Alphinity INVESTMENT MANAGEMENT

Monthly comment – February 2013
Alphinity Wholesale Australian Share Fund

Reporting season rampage

Market comment

The market run continued in February, to the extent that there now seems little doubt that we are in a bull market (see page 4 for a discussion of what this might actually mean). The S&P/ASX 300 Accumulation Index (including dividends) rose by a further 5.3% in February, building on January's 5% and the 17% in the months of June through December 2012. It is interesting to note that, according to the ASX300 (excluding dividends this time), the market bottomed in June 2012 at 3977 and has since rallied to 5077. This is a move of 27% pre-dividends: it feels like a bull market to us. At the risk of hubris setting in, it seems that any pull-back in share prices is short-lived as investors, who are gradually getting less and less from their term deposits and annuities, jump at the chance of shares at a 'lower' price (see page 4 also for the definition of FOMO). Markets never go up in a straight line however and towards the end of February some cracks had started to appear: an uncomfortable result in Italian elections, the approach of the second tranche of the US fiscal cliff (sharp government spending cuts known as 'sequestration'), and suggestions that the latest iteration of quantitative easing in the US may not be infinite after all.

Australian shares in $A outperformed pretty much every market in the world. Korea and Japan weren't far behind and the US and Sweden both rose 3%, but apart from that it was red ink. The UK fell 1%, France and Germany were both down 2%. Shares in Chinese companies traded in HK fell by 5%, Greece was off close to 6% and the Italian election machinations caused a sharper sell-off: Italy was down more than 10%. The $A fell about 2% against the $US and Yen but rose about 2% against the Pound and Euro.

Commodity prices were generally softer in February. Iron ore was roughly flat but base metals fell on poor Chinese manufacturing data: copper down 3% and aluminium down more than 5%. Oil also fell from recent highs: down 4% in the month. Gold fell by about 5% in the month and is now 12% below the level at which it peaked in September 2012.

Portfolio comment

The portfolio performed in line with the strong market in February. The only individually meaningful contributors were our positions in general insurer IAG engineering services company Downer Group and major bank Westpac. There were no detractors of any significant magnitude.

Fund details

Alphinity Wholesale Australian Share Fund	
APIR code	PAM0001AU
FUM ($A million)	125.3
Asset allocation	Australian equity: 97.9%, Cash: 2.1%

Fund performance* – as at 28 February 2013

	1 month (%)	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Australian Share Fund	5.3	15.1	27.7	9.2	12.4
S&P/ASX 300 Accumulation Index	5.3	14.2	23.4	7.2	10.8

* **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 28 February 2013

Alphinity Wholesale Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	7.6%	2.2%
Lend Lease Corporation Limited	0.4%	2.1%
Insurance Australia Group Limited	1.0%	2.0%
Rio Tinto Limited	2.3%	1.8%
Woodside Petroleum Limited	1.9%	1.5%

Market outlook

The February reporting season gave investors just enough to support the share market rally we have experienced since the middle of last year. While earnings did not really surprise positively (see Reporting season wrap below), the downgrades were much more modest than we have seen for a couple of years and were in any case dominated by the resource sector, which has been lagging the market's upward trajectory.

Encouragingly, earnings expectations held up well amongst 'industrial' stocks, supporting current market expectations of a fairly believable 6-7% earnings growth for these stocks this financial year. Our view remains that investors have reason to be a bit more patient this time around, as lower interest rates are likely to not only support increased equity allocations, which we are already seeing the effect of, but also stimulate economic activity. With this in mind, it is not too difficult to justify current market levels.

Our aggregate bottom-up valuations point to the market now being much closer to fair value rather than the outright cheap levels prevailing a year ago, and a consolidation period is likely sometime in the next few months. However, we continue to expect equity markets to be higher by year end.

