Quarterly comment – December 2011
Alphinity Concentrated Australian Share Fund

Santa never made it to Australia

Market Comment

Those expecting a 'Santa Clause Rally' were disappointed this year. Some believe that by tracking seasonal market movements over time, you can predict future performance. One of the more prevalent beliefs is that markets tend to rally strongly into the end of the calendar year, a move exacerbated by often thinly-traded markets. Santa Clause arrived in the US, which finished the month up 3% (all in the last few trading days) and allowed that market to avoid a negative return for the calendar year, but Australia finished the month flat, raising the question whether we had been naughty and they had been nice! The year was fairly miserable for share investors. The best result came from the US, which finally saw definitive signs of economic recovery after years of stagnation. Australian shares were less rewarding, falling by a little over 10% (including dividends). Please see the back page for some market return graphs.

The AUD finished December at USD1.02, virtually in line with where it started the year. A lot of ink is wasted trying to work out where the currency is headed, and Australia's sluggish economy and consequent falling interest rates combined with the modest recovery under way in the US would normally see the AUD heading lower. However it remains attractive relative to the Euro and GBP, and over the course of the year has been the recipient of foreign Central Bank interest as they tried to diversify away from both the USD and Euro. When you look around the world, stable currencies are hard to find. China would be an obvious choice, but without a freely-floating and open currency it is not an option. 'Quantitative easing', a new term for the old-fashioned practice of printing money, tends to undermine the basis on which a currency is founded. Economies which have not needed to undertake quantitative easing have tended to have strong currencies, which makes them less competitive. Switzerland and Japan for example both carried out extraordinary central bank actions in 2011 to weaken their currencies against the Euro and USD respectively. Japan undertook its own version of quantitative easing in October to soften the Yen; Switzerland aggressively sold Francs and bought Euros in September in order to establish a ceiling against the Euro.

Fund details

Alphinity Concentrated Australian Share Fund		Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	EQI0001AU	APIR code	HOW0026AU
FUM (AUD million)	22.6	FUM (AUD million)	19.6
Asset allocation	Australian equity: 97.7%, Cash: 2.3%	Asset allocation	Australian equity: 97.7%, Cash: 2.3%

Fund performance* – as at 31 December 2011

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (%)
Alphinity Concentrated Australian Share Fund	–0.8	3.4	–12.1	–2.1
Alphinity Wholesale Concentrated Australian Share Fund	–0.8	3.7	–11.3	–1.3
S&P/ASX 200 Accumulation Index	–1.4	2.1	–10.5	–1.7

*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 Challenger's Investor Services team on 13 35 66 (during Sydney business hours).

Top 5 active overweight positions as at 31 December 2011

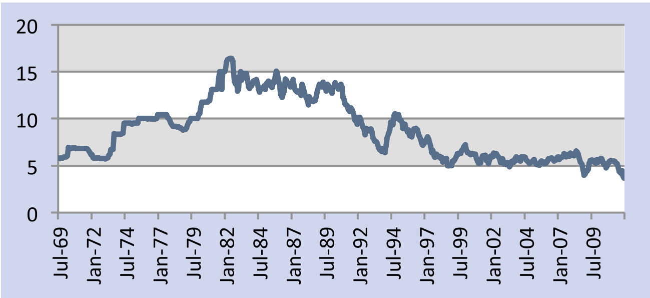
Alphinity Concentrated Australian Share Fund

	Index weight (%)	Active weight (%)
National Australia Bank Limited	5.4	3.8
Westpac Banking Corporation	6.3	3.2
BHP Billiton Limited	11.4	2.6
Telstra Corporation Limited	4.3	2.6
News Corporation	0.9	2.5

So far, Australia has been enjoying the strong AUD (unless you are a manufacturer that is!) and recording significant trade surpluses despite it, thanks to strong commodity prices and high volumes. This may change over the course of 2012 as commodity prices and/or volumes moderate.

