Alphinity
INVESTMENT MANAGEMENT

Monthly comment – May 2013

Alphinity Wholesale Concentrated Australian Share Fund

Taper tantrum

Market comment

May maintained its reputation as being Confession Season, as a number of companies looked at their trading year to date and realised that they wouldn't quite achieve the earnings the market was expecting. This came on top of increasing speculation of 'tapering' in the US. What is Tapering? Essentially it is the end (or at least a scaling back or tapering off) of Quantitative Easing, but more about that later. It is believed by many that the mass of liquidity which has been pumped into the system in the US and many other parts of the world had been flowing into both bond and equity markets, pushing indices to new all-time highs in many of those countries. This month might have marked an inflection point.

The $A might also have passed an inflection point in May, although we are always reluctant to take a strong view on currency. A 25 bp rate cut by the RBA at the start of May to levels last seen in the 1940s appeared to take away one of the currency's props and it fell by 7 cents during the month. The $A, which everyone has been saying for some time is too high, finally broke back through $US parity and finished the month just above 96 cents, its lowest level since this time last year. Should it be sustained, a soft $A will give some comfort to many Australian companies.

May gave away some of the gains made in the bumper month of April but the market is still up 1.5% over the two months, and your fund is up 3% in that period. The ASX300 (including dividends) fell 4.5% in May. We noted the extraordinary skew in returns that took place in April: some of this was reversed with Banks in particular under performing substantially in May – the four big banks alone accounted for three quarters of the market's fall. The $A flattered global equity market returns: US, UK, Germany, France, Italy and even Greece were all up between 3 and 5% in local currencies but 8 and 10% for Australian investors.

Commodities were torn between a strengthening US and a cautious China, and ended up doing not much at all. Iron ore and precious metals were soft but oil and base metals ticked higher. Resource stocks themselves rose slightly in aggregate during May, but some mining services companies were hit hard by the cost-cutting efforts of their customers.

Portfolio comment

The portfolio gave back some of last month's gains, underperforming the market somewhat in May. The biggest contributors were health care company Resmed and fund manager Henderson Group (both beneficiaries of a soft $A), being underweight major bank CBA and not owning NAB, Woolworths or Wesfarmers; the biggest detractors were from major banks Westpac and ANZ and insurer QBE although department store Myer and engineering company Downer also hurt.

Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	16.0
Asset allocation	Australian equity: 98.9%, Cash: 1.1%

Fund performance* – as at 31 May 2013

	1 month (%)	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	–5.0	–1.2	33.3	10.0	11.3
S&P/ASX 200 Accumulation Index	–4.5	–2.4	26.5	7.3	9.0

* **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 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 May 2013

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Australia and New Zealand Banking Corporation	6.3%	5.9%
Westpac Banking Corporation	7.5%	4.8%
Insurance Australia Group Limited	0.9%	3.9%
Lend Lease Corporation Limited	0.4%	2.9%
Woodside Petroleum Limited	1.9%	2.8%

Market outlook

The market outlook has become a little more uncertain as investors are caught between rising bond yields, making high yield stocks relatively less attractive, and few signs as yet of the recent RBA rate cuts getting traction in the domestic economy. While this transition period is not without risks, bond yields would in our view have to increase substantially in order for the dividend yields currently available in the share market to lose their appeal in a significant way. This is unlikely to occur unless economic growth picks up substantially, which itself would also assist company earnings. Equally, while earnings downgrades persist and have recently picked up in frequency, Industrial earnings look set to grow modestly in FY13. In addition, the lower Australian dollar – if sustained – will help boost the $A value of the overseas earnings of Australian companies (these constitute about 40% of total ASX earnings) as well as stimulate the domestic economy. In other words, the case for a gradual shift from low bond yields being the main driver of equity markets to stronger earnings growth is a reasonable scenario and one in which the recent selloff is more likely to be the consolidation period after such a strong run, which we have been flagging for several months, than the beginning of a more prolonged market downturn.

Portfolio outlook

In an environment in which some investors may have lost confidence in the earnings outlook for the market, we believe companies that are able to demonstrate positive earnings momentum will be well rewarded. We believe that our portfolio remains well-exposed to these types of companies across a number of sectors. Insurer IAG, property developer and manager Goodman Group, healthcare companies CSL, Resmed, Primary and electronics retailer JB Hi-Fi are some of the stocks in the portfolio that fit this bill.

The domestic economy is still struggling to gain momentum despite easier monetary conditions, and the global economic outlook remains mixed. There are signs of improvement in the US but the Eurozone is still very weak, and developing economies are somewhere in between. However, should the recent weakness in the $A be sustained, it may present a significant opportunity for a better earnings outlook.

A weaker dollar is a net benefit to the Australian market, through the translation effect of overseas earnings (ie foreign earnings being worth more in $A) as well as a better relative cost position for domestic producers. While the latter will likely require further currency weakness and take some time to have an effect, both factors have the potential to become powerful earnings drivers. If the pullback in the dollar is sustained, or, as some observers expect, the slide continues further, the two main headwinds for Australian company earnings for the last few years - high interest rates and a record high currency - will both have both eased considerably and could eventually turn into tailwinds.

