Monthly comment – August 2014
Alphinity Wholesale Concentrated Australian Share Fund

After the deluge

Market comment

This month was apparently the wettest August on the eastern seaboard of Australia since the last millennium. The deluge from the skies was matched by the torrent of information that constitutes reporting season but, despite all that data, the Australian market in August (ASX300 including dividends) barely moved, rising by less than 1%. We lagged the 3.5% of the US but performed slightly better than most Asian markets and much better than most of the Europeans, although this was partly caused by the strong $A/weak €. The small rise built on July's strong performance and has taken the calendar year to date increase to more than 9% which makes us, along with Canada, the best performing of the major markets in $A year to date: almost double the return from the US market and vastly better than the mid-single digit declines in most of Europe.

August contained the much-anticipated result season, during which every company with a June or December year end reports its earnings to the market – sadly seeming to be concentrated around a few days towards the end of the month. Such a rich mix of data inevitably throws surprises our way, and this season was no different. There were probably more perverse reactions to results than normal, some of which remain difficult to explain even to this point, however there seemed to be some large macro moves taking place. But reporting season is also a great opportunity to catch up with almost all our companies – and a lot we don't own – and get a better understanding of how earnings surprise will develop in the future.

The commodity prices most important to our resource companies remained under pressure in August: iron ore continued its recent downward run finishing the month more than 8% down as concerns around Chinese growth continued.

The oil price continued to fall and is down 10% since the end of June. Aluminium was ~5% higher but copper and zinc fell slightly. The gold price remained subdued despite rising political tensions in a few parts of the world: gold is often thought to be a "safe haven" in troubled times, although we're not entirely sure why.

Portfolio comment

The portfolio underperformed the market in August. Positives included logistics property developer and owner Goodman Group, telecoms company Telstra and being underweight diversified commodity group BHP Billiton. Against that however, positions in electronics retailer JB Hi Fi, global fund manager Henderson Group and not owning global healthcare company CSL all counted against performance.

Asset allocation	As at 31 August 2014 %	Range %
Securities	1.6	85-100
Cash	98.4	0-15

Top 5 active overweight positions	Index weight %	Active weight %
Westpac Banking Corporation	7.8	6.7
ANZ Group	6.6	4.7
Telstra	5.0	4.4
Woodside Petroleum Limited	2.2	4.1
Goodman Group	0.6	3.6

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	-0.1	2.1	15.7	21.0	17.0	12.9
S&P/ASX 200 Accumulation Index	0.6	3.5	14.4	19.2	14.5	11.2

*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 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 relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 (during Sydney business hours).

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Market outlook

The August reporting season brought both positive and negative news. On the positive side it confirmed aggregate earnings had grown by about 10% in FY14, the best rate of growth for three years. The second half didn't slow as much as perhaps had been feared by some, and there was solid cash generation by many companies: partly due to good cost control, partly due to lower interest costs. On the negative side it also confirmed that earnings growth will be harder to come by in FY15 with consensus growth expectations slightly lower post the reporting season at around 5%. Given that analysts are typically too optimistic at the start of a year and have to progressively scale back their expectations, the 5% is not particularly promising. Disappointingly, the fallout from the May budget which forced some companies to temper their earnings guidance towards the end of FY14 appears to be lingering with several outlook statements from consumer leveraged companies highlighting a soft start to the new financial year.

The scarcity of growth saw strongly growing companies well rewarded for their achievements. These companies are often very well managed and in secular growth industries. The only problem with them, in our view, is that on most metrics they are already very fully valued. A number of companies also reacted well to less bad news than feared. Unfortunately, this group of companies doesn't look particularly undervalued either and their challenging outlook has in most cases not changed with this reporting season.

While the low interest rates which have been the main driver of the equity market over the last couple of years remain intact, the generous valuation afforded to many stocks make us slightly nervous that the market is looking a bit vulnerable to any negative news. It must be remembered that bond yields are close to record lows despite the likelihood of higher short term rates in the US in the next 12 months. A lower $A is usually associated with a weaker equity market. However this time around, as commodity prices have already fallen, a lower Aussie dollar would be a very welcome fillip to earnings which could extend the equity market rally further.

Fees	
2012/13 ICR	1.24%
Management fee	0.90% p.a.
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions paid) above the Performance Benchmark
Buy/sell spread	+0.30%/-0.30%

Portfolio outlook

Portfolio management consists of a continuous pursuit of investment ideas. Reporting season's rich seam of information provides a good opportunity to assess whether your investments are working and whether the portfolio is correctly positioned. Our conclusion so far is that, while some adjustments should be made as always, the overall portfolio still has the investment characteristics that we look for in individual companies: attractive valuations, positive earnings momentum, and quality. A feature of the portfolio's performance in August was that while we had a two individually meaningful detractors, we also had a long "tail" of small negatives and a lower than normal number of large contributors. Over longer periods than a couple of months we typically find that the tail swings back which leaves in our view the smaller than usual contribution from winners as the main area to review.

The portfolio had a number of stocks that did well for us during the reporting season. Goodman Group, Woodside, Oil Search, Telstra, CoverMore, APA, Seek, Lend Lease and AMP were some of the highlights and we are either maintaining or increasing our holdings in these companies. So where are we likely to find the future winners that will add further to the overall favourable characteristics the portfolio in our view already exhibits? We believe it is unlikely to be in the companies that have already done so well in the last few months from the seemingly relentless appetite for dividend yield. These companies benefited greatly from the soft patch of US economic data earlier in the year that saw the Federal Reserve maintain its extremely accommodating monetary policy, and the consequent rally in Government bonds this year.

