Monthly comment – February 2012
Alphinity Wholesale Australian Share Fund

Reporting season rampage

Market comment

February is reporting season, which always brings a deluge of information about the companies we cover. With just about every company on the market providing either earnings, sales or a quarterly update, it is a great opportunity for us to review the assumptions in our financial models and, more importantly, meet with the senior management of the companies we've invested in – and many of those we don't – to test them on strategy and outlook. There were more downgrades than upgrades during reporting season, but the fact that the market rose anyway suggests that investors were well ahead of brokers in terms of their expectations.

Although the market was up a modest 2% in February, there was a larger than normal divergence in individual stock returns. It was a dangerous month to be a hedge fund manager: there were many large and surprising stock price movements, no doubt exacerbated by those funds covering short positions. In some cases there was a corporate angle. We have tabled the most extreme moves below.

Corporate activity (aka takeovers) is often an outcome of cheap markets. While investors are sometimes reluctant to buy some stocks despite low valuations, others who feel they have a better understanding of the underlying companies' fundamentals might step up. During the month a number of unloved or poorly performing companies were sought out by trade or private equity buyers, resulting in big price jumps. Some of these may come to nothing, but are good for the share price in the short term.

Australia didn't do quite as well as some other markets, which is not surprising considering the sideshow in Canberra over political leadership that was only settled towards the end of the month. The $A remained around its recent elevated level. It was bolstered by the refusal of the Reserve Bank to endorse the overwhelming market expectation of a third rate cut, with the Governor saying he thought monetary policy is 'about right at the moment'. While disappointing to the market, the Reserve Bank of Australia believes that some parts of the economy need to grow below trend to compensate for the resource sector's above trend growth.

Fund details

Alphinity Wholesale Australian Share Fund	
APIR code	PAM0001AU
FUM ($A million)	124.5
Asset allocation	Australian equity: 98.2%, Cash: 1.8%

Fund performance* – as at 29 February 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Australian Share Fund	2.4	6.2	–6.6	3.2
S&P/ASX 300 Accumulation Index	2.0	5.7	–6.8	3.1

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

Top 5 active overweight positions as at 29 February 2012

Alphinity Wholesale Australian Share Fund

Issuer name	Index weight	Active weight
Goodman Group	0.4%	1.8%
News Corporation	0.8%	1.7%
Bradken Limited	0.1%	1.7%
Oil Search Limited	0.7%	1.7%
Transurban Group	0.8%	1.5%

The US market was up 4%, UK +3.3%, Germany and France +6% and +4.7% respectively as the Euro crisis waned. Closer to home, Singapore was +3%, China +6% but Japan was up almost 11%. Japan is still down 9% since the end of February 2011: it is coming up to a year since the earthquake and resulting tsunami devastated both the country and its share market.

As we head into March, the endgame for the Greek debt machinations is very imminent with a variety of possible outcomes; and US and Israeli rhetoric over Iran's nuclear program seems to be ramping up. We are living in interesting times.

Portfolio comment

The portfolio outperformed the benchmark in February, with good contribution to performance from blokey retailer Super Retail Group, gold miner Medusa, and travel operator Flight Centre. There were no individually significant detractors.

Market outlook

The final scorecard from the February reporting season was net downgrades of around 3% to full year earnings estimates. The market is now looking at a FY12 earnings growth of approximately 3%. This may not sound like a big ask, but the reality is that there is a large 'second half club'; many companies will require a much better second half than what they achieved in the first in order to meet revised forecasts. Some further downgrades before the August full year announcements are thus likely. FY13 expectations are for about 13% growth and this also looks a bit optimistic unless we see a break in the current settings of a high exchange rate and low economic activity outside of the resources sector. The valuation of the market, however, is quite modest at (on our estimation) less than 12 times FY12 earnings. During 2011, the market fell more than earnings and so valuations are looking more attractive. Increased risk appetite thanks to the European LTRO and other liquidity boosting actions have the potential to see markets re-rate in 2012. For more sustainable positive returns, earnings growth needs to improve from the modest level expected in FY12. While we believe that the current earnings estimates for FY13 may be a bit too optimistic, this is not overly concerning to us. The bull market of 2004-2007, when

Big up/down moves in February

Stock	Return	Reason	Stock	Return	Reason
Billabong	63%	Corporate interest	Arafura Resources	-36%	Project issues
Onesteel	43%	Result, upgrades	Aquarius Platinum	-24%	Result, downgrades
Seek	29%	Result, upgrades	Industrea	-22%	Result, downgrades
NRW Holdings	26%	Result, upgrades	ERA	-18%	Result, downgrades
Goodman Fielder	25%	Corporate interest	Platinum Australia	-17%	Result, downgrades
Super Retail	21%	Result, upgrades	Aquila Resources	-15%	Result, downgrades
Echo Entertainment	20%	Corporate interest	FKP Property Group	-13%	Result, downgrades

earnings estimates were raised as the year progressed, was an unusual period. The traditional earnings pattern for most of the prior decade was that earnings estimates started off the year at around 13-15% and then were scaled back to mid-to-high single digit over the course of the year. Together with dividend yields of 3-4% this was sufficient to provide attractive annual returns of 10-12%. This is a reasonably likely scenario for the next 18 months.

