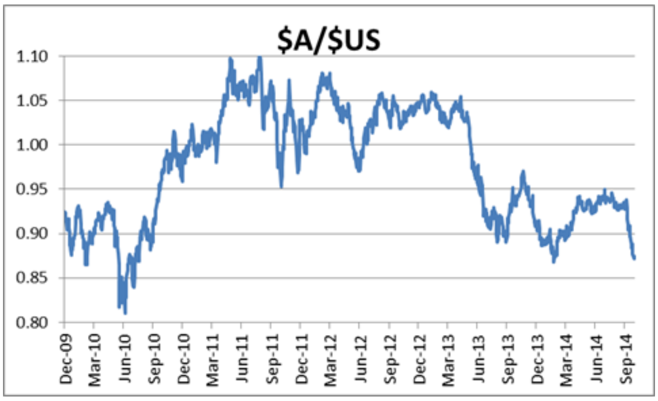
Monthly comment – September 2014
Alphinity Wholesale Australian Equity Fund

Tough month

Market comment

September turned out to be a rather nasty month in the Australian share market, losing a little over 5% in local currency terms (S&P/ASX300 including dividends), and a bit more than that for foreign investors considering the rather significant slide in the $A that developed during the month. Over the quarter ending September the market actually fell by 0.6%.

The $A fell by almost 7% against the $US (-4% against the Reserve Bank of Australia's trade weighted index) and is now close to the lows it experienced in March: the long-awaited dollar drop may at last be happening. We have been looking to such an event to provide a bit of a fillip to a number of our companies: those with significant offshore earnings which will be worth more in $A than before, and those who have been finding competition from offshore players impinging on their earnings may find a little relief.



Source: Bloomberg

Global markets were decidedly mixed, with the major currency moves making a big impact. The UK's -2.9% became +1.4% in $A (-0.8% and +1.4% in the quarter). A degree of relief that Scotland had decided not to break away from the UK was reflected in the strength of the Stirling. The US market's -1.4% became +4.7% (+1.1% and +9% for the quarter). Germany was flat in Euros for the month but up 2.7% in $A (-3.6% and -4.1% for the quarter). It was a good period to be a currency trader.

Less so to be a commodity trader. Iron ore continued its recent downward path and fell 17% over the quarter (10% in $A), as did thermal and coking coal. Oil, which one would expect to be rising in price given the concerning events in some of the major oil-producing regions, actually fell in significantly in price over the quarter (-17% in $US) thanks at least partially to the recent discovery of a significant new field in Russia. Gold was quite soft in $US (-6%) but the fall in the $A was such that it actually went up in our currency. Over the quarter it was -8.5% in $US but only -1% in $A.

Portfolio comment

The portfolio outperformed the market a little in September. Positive contributors included gaming company Aristocrat Leisure and gas explorer AWE. However these were partially offset by our underweight in blood products company CSL. Over the September quarter, the portfolio underperformed a little. The top contributors were Aristocrat, insurer IAG and not owning mining services company ALS which underperformed significantly after issuing a profit warning. Against those however were positions in Henderson Group and JB Hi Fi which performed poorly during reporting season.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	-5.2	-1.5	5.7	16.8	16.8	13.9
S&P/ASX 300 Accumulation Index	-5.4	-0.6	5.7	14.3	14.4	9.2
Active return (net)	0.2	-0.9	-0.1	2.5	2.4	2.3

*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 2010. Therefore, the inception date for the returns for the Funds is 1 September 2010. 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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Portfolio outlook

The increased market volatility experienced recently, while always slightly discomforting at the time, will inevitably present attractive investment opportunities. As the August reporting season had already identified some valid portfolio adjustments, we would expect our portfolio turnover to pick up from the much lower-than-normal levels earlier this year. Two new stocks that have been added since the reporting season are credit information and data analytics provider Veda Group and Alumina Ltd.

Veda is Australia's leading credit bureau and is experiencing strong growth through an expanding product offering to existing customers, as well as new customer segments. Changes to credit reporting and privacy laws introduced in March 2014 are likely to over time lead to so-called comprehensive reporting (which includes both positive and negative credit history) rather than just negative credit history traditionally sought by lenders. Veda is well positioned to take advantage of the volume uplift expected to be associated with this change.

Alumina Ltd stands to benefit from a tighter demand/supply balance for alumina, the main raw material for making aluminium, over the next few years. In addition, a new pricing structure is being adopted by the industry whereby the alumina price is increasingly set independent of the aluminium price, to which it has historically been contractually linked. Alumina should furthermore be one of the key beneficiaries of the weaker $A, should it be sustained. We anticipate reporting on additional new stocks in our next monthly report.

The more cautious sentiment evident in markets during September and into the start of October is likely to see investors take a more discerning approach to individual companies' risk profiles. We would expect the portfolio, due to it having on average stronger financial metrics (higher Return on Equity, lower net debt), to benefit from this trend change. Overall, the portfolio continues to exhibit stronger earnings growth than that for the broader market, and importantly has positive momentum in consensus earnings revisions. We believe this positions it well for future performance.

