High farce

Monthly comment – October 2013

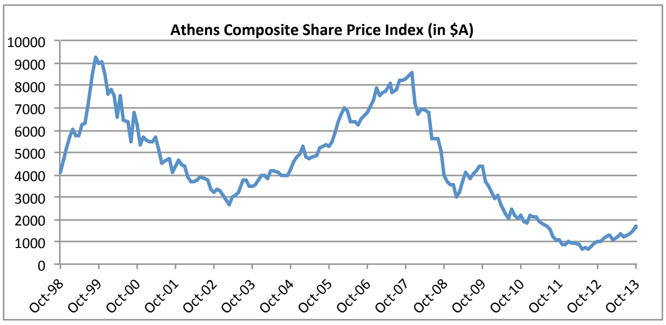
Alphinity Wholesale Australian Share Fund

Market comment

The market moved steadily higher in October, and was only temporarily concerned by the government shutdown and debt ceiling debacles in the US. The flow-on from those events – which predictably were solved at the very last moment and only for a matter of months – is that any possible tapering of Quantitative Easing has been put off for a while more. The US Federal Reserve will keep buying $85 billion of US bonds from the market each month, and global liquidity remains assured. Coincidentally (or not), the US dollar kept weakening and the $A resumed its upward path, pushing towards parity again and causing some stress to a number of sectors which had been starting to feel a bit more optimistic.

Fears of a US default and the Australian dollar's AAA-rated 'safe haven' status meant our currency was quite strong at some points during the month but it finished only fractionally higher – albeit still in the mid-90s – after the Governor of the Reserve Bank of Australia stated his belief that it was 'unsustainably high' and that we should be prepared for it to be 'materially lower' at some unspecified point in the future. As we have stated previously, considering the scale and extent of the offshore operations of most Australian companies, a lower $A would be a meaningful boost to the earnings momentum of the overall market.

Most stock markets did fairly well in October. The S&P/ASX 300 Accumulation Index (including dividends) rose by 4%; when translated into $A, most Western markets were 1-2% behind ours. The challenged Southern European economies did a little better, continuing their recent bounces (Greece +16%, Italy +10%, Spain +7%), but Asian markets were generally softer with Hong Kong flat and Japan and China down 2%. The Greek market has been spectacular recently, almost trebling in $A terms since its lows mid last year. A bit of context is required though: even after this rise it is trading at only a fifth of the level it reached in 2007, which itself was lower than its all-time peak in 1999.



Fund details

Alphinity Wholesale Australian Share Fund	
APIR code	PAM0001AU
FUM ($A million)	126.0
Asset allocation	Australian equity: 98.5%, Cash: 1.5%

Fund performance* – as at 31 October 2013

	1 month (%)	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	3 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Australian Share Fund	4.2	9.3	29.8	21.1	11.8	13.6
S&P/ASX 300 Accumulation Index	3.9	8.9	24.8	17.1	9.6	11.4

* **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 August 2013

Alphinity Wholesale Australian Share Fund

Issuer name	Index weight	Active weight
Insurance Australia Group Limited	0.9%	2.0%
Goodman Group	0.6%	1.7%
Australia and New Zealand Banking Group Ltd	6.9%	1.5%
Woodside Petroleum Limited	1.8%	1.5%
Crown Resorts Ltd	0.5%	1.4%

Portfolio comment

The portfolio outperformed slightly although there were no real standout stocks. There were lots of little ups and downs: the only individual stocks worth mentioning were gold producer Newcrest Mining which added some value (we don't own it and it underperformed) and Carsales.com which detracted slightly in the month.

Market outlook

With the market again moving higher during the month, and valuations approaching – and on some metrics exceeding – historical averages, all eyes are now on the outlook for company earnings. As we have noted many times before, growing company earnings is key to long term sustainable equity market returns. So far there have not been many surprises from the AGM season nor from the bank results. Management commentary remains cautious about the state of the domestic economy, with several noting that the confidence boost from the election has faded without translating into stronger trading conditions.

The one bright spot remains, residential housing, especially in NSW. This should gradually translate into higher construction activity and that usually supports broader consumer spending.

Similarly, the banks have reported earnings that still point to only moderate growth, but importantly credit quality remains strong. In the resources sector, the strong price of iron ore continues to confound skeptics as Chinese steel production has surprised positively and inventories remain low. The litmus test will be early next year when new capacity comes on-stream, but the starting point looks to be from higher price levels than previously thought.

In summary, mid-single percent earnings growth still looks like a reasonable forecast for the market though it has to be said that so far there has been little to indicate that this could surprise to the upside. Valuation and liquidity support from low interest rates should remain in this environment, but room for earnings disappointment is becoming increasingly limited.

Portfolio outlook

Earnings surprises will, we believe, continue to drive relative share price performance. As earnings surprises are typically serially correlated (i.e. good news tend to be followed by more good news and bad news by more bad), such thematics usually take some time to be fully reflected in consensus expectations.

Following the strong run in equity markets over recent months, delivering on earnings expectations will likely become even more important in the near future: both for the overall market and for individual companies. To this extent, the news trend for those companies in the portfolio has, in aggregate, been quite favourable since the August reporting season.

Results from ANZ, Westpac and Macquarie Group have been well received; AGM commentary from JB Hi-Fi, IAG and Flight Centre has been encouraging; guidance has been confirmed by Brambles, APA and CarSales.com; production and/or quarterly reports from BHP, Fortescue, Beach Petroleum and Henderson Group and contract wins for Downer EDI have all been positive. News from Resmed, Myer and Caltex has been more muted but these positions are quite small following some trimming in previous months. We remain optimistic about the overall positioning of the portfolio, and its recent performance suggests that our strategy of identifying and owning companies in, or about to enter, and earnings upgrade cycle continues to bear fruit.

