Alphinity
INVESTMENT MANAGEMENT

Monthly comment – July 2012

Alphinity Wholesale Concentrated Australian Share Fund

Ready, set, go!

Market comment

Olympic fever hit world equity markets in the last few days of July. What had been a month of oscillating negativity – with markets worried about Chinese growth and European stagnation – responded to the starter's gun with alacrity and the month turned out rather well. The ASX 300 (including dividends) rose by more than 4% in July, a medal-winning performance especially when the firm $A is factored in. It was a month in which banks, telcos, utilities and staples outperformed, while materials fell.

Global equities were generally solid, at least in their local currencies: the US S&P500 and UK's FSTE100 were both up just over 1%, France's CAC40 up 3%, Germany's DAX and Switzerland's SMI both rose by 5.5%, but the next candidate for a pending economic disaster and Euro exit – Spain's IBEX35 – fell more than 5%, and Italy's MIB was down almost 3%. Closer to home, Japan's Nikkei fell by 4% and Shanghai by 5.5% but Hong Kong rose almost 2%.

The $A again appreciated against the $US, finishing at $1.05. One of the factors in the recent bout of $A strength has been a trend for foreign central banks to increase their foreign exchange reserves' currency diversification away from the $US and include the $A. This has reportedly included countries as diverse as Russia, Switzerland, Germany, Czech Republic and Kazakhstan. Our Olympians may not have won too many gold medals yet but the $A is making up for that. Gold itself seems to have benefited from the medal tally, rising 1% to finish the month over $US1600. Soft commodities, wheat and corn, rose sharply and oil was higher but most non-precious commodities fell in July: base metals by 2% but iron ore more sharply, finishing the month 12% lower. As we enter August, eyes again are on major central banks as markets anticipate another fix of monetary stimulus.

Portfolio comment

The portfolio lagged the market fractionally in July, with few significant movers but positive contributions from Westpac and Lend Lease and being underweight BHP. Detractors included iron ore exposures Rio Tinto, Fortescue Metals Group and Arrium, and not owning Commonwealth Bank.

Market outlook

The Australian equity market is heading into the August reporting season with perhaps a little more cheerful undertone, buoyed by two consecutive months of solid returns and even modestly positive 12 month returns. The overall market sentiment however remains cautious, and even July's strong returns were dominated by the by now-familiar chase for dividend yield, as evident from the

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 July 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	4.0	–1.7	2.0	3.8
S&P/ASX 200 Accumulation Index	4.3	–2.0	1.3	2.7

* **Returns are calculated before 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 July 2012

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	7.0%	5.2%
Woodside Petroleum Limited	2.1%	3.4%
Rio Tinto Limited	2.3%	3.3%
Australia And New Zealand Banking Group Ltd	6.2%	2.8%
Crown Ltd	0.3%	2.7%

sectors that outperformed. Short term returns remain largely dependent on global macro issues and, in particular, the European debt crisis. Firm action from the European Central Bank as flagged by its President, Mario Draghi, has the potential to lend further support to markets that remain attractively valued. Earnings expectations are muted after yet another year of earnings disappointment due to the all too well known factors such as the high $A, low consumer spending and, in the last nine months or so, falling commodity prices as China's growth rate slowed.

Our conclusion at the end of the February reporting season was that, despite consensus full year earnings growth expectations of only a few percent, this still looked optimistic given that embedded in these forecasts were quite a marked improvement in the second half. These concerns have turned out to be well-founded and, after a string of profit warnings, consensus earnings forecasts are now for FY12 market earnings to be slightly lower than last year. Given that the market fell somewhat during FY12, it can be argued that this is now well 'in the price' and that the focus has shifted to the outlook for FY13. Current growth expectations of around 10% are low by historical standards which is positive as they should be easier and more achievable to meet. However, the headwinds remain frustratingly persistent with the Australian dollar well above parity despite the weakness in commodity prices, which has typically seen the exchange rate soften.

Given both the global uncertainties and the challenges facing the Australian economy, management outlook commentary is likely to be cautious. In summary, company valuations, especially in the more cyclical sectors, provide upside support while earnings still look somewhat vulnerable to disappointment. Fiscal and monetary action around the world is thus likely to have a significant impact on market returns as these have the potential to give important signals about the likely direction of economic activity to both investors and corporates.

