Clime International Fund

Quarterly Investment Report

September 2019

Clime
Integrity Transparency Conviction

Market Commentary

September 2019 Report

Introduction

Markets were volatile over the last quarter, reflecting investor concerns about the US-China trade war and slowing global growth. The mood of the global economy and financial markets is deteriorating: globalization and international trade is under threat; geopolitical risks are rising; negative real interest rates are advancing; and fears of recession are growing. In our view, a recession in the next year or two is far from inevitable, but the risks are greater than at any time since the GFC, and rates are likely to remain at ultra-low levels for a protracted time. For investors, this probably means lower expected returns from their investment assets.

The global economy has been patchy at best: the US and China have slowed to around-trend growth, but Germany, the world's fourth largest economy and the manufacturing powerhouse of Europe, is struggling. Unemployment rates in advanced economies are generally at decade lows, but there are few signs of any inflationary pressures. Markets see accommodative monetary policy as the only solution: cheap money is the means by which "the can is kicked down the road", putting off structural problems until tomorrow. With central bank policy rates so low, advanced economies will be poorly-equipped to counter a recession if one does occur. With the prices of risk assets up over the year, patience has proven to be a virtue so far, and risk taking has been rewarded. However, while we remain steadfast in our view that judicious stock picking will continue to add value, we expect broader asset returns will be below their long-term historical averages over the next few years.

Manufacturing sector struggling

Manufacturing activity is contracting across advanced economies, pointing to the impact of President Trump's trade policies. In the US, a key indicator measuring manufacturing activity in September recorded its lowest level in more than a decade, while global data showed the sector was declining amid fears that trade tensions will escalate further. Output was lower than a year earlier across all 36 advanced economies and sentiment indicators suggest the most geographically widespread manufacturing downturn for seven years.

The global Purchasing Managers' Index in September recorded its fifth month below the 50 mark, the level that divides expansion from contraction. This is the longest period that indicator has been so low since 2012. The PMI for the eurozone fell to 45.7 last month, its lowest reading since October 2012. The Institute for Supply Management index of US manufacturing activity fell more than expected to 47.8, its worst reading since June 2009.

As noted above, Germany is already confronting recessionary conditions, being the most vulnerable large economy to international trade. Germany's leading economic research institute has cut their forecast for economic growth for this year and next, blaming in part "the falling worldwide demand for capital goods." German GDP growth for the year is now forecast at just 0.5%. It can be argued that German industry is now in recession, and this will start to impact the service providers catering to those companies.

In the face of uncertainty and the unpredictability of President Trump, many companies are putting off investment decisions. Others are reckoning with the consequences of higher costs. Although manufacturing is only a small part of the global economy, it is one of the most volatile sectors and often acts as a leading indicator of global economic swings. The World Trade Organization has halved its estimate for trade growth this year, blaming "escalating trade tensions" for the cuts which it said would leave world trade volumes growing only 1.2% this year.

Financial markets

Financial markets have been rattled over the escalating trade war between the US and China as both imposed tariffs and counter-tariffs on imports. Yet despite that, the lack of income returns from cash or fixed deposits has mostly kept shareholders in the markets. Investors' search for "safety" has pushed bond yields to unprecedented low levels, with the yield on 30-year German Bunds turning negative for the first time ever. The US yield curve inverted once again, with yields on 2 year bonds briefly rising above those on 10 year bonds.

There are three factors markets are monitoring. First, markets abhor policy uncertainty, and geopolitical risk is on the rise: President Trump is a wild-card for markets, and inherently unpredictable; and events such as Brexit and the attack on Saudi oilfields are unsettling. Second, the risk of the trade war morphing into a more widespread global currency war is increasing as the US and China compete for global hegemony. And third, political pressures on central banks are mounting. The Federal Reserve has delivered a rate cut and ended quantitative tightening, but President Trump continues to pressure Chairman Powell to do more. Clearly Trump will want rates as low as possible, and the markets as high as possible, at least until the November 2020 Presidential Election.

Investment implications and central banks

What are the investment implications of these various factors? The fall in bond yields is concerning. The capital markets are being supported by ultra-dovish central banks, determined to do whatever they can to extend the economic cycle. To date, expectations of aggressive monetary easing have limited equity market downside in this highly uncertain environment: perhaps this could be called "the Powell Put".

