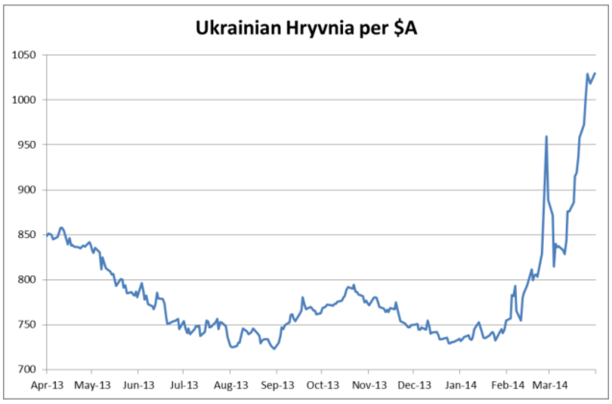
Monthly comment – March 2014
Alphinity Wholesale Australian Equity Fund

Russian into the Crimean Peninsula

Market comment

Geopolitics again featured in March as Russia responded to cries for the liberation of Crimea - or annexed it, depending on your perspective - and North and South Korea traded gunfire, not that you'd notice it in market movements: most of the major equity markets reacted with insouciance. Australia's market (S&P/ASX300 including dividends) was fractionally higher in March and up 2.7% for the quarter, making it one of the better performing major markets in the world. The $A rose by 4% against the $US for both the month and the quarter and the US market fell 3.4% for the month and 2.5% for the quarter. European markets were generally a few percent lower in $A for the quarter, and Russia's MICEX Index was down 7% in March to be off 15% year to date. Somewhat surprisingly, despite losing a fair chunk of its territory, Ukraine's PFTS Index didn't do much worse than Russia, down 6% in its local currency (Hryvnia) and was actually up 24% in Hryvnia in the quarter. The Hryvnia however has depreciated by almost 40% since the start of the year (see chart).



Source: Bloomberg

It is notable that countries close to Russia fared the worst: Latvia, Hungary and Kazakhstan were all down 7-14% in the quarter.

One of the world's brightest spots was New Zealand. It earned the distinction of being the first developed economy to raise rates since the GFC: some emerging economies have done that but mainly to defend weak currencies. The NZ market in $A rose by 2.7% in the month and 10% for the quarter, beaten only by higher-risk markets like Greece, Italy and Indonesia.

Bulk commodity prices were generally weaker as concerns about Chinese economic growth increased. The iron ore price fell by 13% over the quarter, copper fell 9% and the LME base metals index fell 5%. The price of oil fell by more than 3% despite the tensions around Crimea, but the price of gold was up 6.5% in $US largely due to currency weakness in some emerging markets, but only slightly higher in $A.

Portfolio comment

The portfolio outperformed the market nicely in March. The biggest positive contributor to performance was building materials company CSR was as well as not owning gold miner Newcrest and being underweight diversified conglomerate Wesfarmers. There were no detractors of note. The portfolio performed slightly better than the market over the March quarter. CSR, global fund manager Henderson Group and travel retailer Flight Centre all made positive impacts while our position in electronics retailer JB Hi Fi and not owning Newcrest both cost a small amount.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	Since inception^ % p.a.
Fund return (net)	0.8	2.0	16.1	19.8	17.2
S&P/ASX 300 Accumulation Index	0.2	2.0	13.0	16.0	13.9
Active return (net)	0.6	0.0	3.1	3.8	3.4

*Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance.
^The Fund changed investment manager and investment methodology on 12 July 2010, at which time Alphinity Investment Management commenced managing the Funds and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2011. Therefore, the inception date for the returns for the Funds is 1 September 2011. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 (during Sydney business hours).

