Alphinity INVESTMENT MANAGEMENT

Monthly comment – July 2015
Alphinity Wholesale Concentrated Australian Share Fund

A Happier New Year

Market comment

The new financial year started with a recovery from June's trouncing, with the ASX300 (including dividends) returning 4.3% for the month. The month started with a takeover (for ports operator Asciano, by Canadian infrastructure company Brookfield), and the partial resolution in Greece seems to have outweighed further volatility - mostly downward - in the Chinese share market.

Australia's bounce was a little more restrained than in some markets: Europe in particular was very strong, at least in $A terms. The $A resumed its downward path, falling by more than 5% against the $US and 4% on the Trade Weighted Index, as commodity prices came down and the Australian economy seemed to be lagging stronger recoveries in some places.

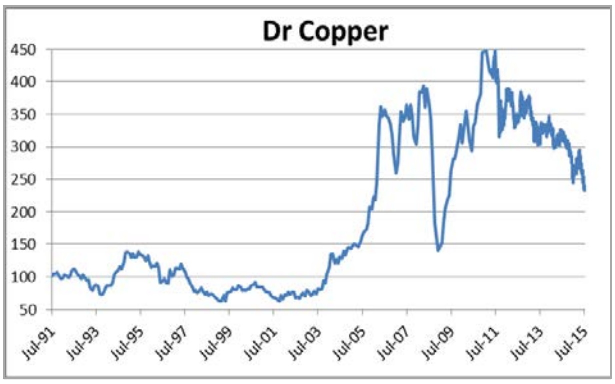
The price of oil continued to fall, Brent being more than 17% lower in the month and the possible opening up of Iranian oilfields to the global market could exacerbate things further. It is just as well considering the falling $A: if not petrol prices would be substantially higher here which would crimp the willingness of consumers to spend even further. Base metal prices were also down, including Dr Copper. Known in the market as the only metal with a PhD in economics because of its supposed ability to pick turning points in the global economy, copper fell a concerning 9% in the July. If it were to live up to its reputation (which we concede is not infallible), things aren't looking particularly flash globally.

Asian markets mostly struggled in $A terms in July, particularly China (Shanghai) which fell by 9% in the month. It is, however, still up 28% for the calendar year to date, and 114% for the past 12 months.

Japan did a little better than ours with 5.6%, as did New Zealand with a tad over 6%. Europe however raced ahead after the end of the Greece crisis with strong gains of between 7% (Germany) and 10% (France). Greece itself was the exception as its market did not trade at all in July. The US market would have returned 7.5% in $A terms but only 2% in its own currency.

Portfolio comment

The portfolio outperformed the overall market strongly in July. Major bank Westpac, gaming machine maker Aristocrat Leisure and bid-for ports operator Asciano were the best contributors to the portfolio's performance in July, as well as being well underweight diversified resource company BHP, and the only meaningful detractor was from not owning global blood fractionator CSL.



Source: Bloomberg

Market outlook

After a solid start to the new financial year, during which global macro concerns have moderated, investor focus is now turning to the domestic reporting season. Although aggregate earnings expectations are for little growth, the decline in Resource company earnings masks high single digit growth expectations for non-resource companies.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	5.6	0.3	7.4	12.7	17.5	12.0
S&P/ASX 200 Accumulation Index	4.4	-0.7	5.7	11.0	15.1	10.1

*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.
^ Figures for the Inception Date for the Fund are taken from 1 September 2010, once Alphinity assumed formal investment management responsibilities. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 (during Sydney business hours).

Monthly comment – July 2015

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The lower $A will boost earnings for companies with overseas operations, but the domestic economy offers little support for companies outside of the housing sector. Mining services companies face a particularly uncertain outlook as the miners seek further cost savings and continue to cut back their spending on new projects. Growth expectations are unusually modest for FY16 for this point in the financial year at around 3% for the overall market, or +6% excluding Resources.

The glass-half-full interpretation of this would be that these low expectations increase the chance of a positive surprise. The glass-half-empty camp, in which we find ourselves, would see the low expectations as reflecting a weak demand environment. Together with the increased capital requirements in the bank sector, low credit growth and a bad debt cycle that appears to have started to deteriorate, it is difficult to see earnings growth accelerating above current expectations. Dividend yield support, on the other hand, remains solid. Equity market returns in the 5-10% range for the new financial year appear to be a reasonable expectation.

