Quarterly comment – June 2011

Alphinity Australian Share Fund

Mid-winter Chills

Market comment

The S&P/ASX300 fell in June for the third month in a row, being off almost 6% at its worst although a late month rally pared the loss to 2% (including dividends). Ongoing turmoil in European sovereign debt markets and further official efforts to moderate economic growth in China contributed to further perceptions of slowing in the Australian economy. Resource prices fell modestly over the month, especially oil which fell 7%, but the $A held up to finish 0.5 cents higher than May at $US1.072. The domestic economy remains soft, as shown by both business and consumer confidence trending down and full-time employment disappointing somewhat. The Reserve Bank of Australia left the cash rate unchanged and softened its rhetoric a little around the likelihood of rate rises, but remains both publicly and privately adamant that its bias remains towards tighter monetary policy. Major international markets were generally similar to ours - the S&P500 in the US down 1.8% and UK's FTSE100 down 0.7%.

Portfolio comment

The portfolio performed in line with or slightly better than the market in June, over the quarter and calendar year to date. The biggest contributors included airport operator MAp, resource company Rio Tinto and resource-related manufacturer Fleetwood Corporation. Our underweight in gas producer Woodside Petroleum also helped. The biggest detraction was from not owning recently de-merged brewing company Fosters, which rebuffed a takeover approach from global brewer SAB Miller, and our position in industrial manufacturer Bradken also cost the portfolio slightly.

Market outlook

The final quarter of the financial year did little to cheer investors already frustrated by the lack of earnings growth in the Australian equity market. As is often the case when negative macro factors dominate, investors took flight to defensive sectors such as telecoms, utilities and consumer staples. And there has been plenty to worry about: natural disasters, nuclear radiation leaks, the European debt crisis, a slowdown in the US recovery and concerns over the Chinese Government's ability to get inflation under control without causing a hard landing of the economy. Look at them in isolation and the picture is less worrying.

The natural disasters have been human tragedies but the economic effects are likely to be temporary. Events such as the floods in New Orleans in 2005 or the Kobe earthquake in 1995 had no long lasting global economic growth impact and we would not expect this year's tragedies to be any different. The European debt crisis and a potential partial default of Greece and Portugal will require painful adjustments by their countries' populations and some European banks, but is less likely to trigger a global debt

Fund performance* – as at 30 June 2011

	1 month (%)	Quarter (%)	6 months (%)	Since inception (%)
Alphinity Australian Share Fund	–2.0	–4.3	–1.0	7.5
Alphinity Wholesale Australian Share Fund	–1.9	–4.1	–0.6	8.3
S&P/ASX 300 Accumulation Index	–2.0	–4.3	–1.3	8.3

* 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). 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.

Top 5 active overweight positions as at 30 June 2011

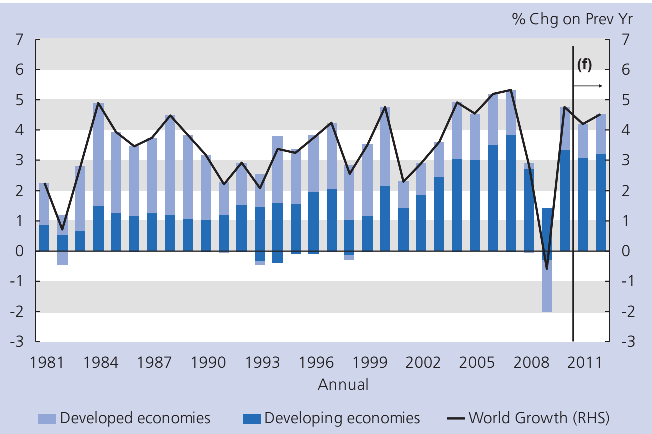
Alphinity Australian Share Fund

	Index weight (%)	Active weight (%)
Rio Tinto Limited	3.2	2.2
News Corporation	0.7	2.0
Henderson Group PLC	0.1	1.7
Fortescue Metals Group	0.7	1.6
Westpac Banking Group	6.0	1.6

crisis in a financial world where banks and corporates (and to some extent also consumers) are less leveraged than at the onset of the GFC.

A stronger US economy would be helpful and while more recent data has been weaker than expected, a recent survey by Citi showed aggregate capital expenditure plans to be 17% up in 2011 on 2010: clearly some sectors of the economy are achieving decent growth. Also, the global economy is much more diversified and less dependent on the US than it was even 10 years ago, and economies such as China, India, Russia and Brazil are all important drivers of global growth. The chart below illustrates the increasing contribution from developing countries to global growth.

