Alphinity INVESTMENT MANAGEMENT

Monthly comment – November 2015
Alphinity Wholesale Australian Share Fund

Marking Time

Market comment

Equities did almost nothing in net terms in November, the market (ASX300 including dividends) falling by 0.7%. This modest return however made Australia the second-best major market worldwide: the firm $A meant that all markets but Japan's – which was up by less than 0.2% – made losses for the month when expressed in our currency. The US market was only fractionally worse than ours but most European markets, while up in local currency, were dragged back by the faltering Euro and finished 2-6% lower in $A. Eyes remain firmly fixed on what the United States Federal Reserve (Fed) will do at its December meeting, but at the same time there are enough concerns about the European economy that seem to be biasing action at its Central Bank towards further monetary easing rather than tightening. In short the macro picture is rather confused.

There was no such confusion in commodity markets however: resource price weakness continued definitively. The $A price of our major export, iron ore, fell a further 14% making it a 25% fall since in two months. Thermal coal, for use in power generation, slipped 7% and coking coal, used in steel production, fell 4%. Oil (Tapis) fell by 10%. Base metals were lower too: lead by 4%, nickel by 13%, and zinc by 10%. Copper was down 11%. Even gold was down 8%. Aluminium looked relatively good falling only 3.5%. Basically there was no positive news in commodities.

While the Australian market overall might have been flat, as the commodity price moves noted above suggest there were some big sector and stock divergences that gave significant potential for out- or under-performance during the month. Pleasingly, your Fund was on the right side of things.

It was mostly about resources in November and BHP Billiton in particular. As if the commodity price trends were not already bad enough, a tragic tailings dam accident in Brazil (see BTW) was a further negative catalyst for BHP. Having the Fund's biggest underweight position underperforming so much (BHP was down 21% in an otherwise flat market) constituted about a third of your Fund's November outperformance. Although we will accept this, we do appreciate that while underperforming underweight positions helps preserve your capital, in order to produce capital growth the portfolio's overweights need to do well. Thankfully this was also the case.

Where to from here? There is no sign yet that the resource price trend is finishing and the main driver of much resource consumption – China's economic growth – remains challenged. But the pleasing Australian GDP numbers for the September quarter along with strong employment data suggests that maybe the non-resource side of our economy is now picking up some of the slack, and goes a long way to justifying the Reserve Bank's decision not to cut interest rates any further.

Portfolio comment

The portfolio outperformed the market significantly in November, although as stated above it was about what we didn't own as well as what we did own. The Fund's biggest underweight position, diversified resource giant BHP Billiton, was also the biggest individual contributor to returns; being underweight its recent spin-off South 32 was also a positive. Large overweights in petrol retailer Caltex and major bank Westpac contributed nicely and there were no detractors of note in November.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	0.6	1.8	3.3	10.8	8.5	9.2
S&P/ASX 300 Accumulation Index	-0.7	0.7	2.1	9.2	6.9	7.7

*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 Fund and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2010. The inception date for the returns for the Fund is 1 September 2010. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 during Sydney business hours.

Alphinity INVESTMENT MANAGEMENT

Monthly comment – November 2015
Alphinity Wholesale Australian Share Fund

Market outlook

The Australian share market has been grinding higher since its most recent low in September, although not very convincingly. Investors are understandably uncertain about what ongoing quantitative easing in Europe and Japan, at the same time as the US moves ever closer to its first interest rate hike since the Global Financial Crisis, will mean for global economic growth and financial market returns. While history is usually a useful guide, the fact that the US Fed is looking to start raising rates when the US economy is showing no signs of overheating and inflation remains well below the Fed's target level of 2% makes this rate-hiking cycle unique in almost every aspect.

So what is our best guess of what will happen? Without wanting to sound flippant, probably not very much. While it's anyone's guess what the short-term market reaction will be, the actual impact on US or even global economic growth will probably be limited. Sub-trend but still positive growth is in our view the most likely scenario in the US, globally, and here in Australia, and interest rates will thus stay low. US inflation will edge higher in the coming year but with the price of just about every commodity under pressure and spare capacity in most sectors it's difficult to see a noticeable outbreak in inflation that might require the Fed to raise interest rates aggressively.

