Monthly comment – July 2014
Alphinity Wholesale Concentrated Australian Share Fund

Yellen from the rooftops

Market comment

The Australian market (S&P/ASX300 including dividends) performed very nicely during July, rising by more than 4%, making it one of the best performers amongst the major markets. July 31 also marked the highest level of the ASX300 price index since 2008, although once dividends are included the prior peak was passed long ago. China did best, up 10% as economic signs appeared to improve, but the US and UK markets were flat in $A (down a bit in their local currencies) and shares in most of continental Europe traded lower - France and Germany by 5%. The better Chinese economy contributed to resource-related markets - primarily Brazil, Indonesia and ourselves - outperforming.

US Federal Reserve (Fed) Chair Janet Yellen appeared to be trying her hand at stock analysis during July. In a fairly unusual testimony to the US Congress, Ms. Yellen gave opinions on matters about which central bankers rarely choose to comment, including the valuations of social media and biotech stocks, which she saw as being "substantially stretched". Aside from those areas, however, she felt that stock prices were not out of line with historical averages and, therefore, she was unconcerned about the overall state of the market. Most attention was given to her comments in an area of her direct expertise: the future of QE and ZIRP (that's Quantitative Easing and the Zero Interest Rate Policy). She confirmed that the Fed would continue to "taper" the purchase of bonds to stimulate money supply with a view to ceasing it completely by the end of the year, and spoke of the approaching end of super-cheap money (its cash rate is 0.25%). While this should not have come as a shock to anyone, the market still exhibited some concern hence the lower US market in July.

However the real economy continues to truck along pretty well, with Q2 annualised GDP growth bouncing back to 4% from its weather-related Q1 slump.

China's resurgence generally helped commodity prices in July. Iron ore prices ticked up 2% as inventories ticked down, and base metals aluminium and zinc were both up about 7%. Oil however fell by 7%, despite some rather concerning political developments in key production areas (Iraq) which were offset by easing tensions in others (Libya and Kurdistan). Gold also fell, by almost 3%.

Portfolio comment

The portfolio underperformed the market slightly in July. Positives included diversified commodity group BHP Billiton and steelmaker Bluescope Steel well as gaming machine maker Aristocrat Leisure and insurance group IAG, while the banks and not owning diversified commodity group Rio Tinto counted against performance.

Asset allocation	As at 31 July 2014 %	Range %
Securities	98.0	85-100
Cash	2.0	0-15

Top 5 active overweight positions	Index weight %	Active weight %
Westpac Banking Corporation	7.7	5.0
ANZ Group Ltd	6.7	5.0
Woodside Petroleum Limited	2.2	3.7
Telstra Corporation Limited	4.9	3.5
BHP Billiton Limited	8.9	3.0

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	4.0	2.8	18.2	23.0	15.5	13.2
S&P/ASX 200 Accumulation Index	4.4	3.5	16.5	20.1	13.5	11.3

*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 Australian share market's strong absolute and relative performance in July can largely be attributed to investors' renewed confidence in China and signs that the Australian consumer had recovered from the worst of the May budget shock. While both developments are welcome, we are cautious about the sustainability of the strong performance of the Resources sector. Having put the economy back on track to meet its official growth target of mid 7%, we think Chinese authorities will again focus on its medium term goal: to make its economic development less dependent on infrastructure investments. This will inevitably reduce the raw material intensity of China's GDP, and have the effect of lowering demand growth at the same time as new supply of those resources are still coming to market.

The rebound in domestic consumer confidence is clearly encouraging but, in reality, probably means a reduced risk of further earnings disappointment rather than the potential for upside surprise. Our market direction over the next few months is thus likely to revert to being led by what happens in the US market. Investors there remain torn between on one hand the positive impact on corporate earnings from stronger economic growth, and on the other hand what this will ultimately mean for US monetary policy settings. This dichotomy is likely to keep a lid on equity returns until the market becomes confident that the US economy can keep expanding even as rates there increase from their current abnormally low levels.

As we have highlighted before, the Australian dollar remains stubbornly high and the strength we have seen since March has clearly taken the edge off some of the potential for earnings upside in FY15. Predicting the currency is something we have learned not to do. That said, should a weaker Australian dollar occur it would most likely be a boost to Australian company earnings and to the share market.

In summary, the equity market has some issues to deal with and few obvious drivers to take it markedly higher. At the same time, valuations appear reasonable, domestic rates are expected to stay low and at least some degree of earnings growth should be achievable. This should be enough to provide positive market returns over the second half of the year.

Portfolio outlook

With few strong themes dominating market, the portfolio remains well diversified across both sectors and stocks. Recent signs of increased nervousness evident in global equity markets should benefit the portfolio, should they become more pronounced, due to the portfolio's quality bias evident through its holdings having on average higher profitability (return on equity) and lower gearing (net debt to equity) compared to the benchmark.

Recent portfolio additions have been made for stock specific reasons rather than any particular sector preference. We have added recruitment company SEEK in the Industrials sector and Sims Metal in Materials. SEEK's earnings are being driven by its international expansion and education business, and we believe these drivers will remain in place. The company also has a strong balance sheet enabling management to pursue further international expansion and/or capital management.

Sims Metal has for several years struggled to meet the market's expectations of an imminent cyclical recovery in its metals recycling business. Improved scrap volumes in especially the US remain a strong earnings driver should they eventuate. However, the main attraction with Sims is a restructuring and optimisation program recently announced by its new management. The earnings upside from the restructuring is significant and not reliant on any market recovery which would add further upside.

