Monthly Comment – October 2015
Alphinity Wholesale Concentrated Australian Share Fund

October Rocks

Market comment

Markets ran hard in October, with many global markets recording high single digit increases in their local currencies. Australia lagged by comparison, even though a one-month return of 4.4% (ASX300 including dividends) would normally be quite impressive. New Zealand raced away, presaging its Rugby World Cup effort, with an $A return of 11.5%. China's equity recovery continued even while its economy appeared to remain sluggish, with returns of between 8% and 10% depending on which index you look at. The US market was up 6%, the UK 5% and most of the continental European markets were 5-8% higher. Japan was up almost 7%: clearly October was a vintage month for equities despite its reputation as being a dangerous month on the markets.

What was behind all this bullishness? Well, part of it was just a bounce back from the very poor returns in the preceding couple of months. Part of it was fears about China's slowdown receding a little. Part of it was some surprisingly "hawkish" comments from the United States Federal Reserve (Fed) suggesting that rates there might go up by the end of the year after all. This is a little counter-intuitive: surely an increase in rates is bearish for equities, not bullish as this suggests? Normally yes, but the US market performance in particular suggests that equities may not be too bothered about rates starting to move up from what can only be described as emergency settings so far into the economic expansion. It has to happen some time, so just get on with it Janet!

Most commodity prices continued to struggle. Iron ore prices fell a sharp 11%, which is not good for our major resource companies, and most base metal prices fell by single digit percentages. Gold however went up a couple of percent.

The local banking sector surprised everyone by lifting home mortgage rates a little in October. Westpac started it by raising its home loans by 0.2% but the others quickly followed with roughly similar moves. It is unusual to have such moves divorced from changes in the official cash rate, however the banks blamed tighter capital rules being forced upon them by regulators as necessitating the move. In any case, it has seems to have put some more cold water on the housing market which, until a few months ago, was white-hot in some parts of the country.

November often acts as a mini reporting season: companies with a June year-end tend to have their Annual General Meetings during the month. When combined with financial reports of companies with March and September year ends, including most of the big banks, we are looking forward to a number of trading updates that should help confirm the investment theses of our positions.

Portfolio comment

The portfolio outperformed the market slightly during the month, continuing its recent strong run of relative performance. The best contributions were from global investment bank Macquarie Group and being underweight both Telstra and major bank ANZ. Against these however was some modest detraction from iron ore producer Fortescue Metals.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	4.6	-5.5	3.2	12.2	8.6	10.1
S&P/ASX 200 Accumulation Index	4.4	-6.6	-0.7	9.8	7.1	8.2

*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.

Monthly Comment – October 2015

Alphinity Wholesale Concentrated Australian Share Fund

Market outlook

Valuation ended up winning the "tug of war" against low corporate profit growth in October. However the earnings picture continues to look challenging with both macroeconomic indicators and corporate profits remaining disappointing, so it's difficult to see this rally turning into a more sustained market move.

The banks are a good illustration of the current market dilemma. On one hand banks appear cheaper than they have for some years: dividend yields are back at 6% or above and PE multiples have contracted significantly over the last six months. On the other hand, the banks' earnings growth prospects are more subdued than for some years. While this is partly due to the recent equity raisings that were required to meet increased capital requirements which has diluted earnings per share, it is also a function of the current low growth environment which is impacting demand for new loans. Add to that a US Fed decision on interest rates which is difficult to call, both in terms of what the Board of Governors will end up doing and how the market will react to it, and we may not be able to rely on international developments to provide the catalyst for the traditional year-end rally this year.

What could spark it is corporate activity. This has been a feature of overseas markets, especially the US, over the last couple of years and while still early days in Australia, there appears to be growing interest from corporates to do things like acquisitions, restructuring and asset sales. The combination of low interest rates and low growth makes acquiring growth look more appealing, and the weak $A has also made Australian corporates appear noticeably cheaper to overseas buyers.

