Quarterly comment – March 2011

Alphinity Australian Share Fund

Risk off/Risk on…

Market comment

The market had already started March on a negative note before the massive earthquake off Japan mid-month which caused a deadly tsunami, and in turn sparked a significant emergency in a nuclear power plant north of Tokyo. The human toll was significant and tragic, but the economic effects are yet to be determined. Japan is Australia's second-largest trading partner and the destination for a large amount of bulk commodities, but equally the rebuilding effort will be massive. At its worst, the market was down close to 7% but as March progressed, further signs of recovery in the US economy helped global markets to recover much of what they lost at the start of the month. In fact, the local market (S&P/ASX300 including dividends) managed to finish higher for the month, but by less than 1%. The $A also continued its recent upward trend, closing the month at fresh post-float highs above $US1.03.

Market thoughts

In a world already struggling with rising oil prices due largely to conflict in North Africa, the situation in Japan raised fears for global growth even further, at least temporarily. Although markets have been volatile, trading volumes in major markets including our own have been quite low, suggesting a great deal of uncertainty among investors. From a pure investment perspective, global shocks such as the avian influenza of the early 2000s or the Japanese earthquake typically see a sharp selloff which creates a buying opportunity. While early days, the recent events appear no different.

Portfolio thoughts

The Australian Share Fund portfolio performed around benchmark in March despite the market volatility.

The best contributor this month was mineral sands producer Iluka Resources, which followed its strong February performance with a 25% rise in March. UK fund manager Henderson Group PLC also performed well, up 5%. Not owning the property owner/developer Westfield Group (-4%) or uranium stock Paladin Energy (-27% after the nuclear incident in Japan), contributed positively to performance.

The only individually material detractors were our positions in small resource stocks, Equinox Minerals and Aquarius Platinum, although these were both modest. Both stocks rank very highly in our stock ranking process and have good prospects once the current uncertainties have passed. In the case of Equinox, our view has already been vindicated as the company was the subject of a takeover bid from Chinese resource company Minmetals Resources in the early part of April. The bid still has some way to play out and we are monitoring the situation carefully.

During the month we exited Ansell, IAG, Macarthur Coal, and Suncorp.

Fund performance* – as at 31 March 2011

	APIR code	Quarter (%)	Since inception (%)
Alphinity Australian Share Fund	HOW0122AU	3.5	12.3
Alphinity Wholesale Australian Share Fund	PAM0001AU	3.7	13.0
S&P/ASX 300 Accumulation Index		3.1	13.1

*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 31 March 2011

Alphinity Australian Share Fund

	Fund weight (%)	Index weight (%)	Active weight (%)
BHP Billiton Limited	15.2	13.3	2.1
Westpac Banking Corporation	8.0	6.2	1.8
News Corporation	2.5	0.7	1.8
Rio Tinto Limited	4.8	3.1	1.7
Worley Group Limited	2.2	0.5	1.7

Market outlook

As we look back at the first quarter of the 2011 calendar year, there has as usual been plenty of market action, with the ASX300 trading in a 10% range. Geopolitics and natural disasters have played a greater role than we can remember for some time. There have been floods in Australia, earthquakes in New Zealand and Japan and political uprisings in North Africa and parts of the Middle East. Coupled with growth concerns in China as its Government tried to get inflation under control, global economic growth has faced many challenges. While it is still too early to be definitive about the impact of the high oil price and disruptions to global production flows, it appears to us that global economic activity will expand in 2011 by 3–4%, which should be supportive for stocks in general and cyclical stocks in particular. In our view, the end of quantitative easing and (eventually) higher interest rates in the US will be the greater challenge for global equity markets in 2011.

In Australia, the market continues to be challenged by our two-speed economy. Many market participants have tried to time the switch from the booming resources and resource-related sectors to parts of the market that have been struggling such as consumer discretionary and other industrial stocks. However, while we have some sympathy for this given the significant difference in sector performance over the last year or so, it appears to us that we don't yet have the prerequisites for this 'normalised' earnings scenario to become reality. Industrial stocks continue to see earnings downgrades, and the main culprits – the high $A, high interest rates and subdued consumer spending – are just not showing any signs of turning from headwinds to tailwinds. In the US, economic macro data is pointing to a year of solid growth which may present some opportunities for companies with substantial operations in North America. However, our recent research trip to the US left us with mixed views of the strength and breadth of the recovery.

Portfolio outlook

As we enter the home stretch of the 2011 financial year our portfolios remain overweight resources and resource-related companies. Our primary exposure remains concentrated in the diversified large cap stocks BHP Billiton and Rio Tinto where we see a superior mix of our preferred commodities (iron ore, coal and copper), attractive valuations and financial strength. We have also added late-cycle commodities such as alumina, aluminium and platinum through investments in Alumina Ltd and Aquarius Platinum. In our view, these companies should benefit from supportive industry trends as well as company specific factors.

We believe that Alumina Ltd is in the process of being re-rated, as its earnings and cash flows will continue to surprise positively over the next 12-18 months. It will benefit from higher alumina prices and lower capital expenditure, having completed its expansion in Brazil. Our positive outlook on alumina prices is not only underpinned by a supportive aluminum price, reflective of high electricity costs and further appreciation of the Chinese Renminbi, but also of tight alumina demand-supply fundamentals. We expect this combination to trigger a fundamental shift in alumina prices, which will flow though into the earnings of Alumina Ltd.