The factor to watch will be wages growth, which certainly appears to have bottomed out. Anecdotally we are hearing about labour shortages, perhaps most consistently in the US construction industry. Ironically this wage pressure is holding back the recovery in housing starts and thus overall US GDP growth.

The Australian economy has shown some resilience in recent months but only enough for the Reserve Bank of Australia (RBA) to maintain interest rates at current levels, not enough to provide upside risk to overall corporate earnings. From a valuation perspective the Australian equity market is trading around its long term averages. Within that however, cyclical stocks, especially Resources and Energy, are trading well below mid-cycle levels while the overall earnings scarcity in the market has any stocks able to exhibit solid earnings growth trading well above historical levels. With no immediate relief in sight for commodity prices and many other stocks looking expensive, a continuation of the slow grind higher for the equity market is probably a reasonable expectation for the next few months.

Portfolio outlook

The Fund has performed well so far in the 2016 financial year. While individual stock selection has contributed nicely with stocks such as Macquarie Group, Aristocrat and Veda some of the highlights, a further driver of relative performance has been through limiting the portfolio's exposure to the fallout from the collapse in commodity prices. The market is now seeing dramatically reduced earnings prospects for stocks in the Resource and Energy sectors caught in the downdraft. The punishment has of course been especially severe for those whose balance sheet has also become strained. With global growth still more likely to disappoint than surprise positively, we see no reason to change this positioning as we head into the new year.

While we are conscious that the lack of earnings growth across the market has been driving up the already high multiples for companies that are able to demonstrate some growth, we are still able to find companies for which we believe the future earnings capability is under-appreciated by the market.

One such company is Super Retail Group which has recently been added to the portfolio. Longer-term followers of Alphinity may recall that this company was a strong contributor to portfolio performance in 2012 and 2013. We exited the stock about two years ago when it faced a much more challenged earnings outlook due to a combination of external and internal factors. Most of these issues have now been resolved and with sales growth now trending in the right direction and cost savings that should result from a large-scale revamp of the group's warehouses and logistics imminent, the company should be able to deliver solid double digit earnings growth for the next few years. The prospect of earnings upgrades combined with an undemanding valuation makes it a stock that should again be able to contribute nicely to returns.

Asset allocation	As at 30 November 2015 %	Range %
Securities	98.5	90-100
Cash	1.5	0-10

Top 5 active overweight positions as at 30 November 2015	Index weight %	Active weight %
Macquarie Group Ltd	2.0	2.5
Goodman Group	0.7	2.2
Caltex Australia Ltd	0.7	2.1
Westpac Banking Corporation	7.8	2.0
Aristocrat Leisure Limited	0.4	1.8

Alphinity INVESTMENT MANAGEMENT

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BTW

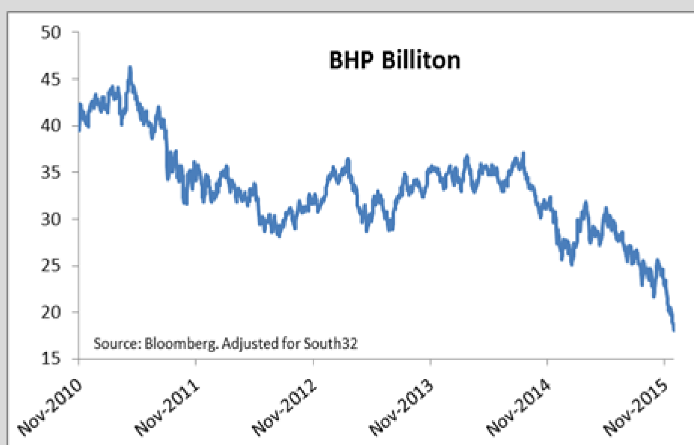
In a month during which bad news stories competed with each other for our horrified attention, it is hard to know which was worse: the man-made disaster in Paris in which terrorists made simultaneous attacks on several soft targets, or the man-made “natural” disaster in Brazil in which dams containing tailings – the residue of iron ore mining activities – collapsed and caused a massive spillage of mud, alleged by some to contain dangerous levels of arsenic and mercury, which drowned possibly as many as 19 people (some are still unaccounted for), wiped away a number of villages and polluted hundreds of kilometres of the Rio Doce River on which many other villages depend for food and water. The sludge has now reached the mouth of the river and is flowing into the Atlantic Ocean, as shown below.