Our portfolio is well exposed to traditional beneficiaries from a weaker currency (Brambles, Computershare, Resmed, Woodside Petroleum) and thus well positioned to benefit from the currency selloff, in our view. More difficult to ascertain is the impact on resource company earnings. The benefit from a falling Australian dollar for the resource sector has often in past cycles been swamped by lower commodity prices. This time some argue that the impact of lower commodity prices has already been reflected in sector earnings expectations while the lower currency has not. Although we have reduced our underweight to the resource sector after its significant underperformance over the last 12 months, we remain of the view that commodity price expectations remain too high, as the impact of new supply is not fully reflected in forecasts.

Our cautious approach to adding domestic cyclical exposure to the portfolio has proved prudent with the recent

deterioration in consumer and business confidence. We will continue to look for signs that the rate cuts are working, and we ultimately expect them to, but remain unexposed to both the building materials sector and domestic media. Two retail stocks, Myer and JB Hi-Fi, have been added to the portfolio since late 2012. Despite a strong first half result and a competitive environment, JB Hi-Fi was able to upgrade its earnings guidance in May and appears to be maintaining sales momentum. Although trading conditions weakened a little for Myer after the warm start to winter, importantly, Myer's stock levels are well under control so the impact of any slowdown in sales growth should be manageable.

BTW

Quantitative Easing is a concept that has been around for centuries but it is only since the onset of the GFC that it has become widely known by this term: until then it had just been called 'printing money'. There have been a few iterations since 2008 in the US, commonly known as QE, QE2, and QE3 (a.k.a. QE infinity, as it is ostensibly open-ended). Perhaps calling money-creation 'QE' provided a veneer of acceptability it might not otherwise have had.

Source: The Economist.

QE involves increasing the monetary base of an economy by buying financial assets from banks – effectively swapping bonds for cash. The intention is that the banks will then lend that money to people or businesses which should spark an economic recovery. As it happened, until QE3 most of the US banks were so worried about creditworthiness that they hardly lent at all – most merely bought higher-yielding financial instruments and took the spread as profit.

QE has taken place in other countries as well but sometimes for different reasons: Switzerland had a typically bullet-proof economy even during the worst of Europe's travails but in 2011 found itself compelled to print money in order to stem its currency's rise against the Euro. Japan has had several instances since its economic malaise first set in in the early 1990s, but most recently the Bank of Japan, encouraged by a new government in late 2012, announced an aim to double the country's monetary base within two years. That lit a rocket under its stock market, which rose by 80% over the succeeding six months, and its currency fell 30% against the $US. So QE appears to have boosted the Japanese economy but cracks started appearing during May.

The problem with QE is that it can not go on forever. Bond market analysis firm Zerohedge says that the Federal Reserve now owns about a third of the $5.2 trillion outstanding US government bonds. As each month goes by that figure rises by $85 billion (just over $1 trillion in a year) so unless things change, Zerohedge says the Fed – itself an instrument of the government – would own the entire $5 trillion stock of US government bonds by 2018. Logically, this is unsustainable.

The mere mention during May of a possibility that the QE drug might be scaled back caused a few (temporary) conniptions in global markets, and May was the worst month for US government bonds since 2004 with ten-year yields rising significantly. One would have thought that the US economy being sufficiently strong as to not to need as much QE would be cause for celebration but the initial knee-jerk in financial markets was to sell everything except the $US, which rose sharply. We will look with interest (and some trepidation) at how people will react when something actually happens!

Australia has been one of the few major economies not to have taken part in QE, which may explain part of the strength in the $A (at least until this month): we hope that our currency can fall a little further which would give some respite to manufacturers and provide scope for earnings upgrades for the many Australian companies with large offshore operations. Macquarie estimates that a 90c dollar would mean in aggregate ~6% upgrades to Australian company earnings: this would be most welcome.

Traveller's tales

Stephane was back in China in April. He said: 'When the mini bus stopped in the middle of a dusty road, I saw a scene somewhat reminiscent of an old western movie. Was there a mechanical problem? The driver pointed, using a harsh-sounding Chinese comment, to a run-down building on the other side of the road. It was lunch time, and this was the lunching place. It didn't look inviting in any circumstance, let alone with all the publicity around the thousands of pigs recently discovered floating in local rivers and the re-emergence of bird flu.

'I didn't want to step out of the bus and risk my health in what was clearly not a restaurant catering to western tastes. The guide came back from the building saying that there was no other place around – I could believe that – and that the food was already prepared, so please just go across the road...

'It turned out that the meal was one of the best of the entire trip. I naturally focused on the vegetarian portions, given concerns around pork and chicken, but they all tasted sensational, and gave me the energy to attack the meetings for the rest of the day. This was an epic stop in one of China's fifth tier cities.'

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