Alphinity
INVESTMENT MANAGEMENT

Monthly comment – July 2013
Alphinity Wholesale Australian Share Fund

Tour de Force

Market comment

The share market trundled steadily higher throughout July on what was remarkably little domestic or international news, other than a few fairly compelling sporting events. The S&P ASX300 (including dividends) was up more than 5%, and has now regained a decent amount of the fall it sustained in May and June. In fact, the market's year to date rise of a little more than 10% (and the Fund, about 14%) would represent a respectable full-year return, and there is still five months and another round of dividends to go.

The market rose in the face of mixed international and local trends. Domestically, a number of companies downgraded their earnings forecasts, some of them just after the end of their financial year. These tended to be dealt with harshly by investors and fortunately your Fund avoided them all, although the real test will be the reporting season which is about to start.

Internationally, a strange situation has arisen. The equity market tumble in May started with representatives of the US Federal Reserve starting to talk about the process of coming up with a timetable to start winding back the extraordinary level of monetary stimulation that has been in place for the last few years: the 'tapering' we've been discussing in recent months. The US market stopped falling in June when some soft economic indicators were released suggesting things there were not as strong as previously thought, and that the start of tapering might have to be delayed. So at least part of the rebound in the US (and many global) share markets is paradoxically because the underlying US economy is weaker than previously thought. This doesn't make a great deal of sense to us – although it must be said that merely talking about tapering causing a ~10% fall in the share market didn't make much sense either. This all underlines why one needs to take a long term view when investing in equities: trying to time entry to and exit from the market is problematic, and it would have been easy to buy in at the highs or sell out at the lows.

The $A continued its downward trajectory, falling a further ~5% in the month to $US0.9030 – the lowest point in almost three years – after the Reserve Bank of Australia's governor seemingly hinted at further rate cuts. As noted in previous reports, the soft $A if sustained should turn into a meaningful tailwind for Australian company earnings.

It was certainly a tailwind for offshore equity returns. Most major markets had similar moves to ours in their local currencies but again the $A flattered them significantly: the best performers in $A were Italy, Spain and France with returns of 11-13%; followed by US, UK Germany with 6-7%. The Asian markets generally lagged but still returned a respectable 3-4%.

Fund details

Alphinity Wholesale Australian Share Fund	
APIR code	PAM0001AU
FUM ($A million)	119.8
Asset allocation	Australian equity: 98.8%, Cash: 1.2%

Fund performance* – as at 31 July 2013

	1 month (%)	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Australian Share Fund	5.7	–1.7	28.5	14.7	11.4
S&P/ASX 300 Accumulation Index	5.3	–1.9	23.2	11.4	9.2

* **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 31 July 2013

Alphinity Wholesale Australian Share Fund

Issuer name	Index weight	Active weight
Insurance Australia Group Limited	1.0%	2.0%
Goodman Group	0.6%	1.8%
Australia and New Zealand Banking Group Ltd	6.6%	1.8%
Westpac Banking Corporation	7.7%	1.6%
Woodside Petroleum Limited	1.9%	1.2%

Portfolio comment

The portfolio essentially performed in line with the market in May and retains strong alpha over longer periods. The biggest contributors were US-exposed health product maker Resmed, diversified financial companies Macquarie and Henderson and being underweight major bank NAB; the biggest detractors were from holding department store Myer and engineering company Downer, being underweight global insurer QBE and not holding gas producer Origin Energy.

Market outlook

Last month we said that the recent equity market volatility would continue in coming months: that forecast looks accurate so far following the strong comeback by the market in July. Global financial markets are likely to keep hanging on every word uttered by representatives of the US Federal Reserve, and Chairman Ben Bernanke in particular. However, economic data and corporate earnings should come more into focus as we enter the Australian earnings reporting season.

There are few direct conclusions for Australian corporates that can be drawn from the recent earnings season in the US, but it is evident that the gradual improvement in both the underlying economy and corporate earnings is continuing in what is still the world's largest economy. Disappointingly, earnings growth in Australia for the year just finished (FY13) again looks like it will end up being close to zero. While a gradual reduction of overly-optimistic forecasts over the course of the year is quite normal, should another year of no growth eventuate in FY14 it would probably be an impediment to market returns.

In FY13, solid market returns were achieved despite the lack of earnings growth largely because lower term deposit rates and bond yields made the solid dividend yields available in the equity market more attractive. In this new financial year it is likely that even lower rates will remain supportive of the equity market, as should high equity yields (relative to bonds). Nonetheless, a more important driver of the market is likely to be prospects for earnings growth. While the earnings growth (or lack thereof) in FY13 was disappointing in aggregate, it masks the fact that non-resource company earnings grew about 5%, the second consecutive year of 'industrial' earnings growth. A similar number in FY14 is a reasonable expectation, even before adding the positive translation effect of overseas earnings which – should current exchange rates remain – has the potential double that growth rate. With a dividend yield of close to 5% and a one-year forward PE of 14x, which is around the long term average, the market looks reasonably well supported and has the potential react positively to any further signs of the rate cuts gaining traction in the overall economy.

