Monthly comment – April 2012

Alphinity Wholesale Australian Share Fund

Greece is the word

Market comment

April was a fairly lacklustre month for equity investors. The market (ASX300 including dividends) rose a modest 1.3%, as did most international markets. The ASX has risen each month so far this year, however other than for January the rises have been quite small. One of the features of the downhill run into June 30 is profit updates by companies approaching the end of their financial years, and 2012 hasn't disappointed – or rather it provided for a series of disappointments. A number of companies did just that in April. Reasons for downgrades were diverse, and included poor weather on the eastern seaboard (Boral, Transfield Services, Stockland, Rio Tinto, Newcrest), cost blow-outs (Seven West Media), margin pressure (JB Hi Fi) and one-off factors (Bradken, Metcash).

Global markets generally did less well than ours, with the US and UK both down less than 1% over the month, but there were steeper falls elsewhere: Germany –2.6%, Japan –5.6%, France –6.2%. However China bounced back from recent poor performance with Shanghai up 6% and Hong Kong +2.6%. The $A rallied slightly during the month finishing over $US1.04, although a larger-than-expected cash rate cut by the Reserve Bank of Australia on 1st May meant it didn't stay there for long.

As we head into May, it feels a little as if history is repeating itself: just as in May 2010 and May 2011, ructions in Greece has the worlds' financial markets concerned about that country defaulting and/or withdrawing (or being ejected) from the Euro. That has been talked about widely in the markets; this time there is open discussion by European officials. Their main focus now is likely to be trying to ring-fence the larger troubled economies, like Spain and Italy, from any systemic shocks.

Portfolio comment

The portfolio outperformed the benchmark nicely in April although there were few individual stand-out performers. Our position in gold miner Medusa Mining and our underweight in gold miner Newcrest added the most, although that was largely offset by industrial services provider Bradken, which suffered a profit downgrade. Otherwise lots of little contributions from the likes of Resmed, Telstra and Goodman Group made up what was, overall, a solid month.

Fund details

Alphinity Wholesale Australian Share Fund	
APIR code	PAM0001AU
FUM ($A million)	127.8
Asset allocation	Australian equity: 98.8%, Cash: 1.2%

Fund performance* – as at 30 April 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Australian Share Fund	1.7	5.5	–4.1	4.7
S&P/ASX 300 Accumulation Index	1.3	4.6	–4.8	4.4

* **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 2010. Therefore, the inception date for the returns for the Funds is 1 September 2010. 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 30 April 2012

Alphinity Wholesale Australian Share Fund

Issuer name	Index weight	Active weight
Rio Tinto Limited	2.7%	2.7%
Insurance Australia Group Limited	0.7%	2.1%
Goodman Group	0.5%	2.1%
News Corporation	0.5%	1.8%
Telstra Corporation Limited	4.1%	1.4%

Market outlook

The Australian Equity market remains supported by attractive valuations and low corporate gearing, but also seems to be capped by modest earnings growth. Earnings downgrades have continued even two months after the end of the February reporting season. Market earnings growth expectations for FY12 which, at the end of February had declined to 3%, now stand at about 2% and it is likely that we will finish the year with no or even negative growth. Expectations for FY13 are also down slightly to about +12%. Interestingly, this is where FY12 expectations were about 6 months ago. While negative revisions to analyst expectations as the financial year progresses is quite typical for the market, rather than something unusual, the problem over the last several years was that there has been little or no growth at all left at the end of the year. So is FY13 likely to be a repeat of FY12?