Portfolio outlook

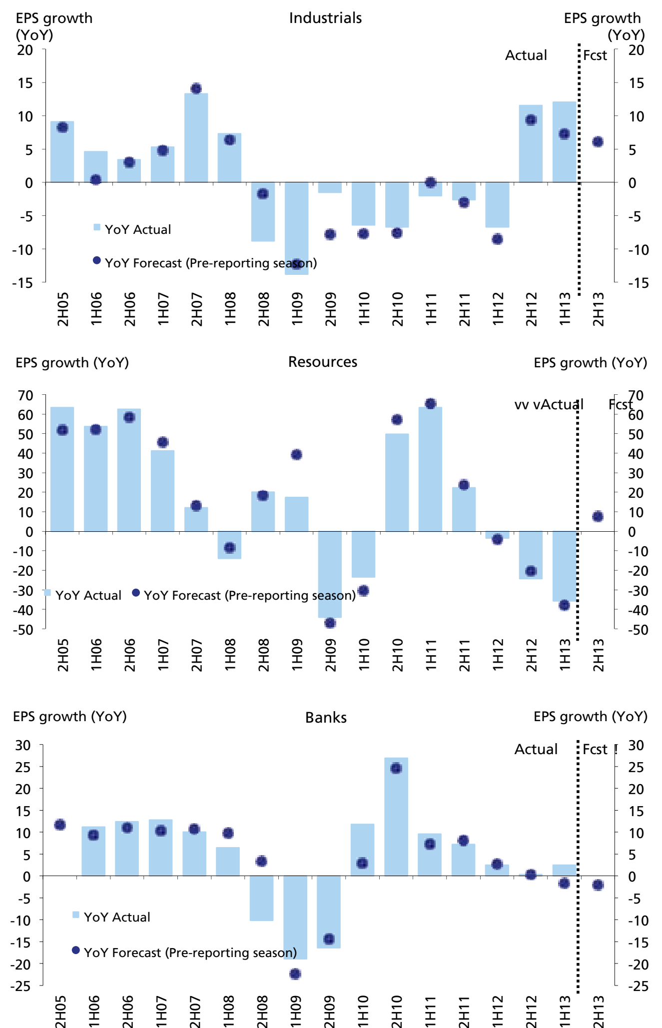
The Fund came through the reporting season in good shape, with the clear majority of our larger overweight holdings seeing earnings upgrades on the back of solid interim results and positive outlook commentary. Over the last six months we have been gradually reducing the 'high yield' stocks to a position close to benchmark weight and increased our exposure to stocks with stronger earnings leverage to interest rates and equity markets such as Myer Holdings, Macquarie Group and Computershare. Following strong results that we believe signaled the end to their respective earnings downgrade cycles, we have added both JB Hi-Fi and Asciano to the portfolios. Should we get further confirmation of an improving earnings outlook we are likely to continue to shift the portfolios further in this direction.

We believe we are already well positioned for the current market environment and are encouraged by our continued outperformance over the most recent months when the market's focus appears to have shifted away from earnings certainty and yield support (which drove the early stages of the rally) to stocks with stronger valuation upside and more cyclical earnings profiles (which seem to be doing well now). Within these settings we continue to focus on stocks with unique earnings drivers which we believe will see them deliver superior returns – against both the broader market and their immediate peer group.

Two such stocks are Lend Lease Group and Downer EDI. While operating in markets that are not without challenges, in our view both companies have secured strong order books, are demonstrating (or are about to demonstrate) improving balance sheets, and underestimated earnings profiles.

