Alphinity INVESTMENT MANAGEMENT

Monthly comment – January 2015
Alphinity Wholesale Australian Share Fund

Grexit? Swexit!

Market comment

While much of Australia was at the beach in January, big moves were afoot in the currency market. Rarely are moves as dramatic as those which happened in Europe. While the currency markets have for some time been concerned about the prospect of a Grexit (Greece exiting the Euro, a circumstance that was not provided for when the Euro was established in the 1990s), it hadn't anticipated what was effectively the exit of Switzerland, a country that wasn't even part of the Euro in the first place (see BTW). Greece remains at risk given that it elected a new far-left governing party during the month which had run on an anti-austerity ticket. This suggests some sort of climax may be approaching which may see Greece remove itself or be kicked out of the Eurozone.

Closer to home, the $A continued to fall sharply and so did share prices in the first part of the month, before recovering in the latter part to finish up a little more than 3% (S&P/ASX300 including dividends). A combination of Swexit, US rate speculation and a drop in the official Canadian cash rate combined to drive the $A decisively below $US0.80, to the lowest point since May 2009. The only currencies it rose against were the Euro and the Rouble. Early in February the Reserve Bank lowered the Australian cash rate in response to the sluggish economy, despite official concern about the rampant property market, in Sydney especially, suggesting caution might be warranted.

The equity market themes that ended last year (falling resource stocks, rising yield stocks) continued and the best places to be in the month were banks, telecoms and property companies. Most commodity prices fell during January, some quite sharply, but gold was a notable exception (+8% in $US, +13% in $A). Oil continued its recent fall and this has gradually flowed through to fuel prices which are now at levels not seen for some years.

In theory this should provide consumers here and abroad with a meaningful amount of extra spending power, although whether they choose to use it or save it remains to be seen. Australia's share market performed quite well compared to others in January, despite the crumbling $A. Some of the stronger European markets did a little better (+4-7% in $A) as did Japan (+8%) and Hong Kong (+9%). Greece (-14%) struggled however, Canada lost 3.5% and the US was only up about 2%. The market is keenly awaiting the interim reporting season in February for hints about where the balance of FY15 might be heading.

Portfolio comment

The portfolio performed fractionally behind the market in January. Property company Goodman Group, gas pipeline operator APA and telecoms company Telstra were the best positive contributors. Detractors included gas producer Woodside Petroleum and media company Nine Entertainment, while not owning gold miner Newcrest hurt a little.

Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size ($A)	124.3M
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%

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	3.0	2.0	11.4	12.7	16.4	11.4
S&P/ASX 300 Accumulation Index	3.2	1.9	12.1	11.3	14.0	9.9

*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).

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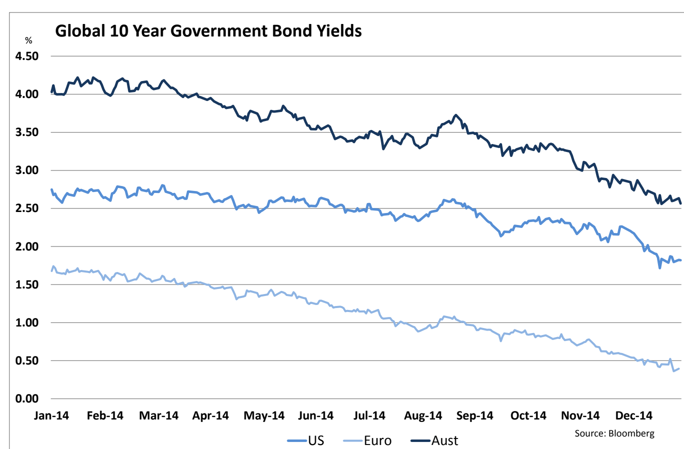
Market outlook

The Australian share market has started the year in a quite optimistic fashion. This somewhat belies the corporate earnings outlook which continues to look subdued. The market instead is relying on bond yields staying low and, while we do not profess to be experts at forecasting bonds, yields have certainly only been going in one direction for some time now.



Considering that European interest rates are around zero at both ends of the curve (i.e. both the cash rate and the 10 year bond yield) and Australian bonds aren't much higher (2-2.5%), it is difficult to argue that Australian stocks offering a relatively secure 4-5% yield are not attractive in a relative world.

