Dear Investor,

We are pleased to provide you with the December quarterly letter for the *Milford Australian Absolute Growth Fund*. Thank you for investing alongside us and trusting us with your capital.

The Fund remains defensively positioned despite the late 2018 sell-off and rally in early January. We think a great buying opportunity is likely to emerge later in 2019 once the impact of the slowing Australian housing market and weakening Chinese economy are more reflected in company earnings and valuations. For the time being our focus is on capital preservation while keeping our powder dry for opportunities later in the year.

## Year Review

Following a strong start, the 2018 year will be remembered for the 4th quarter sell-off which wiped out the positive returns gained over the first nine months of the year. Compared to a 2.8% decline by the ASX 200 Accumulation Index the Fund ended the year down a modest 0.9% after fees, with most of the outperformance over the market occurring in the final quarter sell-off. Although we were disappointed with our final quarter performance, our elevated cash holding minimised the overall fall. Exposure to small caps and some cyclical investments impacted performance when market volatility increased.

The table below shows our top three positive and negative contributors for the year followed by a brief commentary on each.

*Figure 1: Top and Bottom Contributors for 2018*

| Top | | | Bottom | | |
|---|---|---|---|---|---|
| **Stock** | **Attrib** | **Perform** | **Stock** | **Attrib** | **Perform** |
| Pinnacle Investment Management Group | 1.11% | 60% | Experience Co Ltd | -0.69% | -65% |
| Xero Limited | 0.71% | 63% | Boral Limited | -0.68% | -35% |
| Collins Foods Limited | 0.66% | 16% | Unibail-Rodamco-Westfield | -0.63% | -26% |

Pinnacle Investment Management rallied strongly until October as its core investment managers – Antipode, Hyperion and Firetrail – continued to win money. The bull market in growth stocks fuelled the share price gains as Pinnacle traded on increasing earnings multiples until the sell-off began in October. We reduced our position into the rally and were quick to exit our remaining position early into the sell-off which proved to be the right move as Pinnacle remains well below our exit price.

Xero was another investment we sold well during the year. As a leader in the cloud accounting software space with increasing traction in offshore markets, Xero is an attractive long run investment proposition. We correctly anticipated that Xero's shift to a primary listing on the ASX would see increased attention from Australian investors and a re-rating higher for the stock. As this played out and Xero began to trade at a frothy valuation multiple, we exited our position and avoided the October sell-off. We are waiting for the right level to invest again, but don't think it is cheap enough quite yet.

Collins Foods did nothing spectacular from an operational point of view in 2018. However, it continued to report solid results and announced the roll out of Taco Bell in Australia. This caused a bit of excitement in the stock later in the year and combined with defensive business characteristics, led to a strong performance over the final quarter sell-off. We reduced the size of our investment into this strength but retain a large holding.

Experience Co is Australia and New Zealand's leading sky diving operator. Our thesis was that increasing demand for adventure tourism activities and more acquisitions would drive an attractive earnings growth profile. Unfortunately, the company had two sky diving accidents and experienced negative weather events which significantly reduced demand for their sky diving activities. As their earnings fell, the Company came under increased pressure which highlighted various challenges with the business and industry. Our big mistake, other than investing in the first place, was not selling after the first sky diving accident when we should have seen the writing on the wall.

Boral performed well early in the year, reaching its highs in February. But it was all downhill from there. Negative weather events drove the share price lower through the middle of the year and the stock really gave up in the final quarter sell-off amidst increasing negative Australian housing data points. While we sold on the way down, we did not completely exit until recently after a large loss. With significant exposure to housing, there is still a lot of earnings risk which could see Boral trade even lower in 2020. A lesson on the risks of investing in cyclical businesses late in the business cycle.

After doing well in Westfield in 2017 where we sold our position into the Unibail-Rodamco takeover offer at attractive prices, we re-entered the merged Unibail-Rodamco-Westfield (URW) vehicle mid-2018. We were attracted by the 6.5% dividend yield, high quality retail assets and attractive growth profile from their development pipeline. After this, the entire European retail REIT sector suffered a significant valuation de-rating and URW was not spared. While the earnings and dividends have performed to expectations, we suffered a significant capital loss on our purchase. In hindsight, we misjudged how negative the European investor sentiment was towards retail, and how this would impact the URW share price given the marginal price setter was now European rather than Australian investors. However, we still retain a large position as although the European economy is slowing, we think the current 8% dividend yield more than accounts for this.