BTW 1

We love the Olympics, but we're not so keen on tattoos. So it was with mixed emotions (but mostly delight) we found out that one of the up-and-coming athletes appears to be a passionate supporter of ours. On Sydney's beautiful Queen Victoria Building is an enormous billboard featuring The Missile himself, James Magnussen, complete with a tattoo of the Alphinity logo displayed proudly on his arm. The billboard was probably advertising some other company, but we felt as if it was for us. All we need to do now is get him to add the 'lphinity' in lower case italics, sans serif…

Portfolio outlook

Over the last year, portfolio performance has benefitted from exposure to companies with unique earnings growth drivers largely driven by secular trends, such as online advertising and retailing, stocks with solid dividend yields, and avoiding the large profit warnings. The August reporting season is unlikely to provide much comfort about any near term improvement in the overall earnings outlook, however it will be an important time to reassess the potential for further outperformance by the defensive companies which are now starting to look fully valued, even in the current low interest rate environment. Over the last few months we have gradually been reducing our exposure to companies such as Telstra, Transurban and Sydney Airport on this basis. We also remain underweight in consumer staples and utilities. Following the February reporting season we added IAG to the portfolio as we formed the view that the insurance industry cycle was improving. Industry commentary since then has remained positive and we have increased our exposure further by investing in QBE. In an overall cautious corporate environment, we believe the insurance sector will provide some of the more positive outlook commentary. Overall, we believe the portfolio is well balanced between companies we expect to deliver solid earnings reports and those that may benefit disproportionately from a less risk-averse market environment.

BTW 2

We reckon we're pretty cool at Alphinity, and it seems that a UK judge agrees with us. We were early adopters of the iPad and we love them. We bought them without fully appreciating what their potential might be, and they have turned out to be very useful business productivity tools indeed. But Apple has been in a large number of legal disputes all around the world, especially with Korean technology company Samsung, over what it claims to be patent infringements. It seems the remarkable visual similarity between a number of Samsung's products rather annoys Apple, which seems keen to own the tablet space itself. Can you pick the difference?

However last month in a rather backhanded compliment, the judge in the UK denied Apple's allegations of infringement as he thought Samsung's products were not 'cool' enough to endanger any confusion on the part of consumers. According to Bloomberg, Judge Colin Birss said that Samsung's Galaxy tablets 'do not have the same understated and extreme simplicity which is possessed by the Apple design. They are not as cool'. He found that Samsung's products were distinctive by being thinner and having 'unusual details' on the back. In the US, Samsung has been unable to sell its Galaxy Tab since its release more than a year ago for the same reason. A similar law suit is taking place in the Federal Court in Australia, but in the opposite direction: Samsung is accusing Apple of infringing on some of its patents, this time around aspects of the iPhones' 3G data transmission. Early in the hearing, Justice Annabelle Bennett was not complimentary about the merits of Samsung's case: 'Why on earth are these proceedings going ahead?' she asked. 'It's just ridiculous. Why shouldn't I order the parties to mediation?' Yet another court case between the two is kicking off in the US.

Strangely, Apple is one of Samsung's biggest customers: trade between the two exceeds $5 billion per annum. At some point, you'd think the degree of acrimony being displayed between the two might endanger that trade. Apple is presently the largest company in the world by market cap, at over half a trillion dollars. Samsung is less than a third the size. Ten years ago Apple shares traded below $US8; now they are over $600. Samsung has 'merely' trebled over that period.

Traveller's tales

Stephane went back to China in July yet again to find out the latest on the activity and see whether we should become more positive on the resources sector, a sector we have been under weight for the past nine months. Again he spared no effort, working days and nights, venturing through lots of cities, making friends with property builders, contractors and many others to gauge the mood. Unfortunately, whilst the mood is noticeably better on the property front (see picture), steel mills and traders are far more cautious. Soft demand combined with poor order books and a boost in steel capacity has driven utilisation and margins down severely, to a level at which most mills are now generating cash losses. A de-stocking is currently under-way to bring back production in line with demand, putting downward price pressure on the two commodities Australia exports most of: iron ore and metallurgical coal. Some positive signals are however starting to appear on the horizon (late this calendar year?) with a change of tone at the government level refocusing its attention on growth (latest quarter's GDP growth rate was the slowest since the GFC) through looser monetary and fiscal measures. Increased lending and infrastructure investments should start lifting steel demand towards the end of the year. We remain under-weight resources but will keep monitoring these signals carefully to assess whether we need to change our position. Stephane will be returning to China in September (we're investigating dual citizenship to smooth his entry process even further!)

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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