Some asset classes did better than shares in 2011. The returns on government bonds in 2011 were generally 10-15%, depending on the market, corporate bonds a bit less as spreads generally increased. Bond yields fell despite massive issuance by many governments around the world and when yields fall, holders of those bonds accrue capital gains. Bond issuance is likely to escalate further in 2012: Bloomberg estimates that governments will need to raise USD8 trillion in the bond market in 2012 to cover maturities and ongoing deficits. While this is only 'slightly' above the USD7.4 trillion 2011, it must be remembered that global credit is a lot more scarce now than it was a year ago, and that numerous sovereign credit rating downgrades have occurred since then, ostensibly making the task more difficult and expensive. Ten year bond yields are at long time lows in most countries (below 1% in Japan and Switzerland, below 2% in US, Canada, UK, Sweden and Germany, and below 4% in Australia, Mexico and Brazil) so one has to question the capacity for yields to keep falling. Australian bond yields in particular are now lower even than the level they reached at the worst of GFC Mk 1 in 2008, the lowest by far since the 1960s in fact. That doesn't mean they can't go lower, but does make it unlikely. When bond yields rise, holders record capital losses. With the initial yield so low, rather than making capital gains like this year bonds may struggle to record positive returns at all.

Australian 10yr Bond Yields



We're not sure that physical gold really constitutes an 'asset class' as it is not a financial investment (i.e. produces no income), but it also did quite well over the year: starting at USD1,400/oz and finishing at USD1,563, a nice 11.6% increase. However it was a wild ride, hitting USD1,900 on a couple of occasions. Buying in at the wrong time would have hurt. Gold has been perceived to be a store of value for thousands of years even though its intrinsic value is not easy to identify.

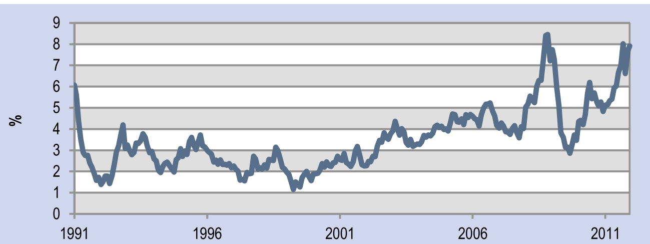
Portfolio Comment

The portfolio performed well in the choppy December market, finishing the month and quarter well ahead of the benchmark. Best contributors in December were Telstra, global media operator News Corporation, toll-road owner Transurban and not owning gold miner Newcrest; detractors included travel company Flight Centre, gas producer Santos and not owning Commonwealth Bank. For the whole quarter, National Australia Bank, gas producer Oil Search, News Corporation. Mining services company Monadelphous and not owning industrial conglomerate Wesfarmers contributed, while Woodside, not owning CBA or Iluka detracted from returns.

Market Outlook

After a year that Australian equity investors would rather forget, where to from here? The natural answer would be that with all the uncertainty in the global as well as the local economy the outlook must be weak. However, equity markets are forward looking and it would be difficult to argue that a lot has not already been priced in. At around 11x FY12 earnings the market is trading close to 25% below its long run average. The dividend yield is also above long run averages at more than 5% + franking credits. This means that it would not take a lot of good news for the market to turn positive. The problem over the last couple of years has been the negative earnings momentum, that is the market's earnings expectations have had to be brought back as the year has progressed. So have earnings expectations bottomed? Probably not. The upcoming reporting season is likely to be lackluster for most domestically focused companies. Commodity price assumptions used by broker analysts still appear too high for the mining sector with growth in China also slowing, as we wrote about in our last monthly report. On the other hand the price the market has been willing to pay for those earnings has been falling at an even greater rate and apart from during the GFC the so called equity risk premium is at levels not seen in 20 years.

