Monthly comment – October 2011

Alphinity Concentrated Australian Share Fund

Off to the races

Market comment

The market rebounded with a vengeance in October, after the fairly tragic September quarter .The S&P/ASX300 including dividends rose by 7.2% in October, clawing back much of the prior months' falls. Unusually, both the Energy and Financials sectors put in strong performances during the month, while Health Care, Telecommunications and Consumer Staples were all flat.

The strong overall market was a little less than the US (+10.8% in local currency – its largest monthly gain in 20 years) and the UK (+8.1%) but much better than Japan (+3.3%). Europe was also strong (+9.4%) on hopes of some resolution of their sovereign debt woes, though the rally was fading at the end of the month as renewed doubts about the latest rescue deal emerged.

The $A rallied with the market rebound, rising from $US0.967 at the end of September to $1.053 despite some soft domestic economic data, but most important was inflation which was shown to have moderated further in the September quarter and paved the way for a small rate cut on Melbourne Cup Day.

The eyes of global equity markets were firmly fixed on the evolving train wreck in Europe, but it is hard to get too excited about the purported solution. Meanwhile, the China slowdown fears have abated somewhat and, even though many resource prices took a hit, share prices rebounded.

Portfolio comment

The portfolio performed well in October, both in absolute terms and relative to the market. The biggest contribution was from not owning defensive supermarket retailers Woolworths or Wesfarmers, or gold producer Newcrest; while our overweights in National Australia Bank, oil and gas producers Oilsearch and Santos worked well. Detractors included defensive stocks like toll road operator Transurban Group and Telstra, and not owning ANZ, though the fund benefited from an overall overweight to the bank sector.

Market outlook

Global equity markets in October were dominated by the high drama in Europe and rallied as the risks of a repeat of the GFC subsided with the new debt restructuring deal for Greece. The fallout in terms of the impact on economic growth, both in Europe and globally, is likely to now come into increased focus. The economic outlook is thus likely to remain unusually uncertain, and a reason for a well-diversified investment strategy. For the Australian equity market, the global flow-on effects are of greater importance than a slowing Europe. In particular, any impact on China where the Government-controlled tightening of financial conditions to rein in inflation has already seen a policy-induced slowdown in the economy.

Fund performance* – as at 31 October 2011

	APIR code	1 month (%)	Quarter (%)	1 year (%)	Since inception (%)
Alphinity Concentrated Australian Share Fund	EQI0001AU	8.2	–2.8	–6.8	1.4
Alphinity Wholesale Concentrated Australian Share Fund	HOW0026AU	8.3	–2.5	–5.8	2.2
S&P/ASX 200 Accumulation Index		7.3	–1.3	–3.7	2.2

* 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.

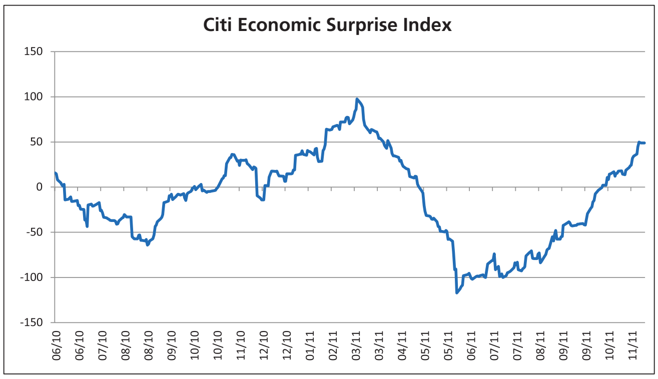
Top 5 active positions as at 31 October 2011

Alphinity Concentrated Australian Share Fund

Issuer Name	Portfolio Weight (%)	Active Weight (%)
National Australia Bank Limited	5.5	3.5
BHP Billiton Limited	11.8	3.1
Westpac Banking Corporation	6.6	3.0
Rio Tinto Limited	2.9	2.6
Santos Limited	1.1	2.5

