Quarterly comment – June 2011

Alphinity Socially Responsible Share Fund

Mid-winter Chills

Market comment

The S&P/ASX300 fell by 4.3% (including dividends) in the June quarter, recovering from June's low point of –7.5%. Ongoing turmoil in European sovereign debt markets, mixed signals in the US economy and further official efforts to moderate growth in China contributed to perceptions of slowing growth in the Australian economy. Precious metals were modestly higher but base metal prices fell modestly over the quarter, and oil fell by just over 10% as US economic concerns grew. The $A however, which is often seen as a proxy for world growth, rose from $US1.032 during the quarter to finish at $US1.072, via $US1.10 in April. The domestic economy remains soft, as shown by both business and consumer confidence trending down and full-time employment disappointing somewhat. The Reserve Bank of Australia left the cash rate unchanged and softened its rhetoric a little around the likelihood of rate rises, but remains both publicly and privately adamant that its bias remains towards tighter monetary policy. Major international markets were generally softer: down but by a smaller amount than in Australia. Over the quarter, the S&P500 in the US was down 1.9%; UK's FTSE100 down 1.3% and Japan's Nikkei 225 down1.6%.

Portfolio comment

The portfolio outperformed its benchmark over the quarter ending June. The biggest contributor was resource company Equinox Minerals, which was sold into a takeover bid during the quarter having risen almost 40%. Other meaningful positives included mineral sands producer Iluka Resources (+26%), airport operator Australian Infrastructure Fund (0%) and not owning energy company Santos (–13%) or Bluescope Steel (–39%). Most of the performance detraction was from not owning a number of the 'defensive' stocks precluded by our Socially Responsible mandate due to their exposure to proscribed industries. These included supermarket (and gaming machine) operators Woolworths (+3%), Wesfarmers (0%) and recently de-merged brewing company Fosters Group (+12%), which rebuffed a takeover approach from global brewing company SAB Miller in June. However, our positions in fertiliser group Incitec Pivot (–11%), fund manager Henderson Group (–15%) and airline Qantas (–15%) each cost a small amount of performance during the quarter.

Market outlook

The final quarter of the financial year did little to cheer investors already frustrated by the lack of earnings growth in the Australian equity market. As is often the case when negative macro factors dominate, investors took flight to defensive sectors such as telecoms, utilities and consumer staples. And there has been plenty to worry about: natural disasters, nuclear radiation leaks, the European debt crisis, a slowdown in the US recovery and concerns over the Chinese Government's ability to get inflation under control without causing a hard landing of the economy. Look at them in isolation and the picture is less worrying.

The natural disasters have been human tragedies but the economic effects are likely to be temporary. Events such as the floods in New Orleans in 2005 or the Kobe earthquake in 1995 had no long lasting global economic growth

Fund performance* – as at 30 June 2011

	1 month (%)	Quarter (%)	6 months (%)	Since inception (%)
Alphinity Socially Responsible Share Fund	–1.7	–3.7	–0.4	7.9
Alphinity Wholesale Socially Responsible Share Fund	–1.6	–3.5	–0.1	8.7
S&P/ASX 300 Accumulation Index	–2.0	–4.3	–1.3	8.3

*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 lease 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 June 2011

Alphinity Socially Responsible Share Fund

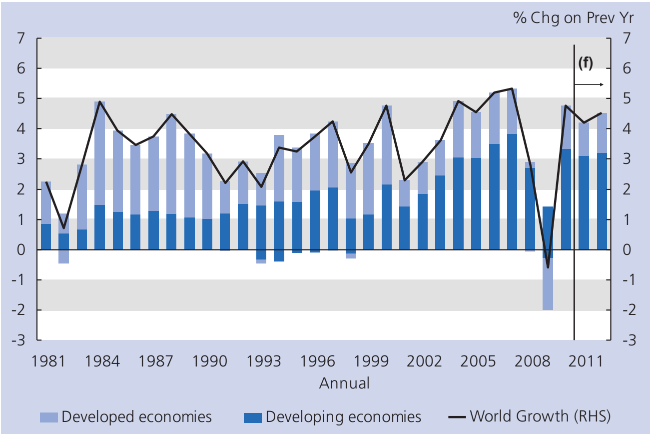
	Index weight (%)	Active weight (%)
Rio Tinto Limited	3.2	2.2
News Corporation	0.7	1.8
Oil Search Limited	0.6	1.8
Bradken Limited	0.1	1.7
Henderson Group PLC	0.1	1.7

impact and we would not expect this year's tragedies to be any different. The European debt crisis and a potential partial default of Greece and Portugal will require painful adjustments by their countries' populations and some European banks, but is less likely to trigger a global debt crisis in a financial world where banks and corporates (and to some extent also consumers) are less leveraged than at the onset of the GFC.

