

REPORT TO THE UNIT HOLDERS IN THE ASPIRING FUND FOR THE
MONTH FEBRUARY 2018

	Aspiring Fund	NZ50G	ALL Ords Accumulation Index (rebased in NZ\$)
<u>Short-term returns</u>			
Month	-2.54%	-0.81%	-1.21%
Last 3 Months	-0.49%	2.28%	-0.64%
Last 12 Months	10.35%	16.83%	12.51%
Financial Year to Date	8.38%	16.36%	6.24%

Long-term* returns and volatility

Return (annualised)	10.79%	6.68%	2.85%
Return volatility (annualised)	8.65%	11.51%	16.21%

* since the introduction of the PIE Tax regime, 30 Sept 2007

Unit Price \$3.4663

ASSET ALLOCATION (approximately):

New Zealand Equities	34.1%
Australian Equities	20.3%
International Equities	14.1%
Bonds	3.3%
Total Cash	28.3%
Short Equities	-1.1%

Net Asset Value of the Fund (approximately): 388.0m

Fund Performance



We had a difficult month in February resulting in a disappointing -2.54% return for the Fund.

February was one of the more extraordinary months we have seen for a number of years.

Headline market returns for the month, both locally and internationally, mask much more newsworthy stories underneath.

The key event of the month, and perhaps for the last year, was the return of volatility and a sharp global equities sell-off at the beginning of the month. The MSCI World Equities Index was down ~4% in February after falling 8% at its intra-month lows. International market moves were US led, with a Flash Crash in the last few hours of trading on February 5th driving US equities down 4% on the day. Importantly it was broad-based weakness with both defensive and growth stocks hit hard. While the immediate cause was generally considered to be the demise of some short volatility funds, the breadth of the sell-off signalled a step-up in investor risk aversion.

Given the easy gains US markets experienced in January (NASDAQ +7%, S&P500 +6%) the strength of the recovery in the back half of February was a surprise to us. This was most apparent in the technology heavy NASDAQ index which rallied ~10% off its lows to finish down 2% for the month but 5% up for the calendar year. Growth remains in vogue.

At the time of writing, 2018 calendar year to date returns for International shares generally remain positive following the 'one way bet' that was 2017 equities performance. So, nothing new to see here?

We are not so sure. The era of low bond yields providing a zero-gravity influence on investors accepting ever expanding share valuations (price/earnings ratios) is likely to be over. In the absence of earnings multiple expansion future returns will be more influenced by earnings growth and dividend income.

Against a back drop of a 4% decline in offshore equities markets, higher volatility, and rising long bonds, a likely outcome would be for NZ equities to perform poorly in the month. The truth was they did and they didn't.

The NZ50 index was down only 0.8% in February (-1.2% when adjusting CBL's share price to zero, compared to the NZ50 return which includes CBL at its last price of \$3.17).

More reflective of offshore markets, the average return of companies in the NZ50 was down 3.3%.

To put the broad-based weakness of NZ equities in context, of the 50 companies in the NZ50 index only 7 companies had positive returns, while 28 were down by 4% or more. This diverse group included; Comvita (-15%), Heartland Bank and Metroglass (both down 12%), Chorus, PushPay, and Z Energy (down 9%), Freightways and Mercury Energy (down 8%), Sky City and Mainfreight (down 6%), and Spark (down 7%).

Interestingly, the weakness did not discriminate between the many companies who reported in-line results and those who did not report at all. We are starting to see opportunities in defensive yield names where current and prospective yield provides a decent buffer over interest rates available in the bond and money markets. Many of these are being sold by international investors who believe the yield trade is over. Given the size of their flows we are quiet accumulators on weakness rather than aggressive buyers.

The reason for the large difference between the return of the NZ50 Index against the majority of the market was the large initial index weight of A2 Milk (7.4%), and thus the material contribution it made to the index return from its staggering 44% return in the month. A2 contributed +3.25% to the NZ50 return, following a stunning result and the capitulation by Fonterra to support its brand and A1-free milk type. The magnitude of A2's rise, which made it New Zealand's biggest listed company by month end, is likely to seal its entry into major world indices. If it does so, we expect more fireworks as the increasing influence of passive index tracking funds sees a surge of price insensitive buying (and selling for the company that may have to make way for A2's index inclusion).

