AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive 17th July 2015

Segmenting the Market

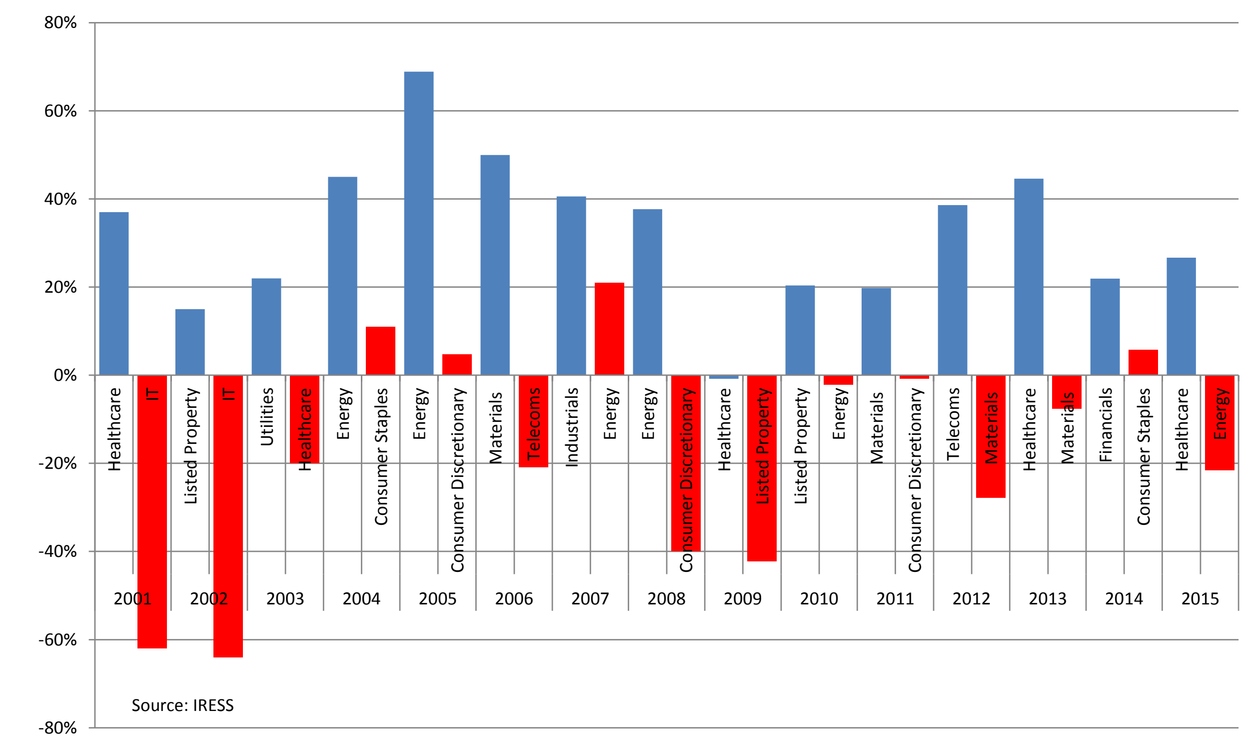
As the 2015 financial year drew to close last fortnight, casual readers of the financial press may have had the impression that 2015 has seen a large degree of variation in the returns with the falls in oil in October and Greek Financial Crisis V2.0 in June. Contrary to the headlines which have reported the end of the mining boom, European financial crises and a weak domestic economy, the 2015 financial year has been average in terms of the dispersion of returns between the sectors. In this week's piece we are going to be discussing the performance of the different industry sectors in the market both over the last 12 months and since 2000.

Why Sectors are Important

As equity portfolios are constructed by blending individual companies rather than investing directly in industry sectors, one could question why we would look at the performance of an individual sector. The reason we look at the performance of sectors is to get a sense of the overall health of an industry, divorced from the company-specific factors (such as management decisions good and bad) that may be impacting an individual company's share price. For example, energy stocks have performed poorly in 2015 and if we were holding an energy company in the portfolio that was still performing well; as the portfolio manager I would be asking the analyst why a downgrade to earnings is not imminent and whether we should be short that stock!