US economic data however has since strengthened, which has reminded investors that the normalisation of US interest rates is inevitable: this should make further outperformance by the yield sensitive companies more challenging. Instead, stronger US growth, at the same time as the Australian economy continues to tread water, is likely to favour companies with US exposure. These companies may finally also stand to benefit from a strengthening $US which will make their US earnings even more valuable when translated back into $A. While we feel we are already quite well exposed to this thematic, this is likely where we will be focusing further attention in coming months.

Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size ($A)	15.6m
APIR code	HOW0026AU

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BTW

North Korea is just about the only hard-line communist state left in the world and remains unusually isolated from the increasingly connected global community. Any objective analysis of the country would suggest that the communist experiment there is not going terribly well, and a steady stream of people smuggling themselves out of the country into China (dangerous as they tend to be returned if caught) or South Korea (where they tend to be welcomed with open arms) speaks volumes about the living conditions there. Its economy is also facing some serious challenges and the North Korean government recently undertook a currency exchange: it declared that its largest denomination banknote (5000 won, the equivalent of about 80 cents) to be invalid and replaced it with a new note. The effect of this should have been to throw the black market into chaos: everyone who had been hoarding cash should have been forced to come clean with their holdings (by swapping them for new currency) or risk being left with paper that was completely worthless.

Instead, what has happened is almost nothing. Admittedly note holders have until 2017 to make the swap but word from the South Korean news agency Daily NK is that people stopped using the local currency for that sort of activity long ago: another "currency reform" which took place in 2009 had already rendered peoples' paper holdings virtually worthless, to the extent that many locals refer to it as "wastepaper". Since that time, much "free market" activity has used alternative currencies: the US dollar is ever popular, also the Chinese Yuan.

However, in a curious twist, another type of currency has become popular: Choco Pies. These are South Korean sweet treats, a biscuit with marshmallow covered in chocolate. They look similar to our Wagon Wheels.

Apparently some South Korean factories based in the Kaesong industrial zone shared by the two Koreas had been handing out Choc Pies to workers who would then return to the North and trade them for other goods at inflated prices. The situation seemed to be getting out of hand so the North Koreans asked the factories to desist handing out these symbols of capitalism, which they did.

However some South Korean unificationists and defectors from the North had have since banded together to re-start the supply of these rather unhealthy-looking items to the North. Vast balloons (pictured above) were being set off in August from near the border, each containing hundreds of Choco Pies – not just to nourish North Korean residents, but also to keep up their currency supplies. But a side benefit is that it annoyed Pyongyang so much that it then threatened to shell the launch sites. Who would have thought sending sweets up in balloons could be such a high risk activity?

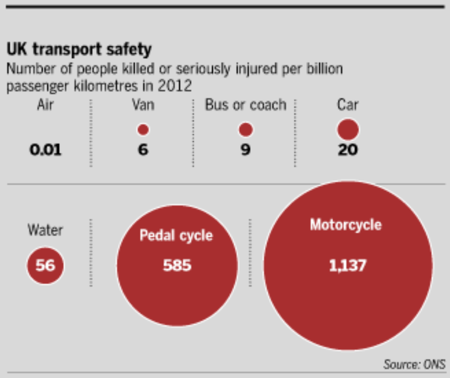
Traveller's Tale

Alphinity was tied to the desk for reporting season, but as frequent users of international airlines we do shudder when a disaster occurs. At the same time as the outrageous and tragic events over Ukraine compounded existing issues at the airline involved there were other incidents costing many lives in Taiwan and North Africa: you would think the pall hanging over the industry might have caused operators to sit back and think about things for a while. Did they?

No, despite the fact the most of the northern hemisphere was in the midst of summer holidays, July ended up being the biggest month on record for new plane orders from US aircraft maker Boeing. 324 individual planes, on some estimates worth close to $US100 billion, were ordered that month, more than three times the number ordered in the prior month. It was enough to cause quite a blip in US economic statistics.

Despite the various tragedies, air travel remains the safest way of getting around. When you think about it, it is entirely unnatural and quite remarkable to be able to climb into a tube of thin aluminium and travel ten kilometres above the surface of the earth at vast speed, then get off safely in another city/country/continent/timezone after just a few hours. Yet the graphic here (using UK data and which appeared in the UK Telegraph newspaper) shows just how safe it is, as measured by injuries per billion passenger kilometres travelled. The fact there are so few incidents involving planes is remarkable.

And flying is so cheap as well. In its recent result presentation, Flight Centre came up with some factoids illustrating just how inexpensive international travel has become. At the dawn of the age of mass air transportation just after WW2 it would have cost $A1170 to fly to London and back, which represented 85 weeks' worth of the average worker's pay. Putting it another way, the inflation-adjusted value of that $1170 in today's dollars is $130,000. By 1980 the jet age was well entrenched the price had risen to $1800, but that represented only six weeks' pay or $9000 present day equivalent. In 2014, a return flight to London can be bought for under $1400, or less than a week's salary. And all this despite the price of oil seemingly stuck close to $US100 a barrel for some years. Fast, safe and cheap – notwithstanding the inevitable risks there's still a lot to like about air travel.



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