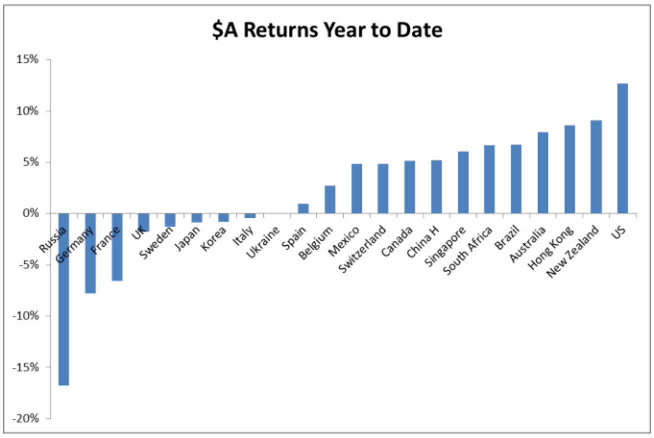
Monthly comment – October 2014
Alphinity Wholesale Concentrated Australian Share Fund

Snap-back

Market comment

October started poorly but bounced back in a big way after the first week or so. The market (S&P/ASX300 including dividends) was down 3% at its lowest point but rose 7% from there to finish the month a little over 4% higher, recouping much of September's loss. Along with Hong Kong, this represented the best major market return, more than double that of the US and various Chinese indices which were all below +2%, and UK and Europe which were all down between 1% (Switzerland) and 5% (France). The Greek market fell 15% in October to be -27% year to date. Australia's markets have fared reasonably well since January being up 8%: not quite up to the level of the US which in $A has returned 12%, but better than most others.

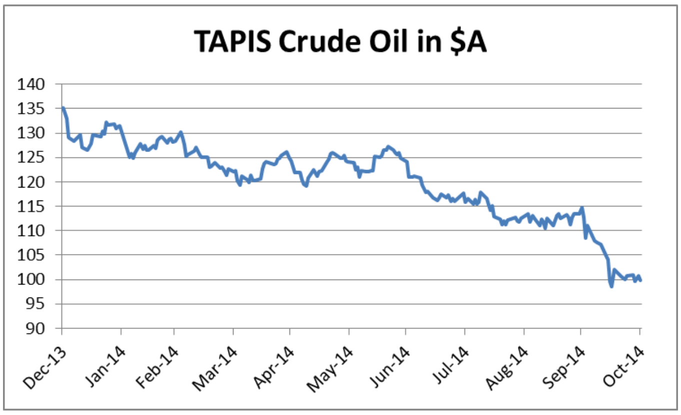


Source: Bloomberg

October marked the end of Quantitative Easing (QE) in the US and, despite the fears of some, its stock market has so far absorbed the change with aplomb; after all its economy is now trundling along quite nicely.

However, Japanese monetary authorities look like they will be taking up any slack that might be left by the US by kicking off a further and larger round of QQE: Qualitative and Quantitative Easing. This is subtly different to US-style QE as it involves buying equities as well as bonds. It now aims to increase Japan's monetary base by ¥80 trillion per annum (that's ¥80,000,000,000,000 or $A800 billion) and get inflation up to its desired level of 2%.

Commodity prices continue to weigh on the Resource sector. Oil has been falling sharply, and the grade most relevant to Australia (Tapis) is down sharply since the start of the year; in October alone it fell by 13% in $A. This is gradually coming through to petrol prices and should provide something of a fillip to consumers' spending power in the lead-up to Christmas if sustained. Iron ore was essentially unchanged at $A90/tonne as at the end of October, but this is down from $A150 at the start of the year. These are tough times for our major resource exporters.



Source: Bloomberg

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	4.1	-1.7	5.5	16.9	15.9	11.9
S&P/ASX 200 Accumulation Index	4.4	-0.6	6.4	15.5	13.8	10.4

*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).

