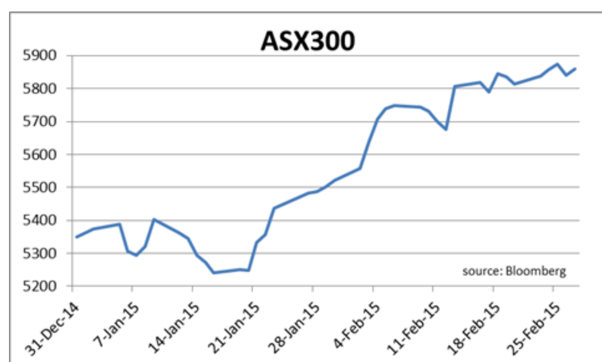
Alphinity INVESTMENT MANAGEMENT

Monthly comment – February 2015
Alphinity Wholesale Australian Share Fund

ShareMania!

Market comment

After the pleasing 3%+ rise in January one might have expected a pause for breath but the market just kept going, recording an astounding 6.9% in February (S&P/ASX300 including dividends). The official cash rate was lowered to an all-time low of 2.25%p.a. early in the month. In contrast – and partially as a result – the equity market has gained 10.4% in January and February (plus tax benefits from receiving franked dividends). The best gains were in the resource sector, which rebounded somewhat from recent losses, while recent strong performers, like the high-yield Telecommunications and Real Estate sectors, lagged. It is probably fair to say that the market was not very discriminating about quality and some companies performed very well on relatively benign news – or even just no bad news.



Generally speaking, it would be reasonable to expect some sort of pull-back after a rise of that magnitude, yet the market's >4% dividend yield still looks quite appealing in the present low interest rate environment. Another development during the month may turn out to be significant: the bid for struggling logistics company Toll Holdings. This foreign takeover may be a foretaste of things to come (see BTW).

Global market returns were generally not as good as ours, the exceptions being a few sub-investment grade places like Russia (+20% in a month!), Greece (+15%!) and Italy (+8%). Poor old Ukraine fell by 30% in $A, making a 50% delta with its troublesome neighbour Russia; most Asian markets were up a very small amount and the US rose by a little more than 4%.

Portfolio comment

The portfolio performed strongly in February but not quite up to the level of the overall market. Financial services companies Macquarie and AMP were the biggest winners in February, and not owning insurer Suncorp also contributed. Detractors included employment and education company Seek and alumina producer Alumina Ltd, while not owning bid-for transport company Toll Holdings hurt a little.

Market outlook

As the dust settles after another busy reporting season, the aggregate market earnings outlook for FY15 is largely unchanged at close to no growth. Resource companies achieved better-than-expected cost reductions offsetting some of the impact of the collapse in commodity prices. The Resource sectors are however still responsible for the dearth of overall earnings growth forecast for the Australian share market in the current financial year. Other sectors saw net small downgrades in February but remain on track for decent earnings growth of 5-10% for the full year, driven largely by cost reductions and the translation benefits from the lower Australian dollar.

With the exceptionally strong start to the year for equity returns, the market has now rerated to around 16 times 1-year forward earnings and a 4.5% dividend yield: this is by no means at record levels but is ahead of the trading range of the last couple of years.

Historically-low interest rates could well support markets at current levels. However, risks have increased in our view, and not only because of increased valuation metrics.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	6.3	11.9	13.1	13.2	17.9	12.8
S&P/ASX 300 Accumulation Index	6.9	12.6	14.2	12.2	15.8	11.4

*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 relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 (during Sydney business hours).

![Alphinity Investment Management logo]