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Monthly comment – March 2014
Alphinity Wholesale Australian Equity Fund

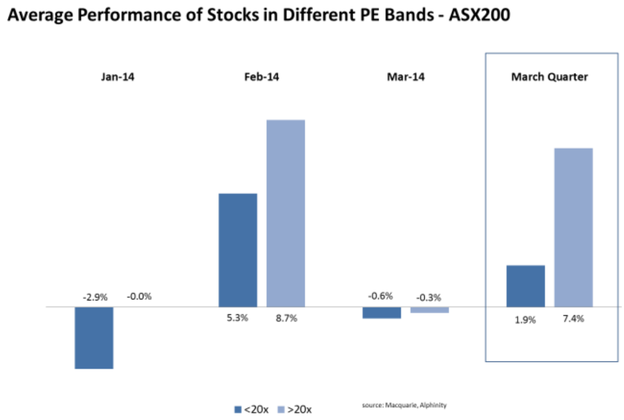
Market outlook

The first quarter of the year has brought some mixed economic news but overall has been broadly encouraging, in our view. The housing market has gathered strength and consumer spending also appears to be improving on the back of what looks like being a sustained low interest rate environment. Together with a recovery in resource company earnings as a result of cost reductions, volume growth and currency benefits, and ongoing growth in bank, domestic insurance and property earnings, the market should be able to report decent profit growth for the current financial year ending in June. We expect the upcoming bank reporting season to be relatively benign which will also lend further support to market earnings.

While a somewhat slower growth rate in China coupled with new supply may leave the resource sector vulnerable to a degree of earnings disappointment, this is not likely to be enough to derail the outlook for growth in company earnings across the entire market. Nervousness around China's growth rate in particular and the timing and impact of higher interest rates in the US will likely continue to cause some volatility in the Australian equity market. However, we continue to expect positive returns for the year and the first quarter positions the market well on the way to achieving it.

Portfolio outlook

Last month we wrote about the importance of remaining disciplined when it comes to valuing companies. A great company is not always a great investment: the market's earnings expectations may already reflect that the company is great. After a couple of months during which some of that valuation discipline was not always apparent in the market it was encouraging to see the portfolio's outperformance resume in March.



The chart above shows the monthly performance for high P/E ratio stocks (ie expensive, in light blue) vs P/E stocks lower (ie cheap, in dark blue). Alphinity's portfolio did well after underperforming fractionally in the first two months and, while other factors played a role, a more balanced approach by investors to the relative value of companies in March seems to have benefited the portfolio. It was clearly a quarter during which valuation wasn't a major focus, and these periods tend to be rather temporary. The relative paucity of high P/E stocks in the Australian market is demonstrated by the fact that the quarter's overall market return of 2.7% was only a little higher than the low P/E band's 1.9%.

The portfolio remains well exposed to stocks which are seeing their earnings expectations being upgraded by the market, and the overall multiple of its holdings remain in line or even slightly below the market average. We believe this puts the Fund in a strong position to continue its track record of outperformance.

Asset allocation	As at 31 March 2014 %	Range %
Securities	98.5	85-100
Cash	1.5	0-15

Top 5 active overweight positions	Index weight %	Active weight %
ANZ Banking Group	6.7	1.7
Goodman Group	0.5	1.6
Aurizon Holdings	0.8	1.6
Woodside Petroleum	1.8	1.4
Insurance Australia Group	1.0	1.4

Fund details	
Manager inception date	1 September 2010
Fund inception date	7 November 2003
Fund size	$56.8M
APIR code	HOW0019AU

Fees	
2012/13 ICR	1.85%
Management fee	0.90% p.a.
Performance fee	Nil
Buy/sell spread	+0.30%/-0.30%

Monthly comment – March 2014
Alphinity Wholesale Australian Equity Fund

Traveller's tales

Bruce found himself in the US briefly in March, traveling to chilly New York and much more temperate Las Vegas and Los Angeles to see a diverse group of companies across the retail, media, online, recruitment, gaming and property industries.

It is easy to poke fun at Americans – the obsession with guns, the overt nationalism that jars with most Australians' sensibilities, the misuse of the English language – but it is a truly impressive country and most of the time a great place to visit. Just the sheer scale of the country and the vision required to make it there is quite remarkable and a little intimidating to those used to a more modest country like Australia.

