Alphinity INVESTMENT MANAGEMENT

Monthly comment – May 2012

Alphinity Wholesale Australian Share Fund

Sell in May and Go Away?

Market comment

The market likes aphorisms. One that has become popular in recent years is 'Sell in May and go away'. This strategy doesn't always work (see BTW below) but is looking good so far this year considering the Grexit-related market moves which saw all major global markets fall in May.

The Australian market fell by 6.7%. The US S&P500 was down 6.3%, UK's FTSE down 7.7%. European markets were a little worse, with falls of between 6 and 8% in the 'good' economies, but Spain was down 13% and Italy almost 12%. The Greek market fell 25% in May, and is now 90% below its September 1999 peak, and European Central Bank (ECB) officials are now openly discussing a mechanism for it to exit the Eurozone. Japan fell by 10% and greater China was also weak, with HK and China H-shares both down around 12%. Taiwan fared a little better, down less than 3%, and Shanghai fell only 1%.

The $A swapped its recent 'safe haven' status with the $US, falling almost 7% from 3c above parity to 3c below, but was fairly steady against other major currencies. Most commodity prices fell: oil down 4%, gold 6%, iron ore 7%, and base metals ~10% overall.

The real excitement in financial markets, however, has been that government bond yields have continued to fall in most countries to the lowest levels in years. In Germany and Switzerland short bond yields actually went negative for a time, meaning that rather than being paid for lending as you would expect, investors were paying the government to mind their money. In other European markets yields rose, with Spanish yields back to levels that proved problematic six months ago and Italian yields half way there. Poor old Greece would need to pay more than 30% to borrow ten year money.

Australian yields finished the month at the lowest levels ever: around 2% for three-year bonds and below 3% for ten-years. This probably reflects an element of excess demand for safety in a market with a limited supply of bonds, but may also be saying something about the prospects for the economy.

Portfolio comment

The portfolio lagged the market in May, after three months of consecutive outperformance. The portfolio remains ahead for the Financial year to date. The largest single contributor was global media company News Corporation, a beneficiary of $US strength, followed by the defensive, high yielding Telstra. Not owning mineral sands producer Iluka was also a positive. Detractors included resource exposures Rio Tinto, Bradken, Whitehaven and Onesteel, while the underweight in defensive retailer Woolworths also cost.

Fund details

Alphinity Wholesale Australian Share Fund	
APIR code	PAM0001AU
FUM ($A million)	113.0
Asset allocation	Australian equity: 98.4%, Cash: 1.6%

Fund performance* – as at 31 May 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Australian Share Fund	–7.3	–4.5	–9.3	0.1
S&P/ASX 300 Accumulation Index	–6.7	–4.4	–9.3	0.1

* **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 May 2012

Alphinity Wholesale Australian Share Fund

Issuer name	Index weight	Active weight
Goodman Group	0.5%	2.1%
Insurance Australia Group Limited	0.7%	2.1%
Rio Tinto Limited	2.5%	1.8%
Westpac Banking Corporation	6.2%	1.6%
News Corporation	0.6%	1.6%

Market outlook

Our thinking over the last year has been that, while on the one hand a lack of earnings growth has been capping the market to the upside, on the other hand attractive valuations, strong corporate balance sheets, and the potential for monetary easing have provided very solid support. With global macro issues again taking centre stage, the outlook for Australian equities has become increasingly uncertain and the range of possible outcomes has widened, at both ends. The situation in Europe of course poses the greatest negative risk and, while we can only speculate on the eventual outcome, it is clear that the extended period of uncertainty has started to impact economic growth not only in Europe but in other regions as well.

Corporations at this point in time are likely to have hit the 'pause' button rather than the 'stop' or 'rewind' buttons. However, yet another financial rescue plan is needed soon in order to avoid a more significant economic growth impact. At the positive end, recent Reserve Bank rate cuts and the decline in the Australian dollar could provide the trend break we have previously highlighted as necessary for stronger corporate earnings growth in Australia in the non-resource sectors. While it is difficult to argue strongly for any certain outcome when the range is so wide, one result does look certain: monetary policy globally and in Australia is likely to remain very accommodative, and interest rates at both the short end and the long end of the curve will stay low for some time. This should eventually support stronger economic growth, especially in Australia where monetary policy has been more restrictive over the last couple of years. It should also continue to see investors attracted to assets or companies with high yields. This is supportive for the overall Australian equity market, which has one of the highest dividend yields in the world, and also for individual companies with attractive dividend yields.

