Monthly comment – May 2011
Alphinity Australian Share Fund

Downhill Run

Market comment

The market broke out of its recent flat trading range in May, but to the downside. The S&P ASX300 was off 4% at its worst but had recovered half of that by the close of the month. Consumer stocks were particularly soft after comments by the RBA increased expectations of higher interest rates, despite no-one outside the resource sector experiencing the conditions normally required for such a rise. Major influences in May included poor global conditions, with most major markets falling between 1% and 3%; weaker US economic data; the re-emergence of debt stress in some southern European countries; and concerns over the state of China's economy, for which Stephane's trip proved very timely. The $A had a pause from its recent strong run with the Trade Weighted Index easing 1.8% over the month. As we expected, substantial downgrading of earnings by the broking community occurred during May. According to IBES data, the ratio of downgrades to upgrades was 2:1, and more than two thirds of the S&P ASX300 constituents received downgrades during the month. As we move into the final month of most companies' financial year, we expect downgrade activity to ease but also for the information flow to slow as many companies enforce a 'blackout period'.

Portfolio comment

The portfolio performed in line with its benchmark in May. Industrial products company Bradken was the biggest single contributor, followed by holdings in coal miner New Hope Corp, toll road operator Transurban Group, and airport operator MAp. There were no individually meaningful detractors, but being underweight $US beneficiary Brambles and defensive supermarket operator Woolworths and overweight Westpac each cost the portfolio a small amount. The portfolio remains modestly overweight resource and resource-related stocks where we see fewer risks to earnings, and underweight consumer discretionary where we see greater potential for disappointment.

Fund performance* – as at 31 May 2011

	APIR code	1 month (%)	Since inception (%)
Alphinity Australian Share Fund	HOW0122AU	–2.0	9.6
Alphinity Wholesale Australian Share Fund	PAM0001AU	–2.0	10.4
S&P/ASX 300 Accumulation Index		–2.0	10.5

* 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 positions as at 31 May 2011

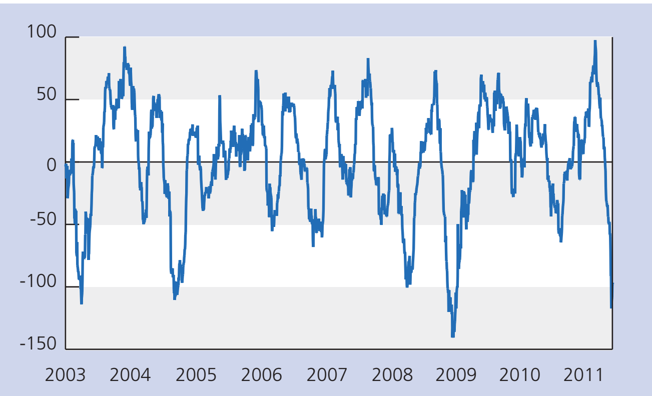
Alphinity Australian Share Fund

Issuer Name	Portfolio Weight (%)	Active Weight (%)
Rio Tinto Limited	5.4	2.3
News Corporation	2.7	2.0
Westfield Group	0.0	–1.7
Transurban Group Stapled	2.3	1.6
Henderson Group PLC	1.7	1.6

Market thoughts

Australian equity market sentiment has turned decidedly negative. Already battling concerns over a slowing China and the struggling non-resources side of the Australian economy, it has been the softness in US economic data of late that has become the main reason for recent market weakness. Citigroup's US economic research team tracks economic releases compared to expectations to arrive at an 'Economic Surprise Index. It turned over in March after quite a strong period, moving from close to +100 (i.e. everything coming out better than the market expected) to its present level of –110 (i.e. everything disappointing). It's hard to see how much worse sentiment could get: even in the depths of the GFC this index only got to –140.