Furthermore, by measuring the performance of stocks in the portfolio against the overall return of their industry, investors can determine whether a manager has stock-picking skill or just happens to own companies in a hot industry. For example the largest bank position in the fund, Commonwealth Bank (+10%) outperformed the wider bank sector that gained 5.6% over the past 12 months.

Top & Bottom Performing Sectors by Financial Year



Dispersion normal in 2015

Whilst the last 12 months might have felt pretty bruising for investors, the difference between the best performing sector (Healthcare +27%) and the worst (Energy -22%) was only in-line with historical averages. Excluding the carnage post the pricking of the dot.com bubble, the average spread has been 46%, with the largest deviations occurring in **2006** (Materials +50%/ Telecoms -21%), **2008** (Energy +38%/Consumer Discretionary -40%) and **2012** (Telecoms +39%/Materials -28%).

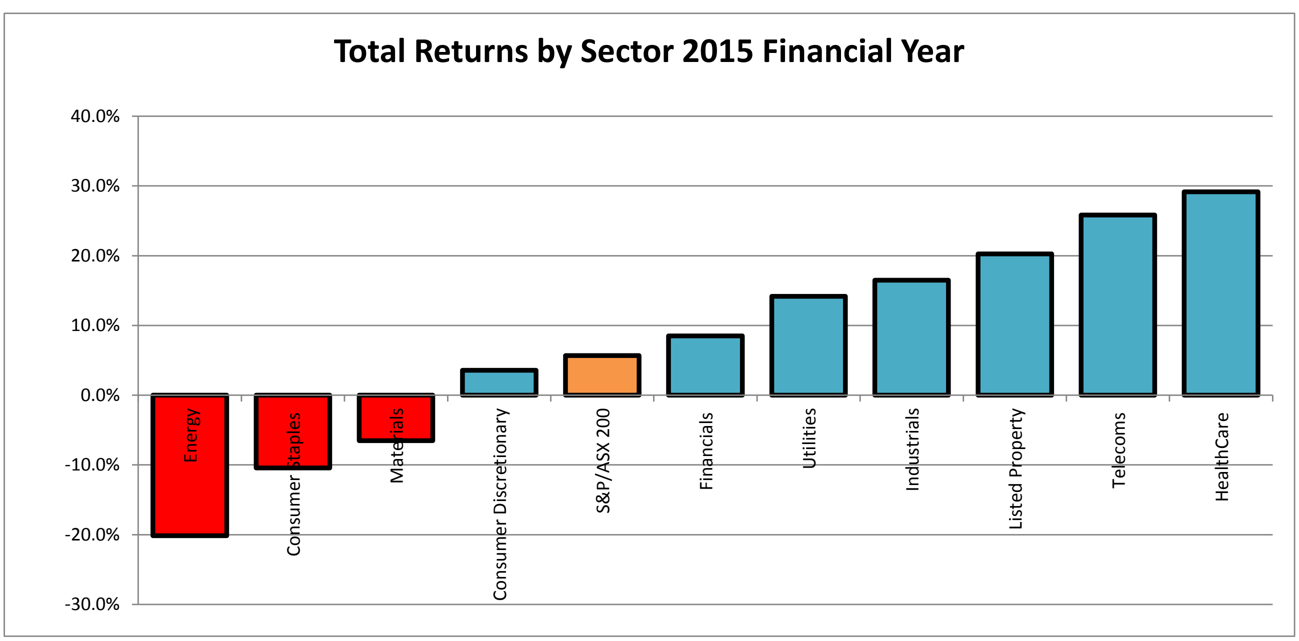
The periods of greatest return differentials occurred when an external event pushed a particular sector against the prevailing winds in the financial markets. In 2006 despite the ASX posting a broad-based gain of +24%, Telstra fell 20% due to increased competition and regulation, as new CEO Trujillo took an aggressive approach towards the telco's regulators. The deviation in 2008 occurred due to oil rising from $50 per barrel in early 2007 to $140 per barrel in the summer of 2008 (due to a combination of speculation and militant attacks on oil facilities in Iraq and Nigeria), despite the initial stages of the GFC hammering most equities.

