Alphinity INVESTMENT MANAGEMENT

Quarterly comment – September 2011

Alphinity Concentrated Australian Share Fund

Risk off (again)

Market comment

The S&P/ASX300 fell in September for the sixth month in a row, being off 6.3% in September alone and 11.6% for the September quarter. Global equity markets were all weaker and the quarter set an ignoble record as the 3rd worst since 2000. Investors fearful of a repeat of the GFC in 2008/09 reacted to the European sovereign debt problems, the US credit rating downgrade by S&P and negative comments about the world economy from the International Monetary Fund by aggressively selling risk assets. The Australian dollar, always a fascinating illustration of changing risk appetite in financial markets, traded down from a high of US$1.10 to finish the quarter at US$0.97. The domestic economy remains unbalanced, as shown by both business and consumer confidence trending down and unemployment deteriorating somewhat. The Reserve Bank of Australia left the cash rate unchanged but for the first time raised the prospect of lower rates, depending on inflationary trends. Unsurprisingly, defensive sectors telecoms (+11.8%), utilities (-1.3%) and consumer staples (-1.8%) outperformed during the quarter against this backdrop. The resource sector significantly underperformed (-18.8%).

Portfolio comment

The portfolio lagged for the quarter largely due to the strong risk aversion in the market. Solid contributions were from toll operator Transurban, pharmaceuticals company CSL, Westpac Banking and not owning gold producer Newcrest Mining. These were offset however by the portfolio positions in Fortescue Mining, mining services company Bradken and BHP Billiton. Not owning conglomerate Wesfarmers also detracted.

Market thoughts

Global macro factors are likely to continue to dominate financial markets over the coming months, however the upcoming Annual General Meeting (AGM) season is likely to bring some more stock specific commentary that should lead to increased differentiation in stock returns. Early signs from the AGM season suggest that while global uncertainty has increased, the actual impact on trading conditions to date has been quite limited. This is also the overall feedback from our discussions with companies during the last few weeks. So while equity prices seem to be discounting a significant global slowdown (see chart on the following page) which may eventuate, there is little hard evidence to suggest that such a slowdown is actually underway.

Fund performance* – as at 30 September 2011

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (%)
Alphinity Concentrated Australian Share Fund	–6.6	–14.1	–10.7	–5.6
Alphinity Wholesale Concentrated Australian Share Fund	–6.5	–13.9	–9.9	–4.8
S&P/ASX 200 Accumulation Index	–6.1	–11.6	–8.6	–4.0

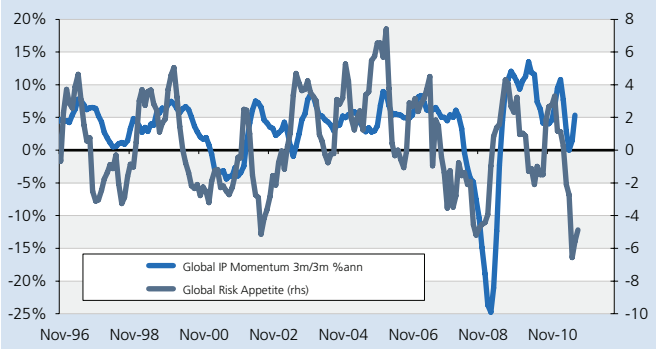
* The Fund changed investment manager and investment methodology on 12 July 2010, at which time Alphinity Investment Management commenced managing the Funds and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 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 overweight positions as at 30 September 2011

Alphinity Concentrated Australian Share Fund

	Index weight (%)	Active weight (%)
BHP Billiton Limited	12.4	4.5
Westpac Banking Corporation	6.1	3.4
National Australia Bank	5.1	3.1
Rio Tinto Limited	3.1	3.0
Transurban Group Stapled	0.7	2.4

Global risk appetite vs. Global industrial production



Source: Credit Suisse

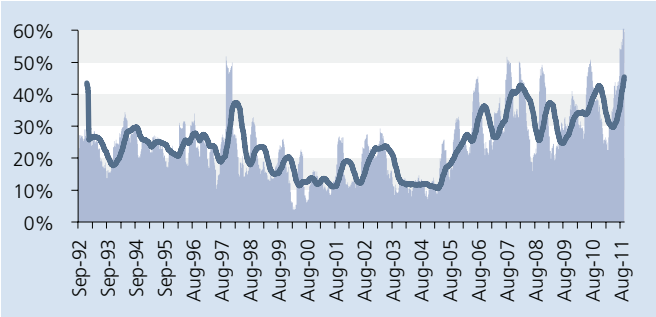
A recapitalisation of the European banks, which appears to be getting closer, should reduce the risk of GFC Mk II and allow the market to focus more closely on the underlying economic and company data. In our view, this data may not be as bad as equity prices are suggesting, and thus a stabilization of equity markets (at least) appears likely over the coming months.