To say Las Vegas is a strange place is an understatement. One taxi driver, who had never left the state of Nevada, said that seeing all the best bits of the world as you can on "The Strip" (Eiffel Tower, Venetian gondolas, Pyramids, the New York cityscape and so on) had given her an appetite to get out into the world and see it for real: one day she will. In most cities the downtown area is where the large and impressive buildings are located. In Vegas the tall, fancy buildings are all on The Strip and downtown, which is a few miles north, is mostly low-rise buildings and dingy motels.

In one of those low-rise buildings which used to be Las Vegas' City Hall and Courts building, across the road from the rather dingy Normandie Motel which proudly claimed Elvis as a guest (presumably pre-1977), lives Zappos. Zappos is an online shoe retailer that was started in 1999 by a couple of geeks who had made a fortune in the 90s tech boom. When they sold Zappos to online retail behemoth Amazon in 2009 they made another.

They sought to imbue a distinctive culture into Zappos. It doesn't compete on price as do most online retailers – its business proposition is based on extreme customer service. And extreme it is – you could say they put the "cult" into culture: "Some companies talk about work-life balance: we are all about work-life integration". It is so distinctive that the company conducts three tours a day of 20-30 people at a time, showing a brief film and giving a tour through the facility. Other companies send teams through to try and learn from the culture. For a charge you can also spend half an hour with various execs and get some individual coaching.

Zappos doesn't have a call centre, it has a CLT – Customer Loyalty Team. Its staff, known as Zapponians, try and out-do each other in niceness to the customer, and will sometimes send flowers or a card or cookies if a close connection is made. One gave the example of patching a customer through to a department store call centre when he found that the shoe she was after was out of stock at Zappos. Zapponians said they weren't surprised if they turned up to work and found a zoo in the foyer, or if a parade with jugglers and clowns traipsed through the office during the day.

The intense customer service extended even to non-buying visitors from the other side of the world. At the end of the tour Bruce was given a hard-cover book about the Zappos culture, and they insisted on transporting him to his next meeting on the opposite side of the city. They followed up with a nice email and the offer of a discount on a purchase. When it comes to the OTT service it set out to achieve, Zappos certainly delivered

Monthly comment – March 2014

Alphinity Wholesale Australian Share Fund

BTW

What activities would you think of normally being involved with organised crime? Drugs for sure, and some essential services like concrete production or waste disposal have been infiltrated in various parts of the world at times. An area you might think less likely iron ore: it's very bulky and very low-value compared to something illicit like drugs. Yet according to The Economist magazine, authorities recently seized 120,000 tonnes of iron ore at the port of Lazaro Cardenas on Mexico's Pacific coast which was about to be smuggled out of the country by the "bloodthirsty drug-trafficking outfit Knights Templar".

It must be hard to smuggle that much stuff. In fact, it must be pretty difficult to seize it too. To put it in context, 120,000 tonnes would half-fill a ship the size of the one pictured (which, incidentally, carried the largest ever shipment of ore, from Port Hedland to China, in June last year: 232,000 tonnes). So what were the Knights Templar thinking? The drug trade is fiercely competitive, and rival gang the Sinaloa Cartel had effectively blocked the Knights out of the drug business in that port, forcing them to look to less traditional areas. The Economist reported that the Knights were also extorting local mine bosses for a few dollars per tonne (with extraction of 4m tonnes a year this adds up) as well as hiding illicit gold within the large, unsuspicious cargo to smuggle into China.

The ore itself would have been worth about $US15m: this was icing on the cake.

However there is hopefully a happy ending to this tale. The Mexican Navy recently took control of the port, leading to the seizure, and the Knights Templar have been hounded out of the region by a combination of the authorities and groups of armed vigilantes. The Sinaloa Cartel is also under attack and its leader, Joaquin "El Chapo" Guzman ("Shorty") who is the 11th richest man in Mexico, is in jail. Hopefully the iron ore trade can now go back to the relatively unexciting industry it has generally been.