**Monthly comment – May 2015**
Alphinity Wholesale Concentrated Australian Share Fund

# Mayday!

## Market comment

The old adage “sell in May and go away” looked quite apt at various points in the month but it turned out reasonably well in the end, the Australian market (S&P/ASX300 including dividends) finishing May about half a percent in the black, maintaining although not building on its good returns for the calendar year to date. The best performing sectors in May were Real Estate and Healthcare, while Banks and Consumer Staples companies underperformed.

The major global market returns were generally quite similar to ours in their own currencies but this time the $A yoyo flattered most of them: in Australian dollar terms the US was +4%, UK +3% and Japan +5%. Greece remains a swing factor, with various debt deadlines approaching and maybe even a decision point about how to handle its enormous debt: its market flat-lined in May. Chinese shares listed in Shanghai (known as A shares) continued to charge along with a further 7% rise in May, taking the 12-month return to an incredible 185% (see BTW).

Commodity prices were mostly soft over the month with Oil tracking 1.5% lower, Aluminium -12%, Nickel and Lead -9%, Copper -8% and the other base metals also down but by smaller amounts. Iron Ore bucked the trend however rising 10% in May as announcements of economic stimulus in China helped it to recoup a little of the losses of the past year.

The Reserve Bank of Australia cut the official cash rate at the start of May to a new record low of 2%, and speculation continues that the sluggish economy will necessitate a further cut or two. We do question whether further cuts will achieve anything other than further stimulating an already bubbly housing market, and we think the RBA shares those concerns.

Bond yields in most countries have risen sharply from lows seen earlier this year, as shown in the table below, and were rising further in June. Bonds lose value when yields rise, and shares of companies whose primary appeal is their dividend yield tend to as well.

| 10 year yields | Recent low | May | Early June |
|---|---|---|---|
| Australia | 2.3% | 2.7% | 3.0% |
| USA | 1.6% | 2.1% | 2.3% |
| UK | 1.3% | 1.8% | 2.0% |
| Italy | 1.1% | 1.8% | 2.3% |
| France | 0.4% | 0.8% | 1.2% |
| Germany | 0.1% | 0.5% | 0.8% |
| Switzerland | -0.3% | -0.1% | 0.2% |

Source: Bloomberg

## Portfolio comment

The portfolio performed slightly better than the market in May. Positions in investment bank Macquarie Group, building materials company James Hardie and Aluminium producer Alumina were the best contributors to the portfolio’s performance, as well as not owning supermarket operator Woolworths however these were partly offset by exposures in major banks Westpac and Commonwealth both underperformed in May.

| Performance* | 1 month % | Quarter % | 1 year % | 2 years % p.a. | 3 years % p.a. | Since inception^ % p.a. |
|---|---|---|---|---|---|---|
| Fund return (net) | 0.4 | -1.0 | 9.9 | 14.0 | 20.1 | 12.5 |
| S&P/ASX 200 Accumulation Index | 0.4 | -1.4 | 9.9 | 13.1 | 17.4 | 10.7 |

*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. The inception date for the returns for the Funds is therefore 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

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## Market outlook

Macro factors continue to dominate equity markets around the world, most notably the sell-off in global bond markets and the heightened uncertainty around Greece's ability to reach a revised debt agreement with its European counterparts. Whether a compromise on Greece's repayment terms can be reached or "Grexit" will occur remains to be seen.

While Greece defaulting and abandoning the Euro would certainly increase volatility further, we believe the consequences for financial markets would be less dire this time around compared to what might have eventuated had it occurred in recent years. The reason for our cautious optimism is that this time the ECB has a significantly increased mandate to purchase sovereign Government bonds issued by its member states. This is likely to reduce the contagion risk substantially, in our view.

To what extent the sell-off in bonds markets is linked to "Grexit" nervousness is difficult to know, but we see little evidence of stronger economic growth which would otherwise warrant higher bond yields. Nonetheless, it's clear that the yield sensitive sections of the equity market will struggle should bond yields continue to rise, or even just be sustained at current levels.

The Australian dollar spent a brief period above $US0.80 in May, and its subsequent retreat is welcome news for domestic equity investors. The weaker $A is one of few positive drivers of Australian corporate profit growth at the moment. And while the largest effect to date has been the translation benefit of overseas earnings, latest trade data suggests that Australian exporters are also starting to see some traction from their increased competitiveness.

The recent pullback in equities has improved valuation metrics that had started to look somewhat stretched. While the sharp increase in domestic bond yields noted above has reduced the relative attractiveness of the equity market somewhat we are fast approaching solid valuation support levels, in our view.