While the direct link to what is going on in Europe is somewhat opaque, but nonetheless likely to exist, the official monetary tightening in China appears to have been exacerbated by lending from non-bank sources (the so called shadow banking system) drying up more recently. The impact has been especially noticeable in the housing construction sector, the largest user of steel in China. As Stephane writes in his 'Travellers' Tales' from his recent China and India research trips, this is likely to be negative for demand for Australian iron ore and metallurgical coal. The slowdown is in our view likely to last a bit longer than current market expectations. We share the view that inflation in China appears to have peaked, and this will allow the Government to ease some of the austerity measures should the economy slow more than intended. It's just that we don't see that policy makers are in any hurry and are quite happy for property prices and construction activity to slow.

While economic data out of Europe is likely to worsen over the next few months, recent US data has been more encouraging. We have updated below a graph of Citi's US Economic Surprise Index that we first published in the May 2011 Monthly Comment. It has shown a very solid bounce from those lows, supporting our long-held view that the US is still in a slow growth recovery.



Source: Bloomberg
Date: November 2011

In summary, from an Australian perspective, global growth is slowing but not collapsing. The RBA rate cut, in our view to a large extent was 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

Our portfolio allocation reflects the unusually uncertain economic outlook, and we used the October market rally to trim our resources exposure further. However, as we see a soft landing in China rather than a hard landing, we believe that the impact on the related mining services sector will be much less significant compared to the GFC and that the miners, especially at the big end of town, will push ahead with their capacity expansions as planned. This, coupled with the recovery from last years' floods, should result in good volume growth and high activity levels. We have added to our holdings in this sector. We also retain our overweight to the energy sector where our holdings are more based on the longer-term growth in energy demand, and the delivery of large scale projects which are now underway. More defensive, high yielding stocks such as Telstra, MAp and Transurban also feature prominently in our portfolios. In addition to being resilient to economic volatility, these stocks also have underappreciated earnings growth drivers in our view. The RBA's 0.25% interest rate cut has seen some renewed interest in consumer discretionary stocks. We remain cautious on the short-term benefit to the listed retailers and domestic house builders, however, we expect the other rate sensitive sector – the Banks – whose earnings are also more resilient in the current economic climate, to continue to perform well.

Traveller's Tales

Stephane is just back from India and China. He says 'while it is hard to come back from China unimpressed, the same cannot be said about India. Little seems to have changed since my first trip there in 2003!'

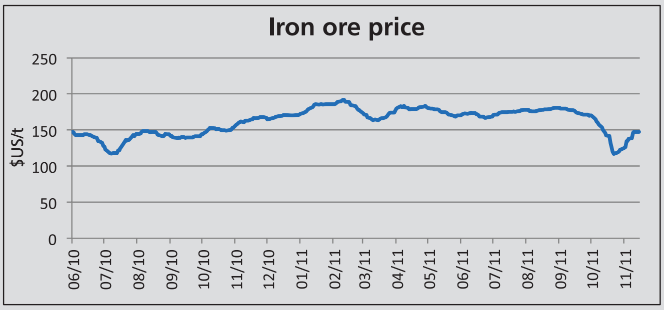
The purpose of this trip was to update our commodity views and get the pulse of economic activity and latest policy intentions. In India, has the recent ban of iron ore exports in Karnataka tightened the market? Is this structural or just a one-off, and if so, how long will it last? How acute are thermal coal shortages, and how big are they likely to become? Is Chinese steel production (which accounts for about half of global steel production) still likely to grow by 7-8% per annum next year? What is the impact of post Fukushima on China's energy strategy?

So many questions, the answers to which strongly affect our view on supply demand fundamentals, and the prices we expect. We sought views by meeting companies across the value chain, across the country and by also meeting with influential government bodies and consultants. It's fair to say that we came back with a view that both countries face a period of lower GDP growth over the next 6-12 months, but for different reasons.