Central banks might help to extend the cycle, but the power of any new measures, such as further lowering rates to almost zero, or purchasing ever more quantities of government bonds, will be less potent than in the past. Eventually, the artificially low cost of capital will either create bubbles in asset prices (we see it in bond markets already) or distort the behaviour of financial markets in ways we do not yet fully understand.

After a decade, central banks are still not observing the inflation they have targeted. Quantitative easing's boost to asset prices has quite possibly become counterproductive – widening wealth disparities, reducing yields and further lowering inflation. All this has been seen before – in Japan, which remains caught up in a decade-long deflationary spiral.

Global equity valuations look attractive when compared with the returns available from cash or bonds, but not when compared with their long term average earnings multiples. Using traditional valuation measurements such as earnings or cashflow multiples suggest equities are mildly overpriced, particularly if the global economy faces further risks of slowing. And yet even though equity valuations are "short of compelling", there are few alternatives that look attractive in this environment.

Market Commentary

Is more easing making the world weaker?

Cutting interest rates from already very low levels might suppress demand rather than stimulate it. In the decade since the GFC, central banks have implemented unprecedented monetary stimulus, both conventional and unconventional, in an effort to boost demand. However, these latter efforts have been largely ineffective and may even have been counterproductive.

On the positive side, lower rates make it cheaper to borrow, thus encouraging investment. Higher asset prices create a wealth effect, which encourages consumption. On the negative side, lower rates reduce income for savers. There are also psychological effects: businesses and consumers worry that if central banks keep lowering rates, there must be a recession in the offing, which undermines confidence. If potential borrowers anticipate further rate cuts down the line, they will defer their borrowing to a later date, thus the lowering of rates can be self-defeating.

On balance, it could be argued that further monetary easing may make the global economy weaker rather than stronger. Because of these offsetting effects, the overall impact of monetary stimulus is difficult to measure. In the US, for example, the shrinking importance of the manufacturing sector - which has fallen from 30% of jobs in the 1950s to 9% today - has reduced the benefit of lower rates in promoting capital spending.

Federal Reserve easing can help boost American exports by pushing the US dollar down, but this does not work if other central banks are trying to do the same thing. Note that the RBA Governor gave as one of his reasons for cutting Australian cash rates the importance of matching overseas cuts in order to keep the AUD from rising and compromising our export competitiveness.

The Australian economy is growing - slowly

The Australian economy is still growing – but very slowly, as evidenced by recent gross domestic product data. In fact, GDP growth is now the weakest since the GFC. Were it not for a big jump in exports due to the high iron ore price and strong government spending, the results would have been worse. The RBA's Governor Lowe remains optimistic that the growth rate will improve, yet he still felt it necessary to lower rates three times this year, justifying the cuts by pointing to the following factors:

- The Australian economy has been going through a soft patch. Over the year to June, GDP grew by just 1.4%, the slowest year-ended growth for some years. The RBA was surprised by the extent of this slowdown.
- While Australia has been less directly affected by the US-China trade disputes than some other countries, there is an indirect effect through slower global growth and increased global uncertainty.
- Over the past year, there has been no growth in consumption per person - unusual when employment is strong. Household disposable income has been increasing only slowly, reflecting subdued wage increases and growth in taxes.
- Slow growth in household income has led people to reassess their spending on discretionary items, which has been weak.
- As housing prices have fallen, there has been a sharp decline in housing turnover to the lowest level in 20 years. With fewer people moving homes, spending on furniture and household appliances has been soft.
- The drought has contributed to slower growth. In some areas, conditions have been the driest on record. Farm output in Australia has fallen for the past two years and there has been a sharp drop in farm income as farmers try cope with increased costs for feed and water.
- Over the past year, the Wage Price Index increased by just 2.3%. This is a pick-up from recent years, but the lift in wages growth has stalled recently.
- Low wages growth is one of the factors contributing to low inflation. Over the year to June, inflation was 1.6%, in both headline and underlying terms.

Continued jobs strength is somewhat surprising, given the soft economic conditions, weak retail indicators and fundamental headwinds, particularly in the construction sector. The lack of improvement in unemployment adds voice to the call for even further RBA rate cuts by the end of the year. However, the RBA may prefer to receive more data on how the stimulus to date is being received, alongside an update of their forecasts before moving rates again.