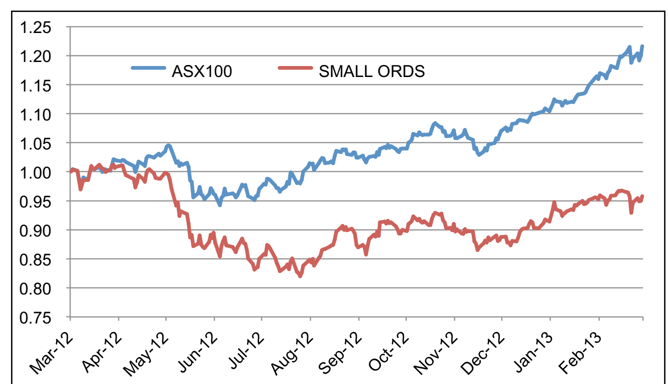
Reporting season wrap

February contained the normal deluge of information regarding most listed companies and, as always, contained a number of surprises. While the market had small overall downgrades, it appears that, at least for 'industrial' companies (i.e. those outside the resource sector), the negative earnings cycle that had been in place for the last couple of years has now largely stopped, and in fact there has been in aggregate an upgrade to FY13 earnings. The adjacent charts, courtesy of our friends at Macquarie, provide a neat summary of overall market trends. The first graph shows that for the half-year ended December 2013, industrial company earnings beat prior estimates (the space between the dot and the top of the bar), and expectations for the second half still seem fairly modest and achievable.



It is a less happy story for resource stocks, which had experienced much steeper downgrades (note the different scale). The expected growth for the balance of FY13 appears ambitious and is probably at risk. Banks have had overall positive revisions in recent months, although the absolute level of earnings growth is much lower than other industrials. Having said that, three of the four major banks have financial years ending in September and Bank reporting season largely takes place in May, which is when we would expect to see more meaningful changes.

Another interesting thing we've noticed is the increasing performance disparity between small-cap and large-cap shares. Pretty much since the Greece-Euro-crisis-related market sell-off in May 2012 – now just a blip on the chart regardless of how significant it felt at the time – small companies have underperformed large companies quite substantially. The chart shows both indices re-based to 1 March 2012 and excludes dividends. Stocks outside the top 100 were hit harder in May and have not participated in the rally since June to the extent that larger stocks have. Your Fund does not have a specific focus on either large- or small-caps but it is encouraging to note that most of the ex-100 stocks in our portfolios did quite well over the period even before dividends, including carsales.com (+75%), Super Retail Group (+61%), Resmed (+57%), Flight Centre (+45%), and Henderson Group (+33%).



BTW

What is a 'bull market'? It defies official definition, but a few pundits have tried. Investopedia.com suggests that it is 'when prices rise or are expected to rise', although this seems a little vague for our liking. Can you have a one-day or one-month bull market? We think not. InverstorWords.com's 'prolonged period in which prices rise faster than their historical average' is a little better but still too vague.

In reality it probably occurs when investor sentiment shifts from being concerned for the security of the money they have tied up in the market, to being worried about missing out on the gains being made. This is also known as FOMO, or 'fear of missing out'.

On any definition, however, it appears that the current market is indeed bullish. The origin of a market being 'bull' is obscure. Some think it to be from the archaic expression 'bully' which meant excellent, although others point to the French term 'bulle spéculative' which is a speculative bubble in a market. To reinforce the analogy, a bull is a fast-charging animal which typically uses its horns when fighting, in this case uses them to toss the market in a upward direction.

By contrast, the bear is a (relatively) slow animal which hibernates from time to time. In a bear market it uses it front paws and claws to drag the market down. The etymology is as obscure as for bull, but one theory is that bear skin traders in London in the 1700s often used to sell hides in advance of receiving them in expectation of lower prices when the market was flooded by shipments coming in from North America – hence for prices to be falling is 'bearish'.

What's the difference then between a 'bear market' and a 'correction'? It appears that a correction is when share prices decline temporarily within a bull market, as can happen, but again interpretation is everything. A more cynical definition might be to say that when the value of shares owned by someone else falls, that's a correction. When shares owned by me fall, that's bearish.

Alphinity Investment Management

Level 15, 255 Pitt Street
Sydney NSW 2000

T 02 9994 7200

F 02 9994 6692
W www.alphinity.com.au

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