

Monthly comment – February 2011

Alphinity Australian Share Fund

Alphinity Concentrated Australian Share Fund

Fast forward and reverse...

Market comment

The market (S&P/ASX300 including dividends) came out of the blocks strongly in February, rising by 4.2% in the first two weeks, but hit the wall mid-month as geo-politics started to take its toll on the oil price, which spiraled as Egypt and Libya revolted. That spread into fears for global growth despite continuing signs of a firm US economy. The market finished up 2.3% for the month.

Market thoughts

The main feature of the Australian market in February was company reporting season. The vast bulk of companies reported financial results for the six months ending December and many gave outlook statements. There was a stark contrast between sectors, as you'd expect in a (cliché du jour) two-speed economy. Anything resource-related had strong prices and volumes but emerging cost pressure; anything consumer-related complained of cautious – even stingy – consumers and price deflation. Industrial

companies varied according to their exposure to resources, and insurance companies seemed to be hit from all sides, with January's natural disasters in Australia topped off with the tragic earthquake in Christchurch New Zealand – which looks like being one of the biggest insured events of all time.

Portfolio thoughts

Both portfolios outperformed their benchmarks in February as holdings across a number of sectors delivered ahead of market expectations. Best contributors this month were medium-sized resource-exposed companies: Iluka was up 25%, Caltex 17% and Worley 9%. A strong result from News Corporation triggered a 11% appreciation for its non-voting shares despite further adverse currency movements, and Asciano rose 9%. There were no individually material detractors. During the month we exited a number of positions (Seek, Macarthur Coal) and established a small position in Aquarius Platinum.

Fund performance* – as at 28 February 2011

	APIR code	1 month (%)	Quarter (%)	Since inception (%)
Alphinity Australian Share Fund	HOW0122AU	2.51	6.44	11.71
Alphinity Wholesale Australian Share Fund	PAM0001AU	2.58	6.69	12.24
S&P/ASX 300 Accumulation Index		2.33	6.31	12.34
Alphinity Concentrated Australian Share Fund	EQI0001AU	2.52	6.19	13.79
Alphinity Wholesale Concentrated Australian Share Fund	HOW0026AU	2.65	6.49	14.17
S&P/ASX 200 Accumulation Index		2.35	6.30	11.98

*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 28 February 2011

Alphinity Australian Share Fund

	Fund weight (%)	Index weight (%)	Active weight (%)
Rio Tinto Limited	4.9	3.2	1.8
BHP Billiton Limited	15.0	13.2	1.8
News Corporation	2.2	0.6	1.6
Transurban Group Stapled	2.3	0.7	1.6
Oil Search Limited	2.2	0.6	1.6