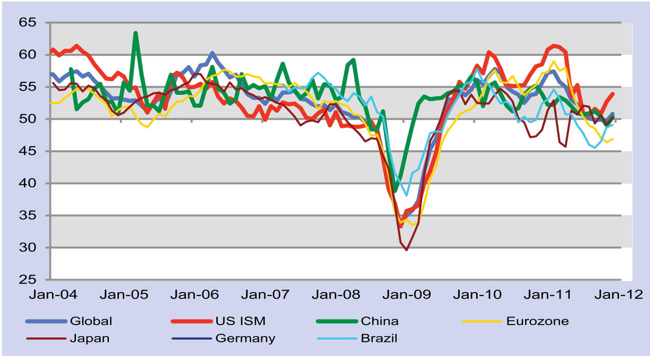
Australian Market Implied Equity Risk Premium



Source: UBS, I/B/E/S, Datastream

With earnings still under pressure, what could make the market turn? Typically when the market is cheap an improvement in leading indicators which signal a forthcoming improvement in earnings can make the difference. One of the best such leading indicators is the Purchasing Manager's Index (PMI); which refers to a company's acquisition of goods (and services). It only took a moderation in the rate of contraction of these indices to stage a powerful market rally in March 2009. PMIs in most regions are now showing some signs of stabilizing and the most well-known of them all, the so called ISM in the US, has strengthened considerably. While too early to make a definite call, another couple of months of this encouraging trend would translate in to better economic growth and ultimately earnings.

Global and Regional Manufacturing PMIs



Source: Morgan Stanley Research, Markit Economics

In the Australian economy we continue to see few signs of strength outside of resources and resources services. Lower interest rates may eventually help but more weakness is likely before any meaningful relief from potential rate cuts. In summary, equities are cheap but will require investors to be willing to look across the valley of lower earnings before moving higher.

Portfolio Outlook

A well-diversified portfolio with earnings certainty and high dividend yields favoured over cyclical recovery potential has served us well over the last quarter. However, it should be noted that the valuation premium for that earnings certainty has increased over the last several months. While monitoring the broader macro factors discussed above in preparation for a potentially more significant portfolio shift, we have selectively been adding stocks over the quarter which should benefit from stronger economic growth but only where we are seeing evidence of these companies outperforming market expectations even in the current environment. Examples of companies fitting this description are James Hardie and Super Retail Group. James Hardie has done an exceptional job in lowering manufacturing costs and expanding its product range to counter an unprecedented downturn in its largest market, the US housing market. While signs of an improvement in housing starts are still only tentative, earnings expectations appear too low for James Hardie as volumes have stabilized and input costs such as wood fibre have fallen. Super Retail Group is one of few retailers delivering sales growth in the current market environment as consumers appreciate its value offers. New stores and the acquisition of Rebel Sport, Australia's largest sport apparel, footwear and equipment retailer offer medium term earnings upside. With the February reporting season when the bulk of the companies on the exchange will deliver their interim results soon upon us we will get an important read on how the companies we are invested in are doing. November's AGM commentary and subsequent trading updates have been encouraging and we are confident that we are well positioned in what should be an exciting 2012.

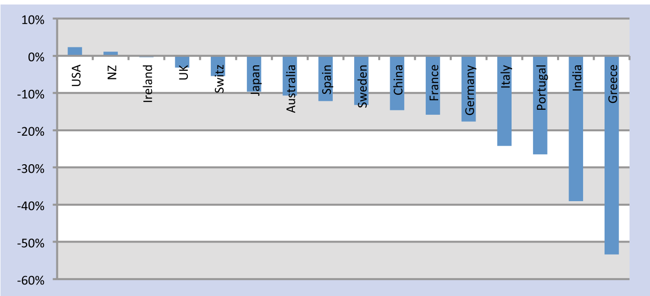
BTW

The Dow Jones Industrial Average rose by 7% in 2011, but the S&P500 was flat over the year, or up about 2% including dividends. 'The Dow', although most often quoted in the media as the benchmark for US equities, is a strange index. It is made up of only 30 companies, and is weighted by the share price, rather than the market capitalization, of the company. Consequently, movements of companies with a high stock price (for example IBM, at ~$180) have a much greater impact on index movements than a similarly-sized company with a lower price (say, General Electric at ~$18). For this reason, most in the market use the S&P500 to get a more representative indication of US share movements. The S&P500, like the various Australian indices, is capitalisation-weighted and also has a much broader spread of companies: 500 in fact. News Corporation bought the Dow Jones index services when it acquired the Wall Street Journal in 2007. It sold 90% of the index business to the Chicago Mercantile Exchange in 2010 for USD675m.

