Alphinity INVESTMENT MANAGEMENT

Monthly comment – November 2011

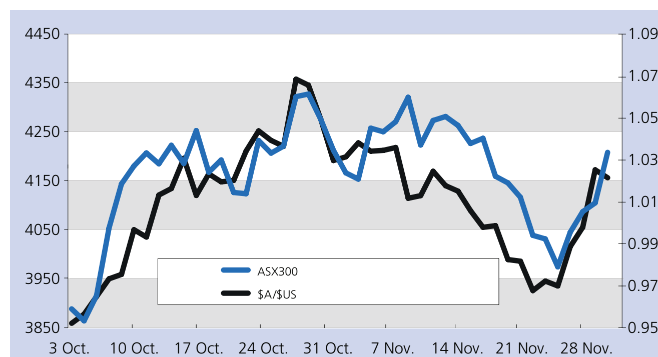
Alphinity Concentrated Australian Share Fund

Up by the stairs, down by the lift shaft

Market comment

It is a common aphorism that equity markets tend to go up by the stairs (i.e. rise gradually), then down by the lift (i.e. have a correction in a fairly short amount of time). After a very strong October, at one point in November it felt as if the troubles in Europe had removed the floor of the lift altogether, before recovering somewhat into month end. Australia was caught in the down-draught of global uncertainty, as illustrated by the $A which is often used as a proxy for global economic growth. Starting at $US1.055, it followed the share market lower, falling below $0.97 at one point, before closing the month back at parity. The S&P ASX300 gave away almost half of its October rise, falling by 3.4% (including dividends) but was off by more than 8% at its worst.

A Macro-driven market?



Source: Bloomberg.

Australia underperformed some global markets, although it is worth noting that the markets in the Asia Pacific region had already closed on the last day of November, before the announcement of some coordinated action by central banks which sent European and American markets sharply higher. Japan's Nikkei was off 6.2% and China (Shanghai A Shares) off 5.5% while the Hong Kong Hang Seng fell 9.4%. By contrast, the US S&P 500 was down by only 0.5% for the month, and UK FTSE 100 was 0.7% lower.

The issues facing Europe are indeed concerning: an increasing lack of confidence that policy makers there have the willingness or even the tools to address the sovereign debt issues facing many European countries is translating into a lack of confidence in the future of the Euro itself as a viable currency. This was shown in the 'failure' of a bond auction in Germany, the only country with a sufficient balance sheet to keep the whole thing together.

No one really doubts the ability of Germany to repay its debts, but buyers of bonds (typically banks, which have their own issues at present and are being forced to liquidate assets by the same authorities expecting them to buy their bonds) are naturally cautious as murmurs of a break-up of the Euro build. Who wants to be stuck with Euro-denominated bonds if the Euro suddenly no longer exists, or if certain countries choose – or are forced – to exit? The implication for bond owners would be significant: quite negative or even quite positive, but bond investors tend to be risk averse and would be wise to watch from the sidelines.

Fund performance* – as at 30 November 2011

	APIR code	1 month (%)	Quarter (%)	1 year (%)	Since inception (%)
Alphinity Concentrated Australian Share Fund	HOW0122AU	–3.6	–2.6	–8.5	–1.6
Alphinity Wholesale Concentrated Australian Share Fund	PAM0001AU	–3.5	–2.3	–7.6	–0.8
S&P/ASX 200 Accumulation Index		–3.5	–2.8	–6.0	–0.8

* 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 30 November 2011

Alphinity Concentrated Australian Share Fund

Issuer Name	Portfolio weight (%)	Active weight (%)
National Australia Bank Limited	9.1	3.9
Westpac Banking Corporation	9.7	3.4
BHP Billiton Limited	14.1	2.8
Telstra Corporation Limited	6.5	2.5
Amcor Limited	3.4	2.5

As the month closed, coordinated monetary policy moves by major central banks had given the markets some hope that there might be a solution after all. We are all crossing our fingers, trusting that the lift will be able to start ascending again, but conscious that there have been plenty of false starts in the European journey so far, and that maybe the US Fed isn't in the most credible position to be handing out crisis-management advice.

Portfolio comment

The portfolio performed in line with the market during November, with the big macro forces still firmly in control, smothering most stock-specific factors. Best contributors in November were predictably defensives foreign currency-exposed stocks: toll road owner: Transurban, Amcor, CSL, and Telstra; while Monadelphous also performed well. The biggest detractor was not owning defensives Woolworths or Westfield, nor Newcrest which benefitted from a recovery in the gold price sparked by global uncertainty.

Market outlook

We believe the Australian economy is likely to remain patchy in the coming 12 months. Global growth is slowing in most regions though from an Australian perspective, not collapsing. US economic data has been one of the bright spots recently but we see the US continuing its slow recovery in 2012 rather than gaining significant momentum, especially as growth in Europe looks set to deteriorate even if (a big if) a viable financial restructuring plan is announced. Growth in China is also slowing. Our most recent China research trip found that property development in particular has slowed markedly in recent months and we expect steel consumption to grow by only 3-4% next year. This will negatively affect the demand for iron ore and metallurgical coal. Alphinity's price expectations for these commodities are now lower than the market's. The Government in China has started to shift towards an easing bias. However, such easing will in our view be very selective as the Government is determined to maintain a tight grip on the Chinese property market to firmly address inflation and cool down property prices. Although we expect commodity prices to soften we see them as remaining strong enough to not cause major delays to current capex plans by miners in Australia. With most of the large capex projects gathering pace in 2012, it is thus too early to call and end to the domestic 'two speed economy'.