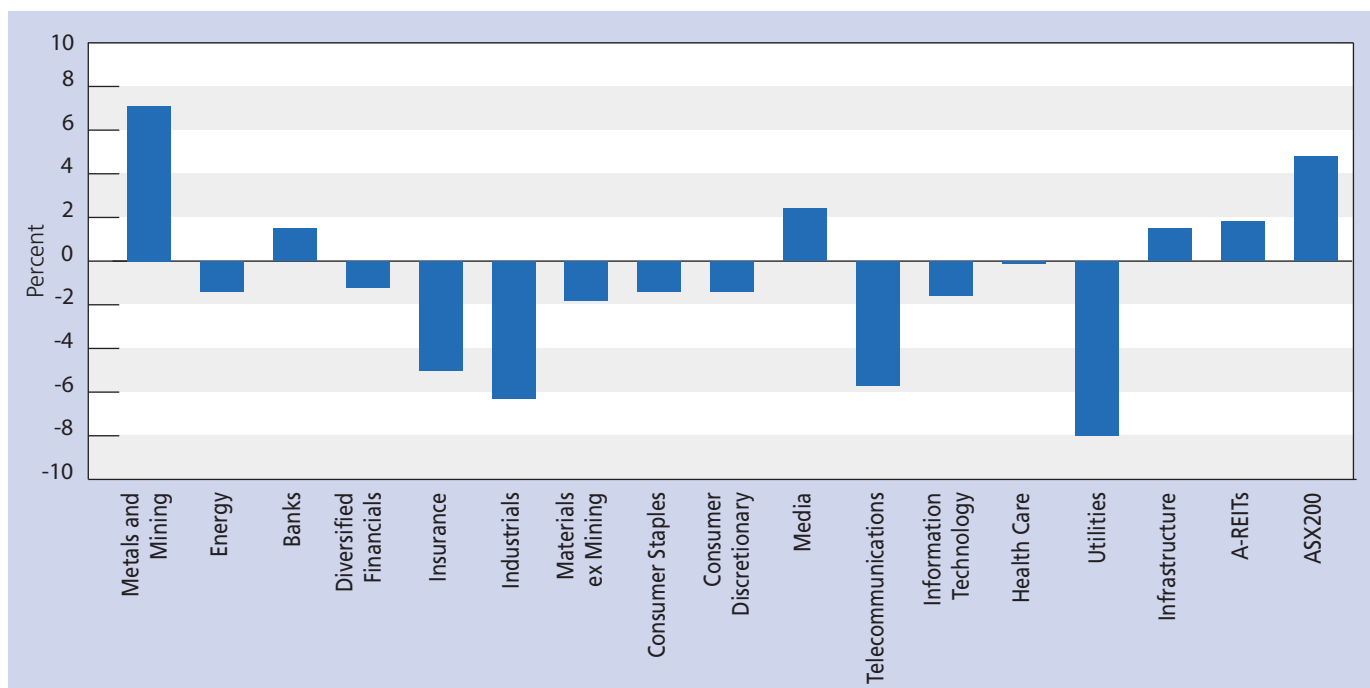
Market thoughts

The recently concluded Australian reporting season confirmed the impact of the two-speed economy on Australian company earnings, with resources companies reporting close to +60% earnings growth for the six months to December 2010, while industrial companies delivered around -7%. It seems that the two speeds are fast forward and reverse. Financials reported earnings growth of about +7% resulting in overall market earnings growth of +14%. Market expectations for FY11 have been reduced by around 2% with both resources and industrials seeing small downgrades. Recent earnings revisions in the chart below shows the significant sectoral divergence.

Reactions to company earnings announcements were unusually muted with fewer than normal significant share price reactions around results. We conclude from this that the sector earnings trends were generally in line with expectations and that investors are reluctant to materially increase or decrease their exposure to either the booming resource sector (are we buying peak earnings or selling too early?) or to weak industrial earnings (are we buying too early or selling at the trough?).

While the Australian economy appears to be struggling outside the resources sector, a range of leading indicators – primarily industrial production – suggest that global economic conditions continue to strengthen notwithstanding the political turmoil in Northern Africa.

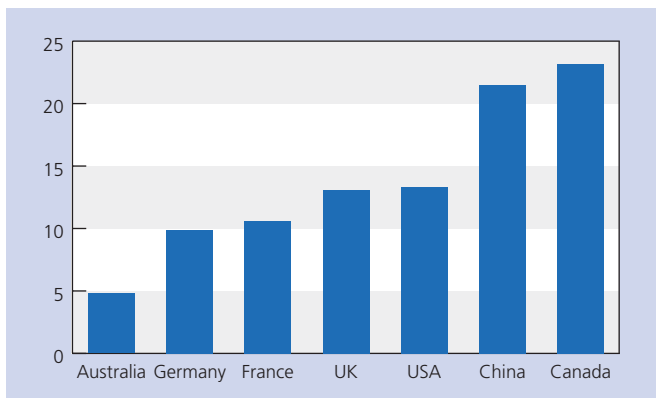
FY11 Earnings Per Share estimate revisions (past three months)



Source: IBES, Company data, Credit Suisse estimates, 28 February 2011.

Global earnings revisions are strongly positive, also in contrast to the situation in Australia. Although we remain positive from a macroeconomic perspective, we are also getting closer to the point when US monetary conditions will start to be tightened. This is likely to have a negative impact on global equity market returns. The equity market impact in Australia as a result of RBA's tightening during 2010 is a useful reminder of what a change in monetary conditions may bring.

Major world market EPS revisions (local currency past three months)



Source: Bloomberg, 28 February 2011

The impact of an eventual global monetary tightening cycle should be less negative on Australian portfolios as the rate cycle in this economic recovery has been leading the world. Indeed it may even be a positive catalyst as some of the headwinds ease. The A\$ strength may moderate, and a likely pause in domestic interest rate rises should support consumer spending. These factors have been two of the biggest drags on non-resource company earnings.

Portfolio thoughts

Our portfolios retain a cyclical bias though our exposure to resources has been reduced to a moderate overweight. We have added select stocks that should benefit from the broader recovery in global economic activity as well as improved domestic consumer spending. Our biggest underweights remain REITs (Real Estate Investment Trusts), utilities and consumer staples.

Our position in Iluka was a strong contributor for the month, with the stock up 25% after the company provided a very positive outlook on the tightness for its products, zircon and titanium dioxide. Importantly, this outlook was backed by greater than expected quarterly price increases for both products, for which Iluka is the price leader. We had taken a position in Iluka some months ago following our fundamental research which projected a shortage of supply for the next few years. Stephane's trip to China in November 2010, during which he met with not only Iluka management but also local industry experts, reinforced our conviction: the supply deficit was already apparent and customers were prepared to accept much higher prices as long as they had enough notice to pass them on to the end consumer. We maintain a positive view on Iluka but have started to trim our position as we feel that some of the upside is now factored into the share price.

