Ausbil Australian Emerging Leaders Fund

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Monthly Investment Report

July 2018

ausbil

Australian equities

Performance review

Fund performance for July 2018 was -0.75% (gross of fees) versus the benchmark return of 0.65%. The benchmark is represented by a composite of 70% S&P/ASX MidCap 50 Accumulation Index and 30% S&P/ASX Small Ordinaries Accumulation Index.

At a sector level, the Fund benefited from an overweight position in the Industrials sector. The underweight positions in the Energy, Consumer Staples, Information Technology and Real Estate sectors also added value. Conversely, an overweight position in the Materials sector detracted from relative performance. The underweight positions in the Consumer Discretionary, Health Care, Financials, Telecommunication Services and Utilities sectors also detracted value.

At a stock level, the overweight positions in Downer, Sims Metal Management, Cleanaway Waste Management, Beach Energy and Fairfax Media contributed to relative performance. The underweight positions in Carsales, Whitehaven Coal and Xero also added value. Conversely, the overweight positions in Evolution Mining, WestGold, Independence Group, Metals X, Altium, Western Areas and Cimic Group detracted from relative performance.

Equity Market Review

The Australian equity market had a positive month, to return 1.3%, driven primarily by the Consumer Discretionary and Financials sectors. Globally, Developed (MSCI World: +3.1%) markets outperformed Emerging (+2.3%) markets but both remained in positive territory despite higher volatility. Within Developed markets, US (S&P500: +3.7%) and Europe (EURO STOXX: +3.5%) outperformed, while the UK (FTSE100: +1.5%) lagged.

Domestically, large-cap stocks (S&P/ASX 20 Accumulation Index: +2.9%) outperformed. Small-cap stocks (S&P/ASX Small Ordinaries Accumulation Index: +1.4%) were almost in line with the overall benchmark, whilst mid-cap stocks (S&P/ASX MidCap 50 Accumulation Index: +0.1%) underperformed.

Energy was mostly lower (Thermal Coal: +5.4%, LNG: -5.8%, WTI Oil: -7.3%, Brent Oil: -7.0%, Metallurgical Coal: -13.2%) Metals were mixed (Manganese: +26.3%, Iron Ore: +4.9%, Aluminium: -4.3%, Copper: -5.2%, Nickel: -6.0%, Zinc: -7.9%, Cobalt: -11.0%). Precious metals were softer (Silver: -3.4%, Gold: -2.1%, Platinum: -1.3%).

Telecommunication Services (+7.6%) outperformed. Industrials (+3.2%) was boosted by Commercial & Professional Services (+5.7%) and Capital Goods (+5.3%). Health Care (+2.2%) benefited from Pharmaceuticals & Biotechnology (+2.4%). Financials (+2.0%) outperformed over the month driven by the Banking sector (+2.7%). Consumer Discretionary (+1.8%) also outperformed, while Energy (+1.2%) and Real Estate (+1.0%) were slightly behind. The underperforming sectors were Materials (-0.3%), due to relative weakness from the Metals and Mining sector (-0.4%), Consumer Staples (-0.9%), Information Technology (-1.1%) due to expensive valuations and Utilities (-1.4%) due to perception of higher regulatory risk.

Economic review

Equity Market Outlook

The corporate profit reporting season is set to take centre stage in August. The Metals & Mining and Energy sectors are likely to come under the spotlight, as commodity prices have moderated over the past six months and higher costs have been flagged. Investors will be particularly alert to results from companies exposed to the domestic Consumer sector, which is facing strengthening headwinds in the form of declining house prices, rising indebtedness among consumers and benign wage growth. More broadly, the ongoing trade dispute between the US and China continues to overshadow the market. The prospect of a negotiated settlement has suffered a setback with the latest warning from China that it will target an increased number of US exports if the US presses ahead with plans to impose tariffs on a wider range of Chinese imports.

Fund Strategy

The smaller cap Resource sector underperformed during the period as macro uncertainty dominated. Commodity prices also remained under pressure during the month, compounding the negative sentiment.

Fund positions were increased in the Capital Goods, Telecommunication Services and Commercial Services sectors. Positions were tactically reduced in the Health Care, Metals & Mining and Consumer Discretionary sectors. The Fund also maintains modest cash levels to be ready to take advantage of market opportunities. The growth tilt in Materials and US$ earners remains evident in the portfolio positioning whilst underweight tilts continue to many of the defensive sectors including the Real Estate and Utilities sectors.

