Alphinity INVESTMENT MANAGEMENT

**Monthly comment – July 2011**

Alphinity Concentrated Australian Share Fund

# NAFC Mk II?

## Market comment

Global and domestic factors both weighed on the market in July. The S&P/ASX300 fell 3.8% (including dividends) as a combination of poor domestic economic news, ongoing corporate earnings downgrades, concerns over Australian Government policy and troubles in Europe and the USA all weighed on the market. One could say that the North Atlantic Financial Crisis is back – if it ever really went away. At least China's economic 'slowdown' appears to be very mild at this point. At the end of the month, the world was again concerned about public debt in several European countries, and that even the USA might default on its debts and/or have its credit rating downgraded. Issues in the US contributed to further $US weakness and consequent $A strength: it finished the month above $US1.10 for the first time since before the currency was floated in 1983.

Credit ratings agencies have had mixed success in recent years but they can still have a big impact on the markets. Greece being downgraded to a 'junk' rating can surely not have been a surprise to many, and the prospect of the USA having less than the top AAA rating should also not be too much of a shock considering its new $US16 trillion dollar debt ceiling equates to more than a full year of the whole country's economic output, not a dissimilar position to that in which Portugal, Italy, Ireland, Greece and Spain all find themselves.

The Reserve Bank of Australia left the cash rate unchanged and softened its rhetoric a little around the likelihood of rate rises, but remains both publicly and privately adamant that its bias remains towards tighter monetary policy. Major international markets were generally softer: the S&P500 in the US was down 2.1%, Canada's TSX down 2.7%, UK's FTSE100 down 2.1%, Germany's DAX down 2.9% but France's CAC40 fell by 7.8%. Asian markets were mostly flat to slightly higher, the standout being China's Shanghai B Share Index which rose by 3.8%.

## Portfolio comment

The portfolio lagged the market by a small amount in July as good performances from Bradken, Henderson, Oilsearch, Aston Mining, Monadelphous and Asciano were offset by falls in David Jones, News Corp and Westpac. The fund's zero weight in defensive telecoms company Telstra and gold producer Newcrest also detracted from returns as those stocks outperformed in the soft market.

## Fund performance* – as at 31 July 2011

| | APIR code | 1 month (%) | Since inception (%) |
|---|---|---|---|
| Alphinity Concentrated Australian Share Fund | EQ10001AU | –4.4 | 4.6 |
| Alphinity Wholesale Concentrated Australian Share Fund | HOW0026AU | –4.3 | 5.3 |
| S&P/ASX 200 Accumulation Index | | –4.0 | 3.9 |

* 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). 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.

## Top 5 active positions as at 31 July 2011

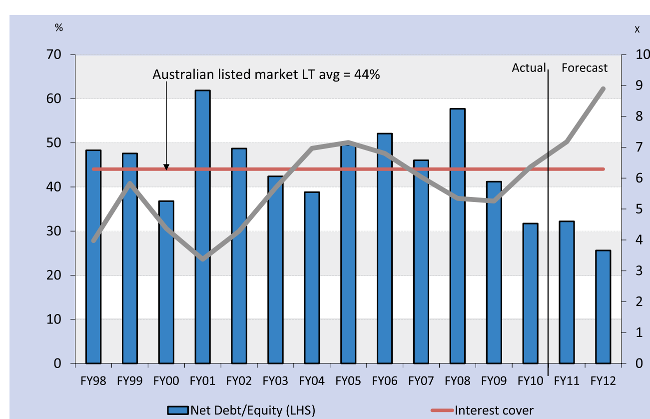
### Alphinity Concentrated Australian Share Fund

| Issuer Name | Portfolio Weight (%) | Active Weight (%) |
|---|---|---|
| BHP Billiton Limited | 17.6 | 5.0 |
| Rio Tinto Limited | 7.5 | 4.2 |
| Westpac Banking Corporation | 9.6 | 3.8 |
| Commonwealth Bank of Australia | 10.2 | 2.9 |
| National Australia Bank Limited | 7.8 | 2.8 |

