Monthly comment – May 2014

Alphinity Wholesale Concentrated Australian Share Fund

Post-budget blues

Market comment

Markets in May turned out to be surprisingly resilient in most parts of the world. In fact, this was the best May since 2009, when the market was bouncing back from the worst of the GFC panic. Australian shares, as measured by the S&P/ASX300 (including dividends), rose by a little under 1%. The apparent first-quarter slump in the US is increasingly looking like the weather-related anomaly we suggested it was at the time, with very strong concurrent indicators presently being published, and China may have reached an inflection point from its recent run of soft data.

So some potentially good news from the global economy to at least partially offset a definitively sour mood that seems to have taken hold in Australia since the Federal Budget was released mid-month. Consumer confidence in May (as measured by Westpac and the Melbourne Institute) fell sharply after the Budget, and especially consumer expectations for financial positions in a year's time, which is apparently at its lowest level since the series started in the 1970s. The fact that the market was up despite such poor sentiment probably says as much about the limited appeal of alternative asset classes as the stock market itself.

Most equity markets elsewhere were also modestly positive but an apparent easing in political tensions caused a couple of stunning results: the Russian and Ukrainian markets were both up between 10 and 15% in their respective local currencies in May, and only slightly less than that in $US terms. As the chart shows, market movements suggest that Ukraine has been the winner over the past year, although the logic of this is difficult to grasp considering that it has not only lost a decent chunk of its territory but also had to cope with military insurgency. Asian markets did fairly well, generally 2-5% higher.

The US S&P500 was up 2% and European markets were largely flat. The $A appreciated slightly during the month, defying the expectation of most economists.

Resource stocks were soft in May but could have been a lot worse considering the movement in the prices of arguably our most important commodity, Iron Ore. It fell sharply, from $US105/tonne to $US92 ($A113 to $A99) although the price of the hard coking coal required to convert iron ore into steel was fairly steady. Precious metals were generally a little softer, with gold and silver falling by more than 3%. Base metals, however, were mostly up led by copper (+4%) and nickel (+5%).

Portfolio comment

The portfolio performed in line with the market in May. Macquarie Group and Oilsearch were the biggest contributors, along with not owning major bank NAB. However the underweight in another major bank, Commonwealth, detracted from the month's returns.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	0.6	3.7	18.4	25.6	12.7	13.2
S&P/ASX 200 Accumulation Index	0.7	2.8	16.5	21.4	10.3	11.0

*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).

Alphinity INVESTMENT MANAGEMENT

Monthly comment – May 2014
Alphinity Wholesale Concentrated Australian Share Fund

Market outlook

The Australian share market appears set to end the financial year with a whimper rather than a bang. The stubbornly firm A$, a Federal Budget that seems to have sapped the consumer of confidence, and a sharp fall in the iron ore price have all taken their toll on investor sentiment.

Having said that, the ASX300 has already returned a strong 19% in the 11 months to the end of May (and your fund 23%). Even during the first five months of 2014, in which market momentum has clearly slowed, the ASX300 has returned more than 4%. Active fund managers complaining about “low valuation dispersion” (i.e. many companies are trading at similar valuation metrics regardless of growth prospects) and “low volatility” (which seems somewhat ironic after several years in which most would have said volatility was too high) may be further evidence of a market that is running out of steam.

However, if one considers what has been driving the share market over the last couple of years – low interest rates, attractive dividend yields and an economy that, while not especially strong, continues to grow – there is little to suggest that any of these factors will not continue to offer support. While corporate earnings growth is reasonably modest, so is the likely potential return from other asset classes. Thus we expect that the market should continue to grind higher.

Portfolio outlook

Low valuation dispersions and low volatility are some of the buzz words in the funds management industry currently. In simple terms this means that there are few stocks that are obviously cheap or expensive relative to the rest of the market, and that there is little movement in the market to take advantage of. While we would agree that it is has become more challenging to identify high conviction ideas, the current environment tends to favour stocks with a combination of share price and earnings momentum, cashflow-backed valuation support and return on equity. These are all key factors in Alphinity’s investment process.

Furthermore, low valuation dispersion, in our view, typically also means that the market has become less disciplined in distinguishing between companies that are likely to be able to deliver or even exceed consensus earnings expectations, and those that have a history of disappointing expectations. Given Alphinity’s focus on earnings upgrade potential and earnings quality, this gives us confidence that the portfolio is well positioned not only for the current market environment but also for a more challenging earnings and market outlook, should that eventuate.

Asset allocation	As at 31 May 2014 %	Range %
Securities	98.9	85-100
Cash	1.1	0-15

Top 5 active overweight positions	Index weight %	Active weight %
Westpac Banking Corporation	7.9	5.4
ANZ Ltd	6.8	5.1
BHP Billiton Ltd	8.8	3.8
Telstra Corporation Ltd	4.9	3.2
Woodside Petroleum Ltd	1.9	2.9

Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size ($A)	15.9m
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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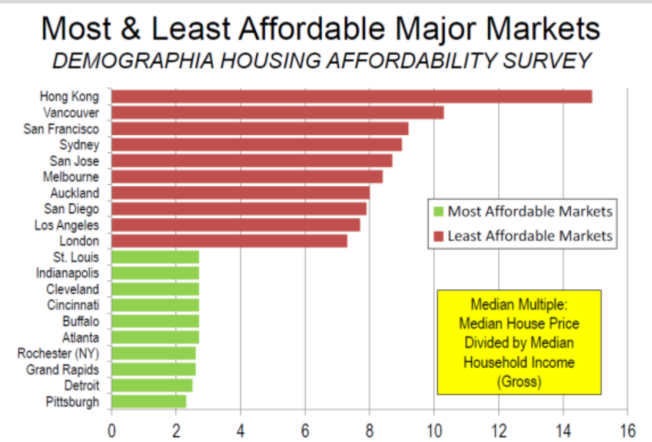
BTW

The topic of house prices is close to the hearts of most Australians, and numerous domestic and global "gurus" have been calling the need for a sharp downward correction for several years now – to no avail. But every now and then some hard data comes out that has the potential to be quite insightful. Alain Bertaud, a scholar of the Stern School of Business at New York University has been tracking housing affordability in nine countries for a decade now and recently released his 2014 study, Demographia. His conclusion? Housing in Australia is expensive.

