Alphinity INVESTMENT MANAGEMENT

Monthly comment – February 2014

Alphinity Wholesale Australian Share Fund

Chilling out with the Polar Vortex

Market comment

The US economy is still the most important driver of world economic growth, and the US consumer the biggest driver of its economy. Both are watched diligently by equity market participants even outside the US itself. A patch of soft data has recently developed in the US which is concerning some of those participants. Is it early signs of the effect of starting to withdraw the unusually large amounts of monetary stimulus commonly known as QE? Is it an underlying weakness in the economy left over from the GFC that is yet to be addressed? Or has it just been the flow-on effect of the Polar Vortex (see BTW)? Janet Yellen, the new Chair of the US Federal Reserve Bank, eventually weighed in and gave the weather the benefit of the doubt, saying that the Fed will take into account the climatic factors when reviewing policy settings.

Concerns were assuaged sufficiently that most markets did pretty well in February. Of the major markets only Japan and Russia went backwards – Russia falling late in the month over escalating tensions with Ukraine – but pretty much everywhere else was up quite nicely. In $A terms most European markets were up 4-5% and the US rose 2.5% but many developing markets rose by less. The $A was up about 2% against the $US and Yen but only 1% versus the Euro and Pound. Our market provided very strong returns in February, more than making up for last month's weak start to the year: the ASX300 (including dividends) rose by 5%. The reporting season provided a lot of data but, importantly, supported our contention that while some earnings downgrades may still occur, the market overall will likely end up with a reasonable degree of earnings growth in 2014 – the first time in some years.

Commodities were mixed: gold was up more than 6% but base metals were roughly flat and oil fell 2%. Iron ore was down about 4%, not helped by some soft data relating to Chinese economic activity.

Portfolio comment

The portfolio performed roughly in line with the rampant market in February. Despite it being reporting season there were few individually significant contributors or detractors to the Fund's performance. Advertising company Carsales.com was the only positive of note, but was offset by not owning fellow-dotcom stock Seek, which detracted modestly.

Market outlook

Our expectation of solid equity market returns in 2014 remains unchanged. While we have consistently cautioned investors not to become too exuberant about global growth prospects, and recent data from both the US and China seem to support that hesitance, the recently-concluded domestic earnings reporting season has been encouraging. As we discuss on the next page, aggregate earnings expectations for FY14 are now slightly higher than they were a month ago,

Fund details

Alphinity Wholesale Australian Share Fund	
APIR code	PAM0001AU
FUM ($A million)	124.5
Asset allocation	Australian equity: 98.4%, Cash: 1.6%

Fund performance* – as at 28 February 2014

	1 month (%)	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	3 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Australian Share Fund	4.7	2.1	13.4	20.3	10.6	12.7
S&P/ASX 300 Accumulation Index	4.9	2.6	10.2	16.6	8.2	10.6

* **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 2014

Alphinity Wholesale Australian Share Fund

Issuer name	Index weight	Active weight
Insurance Australia Group Limited	0.9%	1.9%
Australia and New Zealand Banking Group Limited	6.5%	1.7%
Goodman Group	0.5%	1.6%
Aurizon Holdings Ltd	0.8%	1.6%
Oil Search Limited	0.7%	1.4%

and earnings growth for the current financial year looks to be the best for some time. One disappointment perhaps is the composition of the earnings growth. Industrial companies have seen FY14 earnings downgraded to now be only a few percent above FY13 (although partly because of de mergers) while earnings from resource companies have been the main driver of the overall lift in earnings.

While it might appear reasonable to infer from this trend that low interest rates have not been enough to lift domestic economic activity, we believe this would be the wrong conclusion. The earnings weakness has been largely contained to transport (particularly aviation), energy retailing (Origin and AGL) and engineering companies. Importantly, the sectors that would normally be expected to respond to the low interest rate environment – home builders, building materials and the like – are responding and we believe the earnings recovery is in the process of becoming more broadly-based. This, in combination with the lower A$ and continued cost focus by many corporates, should provide the earnings growth required for positive equity market returns in 2014.

