Quarterly comment – December 2013

Alphinity Wholesale Australian Equity Fund

Santa saves the day

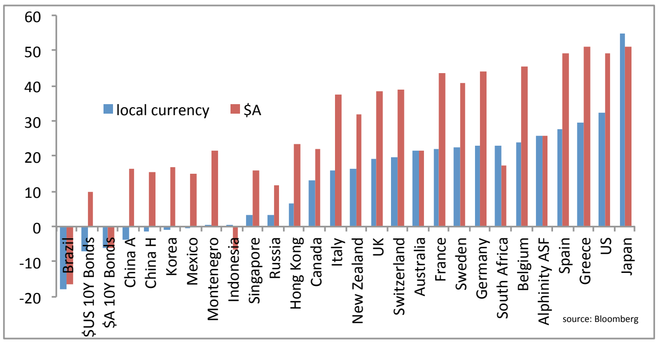
Market comment

At the end of another very strong year in the share market, the traditional Santa Clause Rally saved December from what was looking like being a pretty disappointing month at one stage. The S&P/ASX 300 Accumulation Index (including dividends) slid as much as 5% in the early part of the month but the final scene of the US Federal Reserve's seven-month production of 'Waiting for Taper' was enough to turn it around and finish the month 1% in the black, enough to reverse November's modest decline. The market seems to have done its Taper-worrying well in advance and was actually relieved that a modest (from $US85 billion per month to $75 billion) reduction in the Fed's monetary stimulus program would take place.

It was more Scrooge than Santa in the IPO market however, as the profusion of new companies gradually hit the market, with mixed results (see BTW). It wasn't just IPOs either: considering the time of year a surprisingly large amount of corporate activity took place, including equity raisings and de-mergers. The end result was lots of new companies to look at and a multi-billion dollar call on the equity market, which added to the downward pressure at the start of the month.

Over the quarter, the market rose a modest 3% with the main themes being the $A, which fell by 4% against the $US and a little less against other major currencies, and a series of profit warnings – although thankfully none in companies in your Fund. Most commodities were essentially unchanged for the quarter with the exception of gold, which fell by almost 10% in $US terms to a multi-year low. World financial news was dominated by the steadily-improving US economy and the fairly new regime in China starting to flex its muscles.

2013 was a tough year for bonds and emerging markets equities but most developed markets did very well indeed, and the falling $A boosted most offshore market returns further. In their local currencies, Asian stocks generally lagged – Japan's 50% being the spectacular exception – and most European markets were largely similar to Australia before the impact of currency. The USA and some of the weaker European economies like Spain and Greece all made returns of about 30% in their local currencies and as much as 50% unhedged.



Fund details

Alphinity Wholesale Australian Equity Fund	
APIR code	HOW0019AU
FUM ($A million)	59.3
Asset allocation	Australian equity: 98.1%, Cash: 1.9%

Fund performance* – as at 31 December 2013

	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (%)
Alphinity Wholesale Australian Equity Fund	4.4	24.6	23.7	18.2
S&P/ASX 300 Accumulation Index	3.4	19.7	19.7	14.5

*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 to a single manager investment strategy on 12 August 2011, at which time Alphinity Investment Management commenced managing the Fund and started the transitioning of the portfolio to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2011. Therefore, the inception date for the return for the Fund is 1 September 2011. For performance for previous periods please contact Fidante's Investor Services team on 13 51 53 (during Sydney business hours).

Top 5 active overweight positions as at 31 December 2013

Alphinity Wholesale Australian Equity Fund

Issuer name	Index weight	Active weight
Insurance Australia Group Limited	1.0%	2.0%
ANZ Banking Group	6.6%	1.7%
Goodman Group	0.5%	1.6%
Aurizon Holdings	0.8%	1.5%
JB Hi-Fi Limited	0.2%	1.3%

Portfolio comment

The portfolio outperformed slightly in December although there were few positive or negative stand-out stocks. The only significant contribution to performance was from being underweight global insurance company QBE which suffered a sharp fall in its share price during the month. Over the quarter, the most value was added by global fund manager Henderson, global investment bank Macquarie and not owning gold miner Newcrest. Over the year, not owning Newcrest was again a significant positive, along with our positions in Henderson Group, iron ore play Fortescue Metals, global travel operator Flight Centre, casino group Crown Resorts, electronics retailer JB Hi-Fi and Macquarie Group. The only noticeable detractors were miners Rio Tinto and Medusa and our underweight position in NAB.

Market outlook

Notwithstanding the wobble early in December, the equity market's ascent has had a cyclical flavor to it in recent months. While tapering, which will reduce liquidity, may be a negative for riskier assets and economically sensitive stocks, investors appear to have formed the view that the modest amount of tapering announced by the Fed to date will not derail an improved US and global growth outlook in 2014. Some observers are even talking about the prospect of synchronised global growth, a term we haven't heard for some time. We agree that the prospects for growth look better in the coming year. The US should benefit from less drag from fiscal tightening, China looks set to continue growing even if at a slower rate, and even Europe is showing signs of coming off the bottom: all up there remains the prospect of a reasonable rate of growth in global economic activity. Moderating that is high public debt in many economies which may mean continued fiscal tightness, and with ample capacity in most industries globally it is equally difficult to argue for a significant upswing in business investment.

