

## Monthly comment – January 2011

Alphinity Australian Share Fund

Alphinity Concentrated Australian Share Fund

# Floods, fires, plagues and cyclones...

## Market comment

Floods in Victoria and Queensland, fires in WA, locust plagues in NSW, cyclones in Queensland... all we needed were the Four Horsemen and we'd have the apocalypse as well. With challenges in the natural environment here and political tensions rising in a number of sensitive parts of the world, it is perhaps a little surprising that the Australian share market held up as well as it did. The ASX 300 eked out a tiny gain for the month. The US market rose 2% while the UK market fell fractionally in January.

The \$A was slightly softer over the month compared with the 30-year highs at which it closed in December, but remains close to parity with the \$US.

Commodity prices rose despite some signs of policy tightening in China, although this was partially explained by the impact of the Queensland floods on coal prices. Gold however, retreated from its recent all-time high. Despite higher commodity prices the resources sector sold off in January following a strong run at the back end of 2010. The sell-off was particularly savage at the smaller end of the resources sector. Banks and consumer staples on the other hand outperformed.

## Market thoughts

Recent economic data points to an improving world economy. Somewhat at odds with developments over the last few years, Australia is no longer the 'belle of the ball' as higher interest rates and the strong Australian dollar appears to have taken its toll. While resources companies are enjoying the 'China effect' the upcoming semi-annual reporting season during which most companies detail profit, cash flow and balance sheets will be an important test of whether the apparent cheapness of the market holds true.

## Portfolio thoughts

Both the Alphinity Australian Share Fund and the Alphinity Concentrated Australian Share Fund outperformed in January. Biggest contributors included fund manager Henderson, fertilizer producer Incitec Pivot, retailer David Jones and global media company News Corporation. Our underweight position in Newcrest also added value as gold stocks weakened with the gold price. We remain biased towards cyclical companies as discussed in more depth on the following pages.

## Fund performance\*

|  | APIR code | 1 month (%) | Quarter (%) | Since inception (%) |
|--|-----------|-------------|-------------|---------------------|
| Alphinity Australian Share Fund                        | HOW0122AU | 0.36        | 2.0         | 8.98                |
| Alphinity Wholesale Australian Share Fund              | PAM0001AU | 0.43        | 2.25        | 9.41                |
| S&P/ASX 300 Accumulation Index                         |           | 0.11        | 2.88        | 9.78                |
| Alphinity Concentrated Australian Share Fund           | EQI0001AU | 0.39        | 1.72        | 10.99               |
| Alphinity Wholesale Concentrated Australian Share Fund | HOW0026AU | 0.41        | 2.05        | 11.23               |
| S&P/ASX 200 Accumulation Index                         |           | 0.18        | 2.74        | 9.40                |

\*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 January 2011

Alphinity Australian Share Fund

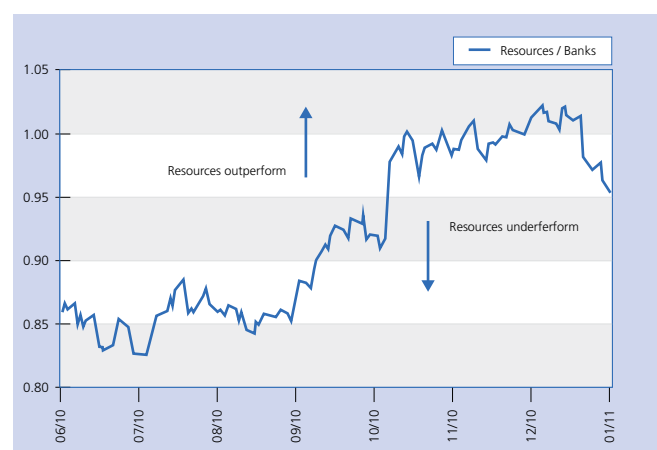
|                         | Fund weight (%) | Index weight (%) | Active weight (%) |
|-------------------------|-----------------|------------------|-------------------|
| <b>BHP Billiton</b>     | 15.4            | 12.9             | 2.5               |
| Westfield Group         | 0.0             | 2.5              | -2.5              |
| <b>Rio Tinto</b>        | 5.3             | 3.2              | 2.1               |
| Woodside Petroleum      | 0.0             | 2.1              | -2.1              |
| <b>News Corporation</b> | 2.7             | 0.6              | 2.1               |

## Market thoughts

As is usual this time of the year, investors are reviewing asset allocation and major investment themes. Some of the key issues being considered are bonds vs. equities, emerging markets vs. the developed world, commodities and resources stocks vs. less cyclical sectors, commodity-linked currencies vs. the \$US and the Euro. Most of these trades are one way or another inter-linked and largely boil down to: Will the US economic recovery – which seems to be strengthening – present better investment opportunities than the by now well-known China ‘miracle’ which, on the other hand, is creating fears of overheating?

