Monthly comment – April 2011

Alphinity Concentrated Australian Share Fund

Confession Season…

Market comment

April continued the recent choppy trading trend for the market. Not as volatile as in March but another negligible move: the market (S&P/ASX300 including dividends) fell by 0.2%. Global markets did better with US and UK markets both up by around 3%, but currency moves more than offset that. The $A gained more than 6% against the $US (less so against the £ and €) to finish the month at fresh post-float highs approaching $US1.10. Precious metal prices remain strong, which suggests it is not so much the $A that is strong, it is the $US which is very weak. So weak, in fact, that S&P put the USA on negative credit watch, threatening to downgrade its AAA credit rating. We continue to expect overall earnings downgrades as we enter 'Confession Season' – the last few weeks before the end of the financial year during which the banks report H1 results and December balance date companies hold AGMs. There were a couple of earnings downgrades in April, specifically Leighton Holdings and Goodman Fielder. Both downgrades were substantial, and both stocks were harshly dealt with by the market.

Portfolio comment

The portfolio lagged the benchmark slightly during the month of April. The best contributor was the position in Equinox. It received a takeover bid from Chinese resource company Minmetals Resources in the early part of April, which was trumped by Canadian company Barrick Gold. We feel that most of the value in Equinox has now been recognized and have started to exit the position. Other meaningful contributors were NAB, Flight Centre and not owning Leighton Holdings. Detractors included Henderson Group PLC, which fell after a couple of months of strong performance, Rio Tinto and Alumina. Not owning Wesfarmers cost the fund slightly.

Fund performance* – as at 30 April 2011

	APIR code	1 month (%)	Since inception (%)
Alphinity Concentrated Australian Share Fund	EQI0001AU	–0.8	13.3
Alphinity Wholesale Concentrated Australian Share Fund	PAM0001AU	–0.8	13.9
S&P/ASX 300 Accumulation Index		–0.3	12.4

*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 30 April 2011

Alphinity Concentrated Australian Share Fund

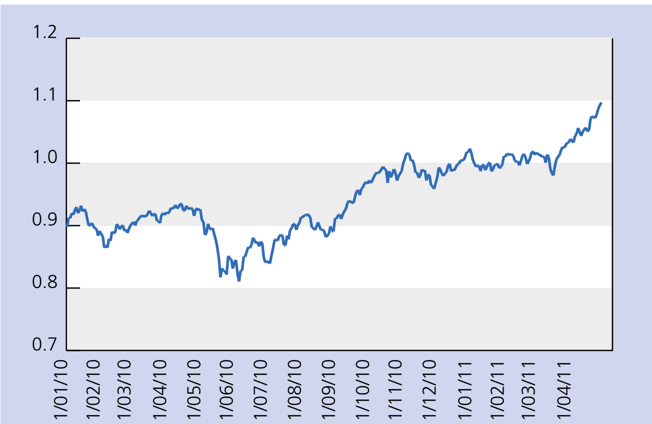
	Index weight (%)	Active weight (%)
BHP Billiton Limited	13.4	5.1
Rio Tinto Limited	3.1	4.0
Westpac Banking Corporation	6.5	3.6
Commonwealth Bank Of Australia	7.3	3.3
News Corporation	0.7	2.9

Market thoughts

Australian equity market sentiment has turned decidedly negative in recent weeks as the main headwinds for non-resources corporate earnings – the strong Aussie dollar and weak consumer sentiment – continue to worsen. Concerns over slowing growth in China, the high oil price, the end to quantitative easing in the US and the ongoing debt crisis in several European countries have also contributed.

Renewed currency strength in particular, is quite a concern for many Australian companies. It is difficult to find companies which will benefit from continued $A strength, which would typically require costs incurred at least partially in $US, but revenues in $A. Most Australian companies have the opposite problem – $A costs and at least some revenues in weaker currencies – a dynamic which tends to be bad for earnings. Exceptions include Coca-Cola Amatil, which buys some of its inputs in $US, but the degree to which it benefits is often over-estimated by the market. The chief beneficiaries are those companies with exposure to resources, as long as resource prices are rising by more than the $A.

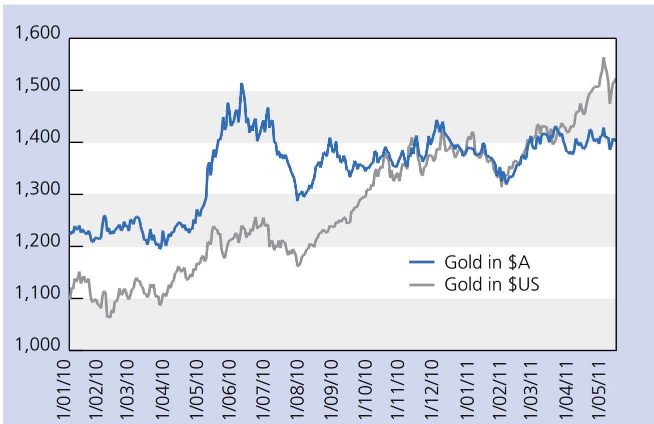
$A/$US



Source: Bloomberg, 30 April 2011

However, not all resource companies are doing well in this environment. The gold price is close to an all-time high – surpassing the peak in the early 80s even adjusting for inflation. Or is it? Looking at it in $A, gold has hardly moved for a year, and the weak $US accounts for all the shift. The performance of gold stocks as a consequence has been mixed, with company specific factors more important drivers of shareholder returns.

Price of gold



Source: Bloomberg, 30 April 2011

In addition to those companies competing with imports or dependent on export markets, many have at least some degree of offshore earnings, and those earnings are worth less the higher the dollar rises. We continue to expect overall earnings downgrades as we enter 'Confession Season' – the last few weeks before the end of the financial year.