Regular readers of our investment reports would be familiar with our view that as global growth over the last decade has become more and more driven by developments in emerging markets rather than the developed world, the outlook for the world economy may not be that bad. Global trade and finance flows will have some impact but developments within the developing economies are more important for our view of energy and resources demand. While iron ore and coking coal prices have been resilient throughout the global turmoil, property sales in China have slowed due to tighter monetary conditions and some nervous investors have pushed the sell button on Australian resource stocks. We find that the best insight on what is really going on will always be found on the ground, and to that end Stephane is heading to India and China in November. We look forward to reporting to you our conclusions from that trip in the future.

Portfolio thoughts

The market at present is highly correlated, meaning there is little differentiation between stock performance. Most price movements are caused by market movement rather than stock-specific factors and therefore there is little or no reward for stock picking. The chart below illustrates this point: active management is able to add the most value when correlation is low, i.e. stocks are moving independently of each other for reasons specific to those stocks. We are encouraged that, according to the chart, periods of high correlation generally don't last for long – so we can look forward to more normal times re-appearing before long.

Average correlation between the ASX 200 members



GS&PA Research, IRESS

We are maintaining a portfolio overweight in banks and energy while we have trimmed our metals & mining exposure to close to benchmark ahead of getting a clearer picture of what the actual demand impact from the global uncertainty and the slowdown in Chinese property sales is likely to be. While we see limited value in the consumer staples sector, our portfolio has several resilient stocks such as infrastructure companies MAp Group and Transurban as well as telecommunications company Telstra, which in addition to being a stable dividend stock has, in our view likely turned the corner in terms of the company's earnings outlook, partly driven by its mobile phone operations.

One of our largest sectoral overweight is in energy, both through oil & gas companies such as Santos and Oil Search and energy coal producers such as New Hope and Whitehaven Coal. We see several reasons to be optimistic about the energy sector.

We expect the market in thermal coal (which is used to generate electricity, as distinct from metallurgical coal used in steel production) to continue to be tight. Demand will be supported by seasonal factors in the short term, and in the medium and longer term a number of forces: (a) India, whose domestic production struggles to keep pace with its demand growth; (b) China, which faces rising costs and ongoing infrastructure bottlenecks; and (c) by Japan, which will progressively shift its energy mix away from nuclear post Fukushima. 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 our coal exposures New Hope and Whitehaven, which should also benefit from their own production expansion programs.

Additionally, the Liquefied Natural Gas (LNG) market has shifted from a buyer's market to a seller's market also on the back of the Fukushima disaster as well as the ongoing quest for greener/cleaner energy. We expect this market to remain tight for another few years which bodes well for companies negotiating new long term contracts. We believe the margins will be further supported by 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, in addition to which they have: a significant increase in production for Santos as well as rising domestic gas prices, and an active exploration program for Oil Search hoping to underpin sufficient gas for a third LNG train.

BTW…

The devastating earthquake and tsunami in Japan earlier this year brought much suffering to a large number of its citizens, but it also allowed the character of the Japanese people to shine through. Not just the willingness to help others in a time of desperate need (amazingly, this turns out not to be an exclusively Australian trait!), but also honesty.

The LA Times reported recently that in the months after the tsunami, not only were more than 5,700 safes washed up onto the shores of Japan and turned in to police, vast amounts of loose cash were also handed in. This included ¥300,000 (~$A40,000) found in an envelope and ¥200,000 in a purse that was spotted on top of a pile of debris. Having been submerged in water and mud for some time, it was quite an effort for the police to get into the safes and while some were empty, others were found to contain cash (over $1m worth in one case) as well as bank books, property title deeds, gold bars and (presumably small) antiques. The contents of the safes have now been returned to owners. The cash in the safes was around ¥250 million but unsecured cash handed in was close to ¥400 million, and many of the finders have reportedly waived their rights to the cash should the owners not be located.

As the Times says: *'Altruism and honesty among different cultures are difficult to measure and compare, but in 2003 a University of Michigan Law School professor conducted what he called a comparative study on recovering lost property in the United States and Japan. [He] left 20 wallets on the street in Tokyo and 20 in New York, each containing the equivalent of $20. In New York, he said, six wallets were returned with the cash intact and two were brought back empty. In Tokyo, finders returned 17 of 20 wallets, all with the cash intact, and all but one waived the right to claim the money if the owner wasn't found.'* One wonders what the result might be if the same experiment were conducted in Sydney…

Alphinity Investment Management

Level 15, 255 Pitt Street
Sydney NSW 2000

T 02 9994 7921

F 02 9994 6693
W www.alphinity.com.au

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