Asset allocation	As at 31 October 2015 %	Range %
Securities	97.3	90-100
Cash	2.7	0-10

Top 5 active overweight positions as at 30 September 2015	Index weight %	Active weight %
Westpac Banking Corporation	7.7	6.4
Macquarie Group Ltd	2.1	5.1
Goodman Group	0.7	3.8
AMP Limited	1.3	3.4
Caltex Australia Limited	0.6	3.2

Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size	$12.6M
APIR code	HOW0026AU

Portfolio outlook

The cyclical rally that led equity markets higher in the first weeks of October was showing signs of running out of steam by the end of the month. As we wrote in last month's report, it is difficult to see a more sustained rally in cyclicals unless demand picks up meaningfully and absorbs the abundant supply which is plaguing all but a few commodities. For this reason we have not changed our underweight to the Metals & Mining sector.

Corporate action could come to the rescue of some of the more challenged companies, as has been highlighted by the indicative bid for energy producer Santos. However, trying to pick the next financially distressed takeover stock is a dangerous strategy, in our view. And in any case, takeover activity over the last couple of months has not been limited to high risk investments. Bids for high quality holdings such as Asciano and Veda have already benefited the Fund's portfolio this financial year.

We expect low interest rates to be a feature of financial markets for several years. As such, we remain holders of some "yield" stocks but only if they also have some attractive earnings drivers. Stocks such as APA, Sydney Airport, Goodman Group fit these criteria. We think this will become increasingly important as the Fed inches closer to its first interest rate hike since 2007. While the Fed has clearly signalled its intention to only gradually raise rates, increased volatility in yield stocks is a likely to be a feature of the coming months. However in aggregate the Fund remains moderately underweight the high yield part of the market, primarily through its underweight to Real Estate Investment Trusts (REITs) and Telstra.

Stocks exposed to the Australian housing market have been under pressure recently as investors fret over a likely peak in the building cycle. While construction activity should remain robust for at least the next 12 months, finance approvals and building approvals provide investor with strong lead indicators with share price performance often pre-empting an eventual slowdown. The Fund's main exposure to residential housing is through Adelaide Brighton Cement, James Hardie and Lend Lease. While all these stocks have a degree of leverage to Australian housing, they are well diversified with large exposure to overseas markets (James Hardie and Lend Lease) and infrastructure (Adelaide Brighton and Lend Lease), where the growth trajectory apart from housing appears solid.

Fees	
2014/15 ICR	1.85%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions payed) above the Performance Benchmark
Buy/sell spread	+0.20%/-0.20%

Monthly Comment – October 2015
Alphinity Wholesale Concentrated Australian Share Fund

BTW

There are some things we struggle to understand about the modern world no matter how hard we try to keep up. For instance when a son or daughter comes to us and says "I want to be a professional video gamer when I grow up" and we condescendingly chuckle and say: "Yes, that would be nice but I'm afraid it's not a real job that you'd get paid for", the child then points us to someone like PewDiePie.

Who is PewDiePie? He is the 26 year old Swede whose real name is Felix Arvid Ulf Kjellberg, a former hot dog stand operator who was recently named as the highest-paid individual by YouTube. Forbes magazine says he's received $US12 million over the past year (up from $US7m in 2014) just from posting five-minute videos of himself playing video games and making funny comments about them. He has 40 million subscribers, which constitutes an appealing young audience for advertisers to target. YouTube pays him a tiny amount per video watched but it all adds up to Big Bucks.

YouTube started as a site on which to share videos between buddies in early 2005. The first video was uploaded by one of the founders in April of that year and is less than half a minute long: it is still on the site but is very unexciting for something that has had such wide-reaching implications. It can be found at https://www.youtube.com/watch?v=jNQXAC9IVRw if you're keen.

Some venture capitalists put in $US11.5 million later that year to help develop it, but the whole company was bought by Google in late 2006 for $US1.65 billion. At the time no-one could work out what the business case was to justify that price but YouTube now generates several billion dollars in ad revenues a year and demonstrates once again that those people at Google are several steps ahead of most.

Alphinity has a soft spot for Swedes, after all 22% of its employees were born in Sweden. So we view the news of PewDiePie's success with a mix of reflected pride and bemusement and we do not begrudge it at all, even if we don't really understand why a sane person would bother to watch a video of someone else playing computer games and talking about it.