Citigroup Economic Surprise Index – US



Source: Bloomberg, 2011, Citigroup

That all was not well with the US recovery was picked up by Johan during his trip in March (see March quarterly report and video). The normal so-called multiplier effect, where stronger corporate earnings leads to more hiring which in turn leads to increased disposable income and so forth, were just not occuring to the extent required to meet most economists' forecasts. So will US corporate earnings collapse? We think it's unlikely. Corporate balance sheets are strong, cost control and capacity growth have remained constrained. Things are getting better, just not as quickly as investors had hoped. What about China? Stephane was on the ground during the month and while the Government's attempts to slow growth in order to temper inflation are certainly having an impact, the common theme across more than 20 meetings was a controlled slowdown with growth remaining robust. We don't anticipate an across-the-board capitulation in commodity prices until the supply response becomes more significant, and while we are being selective in our commodity and thus company exposure, we remain positively disposed towards resources stocks. To get the whole story, see Stephane's video on the Alphinity website www.alphinity.com.au/resources/resources.htm

Portfolio thoughts

As we enter June, the downhill run into the financial year end for most companies, we feel that the market is cheap. Our assessment of the market, based on bottom-up valuation of each company we cover, suggests that stocks are significantly undervalued. While this indicator does not give any hint on the timing of a turnaround or the catalyst that might spark it, our experience over many years is that when our bottom-up valuation upside becomes significant, the market is set to rally at some point. The problem of course is that the earnings expectations for companies exposed to the non-resources side of the Australian economy, and for that matter to most developed markets, remain at risk from further downgrades. However, at 11x FY12 earnings and a 4.8% yield the market should be able to absorb those downgrades. In the mean time we will continue to focus on stocks that, while not immune to the bleaker external environment, have a good degree of control over their own destiny through expansion programs (Fortescue, Rio Tinto, Bradken), good cost control (Westpac, MAP), leading market positions (CSL, David Jones), mining and energy capex (Monadelphous,WorleyParsons) and growth through acquisitions (Henderson Group, News Corporation, Lend Lease).

Travellers' Tales

Stephane went to China and Mongolia in May, braving severe storms in a small plane to get from Seoul to Ulan Bator. His conclusions from that trip are in video form at www.alphinity.com.au/resources/resources.htm. But while Stephane was pounding the Gobi Desert, Bruce was resisting the fleshpots of Macau during a quick two-day trip which coincided with the opening of the newest mega-casino on the Cotai Strip, Galaxy Resort World. We've been going to Macau regularly since 2005 and since then not only has the country grown physically (through massive land reclamation), it has become the biggest gambling market in the world and provides some interesting insights into what's going on in China as well.

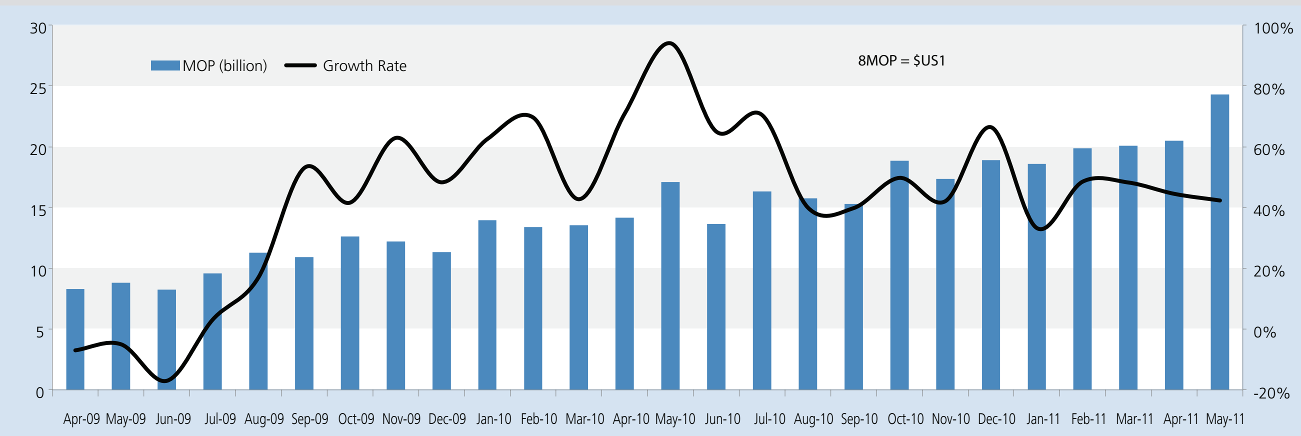
Macau is a fascinating place. It had casinos for many years when it was under Portuguese rule, but it was the liberalization of the market in the early 2000s which allowed the entry of several international players that caused the market to really take off. The first entrant, Las Vegas Sands, built the Sands casino in 2004 and made back its capital cost within a few months. Its success led to some of the world's biggest casino operators clamouring to get in and do the same. Sands itself then spent $US4 billion to build the fifth-largest structure in the world – 980,000m^2 on reclaimed land which opened in 2007 – an enlarged copy of their Venetian casino in Las Vegas.