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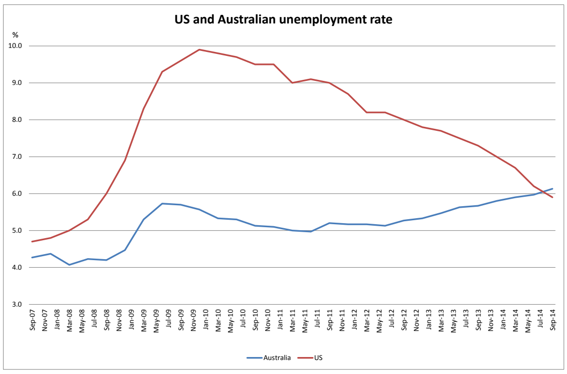
Portfolio comment

The portfolio underperformed the market a little in October. Positives included gaming company Aristocrat Leisure and being underweight major banks Commonwealth and National Australia Bank. Against that however, our position in another major bank, Westpac, and not owning CSL detracted from the Fund's performance.

Market outlook

Last month we wrote about how we felt the sell-off in September appeared overdone considering that the global growth outlook hadn't changed that much: a stronger US largely offset a weaker Europe, and the local market would be getting a boost from the lower $A. The October rebound then begs the question: where to from here? On the global front, the US rate debate hasn't concluded either way so we could see more volatility here, but for now markets have been calmed by a solid September quarter reporting season in the US as well as some pretty encouraging wage and employment data there.

In Europe, the European Central Bank has at least partially implemented some Quantitative Easing which should help, and closer to home Japan has stepped up its QE program considerably. So while the US is edging closer to increasing interest rates, the rest of the world appears to be continuing the flow of cheap money. Back home there appears to be little movement in the economy with the recently concluded bank reporting season continuing its trend of low credit growth but also very low bad debts. The unemployment rate in Australia is also creeping up and is now officially above that of the US.



Source: Bloomberg

In summary, it feels as if we're back to the familiar theme of a share market which is well supported by a solid dividend yield relative to cash and bonds, but capped by lacklustre earnings growth. An annual return in the 7-10% range looks plausible under such a scenario.

Portfolio outlook

Notwithstanding the soft relative performance for the portfolio in October we are encouraged by signs of increased differentiation in performance between those companies that are seeing upgrades to earnings relative to expectations and those that are not. We would expect the portfolio to benefit from this trend should it continue in coming months, which would be more consistent with history than the experience for much of 2014.

The increased market volatility has, as we expected, provided new investment opportunities. One such opportunity we capitalised on during the month was financial services company IOOF. The company has steadily expanded its wealth management platform creating sizeable synergies along the way. Its most recent acquisition in the financial advice area, while large compared to previous purchases, is consistent in terms of expected efficiency improvements. Fund flows will of course be subject to market fluctuations but IOOF is benefiting from its increased scale and diversity and is well positioned to deliver earnings ahead of market expectations, in our view.

Fees	
2013/14 ICR	1.23%
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	+0.20%/-0.20%

Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size ($A)	14.0m
APIR code	HOW0026AU

Asset allocation	As at 31 October 2014 %	Range %
Securities	97.8	90-100
Cash	2.2	0-10

Top 5 active overweight positions as at 31 October 2014	Index weight %	Active weight %
Westpac Banking Corporation	7.9	6.5
Telstra Corporation Limited	5.1	4.9
Commonwealth Bank Of Australia	9.5	4.6
Goodman Group	0.6	4.2
Woodside Petroleum Limited	2.1	4.0

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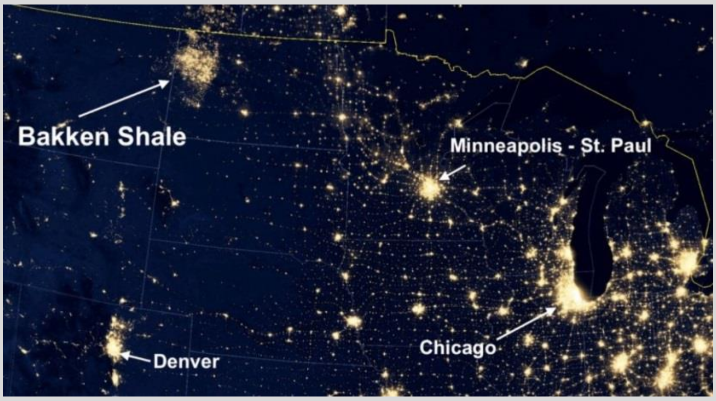
BTW

The energy revolution that has taken place in the US in recent years may not have been noticed very much in Australia but is at least part of the reason for the sharp drop in the price of oil over the course of this year. The US has moved from being a sizeable importer of oil for decades past to now being self-sufficient, removing from it both a big foreign exchange burden and a vulnerability to geopolitical instability.