Asset allocation	As at 31 July 2015 %	Range %
Securities	99.24	90-100
Cash	0.76	0-10

Top 5 active overweight positions as at 31 July 2015	Index weight %	Active weight %
Westpac Banking Corporation	7.6	5.5
National Australia Bank Limited	6.3	5.0
Telstra Corporation Limited	5.5	4.8
Macquarie Group Ltd	1.9	4.6
Goodman Group	0.7	3.7

Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size ($A)	$13.6M
APIR code	HOW0026AU

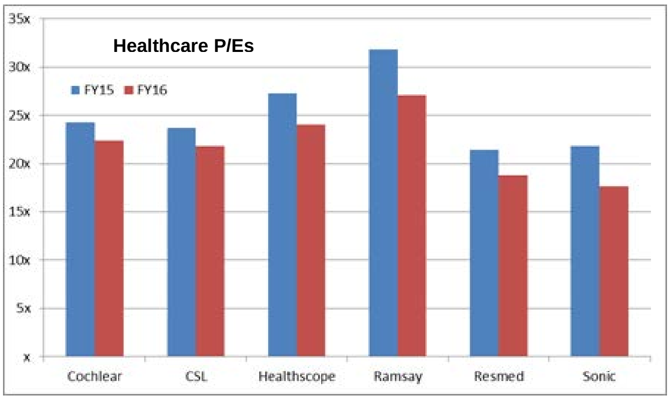
Fees	
2013/14 ICR	1.23%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions paid) above the Performance Benchmark
Buy/sell spread	+0.20%/-0.20%

Portfolio outlook

The portfolio has started the year well and we have made few changes ahead of the reporting season. Our largest active position, in global investment bank Macquarie Group, has already announced a strong first quarter and upgraded its full year outlook. We expect solid results commentary also out of our other large overweights such as industrial property developer Goodman Group, financial services company AMP, pipeline operator APA, telecommunications giant Telstra and petroleum retailer Caltex. Consumer Staples, Resources and Healthcare remain our largest sector underweights.

While the underweights in the first two have contributed handsomely to performance over the last 12 months, our limited exposure to the latter has detracted. The healthcare sector has been buoyed by the fact that most companies in the sector are still achieving decent earnings growth. Underlying factors such as the ageing population and increasing healthcare spending are supportive of their top line growth, and the majority of companies in the sector are also benefiting from the weaker $A. Earnings growth has been scarce in the generally low economic growth environment of recent years so exposure to the sector has been in high demand. Our difficulty has been, what is the appropriate price we should pay for that earnings growth?

While earnings growth and earnings revisions have generally been positive, Healthcare sector performance has been well in excess of both earnings growth and earnings revisions, leading to significant increases in stock valuations. On average the sector is today trading at a P/E (Price/Earnings ratio) of 22x forward earnings; this was only 19x a year ago. Ramsay Healthcare, the highest P/E stock of the large cap healthcare companies is on 27x today compared to an already elevated 24x a year ago. While we recognise that earning scarcity is likely to be a feature of the market for some time, paying these kind of multiples leaves little room for disappointment. Any high-P/E stock that disappoints typically gets hit by both earnings downgrades and a multiple de-rating.



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BTW

People whose job it is to think about such things tend to like to slot equities fund managers into style categories, typically “growth” versus “value”: if you’re not one then surely you must be the other. We’d like to declare that Alphinity is neither. We tend to think about the “value” style as buying cheap, often structurally-challenged stocks and hoping they get better, and the “growth” style as buying expensive stocks that might have delivered impressive earnings growth historically but will probably disappoint when growth inevitably slows. Alphinity, rather, seeks stocks for which the market has underestimated potential earnings growth, and are therefore likely to get a series of earnings upgrades. And conversely avoids the opposite. We are quite prepared to buy stocks that appear “cheap” on market estimates, and those that might appear “expensive” if we see greater upside: each potentially has a place in our portfolio.

