Alphinity INVESTMENT MANAGEMENT

Monthly comment – August 2011

Alphinity Australian Share Fund

Crisis? What crisis?

Market comment

'Rollercoaster' is an over-used metaphor in relation to the stock market, but felt like an apt description during August. The month started on a sour note, with geo-politics and geo-economics both contributing to what was a minor rout on global markets. The ASX300 fell sharply in the first week, recovered much of that in the second, fell by a small amount in the third before finishing the month on a firm note only 1.3% lower including dividends. Had you gone out of contact on the Horses' Birthday and come back at the start of Spring, you'd be wondering what all the fuss was about. However that fairly flat overall result was made up of some very different constituent parts: the best performer in the benchmark was up 21% while the worst was down 41%. It was a month that contained reporting season, when companies with June or December balance dates are required to advise the market how they've been travelling. These times usually provide an opportunity for stock selection to shine through, however this time macro moves dominated the market.

Global markets followed a similar path to ours, and the fragility of investor confidence was shown by movements in the $A, which is seen by many in financial markets as a proxy for global growth due to its resource exposure. The $A fell with the stock market, from its long-term highs at the end of July of $US1.10 to close to parity a week later, before regaining much of that loss by month end to finish at $1.07. This is in stark contrast to three years ago, during NAFC Mk I, when the $A fell from $US0.97 in July 2008 to a low of $US0.60 after the collapse of Lehman Brothers in October. While it is too early to say that the current bout of currency weakness is over, it is clear in hindsight that 60c in 2008 was a massive opportunity for offshore investors to buy Australia (currency, equities, assets) and it seems that they didn't wait as long this time. Of course, with what's happened in the US economy, and with QE and QE2 over the past few years, the $US possibly looks less like a 'safe haven' than it might have before. In fact, finding safe havens in August proved difficult. Gold (up 12%), was the most obvious choice.

The Reserve Bank of Australia (RBA) again left the cash rate unchanged but importantly shifted gear from outright hawkishness ('next move is up') to a more balanced view as it responded to the very soft retail and consumer sentiment data, not to mention unemployment ticking above 5% from recent lows. A degree of softening in inflation should emerge in the coming months as fresh food prices (especially those outrageously-priced bananas) should trend lower for seasonal reasons. Economic growth concerns were sparked by some high-profile job shedding as manufacturing companies struggled with the high currency. Unemployment ticked up slightly.

Fund performance* – as at 31 August 2011

	APIR code	1 month (%)	Since inception (%)
Alphinity Australian Share Fund	HOW0122AU	–2.9	0.1
Alphinity Wholesale Australian Share Fund	PAM0001AU	–2.8	1.1
S&P/ASX 300 Accumulation Index		–2.0	2.1

* 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 Challenger's Investor Services team on 13 35 66 (during Sydney business hours). 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.

Top 5 active positions as at 31 August 2011

Alphinity Australian Share Fund

Issuer Name	Portfolio Weight (%)	Active Weight (%)
Rio Tinto Limited	3.0	1.7
Oil Search Limited	0.7	1.7
BHP Billiton Limited	12.1	1.7
Transurban Group Limited	0.7	1.6
News Corporation	0.7	1.5

Major international markets were softer: the S&P500 in the US was down 5.7%, Canada's TSX down 1.4%, UK's FTSE100 down 7.2%, Germany's DAX down 19.2% and France's CAC40 fell by 11.3%. Asian markets were also down sharply, most in the high single digits. In that context, despite our soft currency, Australia's performance looks pretty good.

Portfolio comment

The portfolio under-performed the very macro-driven market in August. The largest contributors were our positions in global media group News Corporation, property company GPT and engineering group Monadelphous, and not owning retailer Woolworths or chemicals group Orica. The largest detractors were our positions in UK fund manager Henderson Group, resource company Rio Tinto and engineering group Transfield Services. Not owning insurer Suncorp or global property developer and owner Westfield Group also cost some performance.

Reporting season wrap-up

Company-specific factors dominate most reporting seasons, but this year it was definitely the macro environment which held sway. Earnings overall were downgraded over the course of August, but the scale of those downgrades seems to be diminishing – suggesting that the market may now have factored in most of the bad news that we've been talking about all year. Looking at overall earnings growth expectations, the market multiple for the current financial year (FY12) is 10.7x suggesting the market is either outrageously cheap or that expectations need to be lowered even further. We suspect there may still be a few companies with risks to earnings, but this increasingly looks like a buying opportunity, albeit without an obvious catalyst.

From a sectoral point of view, what did we learn from reporting season?

Financials: Banks continued to have relatively resilient earnings, although top line growth is getting harder to come by: strong sustainable dividend yields are now the focus. On the other hand, insurance companies tended to have relatively resilient top line growth and we think this will only improve, but are still feeling the effects of both large natural catastrophes as well as investment market volatility on their bottom lines. Wealth management businesses were also affected by the investment markets, but appear much better prepared for this bout of volatility compared to a few years ago.