The scale of oil and gas development there is even visible from space. While you would expect to see the lights of major urban areas, there is now what looks like a mega city in a place that would have been pitch black just a few years ago. The photo here was taken by NASA and appeared in the Washington Post. The Bakken Shale formation which stretches across North Dakota, Montana and into Canada is now clearly visible and, while it lacks the intensity of light of a major metropolis like Chicago, the geographic spread is impressive. And the economic impact is equally impressive.

The light itself is a combination of things: much of it is illumination of oil derricks and mining camps, but there would also be a number of gas flares, where uncatchable or unusable gas is burnt off rather than released into the atmosphere. The gas boom has also become an economic boon for North Dakota which is now producing a million barrels of oil a day, and enabled its GDP to grow at the fastest rate of any US state in 2013. And not only the result of oil and gas: it has also had flow-on effects to business and especially property – rents in some parts of North Dakota rival those of Manhattan.

Of course the process of extracting oil and gas from shale rock is more than a little controversial. In order to get the rock to release the hydrocarbons it needs to be fractured, and the various processes required to “frack” a hard rock like shale has a lot of critics. It is much more environmentally intrusive than the relatively gentle fracking required in Australia’s soft coal – and even that practice generates enough bad press here.



Ironically, the success of the industry may end up its undoing. As the price of conventional oil falls, which is at least partly a result of there being so much US shale oil around, the relatively high-cost unconventional oil sources become less economically viable. The International Energy Agency has estimated that a decent portion of US oil production has a break-even price between $US60 and $US80 barrel. At the end of October the price of West Texas Intermediate Crude was $US80/barrel, the lowest price since the end of the financial crisis, so things are starting to become marginal.

Does this mean that shale oil production will cease if the conventional oil price falls much further? No, it isn’t quite that easy to start-up and shut-down production and in any case the cash cost of production (which excludes capital costs which are largely sunk and not able to be recovered whether you produce the oil or not) would be well below that, so it would take a much lower oil price than now to impact US production. However it will inevitably impact exploration activity, so if you worked for a US engineering company specialising in oil, might be wise to go easy on the Christmas gifts this year. But a lower oil price, if sustained, would ultimately be good for US (not to mention global) economic activity so, as always, there will be winners and losers.

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Traveller's Tale

Andrew and Stephane both went to sunny Queensland in October to kick some tyres (or coal train bogies in Andrew's case). Visiting Gladstone, you would be forgiven for thinking the resources boom was still in full swing. There are still enormous multi-year projects going on in the area, with total construction spending approaching $100bn. The three Liquid Natural Gas plants on Curtis Island (pictured) are nearing end of construction, although the Wiggins Island Coal Terminal (WICET) and Wiggins Island Rail Project (WIRP) are less advanced. The scale of all these projects is mind-blowing to see in the flesh.

Of course while the coal seam gas is booming as an industry in Queensland, the price of coal itself is under a lot of pressure and there is a suspicion among some that the WICET project is quite deliberately being run behind schedule, and that some in the industry wouldn't mind if it stayed that way!

It is a reminder that the resource industry requires very large and very long term decisions to be taken without much control over what the price of what it produces will end up being. It also explains why despite the currently depressed coal and iron ore prices a number of large projects are still going ahead, including the Galilee Basin coal fields in Queensland and the West Pilbara iron ore in WA.

WICET was devised and planned over about a decade and during a time when far more tonnes of coal were bid into the project than it could possibly handle. This explains why there are plans drawn up for three further WICET expansions which, if constructed, would grow the port from 27 million tonnes pa now to 114 mtpa when fully built out. For some context, the whole of Queensland only exported ~208mt in 2014!

While Gladstone is being transformed by these projects it is the aftermath that will be more interesting. It takes far more people to build a gas plant than to operate one: for example at the peak the number of workers on the three LNG processing plants was ~11,000, whereas it will take fewer than 1000 to run and maintain. Similarly for WICET: ~1000 construction workers but ~100 to run. The canary in the coal mine, so to speak, is the local property market and some evidence of stress can already be seen. The Gladstone Observer ran an article in October pointing out that although property is booming in much of the rest of the country, house prices in Gladstone were down 13% over the year and unit prices a whopping 25% - and that's before the construction teams have left!

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