Monthly comment – October 2012

Alphinity Wholesale Concentrated Australian Share Fund

An ill wind

Market comment

The depredations of hurricane Sandy across the eastern coast of the USA and Canada, which closed US markets towards the end of the month, didn't stop Australian shares rising 3% in October. The S&P/ASX300 (including dividends) has been up for five consecutive months and has now 15% above its most recent low in June. The market is up 10% for the 12 months ending October, despite all the challenges still facing the world economy. The most obvious immediate challenge is the 'fiscal cliff' in the US, whereby the US government is bumping against its debt ceiling. If that ceiling is not lifted there will be automatic spending cuts and tax increases in the new year, which will put at risk the nascent recovery underway in the US. The political climate is not conducive to that being resolved, but history suggests it will be.

Major offshore markets lagged Australia: the US S&P fell 2% but UK, Japan and Germany all rose by a little under 1%, France a bit better up 2%. Hong Kong was 4% higher but the main Chinese indices showed sharp divergence: shares on the Shanghai exchange fell by 0.8% but China H-shares – which are Chinese companies traded in HK but only available for non-Chinese buyers – rose by 7.6%, possibly indicating an increasing willingness of foreigners to gain exposure to that market after a period of some softness.

The $A was flat for the month but commodities and precious metals were mostly lower: copper fell 5%, lead and aluminium were –10%, zinc –11%, and nickel –12%. Tapis Oil fell by 6%, silver by 7% and gold was a relative outperformer, only falling 3%. In such an environment, Australian resource stocks held up very well.

Portfolio comment

The portfolio performed strongly in October from a diverse collection of stocks. Property companies Goodman Group and Lend Lease contributed well, as did automotive and sports retailer Super Retail Group, global travel agency Flight Centre, diversified resource group Rio Tinto and not owning gold producer Newcrest. The only individually meaningful detractor was engineering group WorleyParsons.

Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	17.0
Asset allocation	Australian equity: 98.7%, Cash: 1.3%

Fund performance* – as at 31 October 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	4.1	8.7	13.8	3.5	7.4
S&P/ASX 200 Accumulation Index	3.0	7.5	10.3	3.1	5.9

* **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 October 2012

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	7.2%	4.0%
Rio Tinto Limited	2.3%	3.9%
National Australia Bank Limited	5.4%	3.8%
Lend Lease Corporation Limited	0.4%	3.2%
Insurance Australia Group Limited	0.9%	3.2%

Market outlook

The gains made by the Australian equity market in October were significant: not only because they represented the fifth consecutive month of positive returns, the longest winnings streak for more than three years, but because they were made in the face of further earnings downgrades as many industrial companies made cautionary annual general meeting (AGM) comments, many resources companies released weak production reports, and two of the major banks announced lackluster full year results. The fact that the market ended higher despite these headwinds is encouraging as it suggests that market participants are increasingly attracted to the better relative valuation of equities compared to bonds and cash. The breadth of the market gains, with all main sectors providing positive returns for the month, was also noteworthy as it means that the market should be less vulnerable to a specific setback (such as lower growth in China or falling commodity prices). While stronger earnings will eventually be required for the market to move sustainably higher, lower interest rates and at least a moderating – if not outright weakening – Australian dollar should help in this regard. Tempering our enthusiasm is the fact despite almost 12 months having now passed since the current rate cutting cycle began last Melbourne Cup Day, there are few notable signs that monetary stimulus has had any meaningful impact on consumer confidence and spending/investment decisions. But for now, the weight of money argument seems to be winning out.

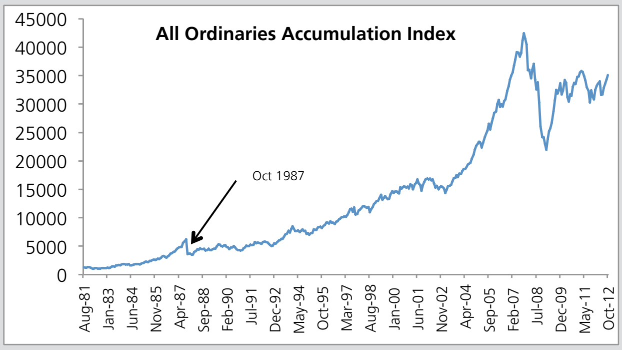
Portfolio outlook

There were no major shifts in the portfolio during the month. It remains underweight in resources and around benchmark weight in banks. The largest positive sector skew is in Insurance, where we are positive about the outlook for both general insurers such as IAG, and life insurance/wealth managers like AMP. One of our larger underweight sector positions is in consumer staples: we find it difficult to justify current valuations given a fairly sober earnings outlook for each of the companies.