## Portfolio outlook

The Alphinity investment process is built around continuous active management of portfolios. After all, the relative attractiveness of stocks change with movement in their share prices as well as changes to company prospects. This typically leads to gradual changes in our portfolio holdings over time. Occasionally however, perhaps once or twice in a share market cycle, larger changes occur in the market environment which warrants greater scrutiny of the overall portfolio positioning. Examples include the impact of the Global Financial Crisis on share markets in 2007-8, the subsequent snap-back in 2009, and the apparent end to the multi-year trend of a strengthening Australian dollar in 2013.

Recent bond yield movements suggest we may be at the beginning of another such event. We believe the portfolio is well positioned to benefit should this be the case, as we are underweight yield sensitive sectors such as REITs, infrastructure stocks and more recently Banks.
As discussed in the Market Outlook section, a continued sell-off in bond markets is far from a foregone conclusion. However we feel it is too early to undertake a more significant portfolio repositioning as this would typically involve an increasing the weighting towards cyclical stocks, where we still see a distinct lack of earnings momentum.

A clearer picture should emerge in coming months. In the meantime, we continue to focus the portfolio on individual companies with solid earnings drivers, attractive valuations and qualitative factors such as cash flow and balance sheet: this strategy has shown strong returns over the long term.

| Asset allocation | As at 31 May 2015 (%) | Range (%) |
|---|---|---|
| Securities | 98.2 | 90-100 |
| Cash | 1.8 | 0-10 |

| Top five active overweight positions as at 31 May 2015 | Index weight (%) | Active weight (%) |
|---|---|---|
| National Australia Bank Limited | 6.1 | 4.6 |
| Westpac Banking Corporation | 7.1 | 4.5 |
| Macquarie Group Ltd | 1.8 | 4.5 |
| Telstra Corporation Limited | 5.2 | 4.4 |
| AMP Limited | 1.3 | 3.3 |

| Fund details | |
|---|---|
| Manager inception date | 1 September 2010 |
| Fund inception date | 31 October 1994 |
| Fund size ($A) | 27.4M |
| APIR code | PAM0001AU |

| Fees | |
|---|---|
| 2013/14 ICR | 0.90% |
| Management fee | 0.90% p.a. of the net asset value of the Fund |
| Performance fee | Nil |
| Buy/sell spread | +0.20%/-0.20% |

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## BTW

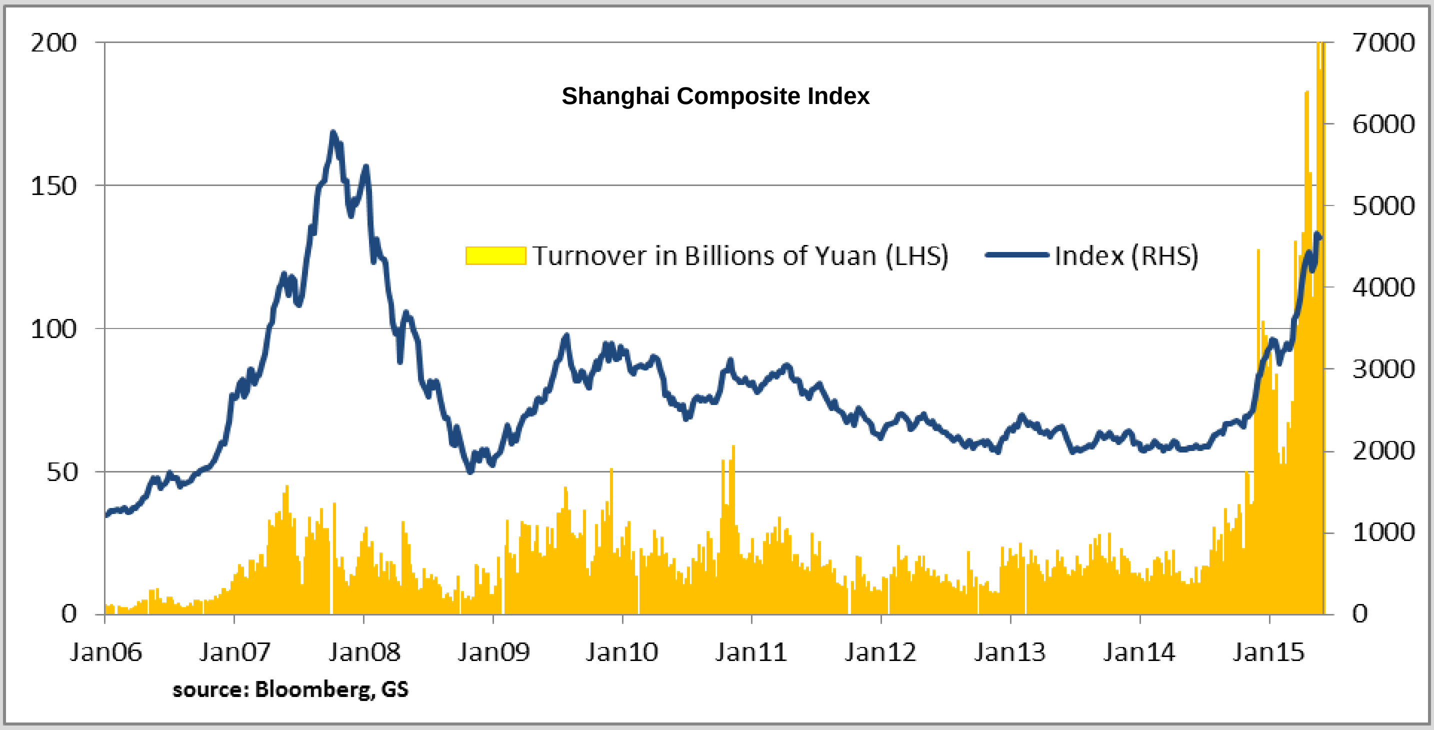
Chinese shares were struggling for quite a while there but for much of the last year they've been on a tear. There have been a lot of factors driving this, including improving investor confidence as a result of booming property prices, increased margin lending, and the anticipated economic impact of economic stimulus in China this year and the government talking it up. Margin loans to stock investors have more than trebled in the past year, and millions of new stock trading accounts are being opened each month. Annecdotally, according to *The Economist,* many are "small-time day traders with little understanding of what they are buying" but keen to join the frenzy regardless.

