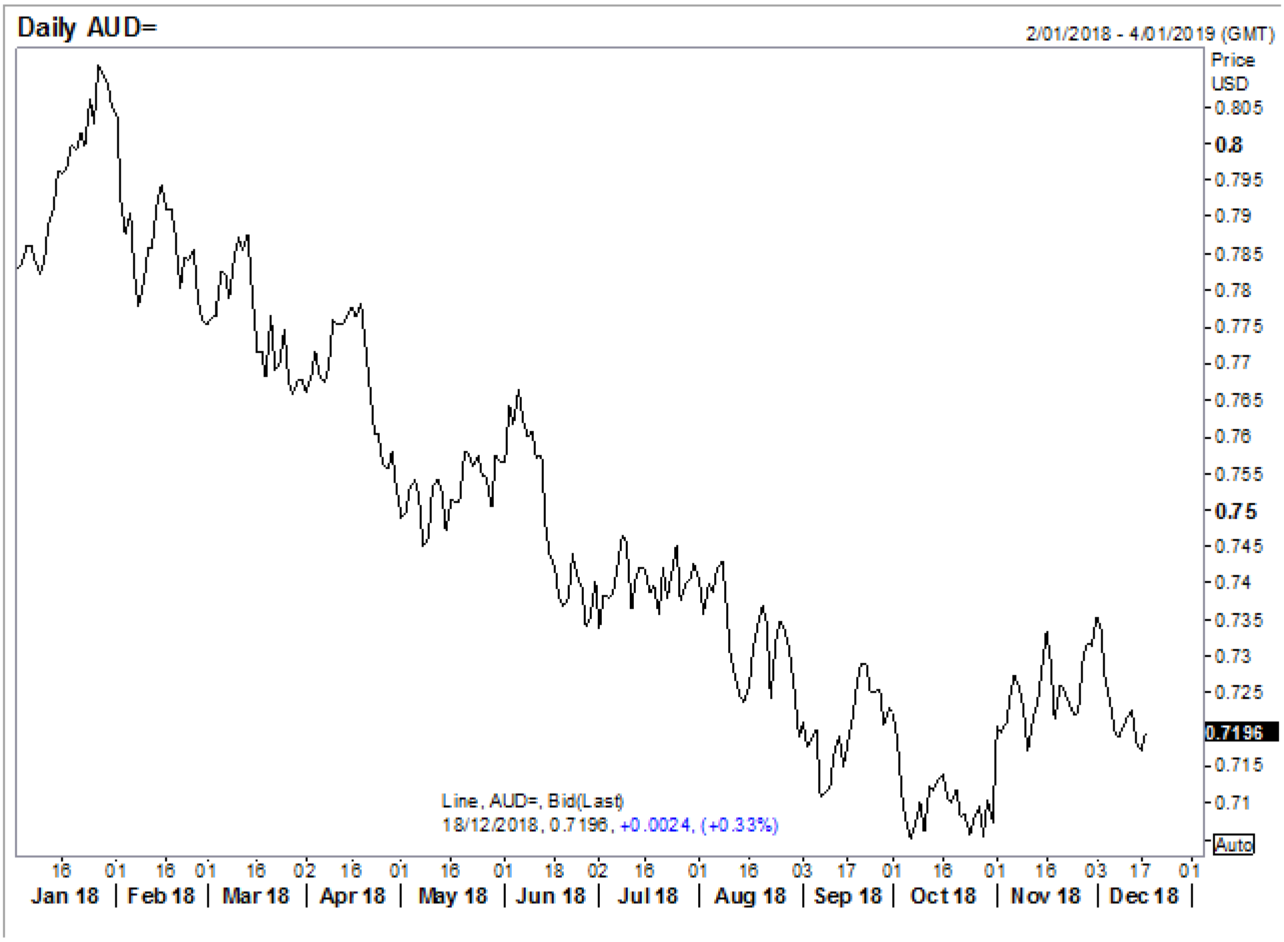
BHP



The energy sector did well for most of the year until the party ended in October, with the global sell-off and a collapse in oil prices. OPEC+ have how signalled that enough is enough, with output cuts which should bring a floor into the oil price. This will bode for improved sentiment towards the likes of **Oil Search** and **Woodside** which are well positioned to ride the burgeoning demand for LNG within the Asian region.