Oil shock quickly reversed

The attacks on 14 September on Saudi Arabia's oil facilities have put the oil market back in focus for investors and policy makers alike. The event was reported to have been the largest single supply disruption in the oil market for half a century, crippling half of Saudi oil production and temporarily halting production of approximately 5% of global oil production.
Surprisingly, the supply shock caused by the attacks had a relatively muted impact on the major equity and fixed income markets, and it remains to be seen what long-term impact, if any, the Saudi attacks will have on oil prices. At one end of the spectrum, the 1974 and 1990 oil price shocks had enormous long term consequences on inflation, interest rates and markets. This time, the response seems to have been amazingly short-lived and prices quickly reversed.

Concluding words

Your Manager is responding to the issues discussed above by adjusting portfolios and mitigating potential harm in many different ways. We are generally holding somewhat elevated levels of cash in most portfolios as a risk mitigation tactic, as well as to take advantage of volatility to invest in attractive stocks at discounts to value, should such discounts materialise over time. Our asset allocation and stock selection strategies will ensure that portfolios are well guarded against global market volatility. Furthermore, we are still finding ample opportunities to invest in high quality companies with sustainable competitive advantages – companies that we expect to grow and perform well through the economic cycle.

Bear markets generally coincide with recessions for good reason: during recessions, corporate earnings fall and investor appetite to embrace risky equities reduces. Yet in a world with such low rates available on savings, some argue that there is no alternative to investing in the capital markets.

In any event, and few can be confident in predicting the future, there are practical, sensible solutions to ensure investment portfolios are resilient. Strategies such as diversifying across asset classes, including cash (even if the return from cash is only marginal); ensuring asset allocation is fit for purpose; by focusing on high quality companies; and maintaining a focus on sustainable yield. These strategies have stood the test of time and will continue to do so in the future.

Adrian Ezquerro
Head of Investments

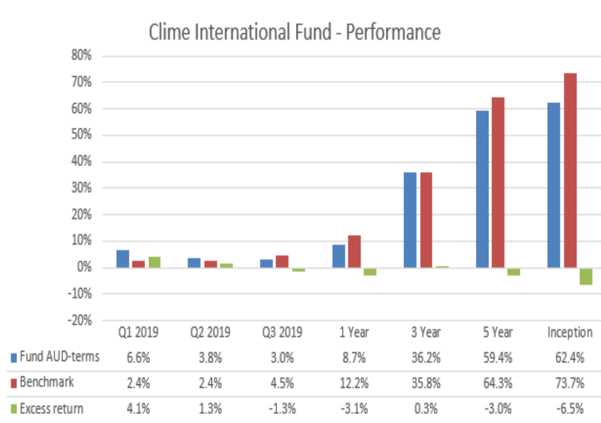
Clime International Fund

Investment Objective

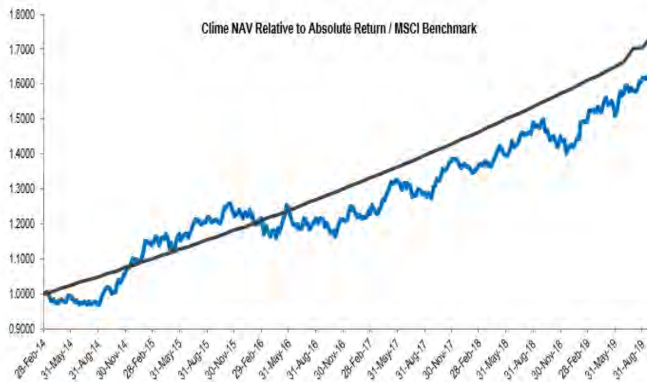
The objective of the Fund is to provide consistent capital growth and a growing level of income over the medium term (3-5 years) by investing in publicly-listed equity securities listed on a global basis, focussing predominantly on companies with a market capitalisation in excess of USD 1 billion. The Fund may not achieve its investment objective. Returns are not guaranteed.

Fund Peformance

Effective from 1st July 2019, the benchmark of the Clime International Fund was amended to the MSCI Index. Performance for the benchmark prior to this from inception of the fund is the 10% absolute return benchmark.