While it is certainly easy to paint a bleak picture, and we have for some time warned investors about the risk of further downgrades to industrial company earnings, we would argue that overall market downside should be limited by strong corporate balance sheets and a low overall market valuation (FY12 PE of 11.2x, 4.8% yield), which should provide some buffer to lower earnings.

Portfolio thoughts

Notwithstanding the challenging macro environment currently facing the Australian equity market, we continue to be enthusiastic about investment ideas uncovered through our research process. It is often in periods with a tough external environment that the underlying quality of a company's management and competitive position is tested. Companies such as David Jones, Caltex Australia, Origin Energy, MAp Group, Coca-Cola Amatil, CSL and WorleyParsons are clearly exhibiting the quality characteristics we seek. Another stock in which we have high conviction is fund manager Henderson Group Plc. Henderson was a strong contributor to performance in the March quarter but lagged during April. We feel that Henderson has a quality business with a balance sheet and management which has created growth options yet to be appreciated by the market. For example, the integration of Gartmore appears to us to be ahead of schedule, with earnings accretion likely to exceed market expectations. With the Henderson share price suffering some indigestion following a large sell down by Gartmore's former private equity backers post deal completion – a purely technical issue – and with our confidence growing in both the deal and the performance of the existing business, this weakness represented an ideal opportunity for our fund to increase its holding. Further weakness in Henderson's home currency the £ remains the key headwind for Australian shareholders.

We also remain overweight the resource sector, particularly through the diversified bulk commodity stocks Rio Tinto and BHP Billiton. The resource sector, and these companies in particular, remain attractively valued in our view. A research trip by Stephane to China in early May should provide us with additional insights on the outlook for the resources sector. These research trips have in the past provided highly valuable input to our outlook for commodity prices. Visits to the operations of companies such as Riversdale (bid for by Rio Tinto), Equinox (bid for by Barrick Gold) in Mozambique and Zambia, respectively, have also been fundamental to our investments in these companies which have contributed to investor returns.

BTW…

Can't get a mortgage? Many in the US don't need to. According to a Bloomberg report, in 2010 there were 200,000 home sales for cash, no mortgage required. Foreclosures and 'short sales' (in which the lender accepts less than the loan face value for the house) accounted for about 60% of the cash sales. One investment fund which was set up to exploit the fraught US housing market gave an example of the economics: it bought a house in Florida for $US32,000 which had previously sold for $285,000 in 2006. It needed $11,000 of repairs (replacing the interior plasterboard, plumbing and appliances), but is now rented out for $15,000 per annum, $12,500 after taxes and insurance. (Bloomberg 29/3/11). An anecdote perhaps, but it lends credibility to the view we discussed last month following Johan's visit to the US: that while the US housing market remains in a fragile state, the turn when it comes is likely to surprise positively.

BTW…

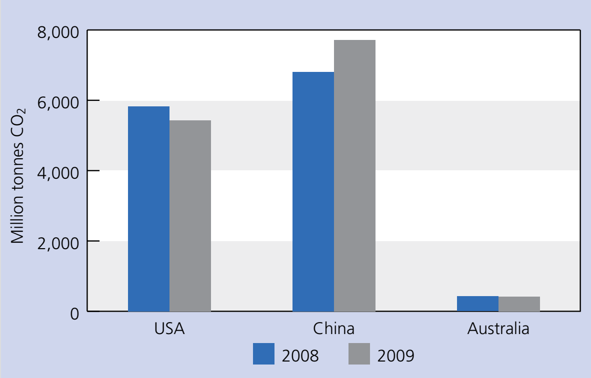
In April, the Federal Government released an audit of the country's 2009 direct greenhouse gas emissions. In 1990, is the Kyoto Protocol base year, absolute carbon emissions were 550 million tonnes. In 2009, the country emitted the equivalent of 564 million tonnes of carbon. In round figures, 40% of this was from the production of electricity and gas; 20% from agriculture, and roughly 10% each from mining, manufacturing, services (including transport) and residential. Emission from Agriculture has halved since 1990, reflecting the much lower rate of land clearing, but this was wholly offset by emissions from electricity/gas and services which have both risen by about 60%. Per capita emissions has fallen by more than 20% (from 32 tonnes to 26 tonnes) but remains high by world standards, in part due to the export intensity of much of Australia's economic activity. Per unit of GDP, however, emissions have fallen by more than 40% over the period.

(Source: Australian National Greenhouse Accounts, April 2011)

One of the shortcomings of this sort of data is that it is often quite old. The change in most countries' per capita carbon emissions (only up to 2006 though) as well as a whole lot of other economic and social indicators, can be neatly charted and tracked over time on the website www.gapminder.org/world (as it says: 'There's nothing boring about statistics').

Another shortcoming is that it is very difficult to get accurate and consistent numbers: if you don't like these, you might find another source that better suits the argument you want to make! For instance, the US Energy Information Administration's atlas of pollution says that carbon dioxide emitted in Australia in 2009 fell by 2% to 'only' 418 million tonnes, far less than the Australian estimates mentioned above no doubt due to a different basis of calculation. That's just under 20 tonnes per person and way below the biggest per capita emitter, Gibraltar, at 152 tonnes (of course, with so few people its absolute emissions are tiny). By contrast, Chinese emissions increased by 905 to 7711 million tonnes in 2009, and the USA's fell by 408 to 5425 million tonnes.

Carbon emissions comparison



(Source: guardian.co.uk/news/datablog/jan/31/world-carbon-dioxide-emissions-country-data-co2)

With these sort of data it is easy to understand the challenges the Federal Government faces in coming up with a scheme that can be easily explained to the electorate and able to gain broad-based support.

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