One month into the new year the market does not appear to have made up its mind one way or the other. Local banks, which traditionally benefit from resources selling, did outperform the market while resources underperformed. However, the shift was not decisive and merely retraced some of the resources sectors strong outperformance during the second half of 2010.

## Performance of Resources vs banks

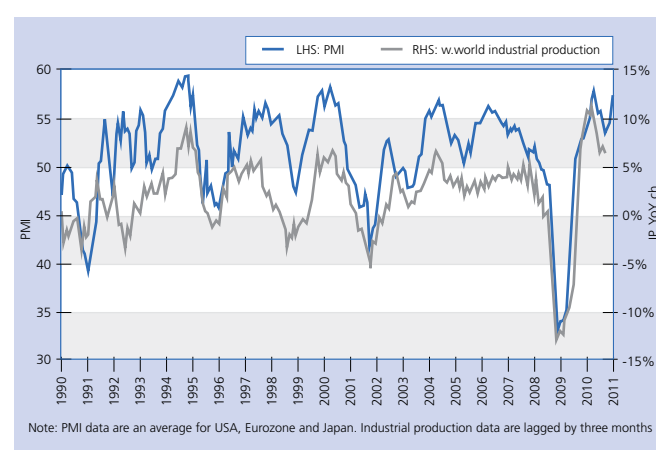


Source: Bloomberg, 31 January 2011

A number of indicators suggest that the US economy is strengthening, warranting greater scrutiny of companies with exposure to what is still the world's largest economy (as President Obama felt the American people needed to be reminded in his recent State of the Union Address, 25 January 2011).

However, for Australian companies with US earnings, the benefit of stronger US growth will continue to be diminished as long as the \$A stays around current levels, making it difficult to advocate for significant portfolio shifts in that direction. Furthermore, stronger US growth and indeed global growth is clearly not a negative for our commodity companies, and recent data supports our thesis that the slowdown experienced in the middle of 2010 was a so-called mid-cycle slowdown which has now passed, while Chinese growth remains solid. Surveys of Purchasing Managers' intentions are usually a good lead indicator of industrial production and are currently painting a bright picture, which should support cyclical companies over the coming months.

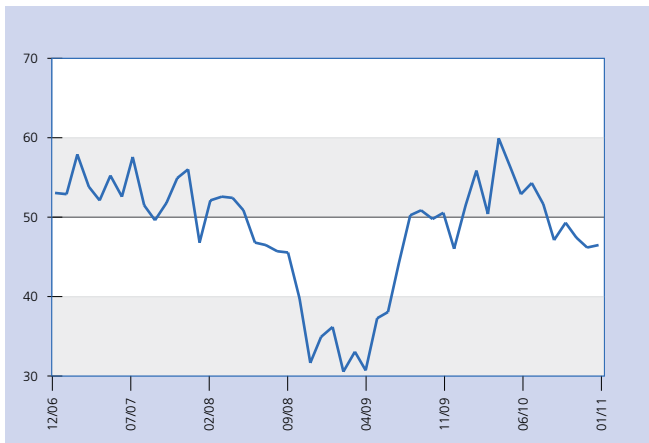
## World PMIs are pointing to strong Industrial Production



Source: ISM, Macquarie Research, February 2011

Interestingly, the one economy not participating in this accelerating growth momentum is Australia. This situation would only have been made worse by recent weather events and has already manifested itself in a number of profit warnings.

#### Australian Industry Group PMI (Performance of Manufacturing Index)



Source: Bloomberg, 31 January 2011

As we head into reporting season, earnings momentum remains with resource-related stocks. This makes us reluctant to make any wholesale shifts away from the large cap end of that sector. Industrials continue to experience the dual headwinds of the two speed economy and strong Australian dollar. However, expectations – and thus valuations – are now sufficiently low to warrant paying increasing attention to stocks which are able to withstand these pressures, and which will eventually benefit from any easing thereof.

#### Portfolio thoughts

The portfolio remains biased towards companies benefiting from stronger global growth, primarily through our holdings in the resources sector and we see no reason to alter this overall position as long as global industrial production continues to show solid growth. In our process, however, we are also disciplined in ensuring that we are exposed to quality companies with solid balance sheets and attractive valuations. This paid off in the month of January when our stock selection within the resources sector more than compensated for the portfolios being overweight the sector as it underperformed the market.