The gold sector enjoyed a strong performance in 2018, with our key producers **Evolution** and **Saracen** performing robustly. We placed multiple buy recommendations on the duo during the year, and we expect the thematic tailwinds to continue in 2018.

Part of the driver for the gold stocks (with costs in local currency, and revenues in US$) was a weaker currency. The RBA left rates on hold for the 28th consecutive month in a row this month, and we see little change to this stance through 2019, with a creaking housing market, low inflation and high levels of consumer debt. This should keep a lid on A$ strength even as the Fed moves to a more ‘neutral’ stance.



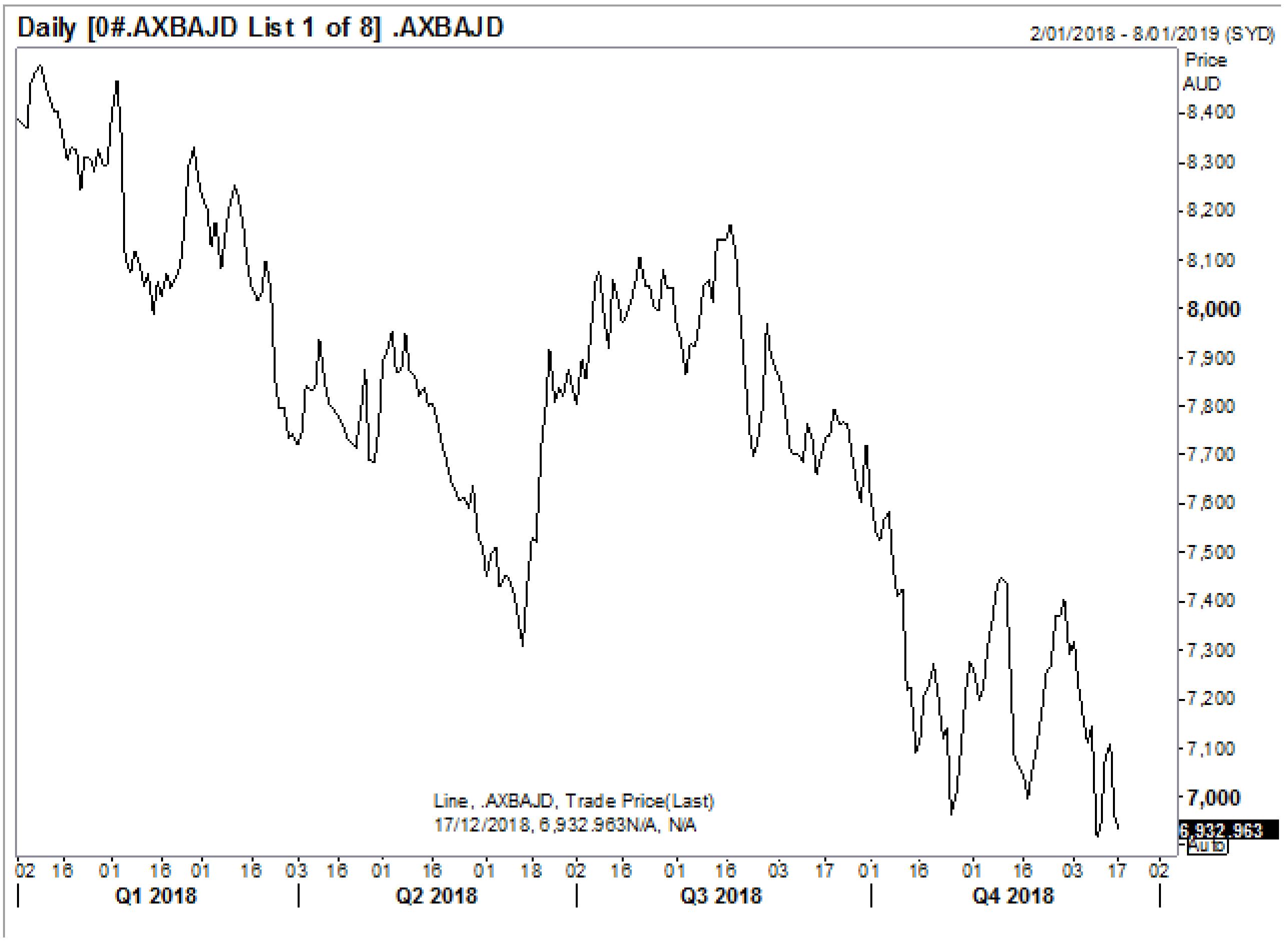
A weaker currency should also benefit the agricultural stocks, which were also hampered by the prolonged drought. **Nufarm** underperformed heavily, while **Elders** lost ground over the year. But we believe both companies are on the right track, in looking to make opportunistic acquisitions in advance of climactic conditions becoming more favourable.