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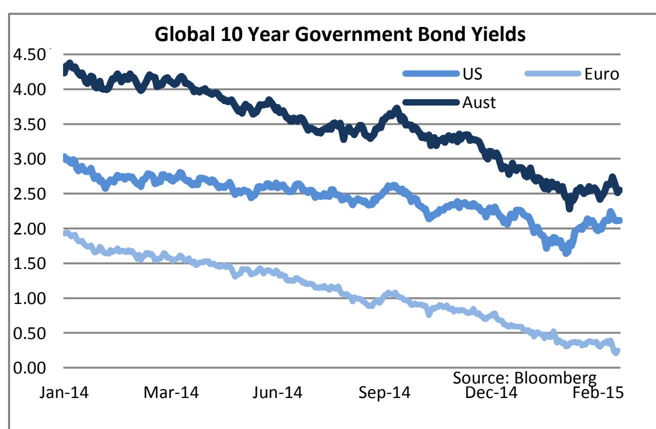
Earnings risk still remain for Resource companies (both in the Metals & Mining and Energy sectors) and, while cost-out achievements have been impressive across the market, sales growth remains elusive in most sectors which puts the sustainability of current growth rates into question. The US equity market may furthermore provide less of a positive lead as we edge closer to "lift off" for US short rates. Low interest rates are clearly in front so far in the equity tug of war against the lack of earnings growth, but a pullback would not surprise at some point in the next few months.

Portfolio outlook

Our underweight position in Resources has been a solid contributor to performance over the last 12 months. While it hurt a little in the month of February, when resource company shares were buoyed by investors' increased risk appetite and revelations of companies' impressive cost reductions, we believe this outperformance will be short lived as the prices of key commodities remain under pressure. Energy stocks also fared a bit better in February as the price of oil stabilised after more than six months of falling prices. Again, we believe this to be temporary. The build in global oil inventories shows no sign of abating and we believe there is a risk investors could be disappointed as market expectations are for a relatively swift rebound in prices. We have thus further reduced our underweight to the sector by selling Oil Search.

The outlook for "yield" stocks has been complicated by recent market developments: US bond yields have rebounded somewhat, in anticipation of the Fed increasing cash rates, while European bond yields have continued to fall.



Australian yields however have increased along with US rates but to a lesser extent than the historical correlation would suggest, highlighting the fact that economic growth in Australia remains weak, as indeed it does in most regions outside of the US.

The fund is moderately underweight "yield' stocks and we would be looking for stronger economic growth in the domestic economy before shifting this position notably, especially as the ageing population adds a structural element to the demand for high yielding assets. The case for a stronger $US against most other currencies on the other hand appears firmly established. We continue to have a portfolio tilted towards companies that are operationally performing well (or improving) that will also benefit from a stronger $US.

One such stock is Incitec Pivot. The company has some inbuilt volatility through its leverage to global fertiliser prices and mining explosives in both North America and Australia. However, the company has reduced this exposure by signing long term contracts (e.g. in Australia for explosives during the mining boom). IPL has also been through a period of heavy investment in new growth projects and while the largest one, an ammonia plant in the US, is still under construction, increased cashflow and returns are now within sight. An improved operational performance after some much-needed maintenance spending last year also appears to be on track. Combined with significant translational as well as transactional benefits from the weaker $A, we believe the company's earnings has the potential to surprise to the upside.

Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size ($A)	130.8M
APIR code	PAM0001AU
Fees	
2013/14 ICR	0.90%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	Nil
Buy/sell spread	+0.20%/-0.20%

Asset allocation	As at 28 February 2015 %	Range %
Securities	97.5	90-100
Cash	2.5	0-10

Top 5 active overweight positions as at 28 February 2015	Index weight %	Active weight %
Goodman Group	0.6	1.9
Macquarie Group Ltd	1.6	1.7
APA Group	0.7	1.7
Aristocrat Leisure Limited	0.3	1.7
Westpac Banking Corporation	7.9	1.6

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BTW

The bid for Toll Holdings that took place in February could turn out to be a harbinger for the local share market. Toll released its earnings for the first half of FY15, the quality of which should have made its share price drop sharply, but was saved by a takeover bid for the company by Japan Post at a 50% premium to the prevailing share price.

From a fund manager's viewpoint, this is like winning the lottery: rather than owning a losing position, you get a completely undeserved winner. This is low quality performance as it is unrepeatable, but it is what it is (you can probably deduce from this spray that we didn't own Toll!).

A bid from out of the blue was a good outcome for its shareholders, but why was Toll an appealing target for Japan Post? Some point to the $A which now at six-year lows against the $US and 30% below its 2011 peak of $US1.10, but this doesn't really stand up to scrutiny. For a start, the $A hasn't fallen that much against the Yen – in fact it is only about 7% below its all-time high. Japan has engaged in aggressive Quantitative Easing in order to get its currency lower while the Reserve Bank of Australia has merely been "jawboning" (ie consistently saying that the $A is too high), with the recent rate cut being the only tangible action that might have impacted the currency. Secondly, it doesn't make sense to buy Australian assets just because the $A is low, as the earnings one buys will also be worth less to the acquirer. So in reality, unless the buyer thinks the low currency is quite temporary or there are other factors, such as valuable non-Australian operations, just having the $A fall should not have been a major factor in Japan Post's considerations.