A stronger US economy would be helpful and while more recent data has been weaker than expected, a recent survey by Citi showed aggregate capital expenditure plans to be 17% up in 2011 on 2010: clearly some sectors of the economy are achieving decent growth. Also, the global economy is much more diversified and less dependent on the US than it was even 10 years ago, and economies such as China, India, Russia and Brazil are all important drivers of global growth. The chart opposite illustrates the increasing contribution from developing countries to global growth.

Our recent research trip to China showed that growth is certainly slowing but by no means dramatically, and the Chinese government has shown in the past that if economic growth slows below its comfort levels of 7-8%, it will quickly reverse its policies. But what if China did experience a more significant slowdown? How bad would it be for the Australian equity market?

Developing economies driving world growth

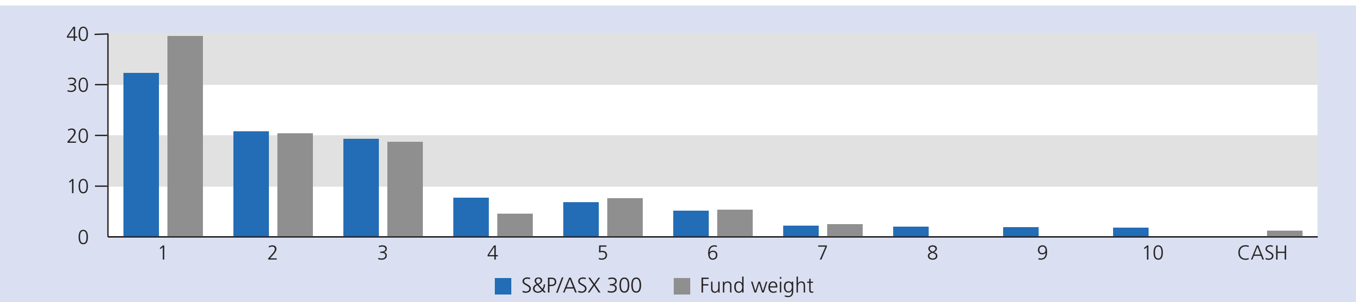


Source: Macquarie Research

While it would obviously be negative for the resources sector, the two major headwinds for Australian industrial and bank earnings over the last year have been rising interest rates and the strong Australian dollar. Both of these should fall in such a scenario thus boosting the non-resources part of the domestic economy.

Finally, while it is easy to be overwhelmed by all the negative commentary, how badly did the Australian equity market do in FY11? Not bad at all is the answer. In fact, the total return for the ASX300 Accumulation Index of 11.9% was above the long run average. To that, those investors who can utilise them can add franking credits. With the market trading at a PE multiple of 11x one year forward consensus

Portfolio and Index by SRI deciles



Source: CAER

earnings, and with a yield of close to 5%, even if there are further meaningful downgrades of FY12 earnings, it is feasible that a similar return will be generated in the new financial year.

Portfolio outlook

The Alphinity Socially Responsible Share Fund portfolio was well positioned for the soft market and we aim to have it positioned equally well for any upswing the market might experience over the balance of the year. Our strategic thesis has been for some time that the sell-side of the market has been way too optimistic, but a large number of downgrades have taken place in recent months to at least partially rectify that. Now we look towards the August reporting season for confirmation of last year's results from the companies themselves as well as thoughts as to the direction of the underlying businesses they operate

The portfolio has had a position in News Corporation for some time, and while we believe that a strong financial case to own the stock remains, the revelations around phone-hacking in the UK caused us to re-assess the position, which was sold in July. There are some encouraging signs that governance might improve in the wake of the scandal, which may make News an investment candidate in the future, however we will need to see the evidence first. The portfolio contains a modest overweight to energy stocks, biased towards the cleaner energy produced by Origin and Oil Search; a significant overweight in industrials, consisting of a number of individual stock stories; and no exposure at all (which is a significant underweight) to consumer staples stocks – many of which fall outside the Fund's investable universe.

BTW...

Motor registries in Australia have cottoned on to a good revenue raising opportunity: if you want to wear your heart on your sleeve and tell everyone which football team you support, you can – for a few hundred dollars and a modest annual fee – buy your car a number plate with that team's logo on it. A recent trip to the US revealed a sobering variation on that theme: we spotted a Texas-registered pick-up truck with a registration plate advising that its owner had been awarded a Purple Heart – the medal awarded for being wounded or killed while serving in the military.

BTW...

The end of a financial year often raises thoughts of charity, for noble reasons or sometimes just for a tax deduction. How does Australia rate in the global giving stakes I hear you ask? A report by the Charities Aid Foundation www.cafaustralia.org.au/research.php suggests that both we and our NZ cousins stack up quite well, with government encouragement to give (tax deductibility) cited as a contributing factor. CAF had the Gallop Organisation poll a statistically significant number of people in 153 countries and used the data to construct a World Giving Index, taking into account not just monetary donations but also the volunteering of time and 'willingness to help a stranger'. Australia pips NZ to top the list thanks only to the alphabet, as the index score is identical for both. Impoverished Madagascar and Burundi come at the bottom of the list. The Foundation also found that there was a close to 70% correlation between countries whose population gives to charity and that populations' well-bring, or satisfaction with life, although it is not clear which is the causal and which is the dependent factor. A less strong but still significant correlation exists between giving and the overall wealth of the country, although Ireland – which has been struggling under very difficult economic conditions for some time – still ranks third overall. As the report says, 'It would be reasonable to conclude that giving is more an emotional act than a rational one'. In just about every region women are more generous with money than men, but slightly less generous with time, and generosity for all country groups tends to increase with age. So, countrymen, take a bow, but also remember to keep digging deep.