Portfolio outlook

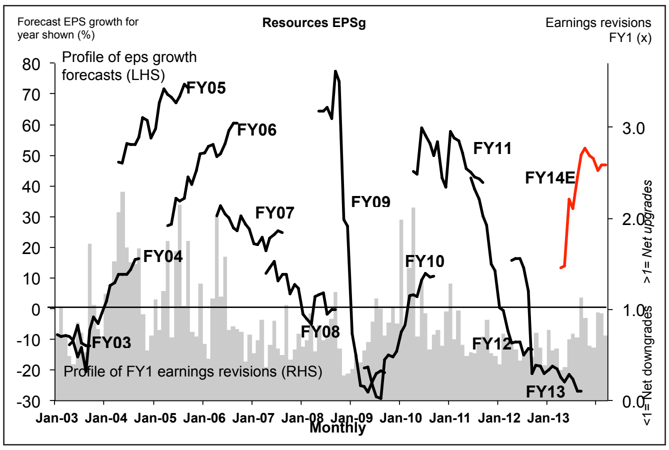
While the portfolio essentially matched the very strong benchmark return in February, rather than outperforming as we would expect, we are encouraged by the results announced by our key holdings, with 9 of our 10 largest overweights seeing upgrades to full year earnings expectations. Importantly we continue to see these companies, and your portfolio in aggregate, as being attractively valued.

The market has shown a tendency in recent months to accept eye-watering earnings multiples for a handful of companies. We acknowledge that many of these companies have some enviable attributes: they are industry leaders, have strong management and a track record of earnings growth and cashflow generation. Investors' enthusiasm for them is thus understandable. However a disciplined approach to valuation is as important as ever for sustainable returns, in our view. We believe your portfolio remains well positioned for further outperformance.

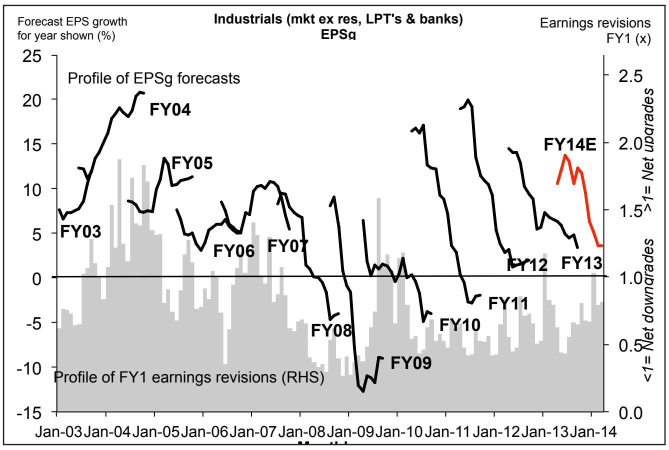
Reporting Season Insights

Every company with a June or December balance date – which is most – updated the market on earnings during February. Many that have other balance date, like most of the banks, gave quarterly updates. Such a deluge of information can take a while to process but there are usually some themes that emerge.

This time, it appears that the wave of downgrades our market has experienced over the last few years is dissipating. Downgrades are quite normal, as the charts (courtesy of Macquarie Equities) below demonstrate, and this is why Alphinity's process of seeking stocks in an upgrade cycle is so powerful – those stocks tend to outperform. The market will typically start out a financial year with earnings growth expectations of 10-15% but those will be progressively downgraded over the course of the year to finish up about half: still not a bad outcome and one which supports a market return of that plus dividends, totalling 10-12%. This year the market is unusually bifurcated: resource company earnings are still expected to grow by well over 40%, which is no net change since January.

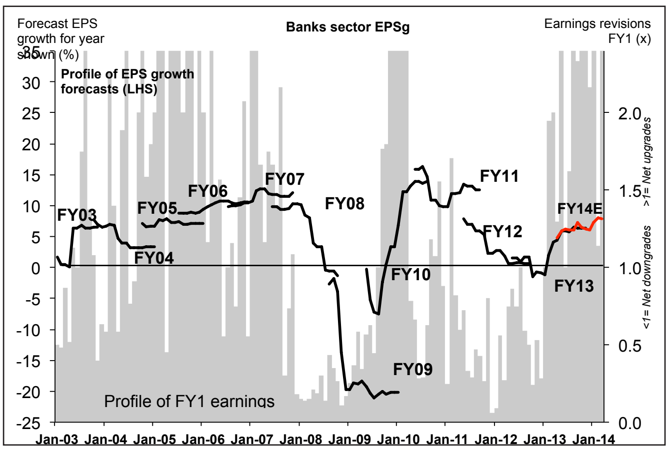


Industrial company earnings for FY14, having started at the typical mid teen percent last year, have much more subdued expectations but even this close to the end of the financial year there is still a modest degree of earnings growth remaining. Importantly, part of the reason for the downgrades in February is not poor operating performance but the change in company structure of three large companies (Amcor and Brambles de-mergers and Telstra divesting a couple of divisions) so the underlying earnings trend is actually a bit better than it looks.