The November RBA rate cut, followed up in early December by another, largely reflects the uncertain global outlook and may offer some relief to interest rate-sensitive sectors such as discretionary retailing. However, we believe the RBA is reluctant to initiate a traditional full scale rate cutting cycle at this point. The consumer will need quite a significant cut in interest rates to substantially alter spending patterns, and this will only come should economic conditions deteriorate further. The Government's focus on achieving a budget surplus in FY13 is also at best likely to be growth neutral, and possibly negative. The Australian equity market is currently caught between two opposing factors. On the one hand the market is on most measures cheap. Even using longer-term valuation metrics such as price to trailing 10 year average earnings the market is trading below historical levels. On the other hand, earnings continue to show lack of positive momentum with resource earnings in recent months joining the negative revisions trend of Industrial and Bank earnings. The aggregated return for the companies in our CRM is currently in excess of 20%. We see this as clearly within the potential return range for the market, although the downside risk to earnings does pose a risk to this being realized in the near term.

In summary, from an Australian perspective, global growth is slowing but not collapsing. The RBA rate cut, in our view, was to a large extent a reflection of the uncertain global outlook which may offer some relief to interest rate sensitive sectors such as discretionary retailing. However, we believe it is too early to call and end to the Australian two-speed economy.

Portfolio outlook

With domestic and global growth slowing we believe it's prudent to maintain a well-diversified portfolio with earnings certainty and high dividend yields favoured over cyclical recovery potential. We are therefore maintaining a portfolio overweight in banks, while we have trimmed our metals and mining holdings further, and also have some limited domestic consumer cyclical exposure. We see little value in the consumer staples sector. However, our portfolio has several other resilient stocks, such as infrastructure companies MAp Group and Transurban and telecommunications company Telstra. Telstra, in addition to being a stable dividend stock, has in our view likely turned the corner in its earnings outlook, primarily driven by its mobile phone operations. We believe that dividend yields in the current investment climate are likely to contribute more than normal to overall returns.

The portfolios retain a substantial overweight in Energy, both through oil and gas companies and thermal coal companies. We remain believers in the energy sector. Thermal coal (which is used to generate electricity) will remain tight despite the expansion in Indonesia mentioned in Traveller's Tales below. However longer-term demand will be sustained by a number of countries needing more coal for electricity production, including India, China, and Japan which will progressively shift its energy mix away from nuclear after the Fukushima disaster earlier this year. Supply on the other hand, could be negatively affected by yet another El Nina weather pattern this year (affecting 80% of the seaborne volume) and by Indonesian policies favouring domestic coal consumption. This price dynamic bodes well for coal exposures New Hope and Whitehaven, which should also benefit from their own production expansion programs.

The Liquefied Natural Gas (LNG) market has shifted from a buyer's market to a seller's market over the course of 2011 as people seek greener/cleaner energy. We expect this market to remain tight for another few years, especially in an elevated Brent oil price environment, as new sources of oil supply will have to come from more expensive oil sands and deep sea sources, and an increasing reliance on OPEC production. Santos and Oil Search should both benefit from such an environment.

Traveller's Tales

Stephane again hit the planes this month, this time heading to Indonesia to get some idea of where that country is heading with respect to its coal mining activities. He says: Indonesia exports 285mt thermal coal a year, making it not only the largest seaborne supplier (around 40% market share) but also the one country that has surprised the market the most by its ability grow its export volume year after year. Our trip suggests that, despite demand growth of 8% pa in its domestic market and fast tracking of a 10GW coal-based power generation program, exports will keep growing at a rate of around 20mt a year. Whilst this is marginally negative for seaborne coal prices, we believe those prices will be supported by increased demand from India and higher transportation costs in China. On the other hand, the volume growth should bode well for players such as Orica which supplies mines with explosives. We also came back with some skepticism about the Indonesian government's intention post 2014 to prevent the export of raw materials such as bauxite in order to stimulate local value add. The absence of new alumina plants suggests this is unlikely to happen or be enforced by then, a negative for AWC.

BTW…

What is the best way to get ahead financially? A British survey recently came up with a startling result: almost 30% of the people surveyed thought that winning the lottery was the best way of improving their financial position! A similar proportion elected more traditional strategies such as 'paying down debt', and 'saving more'. We know that times are tough in the UK, but 30% seems like a very large proportion of the population to believe that a highly improbable event like winning a lottery was worth 'pinning your hopes on', as the article says. Of course, as with any survey it pays to look at who conducted it and why, and in this case it was the Institute of Financial Planning to release during UK Financial Planning Week. It concluded that only 19% of Britons were saving enough to provide for their future needs, and that 47% lacked confidence that they will have sufficient to afford a comfortable retirement. 66% of women and 54% of men said they worry about money always or most of the time, and 77% believed they would be happier if they had more money. Only 14% of women and 23% of men were satisfied with their current financial position.

The survey result may be concerning for UK financial planners but will give some encouragement to teachers in the Canadian province of Ontario: their pension fund owns the UK National Lottery.

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