Consensus EPS estimates for the S&P/ASX MidCap 50 Index forecast earnings growth at +9.0% for FY19 and +5.0% for FY20 which delivers PE valuations of 20.6x and 18.8x for 2019 and 2020 respectively, with a dividend yield of 3.4%. For the S&P/ASX Small Ordinaries Index, consensus EPS forecast earnings growth rates are +22.7% for FY19 and +18.1% for FY20 with PE valuations sitting at 17.5x for FY19 and 14.8x for FY20, with a dividend yield of 3.3%.

Economic Review

Risks of an intensifying global tariff war were markedly reduced after European Union Commission President Junker and US President Trump agreed to “work together toward zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods”. US real GDP growth surged to an annualised rate of 4.1% in the June quarter, following an upward revision of the March quarter result to 2.2%. Averaging the last six months, real growth has accelerated to 3.1% in the June quarter, up from 2.6% in the December quarter of 2017.

The European Central Bank left policy unchanged and “took note” of the positive meeting between President Trump and his EU counterpart. ECB President Draghi was quick to point out that it was “a good sign”. Forward guidance was adjusted slightly to “convergence of inflation to rates that are below but close to 2% over the medium term”, from “evolution of inflation remained aligned with current expectations of sustained improvement”.

Chinese authorities aggressively eased policy settings due to slower economic activity and tightening financial conditions. The State Council agreed to make fiscal policy more “proactive” and to keep liquidity conditions “reasonably adequate”. The Bank of Japan introduced greater flexibility into its monetary policy operations, lowered its inflation forecast and retained its GDP macroeconomic forecasts. The BoJ will be reducing the size of financial institution excess reserve balances currently subject to a negative interest rate. It will resize its equity ETF purchases and will continue to target a 10-year bond yield of zero, responding promptly to any large deviations.

The Australian Labor Party benefited from ‘Super Saturday’s’ five by-elections. The seats of Braddon in Tasmania and Longman in Queensland were expected to be close, but resulted in comfortable wins for Labor. Headline inflation rose by 0.4% in the June quarter, with the annual rate rising to 2.1%. The average of the RBA’s underlying inflation measures was steady at 0.5% with the annual rate at approximately 1.9%, just below the lower end of its target band.

Economic outlook

Economic Outlook

2018 will see ongoing synchronised global growth at a robust 3.9% plus pace compared to the post-crisis period average of 3.3%. The US economy accelerates to between 2.7% and 3%, as fiscal policy drives a capital expenditure investment boom. The Eurozone consolidates at 2.3%, Japan maintains a positive output gap growing at 1.4%, and China remains focused on 'high quality' growth in achieving its 6.5% target.

Cash rates and bond yields continue to rise at a modest and gradual pace, with the US Federal Reserve hiking 3 maybe 4 times, taking the cash rate to between 2.25% and 2.50%. On auto pilot, there is ongoing 'quantitative tightening' as US$480bn of bonds mature in 2018 and US$600bn in 2019 and 2020 respectively. European Central Bank QE tapering is extended and volume is reduced in stages from €30bn per month to zero, with rates on hold until Q3 2019. The Bank of Japan is expected to shift its target bond yield rate later this year and again in 2019.

US dollar appreciation leads to a modest tightening in financial conditions and the Euro depreciates on ongoing QE. The currency and rate adjustments should see developed equity markets outperform, while the peripheral emerging markets underperform. The risk of contagion flowing into the core emerging markets seems limited, but is a risk requiring monitoring.

The Australian economy is entering a record 27th year of uninterrupted growth, with unemployment heading lower and core inflation a little below its target range. GDP growth is forecast to be 2.7% to 3.0% in 2018, rising to 3.1% in 2019 as growth transitions to the non-mining sector and broadening business activity offsets potential downside risk from indebted households. The unemployment rate is expected to trend lower to 5.1% and core inflation to rise to 2% in 2018. Broadening economic growth and higher wage and inflation outcomes should see a tightening cycle commence. The timing has been pushed out to Q3 2019 from Q4 2018. Reflecting the themes voiced by RBA board members: (1) the next interest rate move will be up, but not just yet; (2) the Reserve Bank should be a source of stability and confidence; and (3) expect a slowing in housing credit growth from tightening mortgage lending standards. Meanwhile an unchanged cash rate should place downward pressure on the Australian dollar as the interest rate differential moves further in favour of the US. The currency is forecast to test the lower part of the 72-78 US cent range before closing at 75 US cents by year-end 2018 and 2019.