Domestically-focused Japanese companies like Japan Post face a difficult home market: demographic trends in Japan are very challenging. Lacking the immigration which has characterised polyglot societies such as USA, Canada or Australia, combined with the impressive longevity of the Japanese people, means the population is ageing swiftly and this provides significant challenges for the economy. Decades of very low economic growth and those poor demographics has meant that many Japanese companies have been forced to look outside Japan for growth.

Australia has been a popular place to expand for its beverage companies, for example. Brewer Kirin has spent billions of dollars assembling an Australian empire covering milk, beer and wine. Competitor Asahi likewise has bought up as much as it can, now controlling Schweppes and Pepsi here as well as NZ-based Spirits producer Independent Liquor. Alphinity met with Asahi in Tokyo last year to talk about its Australian strategy and the company was clear that it was the top line rather than the bottom line it was primarily interested in: it was earning plenty of return in its domestic market but needed an element of sales growth to ensure the future of the company when the demographics really deteriorate.

But one of the bigger factors might end up being as simple as funding cost. Toll at the bid price is trading at 22 times current year earnings and 21 times FY16 – expensive for a struggling industrial company with such a modest earnings growth outlook. How can Japan Post make economic sense of such a transaction? Japan Post has a banking arm which accepts deposits from Japanese consumers. One of our brokers pointed out at the time of the bid that its funding cost – based on the JP one-year deposit rate – was 0.03% (three hundredths of a percentage point) and that Japan Post had more than $US2 trillion on deposit at that rate. With those metrics, buying pretty much any earnings stream is accretive regardless of the price. Japan is not alone in having extremely low funding costs – much of the world is in the same situation. So while Australian shares provide such a good earnings and dividend yield, the possibility remains that further bids such as that for Toll will occur.

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Apple Bites

Apple Inc* is an intriguing company and its incredible record of innovation has enabled it to become the largest company in the world by market capitalisation. It went through a rough patch a couple of years ago when it started getting earnings downgrades and its share price almost halved between September 2012 and April 2013, then its founder Steve Jobs died later that year. Was it all over for Apple?

As it turns out, no. The company responded by doing what it was good at: producing beautifully-designed pieces of consumer electronics desired by lots of people. The downgrade cycle ended and earnings upgrades resumed and its share price has since more than doubled. Apple's most recent quarterly result revealed some interesting factoids which, courtesy of businessinsider.com.au, we relate (with a few tweaks) below.

- Apple's market cap is US$740 billion. That is more than the GDP of all but 17 countries. Number 18, The Netherlands, had a GDP of US$720 billion in 2013, according to CIA estimates.
- Apple's quarterly revenue just from the iPhone was $51 billion, greater than Yahoo's entire market capitalisation of $40 billion.
- Apple's iPhone revenue was more than three times Google's $16.5 billion total revenue in the same quarter.
- Apple's iPhone revenue was almost twice Microsoft's total quarterly revenue of $26.5 billion.
- At 74.5 million units, Apple sold seven times as many phones as Microsoft's entire Nokia business. In fact, 74.5 million is more iPhones than Apple sold during its entire 2011 fiscal year.
- Apple has $178 billion in cash, more than enough to buy IBM at its current market cap of $152.3 billion.
- In fact, Apple could buy Ford, GM, and Tesla and still have $41.3 billion left over.
- Apple's iPad revenue alone, $9 billion, is more than enough to buy sports camera maker GoPro at its current market cap of $6.6 billion.
- Apple's post-tax profit last quarter was $18 billion, the largest quarterly earnings for any company ever, according to Wikipedia. The previous record was held by Gazprom, Russia's enormous oil and gas company, which booked a $16.2 quarterly profit in August 2011. In fact, every other company in the top 25 most profitable quarters of all time is an energy company.

Apple CEO Tim Cook on the way to the bank

Alphinity Investment Management

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*Apple is a US-listed company and not eligible for inclusion in this portfolio