Macau is quite important from an Australian gaming company point of view: Crown owns a large part of one of the operators there (MPEL), and Aristocrat is a major supplier of electronic gaming machines into that market. In addition, Australian casino group Echo Entertainment (which has just demerged from Tabcorp) sees China as a major potential source of new customers and recently bought a couple of corporate jets to ferry players back and forth.

But the most impressive thing about Macau has been its growth. Gaming revenues have been growing at extreme rates for some time and there's little sign of them slowing just yet. One factor has been a degree of under-reporting in the past – the 40%+ rate now is probably really 'only' 20% or so. The 'junket operators' seem to be able to find a never-ending supply of wealthy mainland Chinese individuals willing to be feted, pampered and then lose large amounts of money. One junket operator we spoke to happily admitted that 90% of his 'high rollers' lose large amounts, however many gamblers seem to attribute those losses to 'fate' rather than mathematics. While enforcing gambling debts can be a challenge, that is a problem for the junket rather than the casino.

But a cloud on the horizon is the Chinese central government: every now and then a public official or executive from a state-owned enterprise is found to have gambled away money that is not theirs. The consequence for the individual can be extreme, but the risk for the industry in Macau is a larger-scale crack-down which typically includes restrictions on the number of visas issued to mainland Chinese.

Macau monthly gaming revenue



Source: DICJ

BTW…

More than a few times in recent months we've reached for our calendars to check the year: some parts of the market have been partying like it's 1999. Like internet stocks in the US. There has been a lot of chat about the 'value' of Facebook, as the media would report that it was 'worth' $10 billion in 2009, then $35 billion in December 2010, then $50 billion in January, and $60-75 billion has been talked most recently.

During May, the IPO of professionals-oriented social networking site LinkedIn Corp in the US saw that company debut in spectacular fashion. Priced at $US45 per share, it hit the market at $80 and traded up to $120 on the first day before settling in the $90s, and finished the month just above $80. At that point, the company was valued at about $US8 billion, which represents what some would consider a ritzy multiple almost 1200 times the 7cps it earned in 2010 – about 100 times that of the overall US market. What's going on? How could the sellers of those shares into the IPO (at $45) have got it so wrong? How could they be so foolish as to have sold at 'only' 640 times earnings?

Part of the problem is that we use the last traded price of a particular stock and multiply that by the number of shares on issue to come up with the company's market capitalisation. Most of the time you can make a good case to do that due to the impact liquidity has on finding an equilibrium price. It falls down, however, when there is a large imbalance either on the supply side or the demand side which overwhelms fundamentals. That happened during the GFC when some companies traded way below their fundamental value, purely because there was lots of sellers but no buyers. The opposite seems to be the case for LinkedIn.

Facebook is a private company, not listed anywhere. It does not publish financial accounts. Any share transactions that take place are completely opaque to anyone other than the buyer and the seller. The fact that some people were desperate enough to own some that they were willing to pay a silly price doesn't necessarily mean that the entire market would.

It's not that different for LinkedIn Corp really: yes the shares are now on-market, but fewer than eight million shares were sold into the IPO. In the nine days it traded during May a total of 55 million shares changed hands, almost seven times the amount sold in the IPO. There are a further 87 million shares outstanding that were not sold, so it's fair to say that the scarcity premium was significant.

We believe it is important to differentiate between the price at which something trades and its fundamental value. It could be that the true value of LinkedIn is far greater than the $US81 at which it was trading at the end of May. After all, Google first traded in 2004 at $85 and is now around $500 (having reached $700 just before the GFC). But it would be wrong to say that a company with such a small free float is 'worth' $8 billion.

Everyone wants to own the next Google, but Googles don't come around very often.

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