The media sector saw the consolidation we were expecting with **Fairfax** and **Nine** agreeing to a merger. This hasn't helped the shares, but we see the tie-up as extracting powerful synergies, with a big nudge also being given to high value digital properties in Stan and **Domain**.

The banking sector was under pressure for much of the year as well, and our decision to cut two of the Big Four (CBA and Westpac) proved warranted. The Royal Commission clearly eroded sentiment heavily, and 2018 was really the year that the regulators, government, and arguably the public, got their pound of flesh. This has continued across the Tasman this week, with the RBNZ proposing raising capital requirements significantly for banks with a presence there (and weighing on **ANZ** shares in particular).

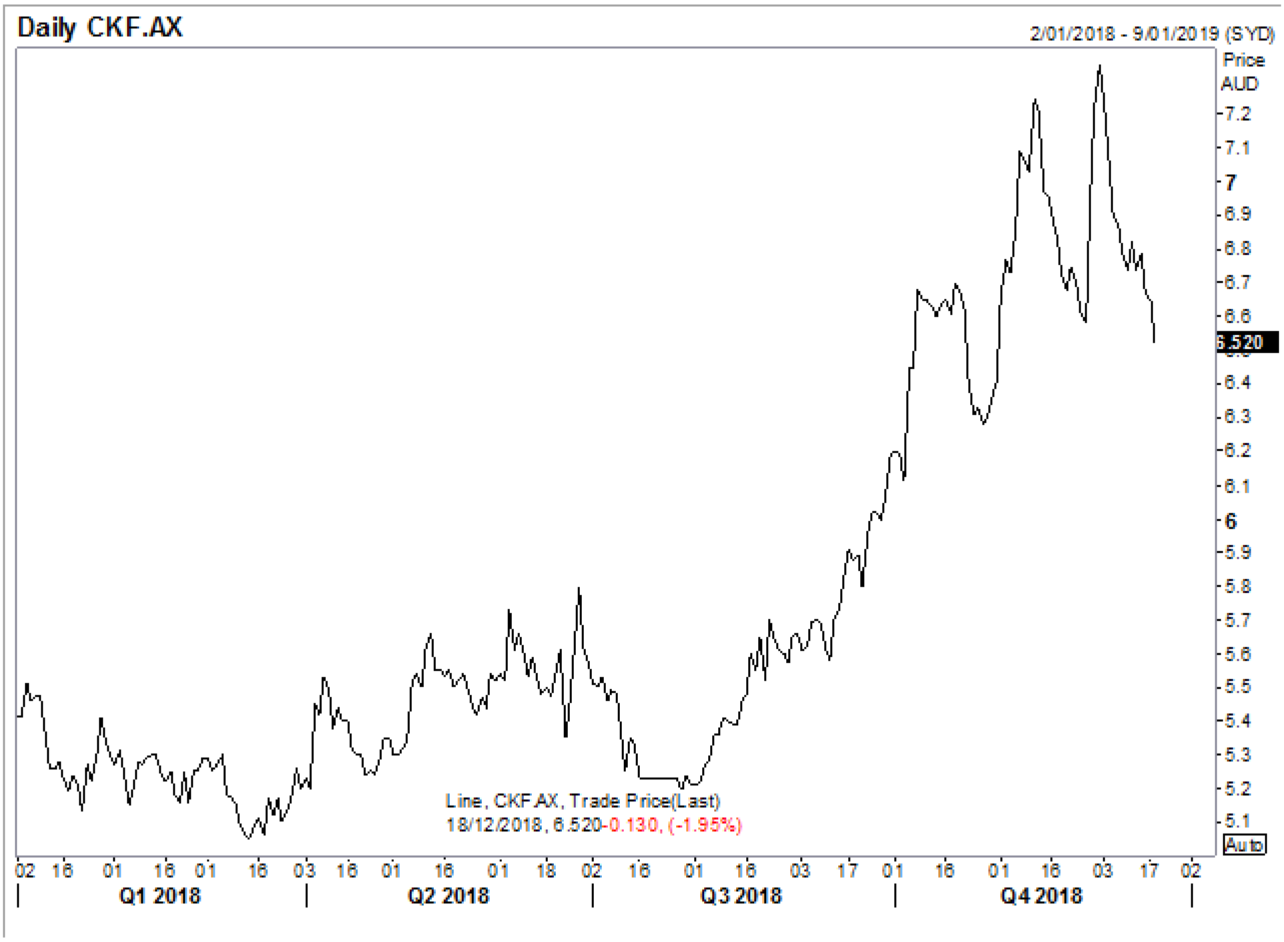
Perhaps what many fail to realise, is that much of the costs being loaded onto the banks will be passed on, meaning higher costs for borrowers. This should help support margins for the sector, and should make for upside rise in a sector where sentiment is depressed and valuations are around historic lows.