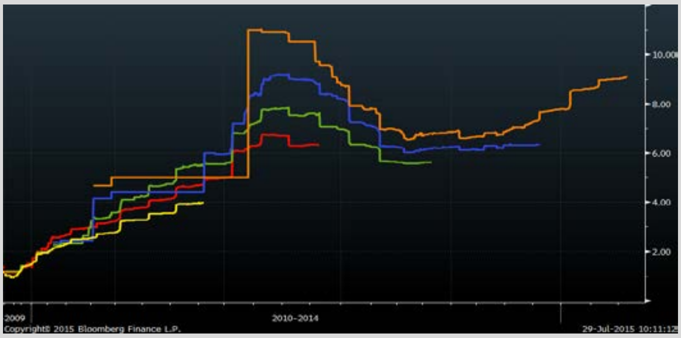
The danger of being just growth or value was brought home to us by a Bloomberg article about Apple Inc. We’ve written about Apple before in our monthly reports: even though our Australian Equity fund can’t invest in Apple stock there are plenty of lessons to be learned. We pointed out in April 2013 that Apple’s under-performance had coincided with a series of EPS downgrades, and posited that this underperformance would turn around when it started getting upgrades again. Funnily enough this came to pass: the downgrade cycle finished soon after, and Apple shares have more than doubled since then. (Incidentally, this supports our belief that our process should work just as well for global stocks as it does here).

But this Apple article looked back further, and indirectly points out the danger of dismissing a stock just because it looks “expensive”. In mid-2003 Apple was trading at a (split-adjusted) price of $1.50, which represented a massive 165 times then expected FY03 earnings: how could anybody justify buying, or even continuing to own, such an expensive stock? Surely it must have been a big underperformer subsequently as the shares de-rated towards the rest of the market?

As it turned out, no. Apple shares have since gone up by more than 80 times, to $US121 a share at the end of July. Why? Because its earnings subsequently exploded (in a good way, upwards) to a much greater extent than the market expected in 2003. Remember, at that point Apple was in its first generation of iPods, tablets like the iPad didn’t exist and it didn’t even make phones until 2007.

The chart above shows the progression of the US market’s estimates of Apple’s 2006 to 2010 financial years’ earnings. By 2010 each Apple share was *earning* more than the $1.50 its shares were trading for in 2003; its share price by then was over $40.

The chart below shows the next series of Apple’s earnings revisions, from 2011 to 2015. Apple went on to earn $6 per share in 2014 and the market is now expecting it to make $US9 a share in the year about to end. It demonstrates one of the systematic biases the market (and human nature) has: the idea that a trend will fade. Yes, it will eventually, and did for a while a few years ago, but that just reinforces the importance of carrying out strong fundamental research to prove or disprove the case for when that might happen. And in 2003 Apple, with its record of disrupting and transforming industries, was well-placed to keep doing that.



These days, it is possible that the much more incremental improvements made with each iPhone release and the seemingly slow start for the Apple Watch may be the start of a period of disappointing earnings growth – whether this is the case remains to be seen.

Monthly comment – July 2015

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Traveller's Tale

Johan tried to set a new record in number of cities visited within a week. He left Australia on a Sunday for a series of healthcare research meetings which commenced on the west coast of the USA on the Monday and finished in Europe on the Friday. In that time he visited healthcare companies, attended a blood plasma conference and went to hearing aid and sleep clinics in Los Angeles, San Diego, Washington DC, New York, London, Paris and Frankfurt. He returned rather sleep-deprived but with many valuable insights from the field, concluding, among other things, that the supply tightness in the US Intravenous Immunoglobulin market has eased considerably, making price competition for CSL more likely in the future; and that bionic ear-maker Cochlear continues to regain market share in the hearing aid market thanks to its popular wireless accessories.

After suffering many hours stuck in heavy traffic between meetings he was pleasantly surprised with the traffic situation in California which was only beaten, as one would expect, by the German efficiency of Frankfurt. London, closely followed by Paris, took the wooden spoon for worst congestion.

The biggest revelation on the logistics front however was the efficiency of Uber. Finding himself unable to flag down a taxi on the Champs-Elysees he resorted to Uber and, within a few minutes, was ensconced inside a luxurious limo which cost not that much more than a Gauloise-reeking cab would have. He was so impressed by the service that he used Uber again to get from his last meeting in Paris the following morning to the airport.

It seems Parisian taxi drivers are less impressed, as a few days later they burned some cars and blocked access to airports and train stations in a protest against the Uber service. Luckily for Johan, by then he was safely on-board his eighth flight of the trip – homeward bound.

Source: Reuters

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