As fundamental equity investors we would feel more comfortable if we were relying on corporate earnings to drive the share market rather than bonds. However while the slump in commodity prices has eroded some of the domestic earnings gro wth in FY15, other sectors are holding up better and look to be on track to deliver at least mid-single digit earnings growth. The fall in the A$, the dramatically lower petrol price and the RBA's most recent rate cut should all assist company earnings later this year. For the next few months however, the direction of bond markets are likely to determine equity market returns.

Portfolio outlook

2014 saw strong outperformance by stocks with strong and/or defensive earnings growth and dividend yields, essentially following the lead from the move in bond yields discussed above. This has resulted in stretched valuation metrics for many of these stocks, especially relative to stocks in more economically sensitive sectors. This is a challenging environment for fundamental stock pickers such as Alphinity.

Do we position ourselves for the inevitable but difficult-to-time "snap back" in stocks pushed higher by investors scrambling for yield and earnings certainty, or do we stick with the current sentiment and let our winning stocks run with less regard to valuation?

Given the weakening economic outlook we are reluctant to take a pro-cyclical stance at this time and have further reduced our cyclical exposure, predominantly through reducing our position in the Energy and Resources sectors. Our stock selection within the Energy sector last year (primarily Woodside and Oil Search) helped us to avoid some of the more dramatic falls in stocks with stretched balance sheets as well as leverage to the oil price (such as Santos and Origin). While all Energy names have been weak in recent months, our analysis suggests that share prices are still factoring in quite a dramatic turnaround in oil prices, to more than $70. This looks too optimistic to us and we have exited Oil Search and further reduced our holding in Woodside.

At the margin we have increased the portfolio's exposure to stocks benefiting from the low bond yield environment by adding toll road operator Transurban and property owner GPT. These complement our longer term holdings in other high yielding stocks such as Telstra, pipeline company APA, property companies Goodman Group and Mirvac and the Banks. This takes us close to a neutral position in the "yield" sectors relative to the benchmark. We believe this will resolve one of the drag on our performance in the previous year when the alpha contribution from owning some of the best performing yield stocks was offset by a total sector weighting less than the benchmark. Our slightly more defensive stance is balanced by our holdings in stocks such as Macquarie Group, AMP, Aristocrat, Seek, Veda, Lend Lease and CSR. These stocks, we believe, are typical of stocks with underappreciated earnings growth outlook that Alphinity seeks.

Asset allocation	As at 31 January 2015 %	Range %
Securities	98.4	90-100
Cash	1.6	0-10

Top 5 active overweight positions as at 31 January 2015	Index weight %	Active weight %
Goodman Group	0.7	2.0
Aristocrat Leisure Limited	0.3	1.7
APA Group	0.6	1.6
Macquarie Group Ltd	1.4	1.5
Westpac Banking Corporation	7.6	1.5

Alphinity
INVESTMENT MANAGEMENT

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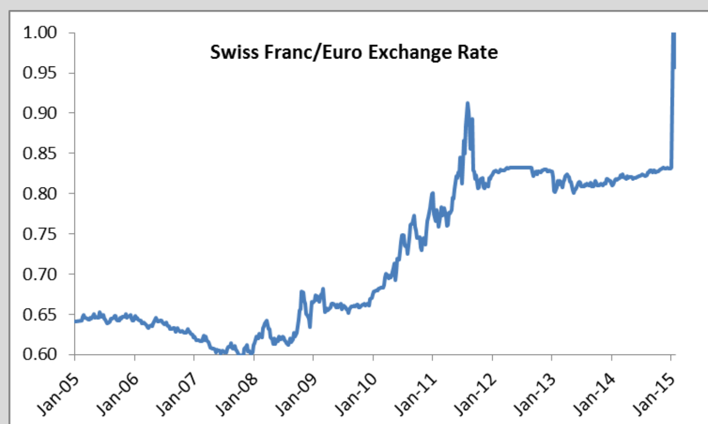
BTW

The Swiss have a long and mostly proud history of standing apart from the crowd, difficult when you are surrounded on all sides by that crowd. Despite a dearth of natural resources, other than the spectacular scenery for which it is rightly a top tourist destination, Switzerland built its wealth over hundreds of years on a blend of chocolate, numbered bank accounts and cuckoo clocks*. And more recently, tennis players. Switzerland has been vying with Australia in recent years to be the wealthiest country in the world per head of population and when the next report comes out reflecting the higher Swiss Franc and lower $A, it will probably be well ahead.