	Q1 2019	Q2 2019	Q3 2019	1 Year	3 Year	5 Year	Inception
Fund AUD-terms	6.6%	3.8%	3.0%	8.7%	36.2%	59.4%	62.4%
Benchmark	2.4%	2.4%	4.5%	12.2%	35.8%	64.3%	73.7%
Excess return	4.1%	1.3%	-1.3%	-3.1%	0.3%	-3.0%	-6.5%



Top performers over the quarter are highlighted below:

Total Returns in AUD from 30th June 2019 to 30th September 2019	
Alphabet	17.2%
Medtrnic	17.1%
Booking Holdings	8.9%

Some noticeable weak performers during the quarter are highlighted in the table below:

Total Returs in AUD from 30th June 201 to 30th September 2019	
Fresenius Medcal Care	-10.1%
Facebook	-4.1%
Tencent	-3.1%

Positions Purchased

Bought Intercontinental Hotel Group

Intercontinental Hotels Group (IHG) has a very strong brand across its portfolio with the Holiday Inn Brand the largest hotel brand in the world.

The company is well positioned in all major markets with their predominant focus on the Americas region.

We expect IHG's growth opportunities in Asia to meaningfully contribute to the group's earnings potential over the next decade and beyond.

IHG has an attractive recurring-fee business model with low capital requirements.

The asset-light business model generates about 95% of its cash flow from franchised and managed hotels with these two segments making up 99% of rooms in the group.

Growth in global spending on travel and tourism, in inflation adjusted numbers, is accelerating per the graph below and IHG should continue to gain market share in the hotel category.

Chart 4: Global travel & tourism industry real inflation adjusted revenues ($ in trillions)

Source: World Travel and Tourism Council

Intercontinental generates close to 50% return on capital and the free cash flow yield of 5.5% is in line with the average free cash flow yield of the fund.

If our forecasts are accurate the average free cash flow yield for the group over the next 5 years would be close to 6,8% from today's share price levels.

Analysing both return on invested capital as well as IHG's the ability to distribute free cash flow back to shareholders the company has a very impressive track record.

By example IHG has returned in free cash flow close to 60% of its market capitalisation for an investors who initiated a position in the stock in mid 2013.

We believe this dynamic will continue for the foreseeable future.

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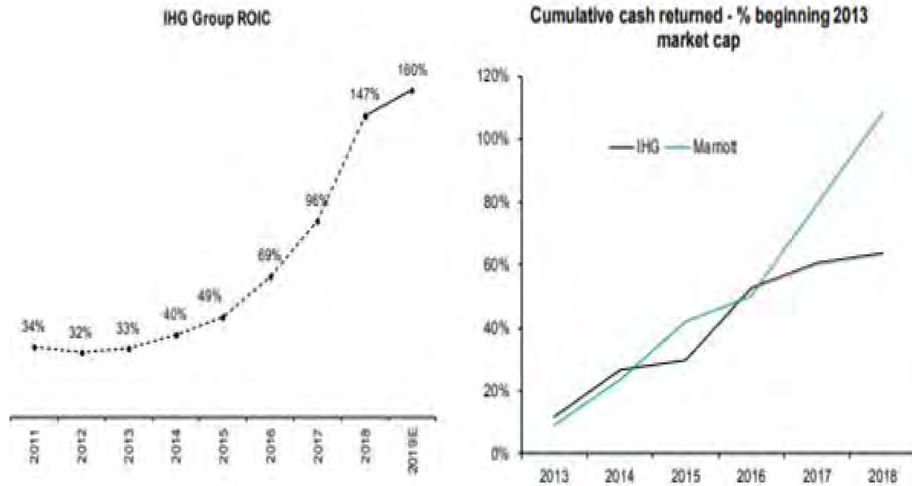
Asset-light hotel businesses generate 100% ROIC, and can return substantial cash to shareholders



Added Johnson & Johnson

Position added to on weakness. With the stock moving sideways over the last 18 months and the company forecasting high single digit growth in earnings and free cash flow over the next few years the valuation has improved to the point where we are comfortable owning a bigger position in the fund.

Added to Fresenius Medical Care

We added to Fresenius Medical Care following a pull-back in price subsequent to their results. Fresenius reported results with organic growth of 4.4%. Whilst the core Dialysis business outperformed expectations, driven by a healthy US dialysis performance, group adjusted operating profits declined 12.1% year-on-year on a comparable basis, primarily the result of an accrual reversal related to the recognition of revenues from Medicare's End Stage Renal Disease Seamless Care Organisation (ES-COs). Nevertheless, long-term we see appealing value given improving treatment growth in the US and increasing exposure to the fast-growing home dialysis market. The valuation is also at a multi-year low which reflects in our opinion a slower growth trajectory than what management promised two years ago.