Similarly in 2012, the underlying equity market was weak after commodity prices re-rated from the artificial highs created by Hu Jintao's 2008 $586 Billion stimulus plan. This plan resulted in artificially high demand for in Australian iron ore that was used to build structures such as the luxury 312 room Tangshan Grand Metropark Hotel. This hotel (which I have visited several times), was built in 2011 by a local steel company under the direction of the government, in a generally tourist-free gritty steel town 180kms west of Beijing. Conversely in 2012 Telstra (+37%) outperformed the market by 44% after several years of underperformance as management outperformed low expectations, maintained the dividend and allayed concerns about structural separation.

2015 Report Card

The top performing sectors in 2015 have been **Healthcare** driven by Ramsay (+37%), CSL (+32%) and Resmed (+35%), all of which have benefited from a falling AUD (down -18%) and defensive, albeit expensive earnings. **Telecoms** were strong with Telstra (+24%) looking quite pedestrian when compared to the second tier telcos such as TPG (+65%) and iiNet (+33%) which benefited from takeover activity. **Listed Property Trusts** were strong across the board from offshore buying due to the yield differentials between Australia trusts (5.0%) and their European (3.2%), US (3.3%) and Asian (2.8%) counterparts. Indeed the worst performing trust Mirvac (+9%) was even ahead of the ASX 200's return. Heavyweight Westfield (+30%) and Goodman (+29%) led the change in the sector assisted from a falling AUD.

Conversely the worst performing sector was **Energy** after USD price per barrel of oil declined -44% and the biggest impact was felt by companies still building LNG projects like Santos (-42%), rather than the producers Woodside (-9%) whose earnings were cushioned by a falling AUD. The normally stable **Consumer Staples** sector declined after investor concerns about declining margins in the grocery market due to Aldi and a reinvigorated Coles/Wesfarmers (-2%), impacted Metcash (-56%) and Woolworths (-20%). The **Materials** sector fell -7% on declining commodity prices though with a significant dispersion of returns; Newcrest (+24%) netted off against Arrium (-77%), Fortescue (-53%) and Bluescope (-44%). Heavyweights Rio (-5%) and BHP (-12%) performed roughly in line with the sector return, BHP lagging due to its oil and gas exposure.



Aurora's View

The dominant investing themes in 2015 were falling commodity prices and the global hunt for yield, with global investors being the marginal buyers having the greatest influence in setting prices. Foreign investors hunting for yield are only concerned about the headline yield offered by a company, rather than its after tax return as they gain no benefit from Australian franking credits. The sectors that outperformed in 2015 were dominated by sectors comprised of companies that do not pay Australian taxes namely; Healthcare (offshore earnings/low dividends), Listed Property (Investment Trusts so no tax) and utilities (minimal taxes paid).

Consequently, 2015 was a very tough year for a fund manager seeking to maximize after tax returns through accumulating additional franking credits. However, we strongly view that franking credits not only provide additional after tax returns for domestic investors, but the actual payment of taxes on earnings provides us with a strong signal as to the quality and sustainability of a company's earnings. Obviously no company is paying tax (and generating franking credits) on artificially inflated earnings and we note that in 8 of the last 12 years, the top performing industry sectors have been comprised of companies that pay franked dividends.

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Aurora Funds Management Limited is a fully owned subsidiary of ASX listed, Keybridge Capital (ASX Code: KBC). Aurora is a boutique investment manager that was established in 2003, and has established a long track record of producing risk adjusted returns for retail, institutional and high net worth investors. The investment strategies are offered through both ASX listed investment vehicles and managed funds. They aim to deliver income whilst also managing the risks associated in investing in Australian and global equities.

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- **Aurora Absolute Return Fund (ASX code: ABW)**
- **Aurora Fortitude Absolute Return Fund**
- **Aurora Global Income Trust (ASX code: AIB)**
- **Aurora Property Buy-Write Income Trust (ASX code: AUP)**

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