Johan will soon be heading to the USA, where he will meet with the management of different companies in different sectors across the country. This will provide a first-hand view of what's going on in what is still the world's largest and most influential economy. We'll have more on that next month.

BTW...

Australia's economic dream run continues but some sectors are being left behind. The issues facing retailers of discretionary goods have been well publicised, but the reason for those difficulties is not well understood: the consumer should in theory be spending up big. The unemployment rate is close to all-time lows and the vast majority of jobs added over the past year have been full-time; wages have been increasing steadily; the period of GFC stimulus is well behind us so should no longer be affecting prior year comparisons; and the wealth effect should be supportive with both house prices and equity markets firm. So why aren't people spending? The savings rate as disclosed in the National Accounts has risen to around 10%, the highest for a generation. There are a couple of obvious headwinds including a lot of chat about shopping online and, yes, interest rates have risen a bit – but the positive factors far outweigh any drag from mortgages. A high rate of overseas travel is probably a factor as well.

This retail malaise has claimed some victims. The highest profile has been RedGroup which went into voluntary administration in February. RedGroup owns various book retailers with 260 stores across Australia and NZ with 2500 staff. RedGroup itself is owned by a Private Equity (PE) group, which bought Angus & Robertson Whitcoulls in 2004 and Borders in 2008 for well over \$200m in total. According to media reports, it had \$170m of debt and debtors when it pulled the plug on itself. Coincidentally, the now-unrelated Borders group in the US sought Chapter 11 bankruptcy protection that same week. A common PE strategy is to buy into a market segment (like book retailing) and consolidate it (i.e. buy more book stores), then use the greater degree of market power to build earnings, then sell the larger group to

the market at a high multiple. The internet has proved to be a disruptive force for all book retailers with sites like Amazon.com and Book Depository providing cheap products and high service levels despite being on the other side of the world. There were other factors in play, according to feedback from disgruntled customers.

Retailers tend to have a lot of operating leverage, so the high-debt PE model either works really well or really poorly. The trick is to sell to the market before it all unravels, but it looks like the PE owners of RedGroup missed the opportunity. Myer's didn't. Its IPO in November 2009 was impeccably timed (for the seller, not the buyers), and its management is now trying to live up to the expectations it created back then. Other PE-owned retailers who might end up coming to market include Witchery, Super A Mart, Rebel Sport, Barbeques Galore, Godfreys, Colorado and NZ's Noel Leeming. It's fair to say that the market will look at any floats by PE with a fair degree of skepticism. Of course, not all PE listings are like that and JB Hi-Fi is a notable exception. It floated in 2004 at \$2 and is now not that far from \$20. However, not many retail formats have such an immature store network or appealing exposure to digital products.

Alphinity's current retail exposure is limited to a small position in up-market department store David Jones. DJs has virtually no debt and, while the present retail environment is not providing it much joy, the company was well prepared for it and has a credible program of cost initiatives to provide a modest degree of earnings growth until the retail cycle recovers, as it inevitably will. DJs won't report earnings until the end of March but did announce flat sales for the six months ending January 31, a stark contrast to its mass-market competitor Myer which was down sharply. It seems the more affluent consumer is still spending, but even they are cautious.



Alphinity Investment Management

Level 15, 255 Pitt Street
Sydney NSW 2000

T 02 9994 7921

F 02 9994 6693

W www.alphinity.com.au

Any information contained in this publication is current as at 28/02/11 unless otherwise specified and is provided by Challenger Managed Investments Limited ABN 94 002 835 592 AFSL 234 668, the issuer of the Alphinity Australian Share Fund (ARSN 092 999 301) and the Alphinity Concentrated Australian Share Fund (ARSN 089 715 659) (Funds). References to Alphinity Wholesale Australian Share Fund and the Alphinity Wholesale Concentrated Australian Share Fund are to the wholesale class unit in the relevant fund and references to the Alphinity Australian Share Fund and the Alphinity Concentrated Australian Share Fund are to the retail class unit in the relevant fund. It should be regarded as general information only rather than advice. It has been prepared without taking account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on any such information, consider its appropriateness, having regard to their objectives, financial situation and needs. Each person should obtain a Product Disclosure Statement (PDS) relating to the product and consider that PDS before making any decision about the product. A copy of the PDS can be obtained from your financial planner, our Investor Services team on 13 35 66, or on our website: www.challenger.com.au. If you acquire or hold one of our products, we will receive fees and other benefits, which are disclosed in the PDS for the product. We and our employees do not receive any specific remuneration for any advice provided to you. However, financial advisers (including any Challenger group companies) may receive fees or commissions if they provide advice to you or arrange for you to invest with us. Some or all of the Challenger group companies and their directors may benefit from fees, commissions and other benefits received by another group company.