At home, a modest improvement in growth also looks plausible. The Reserve Bank of Australia's rate cuts are finally having a positive impact on consumer confidence. After a few years with an elevated household savings rate, Australians appear willing to loosen the purse string somewhat and this should continue to help the housing market in particular, with flow on benefits to general consumer spending. The offset, of course, is an ongoing slowdown in mining investment but at this stage with commodity prices in general holding up quite well the slowdown has been orderly.

The prospects for better general economic growth are well aligned with corporate earnings which, after some disappointing years, looks to be on track for mid-single digit growth. Should the weaker $A be maintained there will be a positive translation effect on overseas earnings, and this will augment earnings growth from the improved domestic demand outlook. So while we would temper some of the more optimistic market forecasts for both global and domestic economic growth, with share market valuations trading around long term averages, arguably lower risk of earnings disappointment, and the continued tailwind from money flows out of lower returning asset classes, the Australian share market looks well positioned for another year of solid returns.

Portfolio outlook

The New Year often begins with a spurt of market activity as investors look to position their portfolios for the coming 12 months. Given the current sentiment as discussed above, it wouldn't surprise us if investors initially seek to increase their exposure to cyclical stocks. We gradually built a slight cyclical skew into the portfolio over the course of 2013, especially in the second half. Given our view that economic growth will be better in 2014 but not greatly so, we are unlikely to significantly increase this bias other than for stock specific reasons. Instead, as is typically the case, our portfolio remains well diversified across major sectors of the market with our active positions primarily taken within sectors. Over time this has proven to be a less volatile and more reliable way of generating outperformance than through taking significant sector skews. Our largest sector overweights remain Energy and Consumer Discretionary while Health Care has become our second largest underweight after Consumer Staples.

The portfolio produced very solid absolute and relative performance over the last 12 months, including in the final quarter of 2013. As we don't envisage a major shift – up or down – in the macro outlook, any repositioning of the portfolio is likely to continue to be gradual. We look forward to the upcoming interim reporting season which is now only a few weeks away. It typically shows which companies are delivering on earnings and which aren't.

BTW

IPOs came back with a vengeance in 2013 but not all were successful – that is if you define success as being a good investment for the buyer as we would. If you define it as getting the maximum amount possible for the seller, some were very successful indeed. That tension has always been at play in this sort of activity but normally the need for capital outweighs any greed on the part of the seller. By our count (and thanks to our quant friends at Macquarie who have been tracking these things) there were 61 IPOs over the course of 2013, half of which hit the screens in the final quarter and a quarter in December. Many were very small: two thirds raised less than $100m. Only 15 raised more than $200m and seven exceeded $500m, and the two over $1 billion were both NZ electricity privatisations. In total, $11 billion was raised in 2013 across the 61 IPOs and a total of $356m of profit was made by the buyers: a paltry 3.2% return.

Of the larger floats (greater than $200m) there were mixed outcomes: six resulted in positive returns of 8% or more up to the year end, and four of those six were 40%+. Eight however were negative, the worst two losing around 20%.

The smaller IPOs (<$200m) were interesting even just from an entertainment standpoint. It was very much a binary outcome with a few doubling or more but some also down by as much as 94% from the issue price. Were you investing in small resource plays you would not have had much joy: eight of the ten IPOs that lost more than 35% were in that line of business.

Our favourite however is an Adelaide-based Asian media play which raised $3.5 million at 20c, listed in February, traded a few thousand shares a couple of days later and has not traded since. The best bid in the screen at the end of December was 2c. The most dramatic was an IT stock that was sold at 50c, hit $2.60 on day 1, but finished the year at 'only' $1.38 – still almost treble the issue price. This would have been more impressive had it not been just 7.6% of the company that was sold into the IPO but it seems the lesson of US internet IPOs has been well learned: keep the supply of stock very short and the price has a better chance of zooming.

Once upon a time being allocated stock in an IPO was considered being given 'free money', but many in the current vintage have been the exact opposite. Our investment banking friends tell us there is a large pipeline of IPOs preparing to hit the market in the first few months of 2014, but considering the performance to date there will likely be little support from investors unless pricing improves a lot.

Traveller's tales

Stephane went to the USA in December as part of a BHP Billiton roadshow of its shale oil and gas assets. He was intrigued by a sign in the foyer of one oil company in Houston prohibiting weapons. That a sign is necessary says something about the US gun culture, of which Texas is possibly the epicenter, but the wording is also a bit disturbing: you can't possess concealed handguns, but would it be OK to have them openly displayed? He was afraid to ask.

It was a very bearable 10-15˚C in Houston but a lot less balmy when he went to New York to meet with other companies in the broader resource and energy space. Most inhabitants of cold places say that there's no such thing as bad weather, just the wrong clothes. New York in the snow is a very beautiful place but unless you have the proper winter attire – an area in which most Australians fall down – it can be very cold indeed. Stephane however was, as always, well prepared.

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