Fund details	
Inception date	7 November 2003
Transition date	1 September 2011
Fund size	$49.4M
APIR code	HOW0019AU

Fees	
2013/14 ICR	0.90%
Management fee	0.90% p.a. of net asset value of the Fund
Performance fee	Nil
Buy/sell spread	+0.20%/-0.20%

Market outlook

What a difference a month can make. After having for some time highlighted how the low interest rate - low growth environment has led to a low volatility - low valuation dispersion equity market with few positive or negative surprises to drive markets either way or to separate the performances of individual stocks, this all seems to have changed during the last month. While it's difficult to be too cheerful about a 5% fall in the local equity market, there are in our view reasons to be more optimistic over the next 3-6 months.

The major cause of the recent global downturn in equities seems to be global growth concerns and, although we certainly agree that economic growth is not particularly strong overall, the picture to us doesn't seem very different to how it has looked for several years now. The US economy is perhaps a bit stronger than before, Europe a bit weaker and China's growth is slowing a bit but is hardly collapsing. For us the reason to be more optimistic going forward is two-fold.

Firstly, the weaker A$ will boost Australian company earnings by several percentage points should it be sustained.

Secondly, the fall in the equity market has obviously made valuations more attractive, unless it also signals that earnings are at risk.

Earnings may be at risk in some instances – after all the correction has partly been driven by lower commodity prices and may also start to impact market-exposed stocks if the falls are sustained. However the fall in share prices to date appears to be greater than any associated earnings risk.

Some of the market decline also appears to have been driven by foreign investors reducing their exposure to the Australian market and the falling $A, which would negatively impact returns in their home currency. This should prove to be a temporary impact and foreign flows may indeed turn positive once the $A stabilises. The impact of US monetary policy to us also seems pretty benign. Short term rates there will likely start increasing some time next year but this will go hand-in-hand with a stronger US economy; elsewhere interest rates are likely to remain low.

Asset allocation	As at 30 September 2014 %	Range %
Securities	98.8	90-100
Cash	1.2	0-10

Top 5 active overweight positions	Index weight %	Active weight %
Woodside Petroleum	2.1	2.2
Goodman Group	0.6	2.1
Aristocrat Leisure Limited	0.3	1.6
Oil Search Limited	0.8	1.5
Westpac Banking Corporation	7.4	1.4

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BTW

Consumers shopping online and buying local goods cheaper offshore than they can locally, reflects the geographically isolated market and high cost structure in place here. You might even have done it yourself, maybe to save a bit of money or possibly to make a protest at the high local prices being charged. Sound familiar? A typically Australian thing you might think? Well, yes, but it's not just us. It happens all around the world: even in the home of consumer electronics, South Korea. They even have a collective name for such people there: "jicgoojok" which apparently means "tribe of direct buyers".

Bloomberg recently reported that even after paying taxes, insurance and shipping, it was significantly cheaper for someone in Korea to buy a Korean-manufactured large-screen television from Amazon in the USA and have it shipped back from North America.

One buyer in Seoul reported paying $US1250 all up to buy a 55-inch Samsung TV from Amazon: the local price was the equivalent of $1900. It took him two weeks to get the TV, but he felt that the 35% saving more than compensated.

According to Korean customs, the most frequently imported consumer items are wine, lipstick, cheese and car tyres (!) and these items could be up to nine times more expensive in South Korea.

Of course, as in any enterprising society, companies have sprung up to support such activities. Like ohmyzip.com, which allows buyers to get around the geographic blocking that would normally stop Amazon shipping TVs to Korea as a result of manufacturer agreements; or like Malltail.com which takes delivery of goods in the US and tests them before forwarding to the buyer, adding another layer of service and convenience. Similar sites are available for Australians doing the same thing.

One thing that annoys consumers is the knowledge that someone in another country is able to buy the same product (or something they perceive to be the same) at a significantly lower price than they can. The internet has provided an unprecedented degree of global price transparency which is making it more and more difficult for companies to treat countries as islands. It is gradually forcing price harmonisation across markets to the extent that in some cases, after a fairly sudden currency fall, it is now cheaper to buy some products in Australia than in the US or Asia. Not many, but some.

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Traveller’s Tale

Shane hit the air bridges in a big way in September, travelling around the US as part of his research into our building materials companies. Going through seven cities in ten days didn’t leave a lot of time for sightseeing but given that most building materials companies and factories don’t tend to occupy inner city addresses, the inevitable long car rides between meetings did provide opportunities to check out the local landscape.

A visit to one factory in Duluth, Minnesota offered a particularly pleasant drive. Located quite close to the Canadian border, Duluth is a town that really does experience all four seasons.

Whilst summers will struggle to match anything like we enjoy in Australia, winters are a different story. Last year the town experienced its second coldest winter on record, including 57 days during which the temperature was below zero - and that’s zero Fahrenheit!

Luckily for Shane it was a very pleasant autumn day and he was able to enjoy the spectacular view of trees as their leaves turned from green to bright orange and red.Being in such a severe climate Shane couldn’t help but consider how vastly different the approaches taken to home construction must be in this part of the US compared to what he’d seen just a few days earlier in Texas.

As home builders look to tap an even more budget-conscious buyer no area is being left untouched in attempts to save costs. Whereas in the past one would expect to find insulation and sheathing between the internal framing and outside siding, you can now find houses without such ‘unnecessary’ features. At least the price of this type of house is affordable: $US135,000 including land! It will be interesting to see how these houses look in a few years, and in the meantime the people in Texas will be hoping that the chilly Artic winds don’t reach that far south.

Alphinity Investment Management

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