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FINANCIAL YEAR 2018: REPORTING SEASON INSIGHTS AND IMPLICATIONS FOR THE AB MANAGED VOLATILITY EQUITIES FUND

A Q&A with Roy Maslen, Chief Investment Officer—Australian Equities, AllianceBernstein

Q. Telstra's result, though down on the previous period, was ahead of expectations and guidance and the market reacted positively. Given that you have sold out of this stock, what was your view of the result? What's your view also of talk of a potential merger between TPG and Vodafone?

We're happy to be underweight Telstra because we continue to believe that the stock is a potential volatility trap. Its two largest businesses—fixed-line and mobile—are likely to continue to weaken, in our view. EBITDA in fixed-line is likely to fall \$2 billion over the coming year as the company switches from its own copper network to the National Broadband Network.

Although the mobile business has grown for a few years, it's already begun to shrink in the face of price competition and we expect it will continue to shrink further in profitability.

A merger between TPG and Vodafone—which the ACC may not allow—would be unlikely in our view to end the price war which has only just started to heat up, even though it's been going on from 2017 and is ultimately what's driving profitability down. For example, new monthly plans for Amaysim, which is backed by Optus, cost only \$10 a month.

Q. What impact has the Royal Commission had on the banks reports and given the current environment do you remain happy to be underweight the banks?

The Royal Commission is continuing and is likely to result in several changes in the banking industry, whether because of fines or increased regulation and scrutiny. There is also greater political risk, with the potential for an increase in the bank levy imposed by the government in 2017, and there may be repercussions from a range of other reviews that are taking place, including those by the Productivity Commission and ACCC into mortgage pricing. There is a risk, for example, that the practice of offering discounted rates to borrowers for the first year of their home loans could come under pressure, on the basis that it's unfair to longer-established, loyal borrowers, who effectively fund the discount through the higher rates that they pay.

From the point of view of managing a defensive portfolio, it needs to be noted that banks are a large part of the index and, given the risk outlook for the sector, it makes sense that the portfolio's exposure to banks should be substantially less than that of the index.

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Q. Are there bright spots in financial stocks? If so, what are they and why?

We believe that of the three main types of financial investments— banks, financial services and insurance—there is in general less volatility in strong, stable insurance companies and we do find some opportunities within that space.

Q. The energy sector may come under scrutiny like that now being applied to the banks. What were your thoughts on energy companies' reporting season and the outlook for the key energy positions in your portfolio?

With the increasing political focus from major parties on the energy market and the increase in retail power bills, it's hard to be certain as to how regulatory changes or direct intervention may affect the industry. As a defensive manager, we've taken a cautious stance and reduced or eliminated holdings where we believe it's prudent to do so until we get greater clarity on energy policy from the major political parties.

Q. Caltex is a key overweight position in the portfolio whose numbers looked strong yet the market sold the stock? Why is that and what is your outlook for the company?

Caltex has a strong position in its domestic fuel refining and distribution business. Broadly, this business has been going very well and the company continues to execute well upstream. The declining Australian dollar and tightening of the global refining network should continue to support the earnings of this business.

The recent weakness is related to market concerns on the more retail-focused part of the business. The company is currently undergoing a strategy to bring franchise stores back into its owner-operated model, and to upgrade its offering through the development of its Foodary convenience store concept. These efforts have caused mediocre results in retail in the short term. While we believe Caltex is unlikely to be a world-class convenience retailer we think that its efforts should improve the performance of what is currently a fairly low-quality customer offer.

Caltex has good cash flow yields and is uncorrelated with high-risk commodity exposures, such as energy, and therefore continues to be a good holding in the portfolio.

Q. Australian tech companies were a highlight of this reporting season. Why is that, and what names do you see doing well and why?

We've seen something of a mini tech boom with several smaller tech companies having very large share price moves so that they are now trading on price-to-earnings multiples that are even higher than those of some of their US peers, such as Amazon. This includes names such as WiseTech Global and Xero. So our view is that, although these might be good companies, valuations are now very high, and this makes the area a risky one to invest in.

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We held one small cap company in this space earlier in the year—Altium—but we’ve already taken profits and no longer hold. An Australian listed tech company that we own is different: it’s not a small-cap trading on a very high p/e. Our core holding is REA Group which is behind www.realestate.com.au. Our research shows that its leading market position is enabling strong cash flow and, even though the housing market is slowing, its profits are going up because houses are staying on the site for longer. Also, people are paying for more premium adverts and, given REA’s strong market position, it continues to put its prices up.

Q With valuations of some global tech names appearing to be quite high, what impact could a potential sell-off of these stocks have on local names?

When we see global tech names sell off, the local stocks that come under pressure are predominately the higher p/e small cap names mentioned earlier, such as WiseTech Global, Xero and Altium, none of which we have exposure to.

Q. Can you comment on the global names in your portfolio and their outlook post reporting season?

In the second quarter of this year, owning global stocks was a drag on performance because Australian markets performed so strongly. This quarter (since June 30) a number of our global stocks have performed particularly well. The three I would call out would be Walmart, where sales are growing rapidly; SalMar, which is a leading Norwegian salmon producer benefiting from currently strong market prices, and Apple, which has been benefiting from the high price-point of its most recent range of phones. While the high iPhone prices have been regarded as controversial in some quarters because they mean that the company is not selling as many phones, the prices are resulting in attractive cash flow. And unlike the other tech companies, Apple trades on a price to earnings multiple only slightly above that of the Australian Industrials index.

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