Even weeks later, the detail of what actually happened remains elusive but the dam bust was surely preventable: better design or better maintenance should have avoided this tragedy. The mine in question is half-owned by Brazil’s iron ore giant Vale and Anglo-Australian resource giant BHP Billiton. Between the two there is a wealth of mining expertise and arguably no excuse for such an event to happen. There is understandable and justified outrage on the part of the people and government of Brazil, and there will no doubt be enormous clean-up costs and fines for the environmental damage imposed on the owners as a result.

To its credit BHP appears to be doing the right thing, to the extent that it can. Its CEO flew in immediately to inspect, express contrition and promise support; its local partner Vale initially seemed less caring but maybe is doing more behind the scenes. Both are funding the rescue operation: no one knows what the final bill will be but no doubt it will be billions of dollars, shared between Vale and BHP. In the context of BHP’s almost $100 billion market capitalisation its share will be manageable but still painful, and it is doubtful that the mine will ever re-open. While insurance should cover at least part of it, the cost will still be meaningful.

So what does this mean for any investment we might be considering in BHP shares? Well, BHP Billiton has been a significant underweight in our portfolios for some time but that has been for reasons other than potentially dangerous mining practices – primarily the poor outlook for the prices of the commodities to which it is exposed – and this aspect has only become worse in the past month.

We have avoided much of this pain on your behalf, but we also know that there will come a point at which all the bad news is priced into the stock and more, and a degree of upside is presented. We will keep looking for that point but until we can see a path towards the earnings upgrades our investment process looks for, it is likely that BHP will remain a significant underweight position in our portfolios.



Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size	$112.2M
APIR code	PAM0001AU

Fees	
2014/15 ICR	0.90%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	Nil
Buy/sell spread	+0.20%/-0.20%

Alphinity
INVESTMENT MANAGEMENT

Monthly comment – August 2015
Alphinity Wholesale Australian Share Fund

Traveller's Tale

Stephane went to the US in November to attend a resource conference in Miami, and with a weekend approaching he had the choice: fly for 24 hours back to Sydney or take a one-hour flight and spend a couple of days in Cuba. What would you do?

("Corner of the Cretins")

He chose Cuba. Cuba has been effectively isolated from much of the world for more than half a century. It started with an arms embargo by the USA in the 50s when Marxist dictator Fidel Castro cosied-up too closely to the Soviets, and this was expanded into a full trade embargo after Castro nationalised a number of US-owned oil refineries there in the early 1960s. Fidel is still alive and pushing 90 years old although he stepped down from the Presidency in 2008 leaving his little brother Raul, who is only 83, in charge. The embargo has meant that Cuba today is something of a time capsule, but this is likely to end soon which will make travelling there a lot easier and no doubt change the country significantly.

So how was it to step into that capsule? Stephane describes it as a unique experience full of contrasts leaving you perplexed. Billboards celebrating their "Liberation" abound yet we know that it is still extremely hard for Cubans to do a lot of things, especially to leave the country. Anti-American propaganda remains alive, as the picture above from the Museum of the Revolution reminds us but at the same time stunning vintage American cars continue to proudly parade through Havana's charming streets, rolling relics of the pre-revolutionary era.

Above all, despite living in such tight financial conditions (Cuba's average income is just $A30 a month), people overall appear to be genuinely happy with no sign of aggression or crime whatsoever: maybe that's what good music, dancing, cigars, rum and strong community values does to the spirit, and it's beautiful to see! Let's hope that the opening of the economy towards a more entrepreneurial or capitalistic model can keep this spirit and joy intact.

Alphinity Investment Management

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