## Market outlook

While the August reporting season will provide a lot of company-specific data points, the overall market direction for the next several months is likely to continue to be dominated by global macro issues: US double dip fears, European debt crisis, China slowdown concerns. There is plenty to worry about and the market is certainly doing a lot of worrying. So what can we expect from the Australian reporting season? Normally, today's continuous disclosure rules for companies mean that large earnings surprises are less common than in the past. However, so-called earnings quality – that is, the composition of a company's bottom line and its outlook comments – can still result in significant shareprice reactions. Interestingly, quantitative research shows that companies which have a positive shareprice reaction on the days around its results release usually keep outperforming the overall market for the next six months or so. As always, understanding the drivers of any surprises and how sustainable they are likely to be is key, so we have a busy month ahead of us. Outlook comments by company management were mixed at the February reporting season, with the degree of optimism largely flavoured by individual companies' exposure to the resource boom on the one hand, or the subdued consumer sectors on the other. Subsequent events are unlikely to have altered this thematic although global uncertainty and a further deterioration in the non-resources parts of the economy, instead of the improvement some had hoped for, are likely to make companies in general more cautious in their commentary this time around. Capital management had started to gain some momentum but is likely to have been put on hold again by most company boards contemplating such initiatives. However, the fact remains that corporate Australia is in a much stronger financial position than it was in 2008 to deal with any financial disruptions. This is true across the market, from banks and listed property trusts to industrial companies.

### Net debt/equity and interest cover




Source: Macquarie

The vastly improved corporate balance sheet strength is not only an Australian phenomenon but is true across most countries, including the US. The problem, of course, is that the same cannot be said for a number of countries' public finances in Europe and also the US. Nonetheless, while the public debt issues are likely to be a drag on global growth, it is difficult to get too negative on the overall market outlook due to the growth contribution coming from developing economies that we wrote about last month, the strength of corporate balance sheets and the overall market valuation, which despite some reasonable earnings risk, looks historically low.

## Portfolio outlook

The pullback in the market is a mixed blessing. On the one hand valuations are, in our view, becoming increasingly attractive as the earnings outlook has not weakened as much as index levels have declined. On the other hand, the stock market is typically a good leading indicator of economic conditions which clearly have deteriorated both domestically and in the developed world. The market fall has also sapped investor confidence. From a portfolio

perspective we are monitoring the situation in China closely and any impact the developed world slowdown might have. Relatively stable commodity prices indicate that the impact on China so far has been muted and we remain overweight resources and resource-related stocks. While balance sheet quality has always been a feature of our portfolios, the current uncertainty has increased our focus on earnings and management quality even further, and we look forward to reporting our conclusions from the reporting season which are likely to set the direction for the portfolio for the coming months.

## BTW…

Trading houses were on a roll in the first half of 2011. Australian magnate Clive Palmer's Resourcehouse Ltd had an unsuccessful go at raising funds in Hong Kong, but Swiss commodity trader Glencore did achieve an IPO in London and Hong Kong which valued the entire company at $A56 billion, although fair to say its performance since listing has been lacklustre. The most successful trading house float this year looks to have been one called Milan Station – also listed in Hong Kong.

Its business model is slightly different to the others': rather than trading commodities, it is essentially an exchange for the trading of used 'luxury' handbags (brands like Prada, Louis Vuitton and Hermes) in almost new condition throughout the greater China region. The idea is that wealthy ladies who are tired of their old handbag, or who maybe acquire the latest high-end brand and no longer need last year's model, can sell it to Milan Station. Milan Station then sells the bag onto someone who is happy to buy an almost new bag for a discounted price. In a brand-conscious society, there is a significant market there. As the website says: 'With its innovative cash trade-in strategy, Milan Station purchases lots of latest or limited edition designer bags in good condition and resells these second-hand designer bags to celebrities, office ladies and housewives. In fact, Milan Station can be credited with changing people's perception of designer bags from mere fashion item into a valuable commodity!'

In any case, Glencore shares had fallen by about 10% from its IPO price in May to the end of July; by contrast Milan Station hit the screens at a 66% premium to its issue price and was up 120% overall in the same time period.

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