Property developer, constructor and owner Lend Lease has been one of our largest active stock positions since about the middle of the year. We are generally fairly cautious about investing in property companies, and the GFC is an example of what can happen when things go wrong, but Lend Lease has developed a much more integrated business model than its peers making it less dependent on winning new construction contracts than most. It has a multi-billion dollar pipeline of projects that stretches on for years and has shown itself to be an accomplished deliverer of major construction projects. Having secured commitments for the first two towers of Barangaroo in Sydney, the potential for a third tower and a Crown-financed casino/hotel provides further upside. It has earned the credibility to be included on the short-list of any large, complex build going on. Combined with an inexpensive valuation, we believe a substantial overweight in the portfolio is warranted.

Time travellers tales

This month marked the 25th anniversary of the 'crash of 87' which saw the All Ordinaries Accumulation Index fall from 6197 at the end of September to 3586: down 42% in a single month. Whereas many of today's fund managers were still in primary school in 1987, some of Alphinity's team had already finished university and were working in the markets to experience that formative event. Cataclysmic as it seemed at the time, however, that 'crash' now appears as a mere blip on the long term chart and actually provided a great buying opportunity in the right stocks. The same index (which includes dividends) has gone on to reach 35333 at the end of October 2012, a multiple of almost 10 times. These numbers help put the last few years into some context: we expect that investing in the right equities will remain the best source of returns over time and that, looking back in a few years, 2008-9 will also be just a blip – painful as it was. While the quantum is impossible to forecast, equities should certainly provide better long-term returns than bonds or annuities, the capital value of which will continue to be eaten away by inflation.



Alphinity is very focused on stock selection: avoiding the wrong stocks is pretty much as important as buying the right ones. The '87 crash is an example: had you bought Bond Corp, Bell Group and Elders IXL afterwards you would have lost everything; had you bought good quality shares however, you would have done very nicely indeed.

For example:

- NAB has gone from $3.90 in October 1987 to $25.79 in October 2012 and paid $28 in fully-franked dividends over that time: $100 (25 shares) would now be worth $644 plus franked dividends of $713 – a minimum value of $1,357 and, depending on your tax situation, probably a lot more. The other banks are fairly similar.
- A $100 (37 share) investment in BHP at $2.70 then would now be worth $1,267, in addition to which you add $925 of partially-franked dividends and distributions – a minimum value of $2,192.
- However, had you bought a $100 ten-year bond in October 1987 at the then sky-high yield of 13.6%, rolled it at the prevailing yield of 5.9% in 1997 and then into a five year bond at 6.5% in 2007, you'd now have your original $100 plus $228 of (fully-taxable) interest income.

Ten year bonds now yield a touch over 3%: buy one now you will have $132 in ten years: no more, no less. Even after the recent rally, the risk/reward equation remains very firmly in equities' favour.

BTW

Italy is home to many famous automotive brands: Ferrari, Maserati, Lancia, Alfa Romeo, all of which are owned by the mass-market car-maker Fiat. Fiat also owns almost two thirds of US manufacturer Chrysler, having extricated itself from a messy deal with US manufacturer General Motors in 2005. It exited that deal with a $US2 billion cheque from GM: Fiat notionally used some of that money in 2009 to buy into one of GM's main US competitors. It is now providing small car expertise to Chrysler – something that brand desperately needed. It is odd to think that the tiny Fiat 500 might have a future in the land that brought Hummer to the world, but the success of BMW's MINI – now quite ubiquitous in many parts of the US – suggests that Fiat might be onto something.

It is difficult to make money on small cars. They cost almost as much to develop and make, yet people are not willing to pay much for them – the MINI is an exception. According to its 2011 accounts, Fiat earned almost as much from selling Ferraris and Maseratis (€352m) as it did from its more plebeian brands (€430m). It is fascinating to parse the numbers further: Fiat made a paltry €211 on each of the 2.03 million 'normal' cars it sold but €6,500 per Maserati (of which it sold 6159) and a staggering €43,000 for each of the 7195 Ferraris that left the showroom! China was cited as a strong market for supercars in 2011: Maserati volumes doubled and Ferrari was up 63%.

Considering the various economic challenges facing the economies of southern Europe, it should be no surprise that conditions in the Italian car market remain tough: Fiat's CEO has described it as 'a disaster'. The impact of austerity measures and very high petrol prices (now €2 or ~$A2.50 a litre) has meant, the UK Daily Telegraph recently reported, that Italian car sales overall are 20% lower than last year, and that the number of bicycles sold (1,750,000) has for the first time surpassed the number of cars (1,748,000). But more serious than buying fewer cars, a recent survey found that 60% of Italians have cut their expenditure on food – even staples like milk and olive oil. Local forecasters now expect consumer spending to fall by 3% in 2012, the largest drop since it became a republic in 1946.

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