He related median prices to median incomes and concluded that to spend three years' worth of your income to buy a house was affordable, 4-5 times was seriously unaffordable and more than 5 times considered severely unaffordable. Of course a measurement like this is a fairly blunt instrument as it ignores factors like interest rates, cost of living and relative tax rates, but there will never be a perfect measure and this is as justifiable as any.



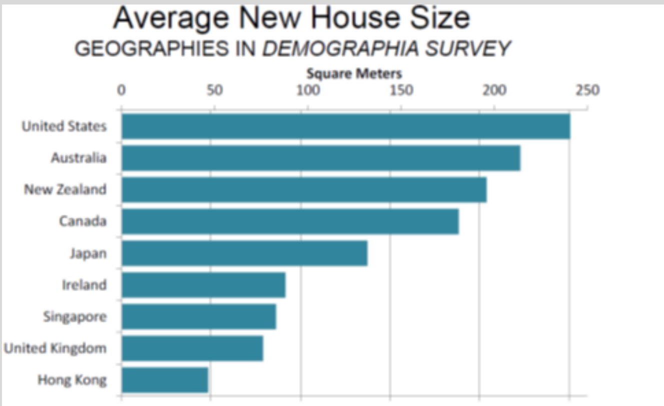
Source: Demographica

The good news? Australia is not the least affordable housing market, although its aggregate of 5.5 times puts it in the "Severely Unaffordable" bracket. That prize goes to Hong Kong, at 14.9 times median income for a median dwelling. New Zealand is in line with Australia while Singapore (5.1x), UK (4.9x), Japan (4x) and Canada (3.9x), follow. The "cheapest" were the USA (3.5x) and Ireland (3.7x).

Of course just looking at national markets can also a bit misleading so he drilled down into 360 individual markets in those countries for some more amazing outcomes. 84 of the 95 "most affordable" markets were in the USA, but there were also 23 severely unaffordable markets including San Francisco (8.5x), Silicon Valley's San Jose (8.3x) and San Diego (7.9x). Nearby Canada also had a wide spread of affordability but the beautiful, temperate and relatively-close-to-China Vancouver was second only in "unaffordability" to Hong Kong at 10.3x.

Sydney and Melbourne weren't much better: 9x and 8.4x respectively, worse even than London which was "only" 7.3x, and greater New York at 6.2x (Manhattan was not split out). Tokyo looks positively cheap at 4.4x but even it was a long way ahead of the most affordable market: Pittsburgh in Pennsylvania USA. Its median income was $US51,400 but a median house cost only $116,000, just 2.3x. The only problem is that to take advantage of it you need to live in Pittsburgh…

At least for our bucks we get a decent amount of bang: relative house sizes suggest that Australian dwelling sizes were at least part of the reason for the cost. At an average of 220m^2, our houses were slightly smaller than in the USA (250m^2) but more than four times the average of Hong Kong. Some consolation at least.



Source: Demographica

Monthly comment – May 2014

Alphinity Wholesale Concentrated Australian Share Fund

Traveller's Tale

Bruce went to Hong Kong, China and Japan in May, mainly to meet with people and companies involved in sourcing goods for Australian retailers. Tokyo and Shanghai are only a couple of hours apart by air, and both have about the same number of people (15-20 million depending on the source) but going from one to the other showed a stark contrast between a developing and a developed economy.

Shanghai has experienced amazing growth in recent years, and being driven around in Shanghai can be quite an experience. There are some very impressive freeways with an enormous number of vehicles, including many upmarket European cars and large smoky trucks, vying for a place on them. Lengthy delays may be the reason that frustration levels seem quite high, judged by the amount of horn-honking and headlight-flicking that took place. Once off the freeways however conditions became much more random, and in the older parts of town it wasn't unusual to turn a corner and encounter a scene like this.

Tokyo was vastly different: Taxis are spotlessly clean, without exception, and many of the taxi drivers wear white gloves and have white lace seat covers in their car. It's not the done thing to open the door yourself when getting in or out: the driver has a lever to do that for you. It was pleasing to see that the Nissan Cedric lives on there, at least as in the taxi market. And drivers are unfailingly polite, to the point of apologising for some heavy traffic. Returning to a Sydney taxi was a bit depressing by comparison.

Air pollution was another significant contrast between the two cities. Air quality monitors were quite prominent around Shanghai, showing the level of fine particulate matter according to the main World Health Organisation metric (2.5 micrograms per cubic metre of air - PM 2.5 for short), a major cause of health issues. Sydney typically has a PM 2.5 level around 10-20, but most of the readings in Shanghai were 50-60, which was considered by locals to be pretty good. At times in Beijing PM 2.5 has exceeded 400 on a sustained basis and peaked at 900. Even in the 50s you could see the air you were breathing, and after a day traipsing around it felt as if you'd consumed a few packets of cigarettes. Tokyo's air was pretty good by comparison, but locals said that if there was ever a problem it could usually be blamed on pollution blowing across from China.

Alphinity Investment Management