Portfolio outlook

Our key portfolio holdings delivered solid earnings reports and were rewarded with positive share-price reactions. We continue to expect a market environment with an improved risk appetite over the course of the year compared to 2011, but with no real change to the overall earnings picture. The positive portfolio performance during the important reporting season gives us confidence that we are well positioned. We remain underweight in the metals and mining sector based on our view of low construction activity in China for the next several months. Stephane is heading to China again this month to see how things have evolved since his last trip in November. Our investments in the broader resources area are instead focused on the energy sector, although we have trimmed our positions somewhat given strong share-price performance. Another offset to our underweight position in the cyclical metals and mining sector is our large underweight position in consumer staples; where we struggle to find any companies that we view as having the potential to deliver positive earnings surprises. Some of our more exciting names are at the mid-to-small cap end and include Super Retail Group, Flight Centre, Carsales, Monadelphous, NRW, Bradken and Medusa Mining which all delivered strong interim results and/or positive outlook statements.

We are typically skeptical of turnaround situations but there were plenty of share-price reactions in February suggesting that some investors are willing to bet on changing fortunes for companies, even those which reported interim earnings that led to downgraded estimates for the full year.

Two companies stood out to us as having reported genuinely better than expected earnings at the half year, along with a more confident outlook: steel manufacturer OneSteel and general insurer IAG. While still early in the improvement cycle, the share price upside potential is significant and we have taken positions in both. In the case of OneSteel, the attraction is not so much the company's steel manufacturing business (which should improve in the second half) as the production growth profile for its iron ore and mining consumables businesses. In fact, the expansion of these two business areas has changed the company's composition so much that management is planning a name change to something more representative of the new group.

In the case of IAG we have for some time been intrigued by the increase in insurance premium rates achieved by industry participants, but our enthusiasm has been tempered by an extended period of natural catastrophes and high claims costs. While it is difficult to forecast when claims will normalise, we were positively surprised by the extent to which management has been able to increase premium rates across the business as well as improve the performance of its underperforming commercial insurance unit CGU and its UK business.

BTW

We wrote last month about some of the characteristics of 'The 1%' in the USA. We subsequently received research from US investment bank J P Morgan regarding proposals that have been made by President Obama to sharply increase tax on people earning over $US200,000. There was a slightly plaintive tone to this note, although given recent trends in bank profitability in the US, perhaps the writer need not worry about being too badly affected.

We found it interesting, if only for the history it gave and the comparison to our own taxation system. President Obama is proposing that income tax in 2013 reverts to levels prevailing before the much-derided (or revered, depending on your position) 2001 Bush administration tax cuts. Should it come to pass, the second marginal tax rate (cutting in at $210,000) will increase from the present 33% to 36%, and the top rate (cutting in at $380,000) from 35% to 40%. This still appears to be well below Australia's top tax bracket of 46.5% however, unlike in Australia, individual US States also get to impose income tax. In New York, where this writer was from, that equates to a further 7%. So overall US taxation is lower than here but this may not be the case for much longer.

The big differences are (a) the income level at which the top tax bracket cuts in: Australia's top tax rate starts at $A180,000; (b) indexation: US tax thresholds are adjusted each year for inflation, whereas we are still subject to "bracket creep"; and (c) income splitting: in the US, married couples have the option of filing joint tax returns and, if one earns a lot and the other not much, share their income across two lots of tax thresholds.

The really interesting thing was a bit of history: top tax rates in the US have been massively higher in the past. Data provided by the Tax Foundation shows that the top US marginal tax rate peaked at 94% in 1945, although you had to be an extremely high earner to pay that much. The 94% rate cut in at an income of $200,000, equivalent to $2.5m pa in today's dollars, so there would only have been a small handful of people who paid those rates. It wasn't until the mid-1960s that the top marginal rate fell to a more "reasonable" 70%, then 50% in the early 1980s.

The higher tax rate alone proposed by President Obama is projected to raise $US442 billion. In addition, he proposed taxing dividends in line with income (to raise $206bn), lifting the capital gains tax to 20% ($36bn) and limiting tax deductions and exemptions ($165bn). Given the fairly dire position of public finances in the US, we are confident that high earners will willingly submit to the higher rate. President Obama has projected that these changes will take public sector debt in 2022 from 90% of GDP to about 60%.

By contrast the current Republican front-runner, wealthy former private equiteer Mitt Romney, is proposing the top tax rate drop from 35% to 28%.

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