Monthly comment – August 2012

Alphinity Wholesale Concentrated Australian Share Fund

The Hangover

Market comment

European economic stress took a breather for its summer holidays, and to watch the Olympics. It was a surprisingly well-run games, despite the threat of a public transport strike during the event, but maybe Britain will now face something of an economic hangover as happened here in 2000. But in the absence of Europe, the FY12 reporting season became the driver of the Australian market. As always there was the good, the bad and the ugly. We're pleased to report that our portfolio was concentrated in the good, and it outperformed solidly in August – a month which also marked Alphinity's second full year managing this fund. The general trend this season was that industrials weren't too bad while resource-related companies tended to disappoint, a reversal of recent form. It was also pleasing to see a return to fairly normal market reactions to company results, in contrast to the same season last year during which big macro shifts relating to developments in other markets seemed to matter more than what companies were actually reporting. While we can't rule out those influences returning at some point, the portfolio's performance in 'normal' market conditions highlights the Alphinity process, which blends strong fundamental research with targeted quantitative inputs, which helps us to identify opportunities and avoid risks.

The ASX300 (including dividends) rose by 2.1% during the month, building on the strong July. For the two months of the current financial year, the market is up more than 6% and our fund up more than 7% – that's more than you'd get from an annuity for a whole year at present. Most global markets performed well: the abovementioned respite from risk aversion allowed a bounce-back in some of the more challenged markets (Italy was up almost 9% and Spain almost 10%), while the US, UK, Japan, Germany and France all edged up by 1-3%. Chinese shares underperformed with the various indices generally falling 3-5% as the China slowdown became more widely accepted. The $A softened towards month end in sympathy with resource prices (and shares), finishing at $US1.03, down from $1.05 at the end of July. Gold however rose by almost 5% during the month as speculation about further quantitative easing in the US and Europe built.

Portfolio comment

The portfolio outperformed strongly in August, with positive contributions from medical equipment maker Resmed, insurer IAG, Westpac and classified advertiser carsales.com, and being underweight CBA. The only detractors of note were iron ore exposure Rio Tinto and not owning diversified conglomerate Wesfarmers.

Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	17.0
Asset allocation	Australian equity: 98.7%, Cash: 1.3%

Fund performance* – as at 31 August 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	3.2	9.9	9.2	5.2
S&P/ASX 200 Accumulation Index	2.1	7.2	5.5	3.7

* **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 for previous periods please contact Fidante's Investor Services team on 13 51 53 (during Sydney business hours).

Top 5 active overweight positions as at 31 August 2012

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	7.35%	5.71%
Lend Lease Corporation Limited	0.43%	3.13%
Australia And New Zealand Banking Group Ltd	6.49%	2.93%
Woodside Petroleum Limited	2.06%	2.82%
Insurance Australia Group Limited	0.83%	2.81%

Market outlook

The Australian equity market has performed strongly over the last three months. Most of the performance in our view has been due to some of the more negative scenarios around Europe, and Greece in particular, not having eventuated. While this may have had something to do with Europe being on summer holidays the fact that the Greeks appear to have voted for sticking with the Euro and ECB President Draghi's comments that 'fulfilling our mandate sometimes requires us to go beyond standard monetary policy tools' is encouraging. Tempering our enthusiasm is the fact that the equity market has now recovered to levels that it has struggled to move beyond over the last year or so. The main issue behind this is the by now familiar lack of overall earnings growth in the market. All previous rallies have led to an expansion in the earnings multiple, and investors have been unwilling to pay a higher multiple without a clear path to a better earnings outlook.

The just-concluded August reporting season gave some mixed messages but all up, the drivers of potentially stronger earnings are frustratingly difficult to identify. Perhaps the most interesting observation was a reversal of recent earnings performance trends between resources and industrials. The resources downgrades were not unexpected as they have been going on for some time and there is likely more to come, but industrial earnings surprised to the upside in the second half, and delivered positive – if modest – earnings growth for the full year. While aggregate earnings forecasts for FY13 were still downgraded, this is the first sign for several years that earnings expectations are becoming more realistic.

The Insurance and Healthcare sectors stood out amongst the Industrials as having delivered the most consistent positive news. The margin improvement in insurance is from increased premiums and lower claims costs – factors that Alphinity had identified and been enthusiastic about for some time – especially for domestic insurers. The profit drivers in healthcare were more company-specific but the relative stability of healthcare spending assisted all companies. Outside of these two sectors, the stocks that surprised and the reasons why were less homogenous. CBA was the only major bank to report but several of the others gave trading updates that largely confirmed low earnings growth for the sector. It is sobering to reflect that property trusts delivered the strongest sector earnings growth at 3-4%, and was the only sector to see upgrades (albeit marginal) to FY13 earnings forecasts.