If the Shanghai Stock Exchange Composite Index keeps up like this it will soon be challenging the all-time high it reached in December 2007. Putting it into numbers, the Index reached 5900 but proceeded to fall more than 70% to as low as 1700 within a year. It meandered along for a few years before starting to rocket in July last year from an index level of about 2000. It is up by 130% since July 2014 and with a few more months like May's +7% it will be back at the all-time high. Now trading at about 20x earnings, the Chinese market isn't cheap but is still a long way from the 40x it reached at the last peak in 2007.

What is perhaps more interesting has been the increase in turnover (dollar value of shares traded) that has gone along with the market rise. Putting it in context, the average daily turnover of the Australian market over the past five years is about $A5 billion. Turnover in the Shanghai market was averaging ¥18 billion (just under $A3 billion) a day until late 2014 but since then turnover has exploded. It has averaged ¥120 billion a day year to date but most recently has been reaching ¥200 billion, which is more than $A40 billion at the current exchange rate.

While moves by the Chinese government to stimulate the economy have been important, one of the main drivers has been the prospect of opening the Chinese market to foreign investors, which will ultimately lead to greater inclusion in global stock market indices like MSCI and FTSE. Some estimate that hundreds of billions of dollars will need to be diverted away from existing markets into Chinese shares over the next few years, and that China could one day make up as much as a third of the major global benchmarks.

This matters because of the rise of index investing in recent years. It would mean those canny index investors will be forced to commit a portion of their portfolios to Chinese shares regardless of how elevated the price of those shares might be. While to us the prospect of designing a global equity portfolio (or any portfolio really) around which companies or countries happen to be decided by an index compiler sitting in London or New York doesn't seem the most logical way to go, the fact remains that index investing is a massive force in global markets and changes to the constituents of an index can have a meaningful impact. So as huge as the return has been so far, the sheer weight of money that will be going into Chinese shares means this may just be the start.



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## Traveller's Tale

Andrew had a whistle-stop trip around the world in May to meet with financial companies – primarily banks and insurers. He was mostly in the UK and USA but also managed to squeeze in a stop in Bermuda. This tiny country of only 65,000 inhabitants has managed to become a global insurance hub for reasons that are not immediately apparent.

A brief perusal of the county's tax laws probably explains most of it, and you can't rule out the appeal of Bermuda's pleasant sub-tropical climate, which rarely rises above 30$^{O}$C or falls below 20$^{O}$C. But we suspect it's really the local fashion which attracts a large number of financial types to a 50km$^2$ island in the middle of the Atlantic, two hours flying time from New York.

Acceptable male business attire in Bermuda is as depicted here: top half shirt, tie and blazer; bottom half pastel-coloured Bermuda Shorts, long, dark socks and business shoes. We note that this is a picture from Google Images, Andrew is not in this picture. His conventional suit did make him stick out a little on the streets of Hamilton, but not as much as he will when he brings the Bermudan fashion trend to the streets of Sydney later this year (after winter as otherwise his knees may get a little chilly).

The appeal of Bermuda probably really is tax though: tax in Bermuda is low by any standard. Company tax is zero. Capital Gains Tax is also zero. Sales tax is zero. Withholding Tax? Zero. Personal Tax? Zero. So how does the Government of Bermuda fund itself? There is a Payroll Tax, ranging between 7% and 14% depending on salary levels. And duties on imported items can be steep. But that's about it as far as tax goes.

Despite having such low taxes, with all those highly-paid insurance chaps in town Bermuda is a very expensive place to visit. Andrew's frugal nature couldn't cope with the prospect of staying there for the weekend so he headed to New York instead. You know things are bad when hotels in New York look cheap!

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