Developing economies driving world growth



Source: Macquarie Research

Our recent research trip to China showed that growth is certainly slowing but by no means dramatically, and the Chinese government has shown in the past that if economic growth slows below its comfort levels of 7-8%, it will quickly reverse its policies. But what if China did experience a more significant slowdown? How bad would it be for the Australian equity market? While it would obviously be negative for the resources sector, the two major headwinds for Australian industrial and bank earnings over the last year have been rising interest rates and the strong Australian dollar. Both of these should fall in such a scenario thus boosting the non-resources part of the domestic economy.

Finally, while it is easy to be overwhelmed by all the negative commentary, how badly did the Australian equity market do in FY11? Not bad at all is the answer. In fact, the total return for the ASX300 Accumulation Index of 11.9% was above the long run average. To that, those investors who can utilise them can add franking credits. With the market trading at a PE multiple of 11x one year forward consensus earnings, and with a yield of close to 5%, even if there are further meaningful downgrades of FY12 earnings, it is feasible that a similar return will be generated in the new financial year.

Portfolio outlook

While last quarter was a difficult one for the market overall, we were encouraged by the outperformance our portfolios achieved. The attractive valuations we see for the entire market and for individual stocks with some cyclical leverage in particular, makes us reluctant to take on a more defensive profile at this point. There are several factors we will be monitoring, but the growth outlook in China remains the key one. We have used the weakness in resource names to diversify away from the large diversified resource companies, in particular BHP Billiton, and increased our exposure to single commodity companies such as Fortescue Mining, New Hope and Aston Resources. We believe that these companies have exciting production growth profiles while also being exposed to our preferred commodities, iron ore and coal. In the oil and gas sector the sell-off in Santos created a good investment opportunity, in our view. The company's LNG export project remains on track, while its production growth profile over the next couple of years is underappreciated by the market. Domestic gas prices are also already heading higher but we expect that the creation of an east coast LNG export market and the carbon tax will further tighten the demand/supply situation, resulting in in additional upward pressure on gas prices as long term supply contracts are renewed over the next few years. We remain cautious on the industrial earnings outlook in general but are finding stocks such as Flight Centre and MAp Group, that we believe can buck the trend for company specific reasons.

Our belief in MAp was vindicated in June when the company announced that it is in negotiations to swap its stakes in European airports for a larger stake in Sydney Airport. We believe this is a first step in a restructuring that will see the company becoming a single asset entity with significant potential to return surplus capital to shareholders. Both events, we believe, will provide further upside to our MAp holding. The difficult financial markets with low levels of trading activity and M&A had already seen us reduce our holding in Macquarie Group early in the quarter. However, Andrew's research trip to the US and Europe (see Traveller's Tales) confirmed our concerns and we sold out of Macquarie Group in June. Heading into the August reporting season we believe company earnings outlook statements will retain the cautious tone of the last year. While corporate balance sheets are very conservative, recent global events are likely to have postponed the momentum that had started to build for various forms of capital returns. Nonetheless, this remains a potential upside once both confidence and a clearer picture of the global growth picture emerge.

BTW...

Motor registries in Australia have cottoned on to a good revenue raising opportunity: if you want to wear your heart on your sleeve and tell everyone which football team you support, you can – for a few hundred dollars and a modest annual fee – buy your car a number plate with that team's logo on it. A recent trip to the US revealed a sobering variation on that theme: we spotted a Texas-registered pick-up truck with a registration plate advising that its owner had been awarded a Purple Heart – the medal awarded for being wounded or killed while serving in the military.

BTW...

The end of a financial year often raises thoughts of charity, for noble reasons or sometimes just for a tax deduction. How does Australia rate in the global giving stakes I hear you ask? A report by the Charities Aid Foundation www.cafaustralia.org.au/research.php suggests that both we and our NZ cousins stack up quite well, with government encouragement to give (tax deductibility) cited as a contributing factor. CAF had the Gallop Organisation poll a statistically significant number of people in 153 countries and used the data to construct a World Giving Index, taking into account not just monetary donations but also the volunteering of time and 'willingness to help a stranger'. Australia pips NZ to top the list thanks only to the alphabet, as the index score is identical for both. Impoverished Madagascar and Burundi come at the bottom of the list. The Foundation also found that there was a close to 70% correlation between countries whose population gives to charity and that populations' well-bring, or satisfaction with life, although it is not clear which is the causal and which is the dependent factor. A less strong but still significant correlation exists between giving and the overall wealth of the country, although Ireland – which has been struggling under very difficult economic conditions for some time – still ranks third overall. As the report says, 'It would be reasonable to conclude that giving is more an emotional act than a rational one'. In just about every region women are more generous with money than men, but slightly less generous with time, and generosity for all country groups tends to increase with age. So, countrymen, take a bow, but also remember to keep digging deep.