Switzerland refused to join the European Community and its currency in 1999, sticking resolutely with the Franc. But being a haven amidst a sea of economic dysfunction post-GFC led to massive appreciation which was having severe disruptive effects on the Swiss economy, so in 2011 the Swiss National Bank (SNB) announced that it would take action in the currency markets to ensure the Franc didn't rise above a 20% discount to the Euro. As the chart shows, this had the desired effect and three years of calmer currency weather prevailed.



However the action needed to keep it there meant that the SNB gradually built up an enormous reserve of foreign currency. By December 2014 it had reached $US500 billion, about half of which was in Euros. With only a third the population of Australia and 40% the GDP, Switzerland had ten times Australia's foreign reserves.

So, the SNB made a fairly bland announcement in January that the peg would no longer be in place, pre-empting by a day the European Central Bank's announcement of its latest round of Quantitative Easing of more than a trillion Euro (€1,100,000,000,000 to be precise).

The effect was instantaneous and dramatic as the chart shows: the Franc appreciated against the Euro by 20% to parity in a matter of moments. This caught currency traders by surprise: the peg had become one of the more dependable features of the global currency trade. A few people were caught short, literally, and a number of small currency trading firms in different parts of the world went belly-up as a result.

Where to from here? It's not easy to see a great outcome for anyone really. Switzerland, already an expensive place to go, has all of a sudden become 20% more expensive to anyone travelling there and tourism operators have already reacted by cutting tariffs sharply. That big reserve of Euros will now be worth tens of billions of Francs less. The economic effects of a strong currency in 2011 will be back in 2015. However it goes to show that even central banks in as strong a position as Switzerland's can't buck the market indefinitely.

The only tool the SNB has left to deter people from buying Francs is offering ultra-low interest rates: you now need to pay the Swiss government to take your money (how does -0.75% for overnight cash or -0.2% for a ten year government bond sound?) This makes Australia's ten year bonds at a historically skinny 2.4% look positively generous.

*Not just cuckoo clocks, Switzerland produces other timepieces as well. According to data crunching website statisticbrain.com, there were 1.2 billion watches made in 2014 with a total wholesale value of $US40 billion. Of that total, only 2.4% (29 million) come from Switzerland but that 2.4% made up 54% of the total value. The average cost of a Swiss watch is $US739 (this may sound on the low side but includes a lot of Swatches, remember).

On the other hand a billion watches were produced in Hong Kong and China but the average wholesale price of a Chinese watch was only $3. It is a little ironic therefore that 28% of the dollar value of watches sold is in Hong Kong and China. The study did not say how many Chinese watches were sold in Switzerland but it's probably fair to assume it was fairly low.

Other watch-producing nations included Japan, USA, France and Germany.

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Traveller's Tale

Alphinity didn't do any travelling in January – other than to the beach – however in keeping with this month's Swiss theme, the place we should have been was a ski resort in Switzerland. And not just for the skiing: the World Economic Forum has been taking place in Davos each January for 45 years and over that time it has become quite an institution: an event where Important People get together and talk about Important Issues.

The 2500 attendees from around the globe this year included world leaders (40 Heads of State apparently), non-government organisations, captains of industry, actors and rock stars: pretty much anyone who is anyone. In years past you would see a phalanx of Australians there but there were only 17 there this year.

There was a big focus on climate change, particularly so ahead of the Paris Climate Summit later in the year. That issue however prompted US publication Newsweek to observe that more than 500 private jets were expected to fly those important people into the area. The local airports could not deal with this number so the Swiss Armed Force was convinced to open up a nearby air base to help cater for the influx. Not only that but fully 20% of the attendees arrived by helicopter. One shudders to consider the carbon footprint of the event.

But all is not lost for those of us who couldn't attend. Most of the sessions are available on the website, www.weforum.org so you still can and see hear presentations from a diverse mix of people such as US Secretary of State John Kerry, author and journalist Martin Wolf, musician will.i.am, opera singer Andrea Bocelli, pop star Pharrell Williams or Alibaba CEO Jack Ma - all without having to endure the demanding private jet flight all the way to Davos.

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