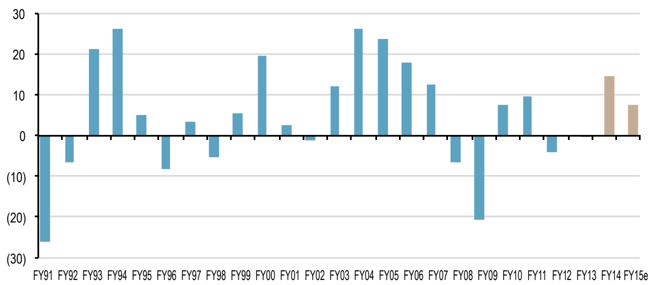
An important difference is that while the market is expecting a reasonable amount of industrial earnings growth in FY15, it is also expecting a further 20% increase in resource company earnings growth on top of the 46% this year: this might turn out to be a challenge.

Banks and Property company earnings changes are typically much more modest, and both revisions and growth expectations are both realistic and quite achievable.



Other things we note:

- the soft $A of recent months added to the earnings growth of the many companies with significant offshore operations. Revenue growth for the market overall increased, from 2% in H2-13 to 7% in 1H-14, partially as a result of this dynamic.
- iron ore-exposed companies had very strong revenue growth, a combination of good prices, high volumes and the lower $A.
- a small number of stocks which had large downgrades account for the bulk of overall earnings downgrades, including AGL, Origin Energy (intense energy retail competition) , Forge (now in administration), Qantas, Suncorp and Treasury Wine Estates, none of which your Fund owns, and Woolworths which your fund is underweight. The Forge experience is a warning sign for other operators in the mining services space as to what can happen when chasing contracts in a declining market.
- not a great surprise that housing exposures did well, including building materials, residential property developers, and some (but not all) retailers, and that stocks exposed to the share market (financial services and fund managers) mostly did very well
- as the chart from UBS shows, earnings growth expectations for the balance of FY14 and for FY15 look quite reasonable and achievable in the context of recent history, which should support decent market returns in the medium term.



BTW

What is the Polar Vortex? Well, according to that fount of all knowledge (Wikipedia) it is a naturally occurring phenomenon normally in place at that time, but this year the Vortex was interrupted by SSW – sudden stratospheric warming – which pushed a wave of cold air much further south than it would normally reach. Or something like that. The end result was that it got incredibly cold in places that are normally quite mild, and in normally cold places it became frigid. Some areas experienced the lowest temperatures since records began in 1870. It even snowed in Texas, and Dallas hit -9°C. Snow can wreak havoc in unprepared places: a lack of snow-clearing equipment in Atlanta meant freeways were rendered useless by large lines of abandoned cars. It even fell below the freezing point in Mexico, a place known more for chilled Corona than hot chocolate.

The beautifully-named town of Embarrass, Minnesota (population 607) has the coldest average annual temperature in the 'lower 48' states of the USA, only 1.4°C. It reached a bracing -37°C on January 8 but that was a long way short of its absolute record low in 1996 which was -53°C! How did Embarrass get its name, you ask? Not from cold-induced shrinkage – apparently it was given by French fur trappers in the early days of the colony who found the nearby river very difficult to navigate: Embarras, in French, means to hinder or to be confronted by obstacles. It picked up its extra 's' from pedantic English speakers over the years.

It is as yet uncertain as to whether the weather is responsible for the poor economic stats being released in the US in recent weeks, but it wouldn't surprise us if the climatic conditions did impact on workers' willingness to get out amongst the elements to, say, start building a house. As always, time will tell. There's even an argument to be made that the delays suffered in the year-to-date is actually creating a degree of pent-up activity which, when released, might make the next few months' economic data look surprisingly strong. That will be something else for us all to worry about.

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