ASX 200 banks



Higher lending will also weigh on a heavily indebted consumer, and with a falling housing market also creating some 'bad vibes.' We do see wage growth coming through next year to help the situation, <u>but have largely stayed clear of consumer stocks in 2018, unless they have a particularly unique defensive offering</u>. We certainly felt this to be the case with KFC restaurateur **Collins Foods**, a stock which we made multiple buy recommendations on during the year. The company also has strong growth prospects in Europe, as well as a new domestic growth angle with the roll-out of Taco Bell. The stock has pulled back recently after making fresh all-time highs.

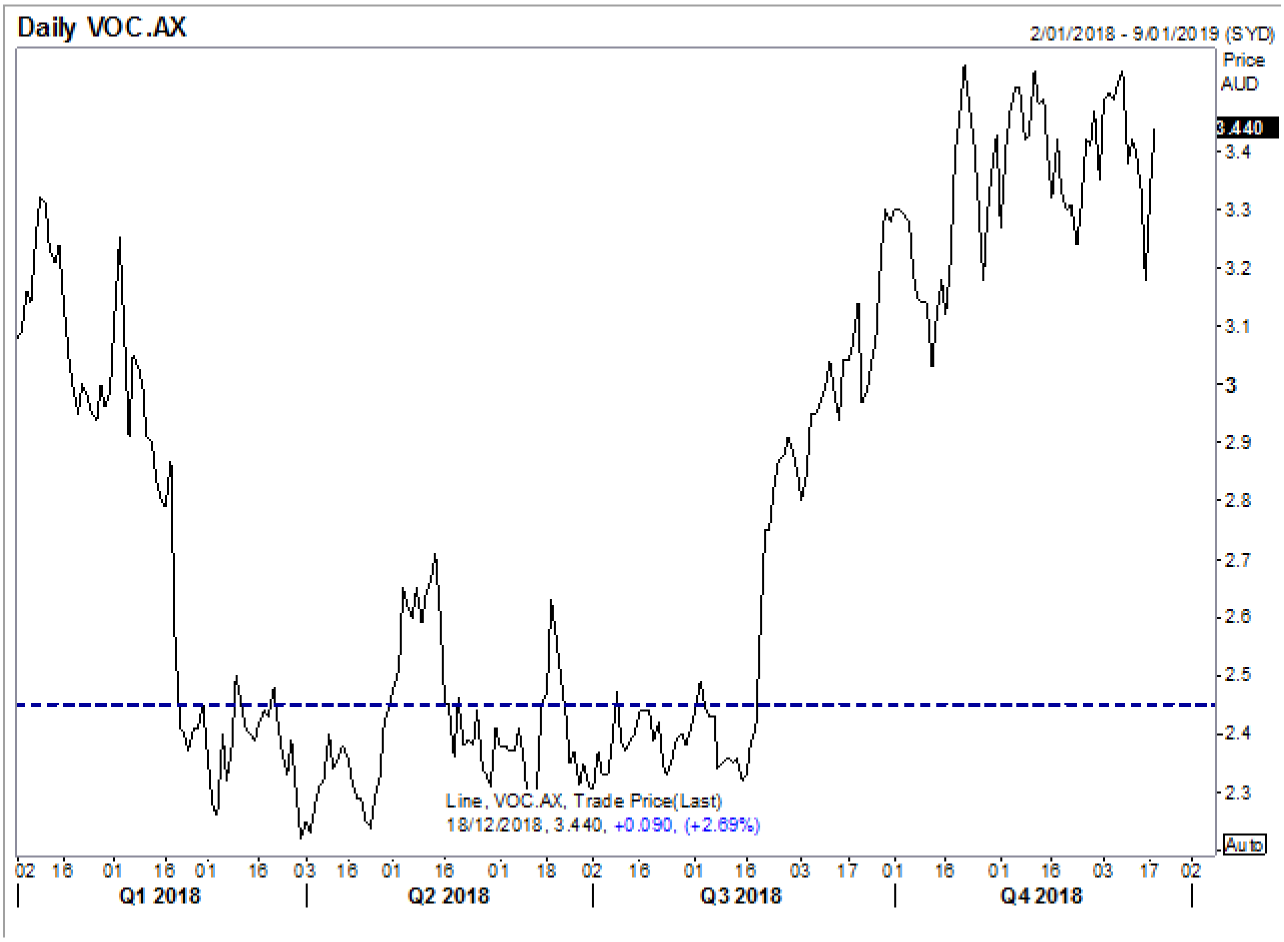
Collins Foods



The telco sector also held up well during the year as a defensive play. **Telstra** is finishing the year lower, but has been gaining ground since the lows in July as investors begin to appreciate the 5G angle. **TPG Telecom** has gone the other way following the regulators concerns about the tie up with Vodafone, but we believe that sense should prevail given a block of the deal would put Australia at odds with many other countries.

We went back into **Vocus** around $2.45 after an exit near the top ($7.75) some years ago and that ended up somewhat prescient, with the shares re-rated sharply in the months following our buy recommendation. We see much further earnings growth being squeezed out by telco turnaround guru Kevin Russell. Speaking of transformations, that at **Spark New Zealand** continues, with the company pushing into sports broadcasting. The shares hit all time highs recently.

Vocus – the right call



Portfolio movements

We remained mindful of the need for prudent portfolio management during the year, and particularly as volatility increased during the second half. We initiated sell or sell half recommendations 26 times in the Fat Prophets Australasian Equities Portfolio over the year, with gains having been reported on 19. The level of sell recommendations belied a cautious approach, and the number seen this year was almost double the average in previous years.

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 2018'). 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 were very selective with our new recommendations during the course of the year, and conscious of the increasing headwinds to the broader market.

The financial service platform stocks have not been immune to the sell-off, given high degrees of operating leverage. While volatile, Members that have taken up recommendations to buy the likes of **HUB24**, **Praemium**, and **OneVue** will have been reasonably positioned, and we believe the outlook remains promising given the thematic of a rising superannuation pot (the overall asset base is forecast to grow to $9.5 trillion by 2035). The Royal Commission is also likely to provide a boost, with an ongoing move to 'independent' providers.