Our persistence with the UK based fund manager Henderson Group was rewarded in January and we think there is more to come. The strong Australian dollar vs. Sterling had seen the shares lag in the last few months.

However, January saw the stock jump 18% on the back of a very accretive acquisition of rival Gartmore as well as a positive update on earnings and Q4 funds flows. While the acquisition had been rumoured, the acquisition terms and extent of synergies were far better than the market was prepared to believe beforehand and we still believe the market is taking a too conservative view of the likely synergies – on top of our already strong conviction that the market is not factoring in the group's leverage to higher margin businesses and recovering investment markets.

January produced a rare event in the market: a formal downgrade from Woolworths. It is a company with a well-earned reputation for excellent management and predictable earnings, however a combination of factors led it to reduce guidance from the 10% EPS growth which we've been accustomed to, to about 7% – earnings are still growing but at a slower rate. Looking at the 2012 financial year, it faces potential operating losses in its new hardware retail business so even if the current softness is isolated, it looks like it may experience another year of subdued earnings growth. This dynamic reinforces the underweight position in our portfolio.

Reporting season is a critical time for all equity managers as it can prove or disprove an entire investment thesis. Most of the companies listed on the ASX have June or December balance dates which means they are required to publish their accounts before the end of February. Notable exceptions are most of the banks and some retailers, many of whom have September or January balance dates respectively.

Last reporting season, August 2010, which came after a number of months of soft markets and coordinated profit downgrades, produced many anomalous share price reactions to good and bad results alike. We expect a more normal reporting season this time.

#### Alphinity news

Alphinity is now a full signatory of the United Nation's Principles for Responsible Investment. We have long adhered to these principles as sound practice when managing money and supporting it reflects our desire to promote them as a matter of good corporate governance. Find out more by visiting: [www.unpri.org](http://www.unpri.org)



An investor initiative in partnership with UNEP FI and the UN Global Compact

## BTW...

January is never as quiet as we would hope for in the markets – and this holiday period was no different. While Alphinity did see a bit of the beach this summer, mostly it was from behind a PDA while assessing insurance costs following the devastation in Queensland and Victoria, following what was going on in China and the resources sector, or keeping track of geopolitical developments in the Middle East.

We did however still manage to maintain our rounds of seeing company management. January is always a good time to see the banks as they do not report in February so are not in blackout. There has also been a lot going on in 'bank-land' since they last spoke publicly around results including out of cycle rate rise, some clarity around regulation and political interference and of course the impact of the floods in Queensland. With this in mind Andrew made his way to Melbourne to see the two Victorian 'business' banks NAB and ANZ. Yes, there was a small tennis tournament on at the time but he reckons the closest he got was a large screen in Federation Square! He caught up with one of the bigger credit unions there to get a different perspective on the sector. He also met with Westpac's head of NZ in Sydney. A few interesting themes came out of these meetings:

- While there is a glimmer of some pick-up in business lending in some segments, it is still pretty lacklustre and patchy. There is still certainly a lot of 'hope' that it picks up, and he sensed a continued investment in that part of the business to take advantage of it when it happens (cost over-runs near term, or cut backs in other divisions perhaps?), but timeframes are being pushed out yet again.

Plenty of talk about strong pipelines – particularly around M&A activity – but there has been that talk for at least a year now. There may also be some further near term disruption in Queensland given the floods, but the banks are hoping for a rebound in the second half of the year.

- The banks are still unsure what will be the full financial impact of the natural catastrophes, but expect them all to take some (modest) provisions against the impact (direct and indirect) at the next results.
- While mortgage lending is relatively soft, this actually finally eased the deposit pricing war that was evident for much of last year (ie less need to chase deposits when lending volumes are low). The savings rate remains at a high level so they are getting good deposit flow anyway. Coupled with the out of cycle rate rise last year, this may see bank interest margins holding up better than expected despite the soft revenue growth.
- The only area that is currently seeing any real margin pressure is in the top-end institutional business with global banks back into the Australian market – including those with large UK government owned parents – and global bond markets are open to companies with good credit.

We will get our first insight in to more solid bank numbers in February when CBA reports its results, and the other banks give their quarterly updates. With a continued slow revenue growth environment, and lingering regulatory and political issues, the main attraction in the banks is their relatively good long term valuation and yield, rather than exciting near term underlying earnings growth.



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