Portfolio outlook

The portfolio is heading into the Australian reporting season with some reduced sector skews compared to its recent history. We have further reduced the portfolio's underweight to the resource sector. That sector's underperformance has been dramatic and the operational benefits from the weaker $A and lower costs will offset some of the earnings pressure from the weakening demand/supply balance which has been putting pressure on commodity prices. We have also taken the opportunity, following the 'tapering'-led sell off in the banks, to increase our position again from its earlier underweight. To us, the banks appear reasonably priced with low earnings risk and strong dividend yield support. To have a more negative view on banks we would require either evidence of stronger earnings growth in more cyclical sectors, or deteriorating bank earnings from an increase in bad loans. Neither of those two scenarios looks likely near term.

The Australian economy remains in the transition phase from resource-led growth to growth in sectors that should benefit from lower interest rates and Australian dollar.

This transition appears to be taking longer than what has historically been the case. In this environment, companies with strong management and 'self-help opportunities' are likely offer the best opportunities for better than expected earnings outcomes. A company that was added to the portfolio during July that fits the self-help bill is Aurizon. This rail freight company is coming up to the three-year anniversary of its privatisation, at which point its ability to pursue more aggressive productivity improvements increases considerably. Companies with such internally generated opportunities that also benefit from the weaker $A will have further ability to surprise positively, in our view.

The portfolio is already exposed to a diverse group of 'currency beneficiaries' such as Resmed, CSL, Henderson, Macquarie, QBE, Westfield, Goodman Group, Bluescope Steel, Woodside and OilSearch. We have recently established a position in packaging company Amcor which, in addition to continuing to execute strongly, will be another beneficiary of the weaker currency. From a sector perspective, our largest underweight remains Consumer Staples as we continue to be underwhelmed by the earnings outlook for the individual companies in this sector.

BTW

When we think 'commodities', it is usually iron ore or coal that first springs to mind. Some consumable commodities, such as wheat, are significant export earners for Australia but while rice is grown here, not much of it ends up on the export market. Rice is grown in most countries primarily for domestic consumption. In fact, only about 8% of the almost 500 million tonnes of rice that is grown globally each year is traded on international markets.

However over the past couple of years the Thai government has seemingly tried to corner the rice market. According to the Asian Wall Street Journal, Thailand has managed to build up a 15 million tonne surplus of rice – close to half a year's worth of global trade – by centralising the buying of rice and paying Thai rice growers substantially above the market price.

There are various theories as to why: was it attempted market manipulation or merely providing subsidies for farmers? Unfortunately, some neigbouring countries seem to have latched onto this and smuggled substantial quantities of rice across the Thai border to enjoy its government's largesse. At the same time, other large rice-producing countries such as India and Pakistan have experienced boom growing conditions and have their own gluts to deal with, while demand has fallen from big importing countries like Nigeria and the Philippines.

The result of all this is a rice mountain, and the rice price in some markets has fallen by as much as 30% this year. Rice has a limited shelf-life – you can keep it for up to three years in good conditions but eventually it goes bad and has to be discarded. But keeping a 15 million tonne pile in good condition in a tropical climate is challenging, and in a world where there are still areas of extreme hunger it would be a tragedy for this food to be wasted.

The only way out seems to be the Thai government selling its excess rice into an already-oversupplied market and taking the financial pain – or maybe even giving it away to poor countries. With the next harvest due to start in November and the warehouses already full to bursting point, action needs to start happening soon.

As is often the case, when governments interfere in markets, the result is that even though a small interest group might benefit (in this case rice growers), the majority loses out.

Traveller's tales

Stephane visited a few resource companies in Perth in July to get a feel for how things are progressing in what might have been a post-mining boom town. The somewhat dour mood there is clearly not being reflected the price of coffee: at $5 for a take away, this price exceeds even Sydney Airport and seems more aligned to the boom times of the past. Companies appear more cautious, even though Iron Ore and Liquefied Natural Gas activity is still progressing at a frantic pace, but the first sign of the activity softening is maybe that labour is certainly easier to find. Contractors have already had it tough, and now the gold miners are struggling. Even so we don't expect the price of take away coffee to collapse, as over the next five years Western Australia's production of iron ore grow by 60% (from 500 million tonnes to 800 million tonnes) and LNG by 150% (from 24 million tonnes to 60 million tonnes). Even though the capital spending boom has now passed its peak, these production volume increases will generate significant royalties for the state government and will still need labour to maintain the plants.

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