Market Returns

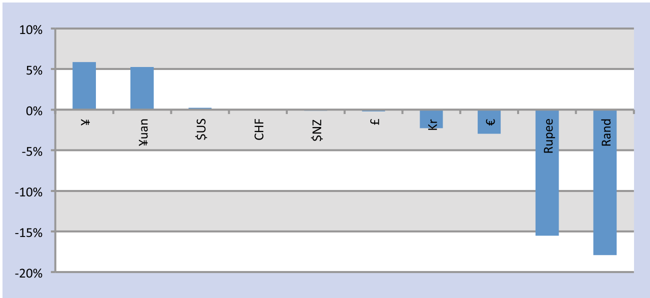
Positive equity returns were scarce in 2011, and those that were positive were only fractional. Australia, although poor, was far from the worst performer. Any investor needs to worry about currency movements so the numbers shown here are in AUD.

2011 Market Returns in AUD



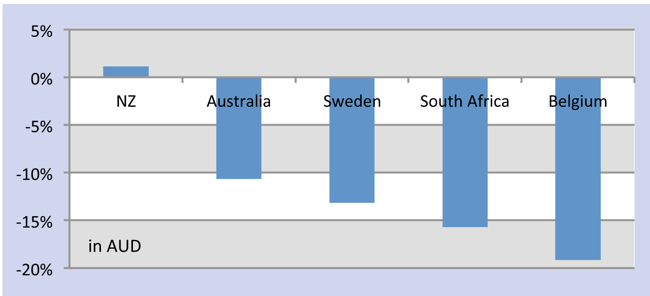
There were few meaningful currency moves relative to the AUD over the year: the South African Rand and Indian Rupee both depreciated significantly, and the Yen and Yuan both appreciated by about 5%. Although there was considerable volatility during the year, from start to finish the USD, Swiss Franc, NZD and Euro were barely changed.

Currency Moves vs AUD over 2011



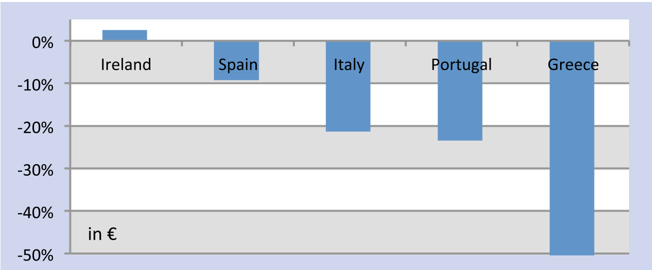
The Alphinity investment team has quite a diverse cultural composition. New Zealand won the 2011 Alphinity Stakes, no doubt buoyed by its victory in the World Cup Rugby, and despite the forces of nature it faced. The preponderance of defensive utility-type companies in its equity market helped in this difficult year. South Africa would have done well were it not for the severe currency depreciation. Sweden was level with Australia excluding a modest adverse currency move; and Belgium was in last place, with similar returns to neighbouring France and Germany. Belgium is notable in that it finally formed a government in December 2011, having been without one since April 2010. This is the longest period 'ungoverned' of any country in modern times – even Cambodia and Iraq only lasted about a year without a proper government. Despite the poor equity returns and lack of government, Belgium's economy actually improved during that period, recording a better rate of GDP growth than some of its neighbouring countries, and a declining deficit as a proportion of GDP.

Alphinity 'Home Market' 2011 Returns



Amongst the PIIGS, Ireland had taken its medicine early (it was down by more than 70% over 2007 and 2008) as it ended with a fairly flat market over the year; the others however did less well. The Euro depreciated by 3% against the AUD in 2011.

'PIIGS' returns in 2011



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