Portfolio outlook

Portfolio performance in May was hurt by the sharp risk-off trade across global equity markets. Owning companies in what is traditionally more stable sectors such as Consumer Staples may have merit from a relative performance perspective in a declining equity market environment, however we have for some time been concerned about the increased earnings risk in this sector compared to its history. This is born out in earnings revisions trends which have been negative for companies such as Woolworths, Wesfarmers and Coca-Cola Amatil for more than a year now. The combination of earnings risk and limited valuation upside makes us reluctant to increase our portfolio's exposure to this sector even as equity market volatility has increased. Our 'defensive' focus in the portfolio has instead been on some of the higher yielding stocks where we have also seen potential for positive earnings revisions. Companies such as Telstra, Transurban, Sydney Airport, and GPT fit nicely into this category. A strong re-rating of these companies over the last year is now limiting further upside in our view and, while recognizing that the race for yield is unlikely to reverse any time soon, we believe the banks and some of the stocks in the utility sector offer more potential upside.

One such stock which we have added to the portfolios recently is Duet Group. Duet's main assets are the 80%-owned Dampier to Bunbury gas pipeline in WA and an electricity distribution network in Victoria. Duet, in our view, offers stable (if low) dividend growth and the potential for a further re-rating of its shareprice in a low interest rate environment. Another company which we have added to the portfolios is Crown Ltd. While not a traditionally defensive company, Crown will benefit from its largely completed refurbishment of Crown Casinos in Melbourne and Perth, as well as growth in its partly-owned assets in Macau. Outside of the more defensive sectors, our holdings are naturally more dependent on global economic growth to not fall away sharply.

While cognisant of the risks, we believe we are holding stocks with compelling growth opportunities and have used the recent sell off to concentrate our holdings to those with the most attractive company-specific drivers and/or improving industry fundamentals. The production growth trajectory of Fortescue Metals Group is becoming increasingly underappreciated by the market and so we have increased our holding of this stock in our portfolios, although we remain underweight the mining sector overall. We have for some time been encouraged by the improving pricing outlook for the insurance sector, and added QBE to complement our existing holding in IAG. While low bond yields may mask some of the benefit from firmer pricing, we expect the improving margin trend to be clearly evident in the upcoming August results.

BTW

The saying is 'Sell in May and go away, come back on St Ledger's Day'. St Ledger's Day is the second Saturday in September, on which a horse race is held marking the end of the 'important' sporting events in Britain. The period essentially encompasses the summer social season there, so it sounds quite appealing to liquidate, enjoy the likes of Wimbledon, Ascot, Henley and so on, then come back to reinvest after it is all over. The same period in Australia happens to cover 'Confession Season', wherein companies realise and have to admit they will not meet their guidance or market expectations, and the August reporting season.

But you can't base an investment strategy on aphorisms. The problem with memorable ditties such as this is that they're right unless they're wrong, and you don't know that until after the event. There are plenty of examples where the opposite would have applied. According to MSNBC, a US fund manager (obviously with too much time on his hands) conducted a study a few years ago in which he emulated returns from investing in stocks from September to May, and 30-day Treasuries during the off months. Even excluding transaction costs and CGT considerations, he concluded that the strategy is 'bunk'. He looked at returns from six start dates since 1950, and 'Sell in May' did indeed beat 'buy and hold' if you started investing in 1960, 1970 and 2000, but not if you started in 1950, 1980 or 1990. He concluded: 'It's pure randomness, how would you ever know when to start?' Then there is the problem with using averages to say anything meaningful about stocks. If you know the average temperature for a month stretching back decades, you can pretty much guess how hot or cold that month will be this year. But that's not true with stocks. They move too widely above and below their averages in most years, and in most subsets of years, for those numbers to be used to predict where they're heading.

Another US fund manager went as far as writing a book devoted to exploding investment myths. In Debunkery, Ken Fisher says 'Sell in May' is 'garbage' because of the averages. He gives the example of September, which has dropped an average 0.7% since 1926. But the month has had many big up and down moves over 85 years. He says if you remove just two of the worst Septembers, stocks break even for the month. 'The average is made up of extremes. If you steer by averages, you're going to get thrown off.'

So, notwithstanding the unthinking appeal of following such advice as 'Sell in May and go away', and the possibility that it might have been right this year, we're sticking to our fundamentals: looking for and owning reasonably-valued stocks which will generate earnings better than the market is currently expecting, thereby providing the market with earnings surprise.

Traveller's tales

Stephane is just back from a few days in the Middle East where he met with some construction companies. He was met with a wall of humid 42°C heat, which apparently gets worse during the summer. No wonder so many of the locals escape during the summer months to the milder and more pleasant European coasts.

It wasn't only the weather that was hot, the cars were too. Stephane can't recall ever seeing so many Maseratis, Ferraris, or Lamborghinis, not even in the streets of Monaco or the wealthy coal province of Shaanxi in China! The construction market appears to be heating up again and is gaining some momentum. Competition however is fierce, and players such as Worley Parsons and Leighton have had to accept cut-throat margins in order to win business. We think Leighton may even be able to get some money back on the challenging contracts it entered into at the crest of the property bubble, when it undertook a joint venture with Al Habtoor. This may start to take away some of the animosity against that stock. But it does not as yet have enough fundamental or quantitative support to make it into the portfolio.

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