At this point the odds seem evenly stacked. The key headwinds to broad-based earnings growth has been the strong A$ and low consumer confidence due to relatively high interest rates and, importantly, uncertainty around the direction of future rate moves. Wet weather in major population centres has also been unhelpful during the last couple of years. Interest rates now look more certain to be lower, although the flow-on of those lower rates is perhaps more difficult to predict than in previous rate cycles. Many industries are structurally challenged from changes in consumer behaviour from factors such as internet retailing, online media etc., and consumers new-found enthusiasm for lowering their debt levels is also likely to be more structural than cyclical. In addition, lower interest rates are likely to be required just to offset the impact on economic growth from the stringent federal budget for the financial year about to start. While it's also too early to predict a significant correction in the Australian dollar, an exchange rate around parity in FY13 would mean that the negative translation impact on overseas earnings would at least no longer feature amongst the headwinds. Commodity price expectations have been substantially lowered over the last six months, but current resource company earnings growth expectations of around 17% look optimistic in view of slightly lower growth in China, new supply gradually entering the market and continuing cost pressures. In summary, earnings expectations for the coming 12 months still look too optimistic, but the probability of the market delivering growth around long term averages of 7-8% have improved. Lower interest rates, a potentially softer A$, and the weather hopefully improving as well should all help.

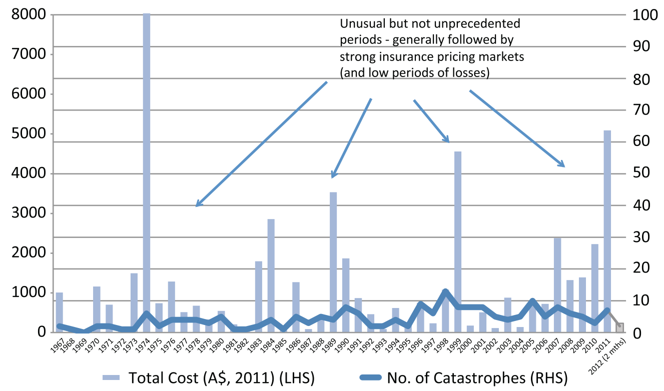
Portfolio outlook

Our focus on companies with positive earnings momentum as well as those with supportive dividend yields (such as the Banks) and avoiding most of the companies that have announced disappointing earnings news has served us well so far this year. As we see no real change to the earnings outlook for the market at this point, we believe the portfolios remain well positioned. Companies such as News Corporation, Super Retail Group, Carsales.com.au and Goodman Group are structural winners, in our view, that can continue to perform well in a challenged overall earnings environment.

We also believe that the slower growth outlook for China is now better reflected across resources company valuations. Our recent visit to China highlighted improved activity levels so we have reduced the underweight to the sector, particularly in companies exposed to iron ore, as we believe prices here will hold up well before new, low cost capacity starts to impact in two or three years' time. Recent comments from a few mining companies about re-evaluating some of their expansion plans in light of lower commodity prices has seen shares in some mining services companies, the last 12 months' best performing sector, also come under pressure. We are travelling to Perth and Brisbane this month to getter a direct feed on what is happening with order books and project pipelines. While the capex boom will obviously come to an end one day, we believe it's premature to say that that day is here. Many companies in the sector will also continue to enjoy multi-year growth in production volumes, rather than just the plant construction capex, and so as is typically the case it's going to come down to picking the right companies rather than buying or selling the sector.

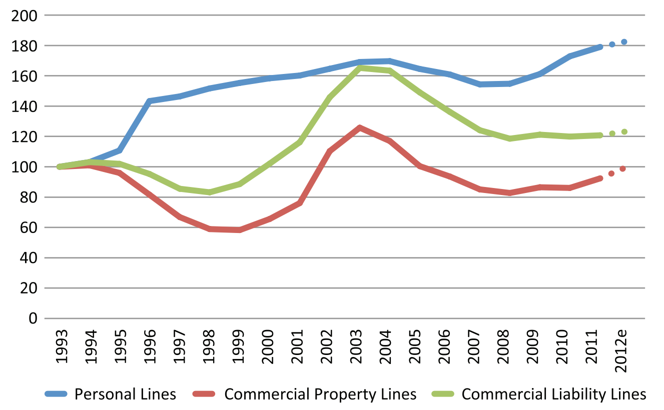
Low credit growth looks to be here for some time and bank earnings are thus likely to remain modest, but banks shares should remain supported by high dividend yields and so we remain moderately overweight the sector, although we have been trimming positions in some other fairly fully-valued yield stocks. We continue to see evidence of an improvement in the insurance margin cycle as claims normalize and insurance premiums rise to compensate for the large claims costs over the few years. This is especially the case in Australia, as shown in the charts, and we believe IAG offers the best exposure to the sector.