Sustainability score

Our external advisor, CAER, assesses the Alphinity Socially Responsible portfolio on a monthly basis for its compliance with the Fund guidelines, and tests the Fund's holdings as to the sustainability of the companies held according to ESG criteria. We are pleased to report that as at the end of June the Fund had environmental factors 41% better than the market, social factors 38% better than the market and governance factors 26% better than the market. Its overall Sustainability Score was 75%, which compares with the ASX300 of 51%.

Traveller's tales…

COCOs and SIFIs

In June, Andrew went to where the real Northern Hemisphere action is: New York, Washington, London and Brussels, visiting financial institutions, bank regulators and terribly important members of the EU and European Commission to gauge the current economic environment and get a better feel for the conditions under which world financial institutions are likely to be operating in the future. The conversations were filled with talk of COCOs and SIFIs – yet more acronyms to add to your financial toolkit – but more of that later.

Economically, the view was mixed – mild confusion reigns as to where things are actually heading. It was clear that a number of sectors hit a wall in May across the northern hemisphere. Many in the US found this hard to explain and were outwardly hopeful that it was just a blip caused in part by the Japanese tsunami tragedy and the wobbles in Europe, but were quietly concerned about a number of domestic issues: a possible double-dip in the housing market, the continued inability for many people to access debt, the unemployment rate and the US sovereign debt position.

The UK seemed far more pessimistic about its outlook, perhaps influenced by its proximity to Europe. It had also seen a slow-down across the economy, somewhat enhanced by the Royal wedding combined with a long Easter holiday. However the UK's austerity measures seem to be biting earlier and harder than was first thought, and they hinted that we should be a bit wary of UK bank credit quality in the next six months. The UK also has a two-speed economy – London and everywhere else – which has implications for NAB's far more regional operations. The broader UK financial sector is clearly also suffering from the debt issues in the PIGS countries (although EU employees have been firmly told to stop using that term).

There was a lot of 'Will they? Won't they?' around Greece (things have played out further since Andrew's visit) and while there seems to be almost universal agreement that Greece will eventually have to default, the 'Extend and Pretend' mantra was trotted out as the best way forward. In a nut-shell, the EU has no idea what the flow-on consequences of Greece defaulting would be and are terrified that it would have large negative consequences for more meaningful economies such as Ireland and Spain, and hence ultimately banks in the UK. Far better to push the issue down the road, and maybe by then those bigger economies will have sorted themselves out. As an interesting aside, while the world seems to be wondering if Greece will be kicked out of the EU, the EU itself seems to have quite the opposite view - it seems to be using this as an opportunity to extend its powers deeper into one of its members.

On bank regulation the message was very simple: 'Banks are bad, they should be highly regulated utilities', and there is very little sympathy for the view that a healthy economy needs banks that make a healthy return. It is very clear, as the recent decision on globally Systemically Important Financial Institutions (SIFIs) capital buffer shows, that every decision on bank capital, liquidity or regulation is likely to fall on the conservative side. Some in the US are still working under the assumption that once again they won't need to follow the world on Basle 3 – we suspect it will be very hard for them not to, and hence a lot of capital still needs to be built up to meet requirements.

One number being thrown around is that an extra $200bn of capital will be required globally by the banking industry to meet Basle 3 requirements. Many felt (hoped?) that they would be allowed to use some form of Contingent Convertible (CoCo) capital to get there. So far, however, the regulators appear to take a more conservative view and prefer conventional equity. The timeline to meet requirements is quite long, but it is not clear to us that the market will allow banks to take their time to get there once the final requirements are set. A potential gulf may open up between the banks that can and do go early to bolster capital, and those that can't.

Either way, the return expectations for banks globally is only going one way. The question that keeps coming up from regulators is 'Why should a bank earn more than 10% Return On Equity?'. With Australian banks generating 15-20% ROEs, that is a sobering thought. Australian banks are in a better position than most global peers, both in terms of starting capital bases and having a pragmatic regulator, but there is only so far the Australian regulators can diverge from the rest of the world and as such we expect pressure will remain on our banks to improve capital levels and to be seen to be as good, if not better than, global peers. This again says to us that there will be pressure on returns over the longer term. Our banks may have escaped the G-SIFI (Global SIFI) buffer, but watch out for the R-SIFI buffer (Regional SIFI). The saving grace for bank share prices however is that they already appear to be factoring much of this in with very appealing yields.

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