BTW

Despite the ongoing woes at the Government level in the US, its stock market has been doing just fine. Many online stocks have been booming recently and Google, which started life not much more than a decade ago, shot through $US1000 a share in October. This is up a nice 50% in 12 months and compares well with its $100 IPO price in 2004. Others have been prospering as well: business networking group LinkedIn is $223 (IPO price in 2011 was $45) and even the enfant terrible of Silicone Valley, Facebook, is trading at $50, finally above the very ambitious IPO price of $37 in 2012. These are now very serious companies: capitalised at $US344 billion, Google is only a few good days on the market away from challenging the second-largest company on the US market (Exxon Mobile at $384b). Given some time, even Apple ($473b) is within reach. Facebook is 'worth' an amazing $120b. LinkedIn looks more reasonable at $27b until you consider that it is about half that of Telstra, which is a very serious business indeed with tens of thousands of employees, billions of capital invested (literally) in the ground. LinkedIn on the other hand has half a dozen geeks and a server*. We won't even discuss Twitter, the loss-making micro-blogging site that is apparently worth $20 billion or so.

The reason for the US market's regard for technology stocks is not that surprising: some are absolute cash machines. Google, for example, generated more than $US5b operating cash and $2.8b of free cash in its most recent quarter alone. Picking the next one of those could be seriously good for the bank balance.

Google's $1000 price however raises the question: Can a share price be too high? We're not talking about the company's valuation, that is fairly simple to work out. The question facing companies with high share prices is: are people put off from buying shares in a company that might otherwise be a good investment, merely because of the share price?

It used to be that some Australian companies felt that high share prices were a turn-off and responded by carrying out a share split: it simply issued one or two (or ten) shares for each that a holder owned and – hey presto – an expensive $20 stock suddenly became a 'much more affordable' $5 or $10. The economic interest did not change one iota – you owned the same proportion of the company and received the same dividend cheque, but somehow this was supposed to be good for shareholders. Thankfully share splits are largely a thing of the past.

Some of the most successful companies have avoided splitting shares: the ultimate example of this is Berkshire Hathaway (BRK) – the great Warren Buffett's holding company – which is capitalised at $US288 billion. At the end of October a single share would cost you $US173,000: an astounding amount of money. You could have picked up a BRK share for about $3000 in 1988 – still a lot of money especially in those days but not a bad return since (actually a bit over 17% pa compound). BRK, like a lot of US companies, doesn't pay any dividends.

We can see that a $173,000 share price is so high that many people simply can't afford to buy even one. Ukulele-playing Buffet had refused to split until an enterprising fund manager created a trust which only owned BRK, for people who couldn't come up with the almost house-sized amount required to buy a single share. Buffet didn't like someone else feeding off his success so in 2011 he created a B-class share with 1/1500th the economic interest of a full share. At the end of October BRK/B traded at 'only' $115 – surely that's a bargain!

*LinkedIn is actually more than six geeks and a server: Bloomberg tells us that it has more than 4000 employees. It is becoming a high-quality data source for companies and employment agencies looking for staff.

Traveller's Tales

Bruce went to Jakarta recently with Coca Cola Amatil, the Australian company that has the Coke bottling franchise in a number of countries in the region, including Indonesia. We don't presently own CCA as it has been in a downgrade cycle for some time, but it is a business we know well and for which we have high regard. At some point in the future it will be poised for earnings upgrades, but not just yet. There were no exclusive insights on this trip as it seemed as if the entire Australian market was there: the group of brokers, fund managers, execs and assorted hangers-on almost filled two tour buses.

Indonesia is a developing country although you would never know it from the very plush and rather expensive hotel. More confronting was the security checkpoint before entering, complete with mirrors on sticks to check under the car for bombs, and before entering the lobby there was an airport-style luggage scan and metal detector to pass through.

Roads in Jakarta are chaotic. There are some major tolled highways that would not be out of place in Australia (not that this is particularly high praise) but the driving style is a little more creative than we are used to. Incomes are growing rapidly in Indonesia and 750,000 new motorcycles are added to Indonesia's limited road network every month. Lane markings are treated as mere suggestions, and at one stage we could count five lanes of cars on a stretch of road made up of three lanes and a shoulder, with motor bikes weaving impossibly between.

Chronic traffic is a challenge if you're in a hurry but a police escort can be arranged, for a fee, to speed up things a little. Our buses had a police car trying to clear the way but still, a 6km trip to dinner at the Australian Ambassador's residence took more than an hour. That may have been an extreme but apparently the average speed of traffic in Jakarta is only 13 km/h! The only problem with police escorts is that they have become quite common, and we were outraged when another police-escorted convoy somehow managed to push past our bus – why was their convoy more important than ours? Or was it just that their driver was more assertive?

But the strangest thing to happen was at the airport. Departure tax of $US20 had to be paid so Bruce duly handed across a $US20 note, only for it to be rejected as too old! Apparently there is an issue date on US currency in very fine print, and for whatever reason the airport would only take notes issued after 2009. Who knew that US dollars expire? Thankfully he was able to find a more modern note in his bundle of money and proceed, otherwise he might still be there!

Alphinity Investment Management

Level 15, 255 Pitt Street
Sydney NSW 2000

T 02 9994 7200

F 02 9994 6692

W www.alphinity.com.au

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