Downside risks to the global economy include challenges to existing trade arrangements, instability in the euro area and possible global negative feedback from US Federal Reserve benchmark rate increases. The Australian economy may be at risk from an exogenous shock to the highly indebted household sector stemming from: (1) liquidity constraints from out-of-cycle housing rate increases; (2) ongoing low nominal wages; (3) rising living costs for energy; (4) a negative change in the employment outlook; (5) further tightening in lending standards and slower credit growth; and (6) a change in government.

Fund overview

Fund Returns

Period	Fund Return % Gross	Fund Return % Net	Benchmark[1] %	Out/Under Performance % Gross	Out/Under Performance % Net
1 month	-0.75	-0.81	0.65	-1.40	-1.46
3 months	-0.01	-0.19	3.70	-3.71	-3.89
6 months	3.40	3.02	4.42	-1.01	-1.39
FYTD	-0.75	-0.81	0.65	-1.40	-1.46
CYTD	2.53	2.08	4.16	-1.63	-2.08
1 year	21.96	21.06	19.32	2.64	1.74
3 years pa	13.74	13.03	14.91	-1.16	-1.88
5 years pa	14.38	13.25	13.97	0.41	-0.72
7 years pa	11.07	9.88	9.69	1.38	0.19
10 years pa	9.63	8.24	6.36	3.27	1.88
15 years pa	13.68	12.18	9.67	4.01	2.51
Since inception pa Date: April 2002	13.24	11.77	9.52	3.72	2.25

Top Ten Stock Holdings

Name	Fund %	Index[1] %	Tilt %
BlueScope Steel	5.44	3.12	2.31
Alumina	5.11	2.12	2.99
Downer EDI	5.06	1.44	3.62
Tabcorp	4.03	3.02	1.02
a2 Milk Company	3.68	2.24	1.44
Iluka Resources	3.45	1.54	1.91
Evolution Mining	3.35	1.28	2.07
Sims Metal	3.19	0.45	2.74
OZ Minerals	3.10	0.95	2.16
Boral	3.08	2.51	0.58

Fund Sector Tilts

Name	Fund %	Index[1] %	Tilt %
Energy	2.00	3.26	-1.26
Materials	46.52	24.41	22.11
Industrials	17.73	13.01	4.72
Consumer Discretionary	9.83	15.40	-5.57
Consumer Staples	5.68	6.46	-0.77
Health Care	2.53	6.92	-4.39
Financials	5.08	13.71	-8.63
Information Technology	3.64	7.95	-4.32
Telecommunication Services	0.96	1.47	-0.51
Utilities	0.00	2.30	-2.30
Real Estate	0.00	5.10	-5.10
Cash	6.02	0.00	6.02
Total	**100.00**	**100.00**	**0.00**

1. The benchmark is represented by a composite of 70% S&P/ASX MidCap 50 Accumulation Index and 30% S&P/ASX Small Ordinaries Accumulation Index.

Fund activity

Fund activity

Major Purchases and Sales

Purchases	Sales
Cimic Group	Cochlear
TPG Telecom	Nufarm

Over the month, the Fund purchased holdings in Cimic Group and TPG Telecom. The positions held in Cochlear and Nufarm were sold during the period.

Cimic Group (CIM) is a major global provider of construction, mining & minerals processing, engineering and operations & maintenance services. The company is well positioned to achieve strong revenue growth across its business operations, led by the recovery in the resources sector and increased infrastructure spending on Australia's east coast. CIMIC presently has a substantial amount of work on hand, and continues to achieve further contract wins. These are supportive of the company's earnings prospects.

TPG Telecom (TPM) is a telecommunication services provider with a strong broadband business operation. Its corporate business unit, which is highly leveraged to increased utilisation of the fibre network, represents an opportunity to drive stronger revenue growth. An earlier network deal with Vodafone provided TPG with a significant extension to its fibre footprint. The NBN poses a significant risk to TPG's margins, however network expansion in regional and rural markets represents an opportunity to substantially expand market share. TPG's business is highly cash generative, but entry into the mobile market may require a substantial near-term capital investment.

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