Industrials: A two-speed sector in itself with mining services-related companies expressing confidence in the year ahead while earnings expectations for others continue to be slowly wound back as the full impact of the slowing economies both domestically and offshore continue to bite. Those businesses that have more stable 'infrastructure' type qualities are also holding up well.

Consumer staples: Trying to cope with price deflation and cost inflation, this normally defensive set of companies struggled more than you would normally expect in the soft market conditions.

Consumer discretionary: It's no surprise that things are very tough in consumer land, and the more the poor conditions are talked about, the bad news seems to feed on itself and things become even tougher. There is no sign of these trends ending, and it is not certain that even a cut in official cash rates – should that happen – would improve things materially

Property: A minor trend towards being shareholder friendly emerged: announcing buy backs was the dominant theme, some even started executing them. Some upgrades from lower cost of debt as GFC-time borrowing rolls off. However, much of the sector is indirectly exposed to the same themes as consumer discretionary.

Telecommunications: A poor equity market and a decent result from Telstra, with its first earnings upgrade for some years, meant the sector performed well in August relative to the market.

Resources: Higher operating and capex costs are creating some headwinds in the sector. Commodity prices however, especially iron ore and thermal coal, are holding well despite global slow-down concerns. The continuation of growth investment bodes well for the mining services sector.

Energy: Earnings surprised positively thanks to higher than expected realised prices and good cost control. The market remains concerned about the implementation of large company-making LNG projects, which as demonstrated by Woodside's experience, can take much longer to be realised and could end up being far more costly.

Healthcare: Earnings resilient as expected though the currency took the shine off the result for those companies with significant overseas sales. Cutbacks in government health care spending had a negative impact on some domestic companies in FY11, though this now appears to be behind us. Cuts overseas, especially in the US, could be the wildcard in FY12.

Market outlook

The markets were volatile during company reporting season, as global-macro forces combined with concerns about a softening domestic economy. As we look into September, those forces have not gone away and, in fact, seem to be intensifying in some areas. European banks, the Euro itself and the US economy are all causing a degree of stress in financial markets which suggests that September will be another unusual month. We take some solace from the fact that Australia's major trading partners in Asia seem to be holding up well, which will support the resource side of the economy, and that some of the soft economic indicators have convinced the RBA to hold off further rate rises for the moment. There is however a reluctance on the part of the Bank to endorse the market's view that rates should be cut. We continue to see good opportunities in some segments of the market.

Portfolio outlook

The global volatility in August meant that the results of individual companies had less impact on relative shareprice performance than normally is the case. However, in our experience, this tends to be a short term phenomenon and fundamentals will ultimately reassert themselves. Our confidence in our key holdings was supported by generally strong results with no or only minor earnings downgrades occurring. We remain confident in our modest overweight in resources, and our underweight in consumer stocks. We also remain exposed to some of the companies supplying services to miners which are benefiting from the factors making the RBA reluctant to cut, such as Bradken, Monadelphous and Fleetwood.

Outside of the resource-related sectors, or companies, the portfolio has for some time had a focus on more stable stocks with a supportive yield. In this category our core holdings are Transurban and MAp and to some extent also the banks. We were encouraged by the full year result of another high yielding stock, Telstra. For the first time in some years, the company came in above market expectations which also resulted in upgrades for FY12. A strong performance by Telstra's mobile operations is driving its improved outlook. The results announcement was the trigger for us to further increase our position from about neutral to a moderate overweight relative to our benchmark.

As readers of our earlier reports would be aware, we find that on-the-ground company and industry information give the best insights into what is really going on at the company level. With Australia's and global growth being significantly influenced by economic activity in developing markets, we will soon be travelling back to China for the third time in a year. We look forward to reporting our findings in a future monthly report.

BTW…

From the "If it's too good to be true, it probably isn't" department, be careful if you're tempted to buy any electronics on the cheap. According to the Sydney Morning Herald, 22-year old Ashley McDowell was picking up food one night in August at a McDonalds in South Carolina when two men approached her in the parking lot. After showing her a new iPad, the police report said, they told McDowell that they had purchased them in bulk and were reselling them for $US300 apiece. McDowell evidently jumped at the chance to snag a cut-rate iPad but explained that she had only $US180. The men decided to sell her one iPad at that price, she told police. McDowell handed them the money and then waited to open the box until she got home - where she proceeded to pull out not a shiny new tablet, but a "piece of wood painted black with an Apple logo", the police report said. The so-called "screen" is filled with mock iPad icons for email, photos and Safari - all held down with black tape. McDowell told police that the swindlers were driving "a white Impala with no rims and no tint", and one of the guys, she noted, had "a gold tooth". Caveat Emptor.

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