Australian Catastrophes (A$m 2011 normalised cost)



Source: Insurance Council of Australia, Alphinity

Australian premium rates (Real – rebased to 100)



Source: JPMorgan

BTW

John Chambers is a bit of a legend in CEO-land. He has been leading high-tech US company Cisco since 1995 and, in a recent interview with Bloomberg, noted that during his reign 87% of the companies in the Fortune 500 had disappeared or been replaced. (The Fortune 500 is Fortune Magazine's compilation of the biggest companies by revenue in the USA). That is a staggering statistic: more than 400 companies which ranked among the biggest in the US, probably the biggest in the world, no longer make the cut. Some have been taken over; others have gone broke, shrunk or just been overtaken by faster-growing companies.

When you think about it, there are plenty of large companies today that didn't even exist in 1995: most internet companies fall into that camp. And there are plenty of large companies back then which are now shadows of their former selves: in 1995 the top ten were GM, Ford, Exxon, Walmart, AT&T, GE, IBM, Mobil, Sears (a department store) and Altria (a tobacco company). In 2012, Exxon Mobil is the biggest (with three times the sales GM had in 1995), followed by Walmart, Chevron, Conoco Phillips, GM, GE, Berkshire Hathaway (warren Buffet's conglomerate), Fannie May (a mortgage company), Ford and HP. Interestingly, GM made about the same sales in 2011 as it did in 1995, but profits today are double. Having gone through bankruptcy during the GFC probably helped.

We like John, partially because he recently bought NDS, a company half-owned by one of our biggest holdings News Corporation, for $US5 billion. This showed the market that there are valuable assets within News which weren't being reflected in its share price. That $2.5 billion will provide a good chunk of the $5 billion cash News will use to buy back its own shares in FY13. But Chambers is also an accomplished business leader who believes that companies (and countries for that matter) need to keep reinventing themselves or will be left behind. That's probably always been the case, but is especially so in the fast-moving internet period (we've heard suggestions that internet years are similar to dog years – ie a year in a dotcom is like seven in a normal business!).

BTW (continued)

Speaking of dotcoms, we've spoken in the past about the potential IPO of Facebook: it is finally here. A sliver of the company will be offered to the public (or at least to select friends of insiders and investment bankers) during May, around $14 billion of stock which will make it one of the biggest capital raisings in history. The implied market capitalisation of the whole company looks like being over $100 billion. In context, that's twice as big as News Corp but a fifth the size of Apple. All this for an idea that was germinated at Harvard in 2004, but now has signed up a staggering 900 million people around the world. BTW, you can 'like' Alphinity on Facebook by visiting our website and clicking on the Facebook symbol at the bottom ☺

Traveller's tales

Andrew recently went to Switzerland to see some of Brambles' operations, but even a carefully stage-managed company visit can go awry. He went to a Reusable Plastic Container (RPC) wash-plant used by Brambles' RPC business (yes, research isn't all exciting trips to Las Vegas and Macau). The dirty RPCs come in from all over Europe stacked on pallets, which of course is Brambles main business. Unfortunately, despite having stacks and stacks of pallets in the wash plant, not one was in Brambles' distinctive blue paint. Next to a 'real' customer, a vegetable grower who uses RPCs instead of the traditional cardboard boxes. Once again, stacks of pallets but none were blue. At this point even the CEO of Brambles was having a chuckle, but he was more concerned when they went into the packing factory only to be shown piles and piles of a competitor's RPCs in use. Thankfully for Brambles, after wandering around the factory for a while, its RPCs were found in another room and working as planned – although it seems they were also being used around the place for things like filing trays and office storage, presumably part of what goes into the annual loss ratio!

One little-known division of Brambles is CHEP Aerospace Solutions, a global pool of aircraft containers: those large funny shaped aluminium boxes designed to fit snugly into a plane's hold. You see them being loaded onto planes, filled with food and cargo. While going through the economics of that business with management, we were surprised to hear that the annual loss rate of these containers is around 2%. There are tens of thousands in the pool, and they go onto reputable global airlines: you have to wonder where on earth hundreds of these containers end up each year…

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