According to Forbes, there are a bunch of other people who have had almost as much financial success as PewDiePie in the wonderful world of YouTube. Like Smosh (two men from California who initially made videos of skits based on Pokemon but now have five YouTube channels, including one in Spanish); like the Fine Brothers (who fairly surreally post videos of people watching YouTube videos of PewDiePie and his ilk, and who now have a show on Nickelodeon); like Lindsay Stirling (who makes ultra-slick music videos of herself dancing and playing the violin); like Rhett and Link (who make shows sending up US morning TV shows); like KSI (a hip-hopping British videogame commentator with 11 million followers); like Michelle Phan (who makes videos teaching girls how to apply make-up, which she has parlayed into her own line of cosmetics). The least of these made $US3 million in the year, which is a reasonable income by most measures.

While we can't help feeling that these might be harbingers of the end of civilization, maybe it's just this millennium's version of the 90s dot com boom, the 80s computer boom, the 70s resource boom, and so on. Easy money if you are in the right place at the right time, so get in early and try to cash out before it all comes crashing down. At least YouTube is reasonably democratic: anyone can try for their five minutes of fame and the few, who resonate with enough of the viewing population, can make it big. But rather than having to convince some risk-averse old execs in a network to give you a spot on TV, anyone can make a video of something they think is good, post it on YouTube and hope that people pick it up and start sharing it with their friends.

On a separate but related note, Macquarie Group constitutes the biggest active weight in Alphinity's Australian portfolios but that didn't prevent us recently from poaching a new staff member from that fine company, and we welcome Adam Solano to the team. While his primary role will be executing trades for the domestic and global equity portfolios, he also develops websites in his spare time. We expect that his blend of youth, enthusiasm and technology skills will only enhance the overall investment effort of the group and help the rest of the team keep up to date with the sorts of things we've written about above.

Monthly Comment – October 2015

Alphinity Wholesale Australian Share Fund

Traveller's Tale

Bruce went to various parts of the USA during the month mainly researching the property market. One of the great challenges when travelling in the US, as many people appreciate, is that of finding acceptable coffee. Without wanting to come across as princesses, life is too short to drink bad coffee and bad coffee is something the US produces in abundance. Coffee is mostly produced in bulk on a drip machine and left on the heat to stew for hours as it becomes even more undrinkable than it was at the start. And consumed by the gallon.

We were horrified in our travels to see the "Coffee Traveler" (sic): coffee in a 96 ounce (about 3 litre) cardboard box not unlike that great Australian contribution to viticulture, the wine cask.

Many non-Americans have been puzzled by the success of Starbucks. From humble beginnings in the 1970s as a boutique coffee shop in Seattle it has become a global chain with more than 22,000 stores with $US20B annual revenues and a market capitalisation of more than $US90 billion. But when you go there you realise that, in the US, Starbucks is pretty much as good as it gets. It recently introduced the particularly Australian Flat White to its menu, and while it is still served way too weak in a cup that is way too big, with a few tweaks it can be made quite tolerable. The best of a bad lot one might say. Probably better than the Pumpkin Spice Latte that was also on offer in the lead-up to Halloween.

But a few enterprising Aussies have recognised the gap in the market and started up Melbourne-style coffee shops in New York City. There is *Little Collins* on Lexington, just near Bloomingdales; as well as *Bluestone Lane* which started out on the lower east side but has become a chain of five around Manhattan with a satellite in Brooklyn since his last visit.

The ultimate however, for a mixture of celebrity and altruism, has to be *Laughing Man* in the uber-trendy TriBeCa district. Founded by our own Hugh Jackman Laughing Man only has a tiny shopfront but it was buzzing when Bruce arrived. No sign of Hugh that day sadly, but it serves coffee from a plantation in Ethiopia, and the profits from the shop go to a foundation which supports education and community development. Most importantly the coffee itself was excellent, which went a long way to justifying the ~$A7 a modest-sized cup commanded in our soggy currency.

Alphinity Investment Management

Level 12, 179 Elizabeth Street
Sydney NSW 2000
T 02 9994 7200
F 02 9994 6692
W www.alphinity.com.au