Traveller's tales…

COCOs and SIFIs

In June, Andrew went to where the real Northern Hemisphere action is: New York, Washington, London and Brussels, visiting financial institutions, bank regulators and terribly important members of the EU and European Commission to gauge the current economic environment and get a better feel for the conditions under which world financial institutions are likely to be operating in the future. The conversations were filled with talk of COCOs and SIFIs – yet more acronyms to add to your financial toolkit – but more of that later.

Economically, the view was mixed – mild confusion reigns as to where things are actually heading. It was clear that a number of sectors hit a wall in May across the northern hemisphere. Many in the US found this hard to explain and were outwardly hopeful that it was just a blip caused in part by the Japanese tsunami tragedy and the wobbles in Europe, but were quietly concerned about a number of domestic issues: a possible double-dip in the housing market, the continued inability for many people to access debt, the unemployment rate and the US sovereign debt position.

The UK seemed far more pessimistic about its outlook, perhaps influenced by its proximity to Europe. It had also seen a slow-down across the economy, somewhat enhanced by the Royal wedding combined with a long Easter holiday. However the UK's austerity measures seem to be biting earlier and harder than was first thought, and they hinted that we should be a bit wary of UK bank credit quality in the next six months. The UK also has a two-speed economy – London and everywhere else – which has implications for NAB's far more regional operations. The broader UK financial sector is clearly also suffering from the debt issues in the PIGS countries (although EU employees have been firmly told to stop using that term).

There was a lot of 'Will they? Won't they?' around Greece (things have played out further since Andrew's visit) and while there seems to be almost universal agreement that Greece will eventually have to default, the 'Extend and Pretend' mantra was trotted out as the best way forward. In a nut-shell, the EU has no idea what the flow-on consequences of Greece defaulting would be and are terrified that it would have large negative consequences for more meaningful economies such as Ireland and Spain, and hence ultimately banks in the UK. Far better to push the issue down the road, and maybe by then those bigger economies will have sorted themselves out. As an interesting aside, while the world seems to be wondering if Greece will be kicked out of the EU, the EU itself seems to have quite the opposite view - it seems to be using this as an opportunity to extend its powers deeper into one of its members.

On bank regulation the message was very simple: 'Banks are bad, they should be highly regulated utilities', and there is very little sympathy for the view that a healthy economy needs banks that make a healthy return. It is very clear, as the recent decision on globally Systemically Important Financial Institutions (SIFIs) capital buffer shows, that every decision on bank capital, liquidity or regulation is likely to fall on the conservative side. Some in the US are still working under the assumption that once again they won't need to follow the world on Basle 3 – we suspect it will be very hard for them not to, and hence a lot of capital still needs to be built up to meet requirements.

One number being thrown around is that an extra $200bn of capital will be required globally by the banking industry to meet Basle 3 requirements. Many felt (hoped?) that they would be allowed to use some form of Contingent Convertible (CoCo) capital to get there. So far, however, the regulators appear to take a more conservative view and prefer conventional equity. The timeline to meet requirements is quite long, but it is not clear to us that the market will allow banks to take their time to get there once the final requirements are set. A potential gulf may open up between the banks that can and do go early to bolster capital, and those that can't.

Either way, the return expectations for banks globally is only going one way. The question that keeps coming up from regulators is 'Why should a bank earn more than 10% Return On Equity?'. With Australian banks generating 15-20% ROEs, that is a sobering thought. Australian banks are in a better position than most global peers, both in terms of starting capital bases and having a pragmatic regulator, but there is only so far the Australian regulators can diverge from the rest of the world and as such we expect pressure will remain on our banks to improve capital levels and to be seen to be as good, if not better than, global peers. This again says to us that there will be pressure on returns over the longer term. Our banks may have escaped the G-SIFI (Global SIFI) buffer, but watch out for the R-SIFI buffer (Regional SIFI). The saving grace for bank share prices however is that they already appear to be factoring much of this in with very appealing yields.

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