In India, the slowdown is driven by a desire to control inflation through higher interest rates. Unfortunately, this is not assisted by allegations of corruption at political levels which have resulted in the freezing of much-needed infrastructure decisions. This should change as some large state elections take place over the next year.

In China, tightening has been going on for almost a year now in an effort to cool the after-effects of the large (4 trillion RMB) stimulus package in 2008. This self-inflicted tightening is very healthy and aims to address the heated property market, which has been fuelled by excess liquidity, negative real interest rates and limited investment alternatives. The other main objective is to bring back inflation from its recent peak over 6% in August to a more healthy 4-5% range, even if this comes at the cost of lower (7-8%) GDP growth. It is very clear from our meetings that this tightening has severely impacted the cash flows of companies, especially Small/Medium Enterprises and property developers. October's drop in inflation to 5.5% has been coupled with expectations that the government is about to ease credit conditions, thereby bringing needed oxygen to the economy, but we believe this easing will be very selective. We believe the government is determined to see a meaningful (i.e. 10-30%) fall in prices in the residential property market by keeping a tight grip on lending to buyers and developers, with the hope that developers will redirect efforts to low-income 'social housing' over the next three years. While social housing will provide welcome activity, it will barely offset the decrease in the broader residential market so we predict flat construction activity next year. This is really important from a commodity perspective as not only will it influence confidence in the economy, construction directly accounts for 30% of Chinese steel consumption and indirectly a further 20%. All in all, we do not expect a hard landing in China, just a speed-bump in what will be an ongoing growth story. We believe economic growth in China next year will be around 7-8%, in line with the maturing nature of this developing economy.

For commodities, we believe that steel consumption will slow in China to around +3% next year. It will grow 10-15% in India, but from a base which is a tenth that of China. This will put pressure on iron ore and metallurgical coal prices in the short term. We have therefore become cautious for the near term on those bulk commodities despite the recent bounce in iron ore prices.



Source: Bloomberg
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We came back very positive about thermal coal prices, as imports by India should more than double by 2015: its domestic coal production is struggling to meet demand growth, and a third of its coal will continue to be trucked to China until at least 2016. In the meantime, China's increasing costs and its appreciating currency will provide support to thermal coal prices.

We are adapting our portfolio positions according to these insights.

BTW…

How happy are you really? The USA's founding fathers declared that 'Life, Liberty and the pursuit of Happiness' would be some of the 'unalienable rights' to which its citizens would be entitled. Economists usually measure well-being in purely financial terms, for example using a country's per capita GDP or GNP to judge how well off its people are. The Kingdom of Bhutan created the concept of Gross National Happiness in the 1970s, and has included measures such as limiting de-forestation – a practice that might provide an economic boost but detract from the living conditions of citizens – in its measurement of the country's progress. Thailand has been measuring happiness since 2006, with mixed outcomes and occasional allegations of data manipulation, and even the UK has considered going down the same route (at least, it did in 2010: nothing has been heard since, and the mid-year riots probably set it back a bit).

The latest country on the Happiness bandwagon is North Korea. It recently released an assessment of 203 countries and found that the citizens of North Korea were the second-most happy people in the world, somewhat at odds with the common Western perception of a starving population being oppressed by a totalitarian regime. China was rated the happiest, Cuba was #3, followed by Iran and Venezuela. Poor old USA came last, and the North's fierce rival South Korea was number 152. Despite utilising the vast research resources available to Alphinity (at least, a quick Google search) we were unable to find North Korea's ranking of Australia. We suspect it is probably somewhere towards the bottom.

Far be it from us to question the credentials of those who compiled that particular index, but we prefer the Gallup World Poll's global survey of happiness in 2010 which was published by that capitalist lapdog Forbes magazine. It showed Australia tied with Canada, Israel and Switzerland in 8th spot, beaten only by the four Nordic countries, the Netherlands, Costa Rica and New Zealand. USA came in at #14 and North Korea didn't get a mention. Maybe Gallup had difficulty finding enough North Koreans with a phone to survey.

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