## Outlook

We begin the year with a defensive position in the Fund and a focus on capital preservation. Our long equity exposure of 62% is weighted towards quality and income equities with relatively low exposure to growth and cyclicals. We also have some defensive gold stocks that will likely perform well in a wider market sell-off. After including our short positions our net equity exposure is 54%. The main reasons for our caution are described below:

1. **Falling Australian house prices and negative wealth effect**. With Sydney now down 11.6% and likely to fall somewhere between 15 and 20%, we are amid the largest downturn in Sydney house prices since modern records began in 1986. This weakness is spreading to other Australian cities with Melbourne down 7.3% and other capital cities down a similar amount. After years of positive wealth effects from increasing house prices, we are starting to see the impact of negative wealth effects. New motor vehicle sales are falling rapidly, and we saw a very large number of retailers' downgrade earnings guidance late in 2018. Housing starts are falling which is flowing into weaker labour markets in the construction sector. The question is to what extent this is going to flow into the wider Australian economy? While it is not guaranteed to cause a wider economic slowdown, we think the odds are high enough to warrant a caution

2. **Weakness in China, Australia's largest trading partner.** China is trying to transition its heavily indebted economy away from a reliance on debt funded fiscal growth to a more sustainable consumption growth model. Despite slowing growth, policy makers are attempting to forge ahead with structural reforms that are necessary to shore up their longer-term growth prospects while avoiding a substantial slow-down in the short-term. But it is a difficult balancing act. This means China is going to restrain from implementing the big-bang fiscal stimulus that reversed the 2009, 2012 and 2015 slowdowns. At least until they are truly desperate. So, we are likely to see a more protracted slowdown in China in 2019 than in the past. The good news for Australia is that iron ore prices have held up well so far, which means the impact on the Australian economy to date is relatively minor.

3. **ASX valuation multiples that do not reflect the outlook and risks above.** While the current ASX 200 multiple of 14.7 times isn't too excessive compared to the long run average of 14.0 times, this is aided by large sectors Banks and Resources which are trading below long run averages multiples. Stripping these sectors out, the ASX Industrials trades on 16.9 times which is high when compared to historical averages and global markets like the S&P 500 on 15.3 times and Dow Jones on 14.5 times. Especially considering the lower growth and elevated earnings risk of the Australian market as we head into 2019.

4. **The end of quantitative easing is deflating valuation multiples globally.** With major central banks withdrawing stimulus, valuations multiples have deflated in most equity markets globally. While the Fed has pushed the pause button on further rate hikes, they are still shrinking their balance sheet and it is uncertain what the full implications will be of the tightening done thus far. We will have a better idea in three to six months' time.

It is important to point out that a cautious equity allocation like this is a temporary position. When conditions are right we will take a more aggressive stance. Before doing this, we are looking for resolution to our key concerns above. If the market takes a significant leg down, and valuations fully reflect challenging economic conditions, the risk to reward on many equities will be very attractive so we will be a significant buyer. Or if the Australian housing market and Chinese economy stabilise, we will gain confidence that the wider Australian economy will avoid an economic downturn and begin to buy equities again. We suspect a great opportunity to buy shares will arise at some point in 2019. But for now, we will be patient, monitor how the economy develops and see what opportunities the market throws at us during the year.

Once again, thank you for investing with us.

Kind Regards

William Curtayne and Wayne Gentle
Portfolio Managers
Milford Asset Management

Disclaimer: Equity Trustees Limited ("Equity Trustees") (ABN 46 004 031 298), AFSL 240975, is the responsible Entity for the Milford Australian Absolute Growth Fund. Equity Trustees is a subsidiary of EQT Holdings Limited (ABN 22 607 797 615), a publicly listed company on the Australian Securities Exchange (ASX: EQT). This document has been prepared by Milford Australia Pty Ltd. as the Investment Manager, to provide you with general information only. In preparing this document, we did not take into account the investment objectives, financial situation or particular needs of any particular person. It is not intended to take the place of professional advice and you should not take action on specific issues in reliance on this information. Neither Milford Australia Pty Ltd., Equity Trustees nor any of its related parties, their employees or directors, provide and warranty of accuracy or reliability in relation to such information or accepts any liability to any person who relies on it. Past performance should not be taken as an indicator of future performance. You should obtain a copy of the Product Disclosure Statement before making a decision about whether to invest in this product.