Added to SPDR Gold Trust Gold Shares

The rally in bonds leading to an estimated 17 trillion dollars of negative yielding corporate and gov-ernment bonds might lead to a panic in to gold as a default asset class. Our view is that gold is well supported at these levels both as a hedge against volatility as well as a hedge against dollar weakness should the trade war escalate in to a full blown crisis.

Market Commentary

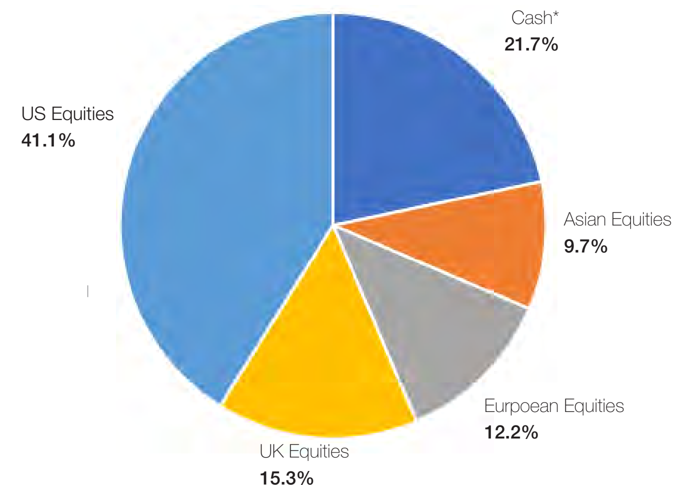
With Brexit, the US-China trade war, and the real threat of recession looming large, equities ex-peri-enced a quarter of uncertainty and bond yields plunged. These risks were well-flagged though, and our defensive position protected portfolios from the worst of the storm. As central banks kept borrowing conditions supportive for business growth, investor concerns were eased, and markets were back on an even keel by quarter-end.

Global interest rates are likely to remain lower for longer, and these low rates could even be-come a permanent feature of capital markets. This is good news for business, and for govern-ment spending, and might mean the difference between a full-blown recession and a mere slow-down in economic growth. But even if we are headed for a global recession, the fact that we're neither in the middle of a banking crisis or a valuation bubble means there are lower associated equity losses.

Equities are not obviously mispriced, but it is critical that earnings growth is achieved for the as-set class to provide acceptable returns from here. The threat of a slowing economy will make this harder to deliver.

While corporate profit margins remain high due to low historical wage growth, lower effective tax rates, and the demand boost in the US from the fiscal stimulus, this is unlikely to continue, which increases the risk of company-specific disappointments.

Asset Allocation



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Snapshot

Portfolio Return (1 year) Wholesale	Portfolio Return (1 year) Retail	Fund Size (Wholesale)	Fund Size (Retail)
8.9%	8.7%	$96.2m	$4.8m

Performance (30/09/19)

	1 month	3 months	6 months	1 year	2 years*	3 years*	Inception*
Wholesale (AUD Portfolio Return)	0.4%	3.1%	7.2%	8.9%	11.9%	11.3%	9.4%
Retail (AUD Portfolio Return)	0.4%	3.0%	7.2%	8.7%	11.4%	11.0%	7.5%
Benchmark	2.0%	4.6%	7.1%	12.3%	11.2%	10.8%	10.4%

Inception: Wholesale Units: 4 March 2014. Retail Units: 11 March 2015.
*Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes. Performance figures compare unit price to unit price for the given period. ** 10%p.a. from 4 March 2014 and then MSCI World Net Total Return Index in AUD from 1 July 2019.

Distributions

Period Ended	Wholesale Units (cents per unit)	Retail Units (cents per unit)
30 June 2019	8.2959	7.1365
30 June 2018	5.5659	4.5878
30 June 2017	3.9597	3.3798
30 June 2016	9.0831	7.5602

Top 5 Holdings

Stock	Ticker	Weight
SPDR Gold Shares ETF	GLD US	5.6%
Microsoft Corporation	MSFT US	4.9%
Medtronic PLC	MDT US	4.8%
Roche	ROG	4.5%
Allergan	AGN	4.3%

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