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

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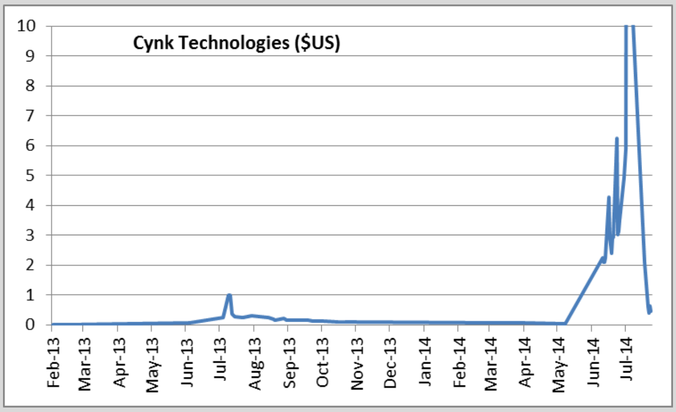
BTW

There is a perception among some sectors of society that the stock market is just like gambling. We take extreme exception to this as a generalisation but acknowledge that the instruments in which we invest can (even though they shouldn't) be used for rank speculation. That's not the purpose of the equity market however, rather an outcome of human behaviour. And human behaviour can sometimes lead to strange events.

A recent example of this is CYNK Technology. This is a company listed in the US and operating in the social media space offering technology which "allows individuals to post a profile and link it to other friends and organisations" – which sounds like pretty much every other social media application. Cynk is based in the idyllic but tiny Central American country of Belize. It listed in early 2013 and for its first year or so traded in a lacklustre fashion mostly cycling between 5c and 25c a share, giving it a market capitalisation well short of $US100m. This in itself appears pretty generous for a company which, according to Bloomberg, has "one employee, no assets and no revenue".

But that all changed in June: it went from 6c on May 15 straight to $2.25 on 17 June (not having traded in between). It closed the month at $6.25 and on July 15 traded at $22 a share, implying that this single employee internet company without even a website (as far as we could find) was "worth" more than $US6 billion. For a bit of context, that's as big as Australia's Mirvac Group, a company with 1200 employees and total assets approaching $A10 billion, and which generates more than $400 million in profits a year.



Source: Bloomberg

Something was obviously wrong, and the US authorities put Cynk into a trading halt. When it re-opened on July 25, Cynk lived up to its name and sunk back to $2.10; by the end of July it was 45c a share – still many times the price it was (not) trading at three months ago.

What happened in between? No one really seems to know, and it is now the subject of an investigation. It appears that Cynk may have been the victim of a "pump-and-dump" scheme whereby unscrupulous operators find a company with very low share price, buy shares indiscriminately with a view to getting others to jump on board, then try to offload their stock at the higher price before the music stops. In addition, it seems to have combined with other market operators perceiving that the company was essentially worthless and short-selling shares expecting them to fall, but instead being forced to cover those shorts as the share price escalated. Whatever it was, both activities appear to us to be the antithesis of investment.

What does it all mean for you? Not much really – a bit of froth and bubble on the other side of the world. A few people made money and a few others lost. But it does emphasise the importance of research and valuation discipline, of treating shares as a serious investment rather than just a gamble. Alphinity spends all day every day making informed assessments of companies' worth and our valuation discipline is such that we would never invest your (and our) precious funds into a company with so little substance in the first place. Alphinity invests in the true sense of the word: we take positions for the medium term in credible companies which have prospects for earnings upgrades above and beyond that which the market is presently expecting. This may not be as exciting as a pump-and-dump, but it has provided our investors with solid returns over the short, medium and long term.

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Traveller's Tale

It's not all Tsingtao and Peking Duck at Alphinity when travelling for research in China: there is also the long distances, the traffic in the main cities, the occasional 'interesting' airline, the pollution, and increasingly common delays at airports. This, along with a number of other annoyances brought on by the exponential increase in air travel in that country, has seen an escalation in 'air rage' at Chinese airports in the last few years. YouTube has examples of this: see a Chinese official who was barred from his flight let his feelings be known to ground staff at https://www.youtube.com/watch?v=zPp7vkbYq78#t=13 (go to about the 1min 30s second mark and admit it, we've all felt this way…)

Andrew was in Beijing in July to take the temperature of the Chinese economy, while at the same time trying to avoid the actual temperature of 41^{o}C outside. He witnessed some surprisingly blue skies in Beijing: it's amazing what shutting a few steel mills can achieve.

On arriving for his 7pm flight to Hong Kong he was informed of a short delay due to 'military exercises'. That short delay turned into a long delay. When he finally boarded at 10.30pm, he was told the 'good news' that he would only have to wait on the tarmac for another half hour! This meant not arriving at his HK hotel until 3am.

According to an article in the UK Financial Times a week later, these military exercises caused a quarter of all flights from the heavily populated east of the country to be cancelled over a three week period. And this is not a recent phenomenon.

According to data from Flightstats, only 18% of flights from Beijing airport left on time in 2013: (compare this with one of the busiest airport in the world, Heathrow, at over 70%). Apparently in the period Andrew was travelling in July, Chinese flight delays and cancelations constituted 60% of all delays and cancellations globally. The military, it appears, controls the airspace and tends to close it to commercial use with little or no warning.

For its part, the military is not taking the criticism lying down. After a similar period last year it pointed to airline mismanagement as a source of the delays, while this year a piece from the media section of the "Ministry of National Defence, The People's Republic of China" has also blamed thunderstorms, typhoons, mechanical failure, smog and 'flight flow control' as other issues. After having a go at the media (and Japan??) for their views it finishes with: "For those who arbitrarily allege that China's policies have changed because the Chinese military conducts a routine drill according to its normal training plan, they either have no common sense or have ulterior motives."

You have been told.

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