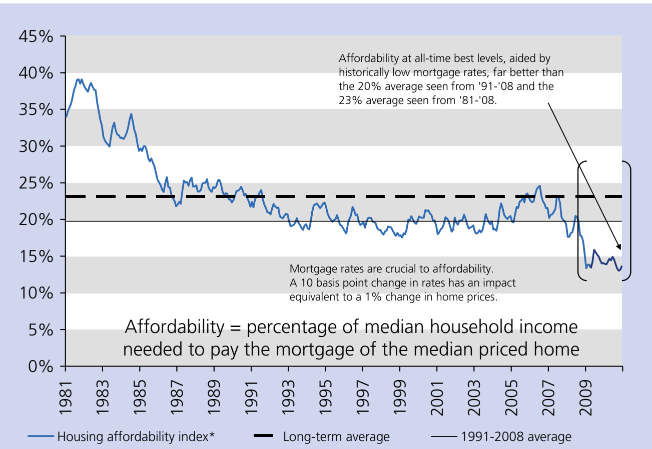
While only cautiously optimistic about the strength of the economic recovery in the US, we have also added some stocks to the portfolio that we expect to benefit directly from the inevitable normalization of interest rates in the US, or indirectly through the flow on effect of any recovery in the US dollar. Two such stocks are QBE Insurance and healthcare products manufacturer CSL. Again, we see strengthening industry fundamentals for these companies in addition to a potentially supportive macro-economic backdrop.

Traveller's tales…

Johan headed to the USA in March to take the pulse on its economy. His travels took him from technology-dominated California, through the 'rust belt' of Kansas City and Chicago, to energy-dominated Dallas and Houston in Texas then on to New York City. He met with 18 companies across a variety of industries.

Even though the majority of recent economic data suggests that the US economic recovery is gathering strength, he came away with a more cautious view. Things certainly are improving but it looks like the recovery will be slow. New York appears to be on a solid footing as the strong financial markets have boosted the fortunes of the more affluent part of the population. However, low to middle income earners across the country are still struggling and have so far seen little improvement in job prospects. Surveys of corporates' hiring intention have turned positive but consumer sectors are yet to see a meaningful impact. The recent steep rise in petrol prices looks to have put the brakes on the economic upswing. On the other hand, Texas reminded him of the two-speed economy back home with the oil price and recommencement of drilling in the Gulf of Mexico lifting activity levels in that state.

US Housing affordability



Source: Credit Suisse

Johan's trip reinforced our view that market estimates for US residential housing starts are overly optimistic at this point in time. We have little exposure in our portfolios to the US housing market however believe it is a sector we need to monitor closely. Decade-low house prices combined with low interest rates (how does a 30-year fixed-rate mortgage below 5% sound?) have resulted in affordability levels not seen in a generation. While not showing up in any statistics, one can't help but think that many potential house purchasers have stayed on the sidelines not wanting to buy into a falling market. This pent up demand should be released once the market shows signs of stabilising and/or the record low interest rates start heading higher.

US manufacturing had been struggling for decades. Recently, however, the weak US dollar and emerging market demand for everything from excavators and planes to power turbines has seen a revival in what is left of many manufacturing industries. With healthy demand and limited supply, margins look set to improve. This should benefit, for example, our investment in Bradken which reported a strong improvement in its US earnings in its recent result.

Capital expenditure in the oil and gas industry looks set to rebound strongly in 2011, a key reason for our investment in engineering services company WorleyParsons. Exploration activity in the US had lagged the rest of the world largely due to the BP disaster in the Gulf of Mexico last year. However, after several meetings with industry representatives it seems to us that the lifting of the moratorium on drilling in the Gulf is gradually translating into activity, adding to global momentum.

While he detected few signs of wide spread inflation, companies with a high level of exposure to commodity costs, soft as well as hard, are likely to face some challenges over the course of the year. The price of raw cotton is now more than twice that of last year and with the consumer having to deal with the recent spike in petrol prices, companies' ability to raise selling prices will be limited. Levi Strauss volumes took a hit when the company recently raised the price of a pair of denim jeans from $32.99 to $38.99. Australian companies may be cushioned from similar issues due to the strength of the Aussie dollar but it is yet another headwind for our local apparel companies which are already suffering from subdued consumer spending.

Some other observations:

- Detroit's city population has fallen by a quarter over the last ten years – back to levels last seen in 1910 – as the US auto manufacturing industry struggled with chronic over-capacity, international competition and a weak economy.
- US manufacturing capacity has by some measures declined by 75% since the 1980s.

- New distribution technologies of streaming TV shows over the internet is rapidly being taken up by the US consumer. The largest streaming company Netflix has 20 million customers and is reportedly responsible for 30% of the internet traffic in cities such as Chicago. The days of chronic over-capacity in broadband may be coming to an end.
- If we didn't know it already, social media marketing is becoming mainstream. Mass market department store JC Penney – or as they like to call themselves these days **jcp** (to appeal to younger shopper) has 1.6 million Facebook 'friends' and are making new friends every day.

BTW...

Pirate economics: Somali pirates have discovered the practical implications of price elasticity of demand. According to the Reuters news agency, one pirate leader named Hussein said that his group was presently holding more than 30 ships, and that dealing with that number was affecting their ability to hijack more ships. By lowering the ransom demanded for the release of the ships, he figured that they would be able to increase turnover. Hussein also seems to have grasped the concept of utility, stating that high ransoms will remain high for captured ships carrying high value bulk commodities. (*NZ Herald* 16/3/11)

BTW...

Former CEO of Royal Bank of Scotland Sir Fred Goodwin has been granted an injunction stopping newspapers publishing information about him, and even identifying him as a 'banker'. And not just an ordinary injunction, but a 'super-injunction': one in which even the existence of the injunction is not to be published. Goodwin's super-injunction was only revealed under the protection of parliamentary privilege. The penalties for breaching this injunction were not made clear, and we know that we're probably well outside the UK court's jurisdiction, but let us make it clear that Alphinity is NOT referring to Sir Fred as a banker. (*The Telegraph* (UK) 10/3/11)

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