So where to from here? With the ASX300 having delivered close to an average year's return (excluding dividends) in the last two months, and with resource earnings still under pressure and earnings in other sectors still subdued, it may be that equity markets need to consolidate at these levels for a while. Monetary policy action, and fiscal in some regions such as China, may provide further momentum especially as stocks which typically react positively to such measures appear cheap.

However, the more fundamental circuit-breaker for a better earnings outlook that could sustain further market gains, in our view, would be a lower $A. This would assist exporting industries, including resources, boost the translated value of overseas earnings and lessen import competition for other sectors. In the past, the deterioration in terms of trade due to lower commodity prices would have by now delivered a falling currency, but the Australian economy's more recent 'financial safe haven status' has seen this relationship broken so far. The team at Alphinity has been around too long to try to forecast the exchange rate but we believe it is the one of the most important factors for equity investors to watch in coming months, both for the general market direction and for relative sector performance.

Portfolio outlook

The key stock positions in the portfolio have served it well over the last twelve months, and importantly also in the August reporting season, and we largely remain comfortable with them. From a sector perspective, we have been underweight in resources for the best part of a year now and, with earnings downgrades accelerating rather than moderating, we see no reason to change this position. We also remain overweight in banks, although only moderately so after such strong outperformance. We believe that earnings, and especially dividends, are defendable for the banks, but we are mindful that the sector has already re-rated considerably. The same is true for other high yielding sectors, such as telecommunication services, utilities, property trusts and infrastructure stocks.

One of the portfolio's larger sectoral overweights is to insurance, and the August reporting season has strengthened our confidence in the merit of this position. We are also maintaining our exposure to the healthcare sector, as we are attracted by the strong underlying demand fundamentals and balance sheet strength of our holdings (CSL and ResMed), with the potential benefit from a weaker A$ providing further upside.

Outside these sectors, our holdings are primarily driven by stock specific factors. The companies that we have identified as 'structural winners' in previous reports – including carsales.com, Goodman Group and News Corporation – remain important holdings although we have reduced our positions somewhat after such strong share price performance. Over many years managing portfolios, we have found it prudent to trim stocks which have diminishing upside to our valuation.

BTW

The Sydney Olympics in 2000 was a sensational experience, but the economic effects on the state of NSW, many argue, was not positive: the state underperformed the rest of the country for years following as spending on vital infrastructure was held back. London may be about to experience the same hangover but on a larger scale. Olympic accounting is fraught with difficulty, but the NSW Auditor General said in 2002 that staging the Olympics in Sydney had cost the public between $A1.7 and $2.3 billion; the UK public's contribution is yet to be calculated but the budget was for £9.3 billion (~$A14 billion) and, according to the normally trustworthy UK media, probably exceeded that by 20%.

It is interesting to compare Australia's medal haul after the Sydney Olympics in 2000 (16 Gold, 25 Silver, 17 Bronze: 6.2% of the total 927 medals awarded) with Team GB's in 2012 (29 Gold, 17 Silver, 19 Bronze: 6.7% of the total 962) with the relative amounts spent on staging these events. Interestingly in the London games, Australia finished 10th on the official medal table (which ranks by the number of Gold), well behind Team GB which was 4th. In the 2000 Olympics in Sydney, Australia came 4th while Team GB was 10th: maybe there is something to be said for the home-team advantage.

Alphinity Medal Table	
Australia	35
New Zealand	14
Sweden	8
South Africa	6
Belgium	3

BTW (cont.)

While some feel Australia put in a relatively poor performance this year, it still managed to top the Alphinity Medal Tally. NZ put in a strong effort for such a small country, including a post-games gold which was awarded when the apparent winner tested positive for drugs. Sweden's strength has traditionally been in winter disciplines, and Belgium is better known for its beer, chocolate, detectives and insightful resource analysts than its sports people.

But at least the Australian business community did OK from the London games: Lend Lease built a magnificent Olympic Village as an example of sustainable urban regeneration (something London is crying out for), and a privately-owned Australian construction company was a major part of the consortium that remediated the heavily polluted land and built the Olympic stadium. The Olympic flame, made out of 204 trumpets representing each of the participating nations, was manufactured by South Australian company, FCT Flames. Another SA company made the bright blue polymer pitch material (a.k.a. Smurf Turf) used in the hockey fields. Then of course there's the impressive new Westfield shopping mall at Stratford that ended up effectively being the gateway to the stadium, atop which is a casino owned by Australia's Crown Ltd. At last, some Gold, Gold, Gold for Australia!

Alphinity Investment Management

Level 15, 255 Pitt Street
Sydney NSW 2000
T 02 9994 7200
F 02 9994 6692
W www.alphinity.com.au

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