With a style of wide diversification and typically individual top-10 positions accounting for 1.5% to 4.0% of the fund, the -5% return of our NZ Equities Portfolio was unsurprisingly more reflective of the average stock return than the Index. This approach has served NZ investors well over-time (examples are smaller positions in large index stocks including Telecom NZ, Carter Holt, Fletcher Building, and Large Caps in general). And importantly, from a risk allocation perspective, we would not recommend a ~11% Fund weight in A2 Milk (its current index weight) or any stock for that matter.

In contrast to the great success of A2, New Zealand's other main corporate stories were disappointing.

Fletcher Building (down 17%) announced yet another round of material development losses, resulting in the resignation of its Chairman and a cleansing session to investors by their newly appointed CEO. We have been wary of peak-cycle risk for Fletchers following industry meetings over a year ago, and with fortunate trading we have made a gain from our modest position.

Sky TV (down 13%) cut their dividend and made material changes to their content pricing (including a surprise ~30% reduction in the effective entry price for Sky Sports). We have avoided Sky following extensive analysis of its earnings leverage and unique shareholder register (including ~13% ownership by high dividend yield rules based funds). Importantly despite the material share price move, the larger reduction in dividend has resulted in Sky's dividend yield falling. This, and the sharply reduced market cap could see significant selling by dividend yield funds. We are unlikely to be interested in Sky TV until both its business and share register have more stability.

Unfortunately, having dodged the Fletchers and Sky TV bullets, the Fund took a shot right between the eyes in CBL Insurance. CBL announced they had under-reserved for their long tail French construction insurance business and, with other write-offs they expected to report a loss of \$75-85 million. The NZX suspended them and then their regulator, the RBNZ, appointed interim liquidators who advised that the company would not be making an earnings announcement. We had a 0.4% weighting in the Fund which we wrote down to zero in our month end numbers.

We thought we knew a fair bit about this business but assumed that the company's independent actuary, the board and management and the RBNZ knew more. As it turned out they didn't and those who knew most were the people who questioned why a New Zealand-based insurer would be better at pricing long tail French construction risk than the locals. This had been our starting point but we were swayed by management's apparent track record, skin in the game (two of the directors had personal stakes worth over \$100 million when the stock was suspended), the RBNZ as regulator and the comfort of regularly audited accounts.

Our Australian portfolio also struggled a bit over the month. The style of the Australian market is to shoot first and ask questions a lot later, if at all. Share price reactions were once again excessive, however overall this reporting round was mildly positive, with industrial firms delivering 5% EPS growth. However we are mindful of Goldman Sachs strategist Matthew Ross's analysis highlighting that two-thirds of industrial firms saw margins contract, and consensus expectations for 2nd half earnings are at decade highs.

Our top contributor was Cleanaway (+6%), which reported a strong half year result following a combination of contract wins and organic growth. They also gave confidence around the pending earnings accretion of the TOX acquisition which is due for completion by the end of the 2nd quarter. Strong results and momentum also saw decent wins in smaller holdings Bluescope Steel (+13%) and Australian Vintage (+20%).

Our worst performers were Woodside Petroleum (-12%) and EML Payments (-27%). Just as the market was getting over the indigestion from Shell selling out of its Woodside stake late last year, the company undertook a substantial capital raising to continue development of its gas portfolio. A large element of the raising was for future development which the market has currently discounted. Our modest position in EML took a hit after the company reported a largely in line result but a more cautious outlook due to contract slippage. Being a hot stock going into the result it could not afford to disappoint.

Our International portfolio had a roller coaster ride before finishing the month slightly down. The long run returns we have enjoyed from this portfolio have been very good, although the persistent strength of the NZD has been a bit of a hand brake. However, our overall conclusion is that the growth stocks we can access are better quality businesses at better value than we can find in NZ or Australia. Our investment in Visa is a good example – we acquired our stake in Oct-16 at US\$83 when it was trading on ~24x forward earnings. Today the stock is \$121 (up 47%) but its earnings multiple has only risen to 25x.

TOP 10 HOLDINGS

Amazon	2.7%
A2 Milk	2.6%
Precinct Convertible Notes	2.5%
Metlifecare	2.1%
Google	2.0%
EBOS	2.0%
Sanford	1.8%
Spark	1.8%
Chorus	1.7%
Contact	1.7%

Aspiring Asset Management Limited

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