Following this line, in June we added **Fiducian** which is a vertically integrated financial services player that provides investment services, financial planning services, information technology solutions, and accounting/accountancy resourcing to its customers. We like that the business has a similarly high operating leverage model with a reasonable cost structure and is set to benefit from the growing potential of the Australian Pension Industry.

Going forward, we remain of the view that the company can continue its momentum from a mix of organic and FA acquisition-related revenue growth, while the recent entry into the White Label Platform Market will create incremental sources of revenue growth. The only limiter, in our view, is if the domestic equity market falters substantially, causing slower than expected fund inflows.

With our belief that the Australian market will firm next year, Fiducian should be well positioned, and also as it continues to make opportunistic acquisitions. The company recently brought in another financial planning business which will take Funds under Management, Administration and Advice to $6.46 billion.

We initiated a high risk buy on **Sky Network Television** in October, having been wary of the company, and the shareholder value that had been destroyed over many years. This has also been as the likes of Spark New Zealand and Netflix have been strong disruptors. Our '180' turn was based on the view that the tide may be finally about to turn, with customer churn starting to stabilise, and the company also making important concessions to 'move with the times.'

A key element of any turnaround is new management, and there is also something on the offer here, with the company yesterday announcing the appointment of Martin Stewart as CEO. Mr Stewart is an extremely experienced (and relevant) replacement, who is well versed in the revival of 'satellite TV' operators, having helped drive growth for businesses in the UK, Europe, and the Middle East.

Mr Stewart was CEO of OSN, the leading pay TV network in the Middle East and was CFO of Sky in the UK when it launched its digital platform, and the company doubled its subscriber base in four years. He also "led the successful turnaround of Ono," a leading telecom operator in Spain, which is now part of Vodafone.

After finally relenting on pricing, the company has also made another important concession to 'move with the times' and provide an internet accessible set-top box which can operate via the cloud (rather than having to have one of the company's clunky aerials installed.) We believe these changes will be the key to further arresting the decline in the company's customer base, which still stands in excess of 750,000 (in a country with a total population under 5 million).

Sky also has a partnership with Vodafone (which Mr Stewart knows well) which it can also leverage. The attempts by the two companies to merge was blocked by the regulators last year, but having accepted this, we are sure that management(s) will look to further leverage their relationship, with both under attack from disruptors. While not without some risk, we expect the turning point for Sky will arrive in 2019 in earnest.

We provided updates on the Fat Prophets 'Income Portfolio' each quarter and the income yield since inception (as at 15th October 2018) in March 2012 stands at 24.2%, which is in addition to the capital growth of 15.9%. This makes for a total return of 40.0% 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 and 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 generally get it right more often than we get it wrong (and raise our hands when we don't.) The annualised return since inception on the Australasian Equities Report was 18.3% as at 30 September 2018, versus 8.2% for the All Ords over the comparable period.

The feedback from Members

If the results from our Member Survey for 2018 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. This is despite 2018 being a somewhat challenging year for markets.

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 again in 2018.

<u>The daily email was separately graded, and received an 'B+' which is a testament to the value placed on it by the majority of Members</u>.

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 plenty 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. We look forward to striving to further improve our offering for Members in the coming year. Work on a new Members' website is underway, and this will be unveiled in 2019. 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 2019 in the next report to be published on the 8th January 2019. As usual, these predictions will cover a range of topics. Signing off on 2018, 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: Spark New Zealand, Fiducian, HUB24, Praemium, OneVue, ANZ, Nufarm, Elders, Vocus, Woodside, Oil Search, Telstra, Spark New Zealand, BHP, Rio, South32, Evolution, Saracen, Nine, Domain and Collins Foods are held in the managed account portfolios. Domain, Nine Entertainment, Telstra, Nufarm, Oil Search, Praemium and Evolution are held in the Global Contrarian Fund.
