Quarterly comment – March 2011
Alphinity Socially Responsible Share Fund

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Market comment

The first quarter of the 2011 calendar year saw the market hit by significant domestic and global uncertainty. January started with floods and fires in Australia, February followed with a large earthquake in NZ and March saw another, even bigger, earthquake in Japan which sparked a tsunami and a nuclear emergency – which remains unresolved even some weeks after the event. In addition, political tensions in various North Africa and Middle East countries which brought down a number of regimes and challenged others, resulted in sharply higher oil prices. All the time, the US economy was recovering from particularly poor weather at the start of the year and showing good signs of a gradually repairing economy. In our own economy, the rich seam of data coming from the February company reporting season provided us with fresh insights into companies we own or are considering.

There was remarkable market movement during the quarter with a 10% move from its highest point to its lowest, but the benchmark finished less than 2% away from where it started. Including dividends, the local market (S&P/ASX300) managed to finish +3.1%. The $A was also volatile in a period which included intervention from the G8 in a successful attempt to restrain Yen strength, but it also finished essentially in line with the December close of $US1.03, albeit with an upward trend.

Portfolio thoughts

The Alphinity Socially Responsible Share Fund returned well above its ASX300 benchmark in the March quarter despite the market volatility. The relative return from this Fund will normally be impacted by its preclusion from owning the large supermarket operators Woolworths and Wesfarmers (Coles) due to the exposure of each to the manufacture of alcohol and operation of gaming machines, however it was not a material impact in the March quarter.

The best contributor in the March quarter was mineral sands producer Iluka Resources, which rose by 46% in the period. UK fund manager Henderson Group PLC also performed well, up 30% despite the impact of a strong $A. Global media group News Corporation was similarly impacted by currency but still managed to rise 11%. Engineering contractors WorleyParsons (+16%) and Monadelphous Group (+17%) rounded out the top five.

The main detractors were BHP +3%, medical device manufacturer Resmed –17%, airline Qantas –14% and industrial product maker Bradken –13%. We continually assess each company owned by the Fund and remain confident about the prospects for BHP, Qantas and Bradken, but have reduced the position size of Resmed.

During the quarter we exited Ansell, Seek and UGL and established new positions in Lend Lease, Macarthur Coal, and Macquarie Group.

Fund performance* – as at 31 March 2011

	APIR code	Quarter (%)	Since inception (%)
Alphinity Socially Responsible Share Fund	GLO0015AU	3.5	12.0
Alphinity Wholesale Socially Responsible Share Fund	HOW0121AU	3.7	12.7
S&P/ASX 300 Accumulation Index		3.1	13.1

*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 31 March 2011

Alphinity Socially Responsive Share Fund

	Fund weight (%)	Index weight (%)	Active weight (%)
BHP Billiton Limited	15.5	13.2	2.3
Rio Tinto Limited	5.1	3.1	2.0
Oil Search Limited	2.6	0.7	1.9
News Corporation	2.4	0.7	1.7
Henderson Group PLC	1.7	0.1	1.6

Sustainability Score

The sustainability characteristics of Alphinity's SRI portfolio is significantly superior to the overall market, according to the monthly assessment performed by our external advisor CAER (Centre for Australian Ethical Research). Compared to the ASX300, our portfolio rates 37% better on Environmental grounds, 38% better on Social and 26% better for Governance. Its Sustainability Score, which weights each stock's ESG characteristics (45% Environment, 30% Social and 25% Governance), comes to 72 which is 41% better than the market overall. Of the Fund's holdings as at 31 March, 12 of the 38 stocks held (31%) were in the top 10% of stocks rated by CAER for sustainability and a further six stocks in the second decile.

Market outlook

As we enter the home stretch of the 2011 financial year our portfolios remain overweight resources and resource-related companies. Our primary exposure remains concentrated in the diversified large cap stocks BHP Billiton and Rio Tinto where we see a superior mix of our preferred commodities (iron ore, coal and copper), attractive valuations and financial strength.

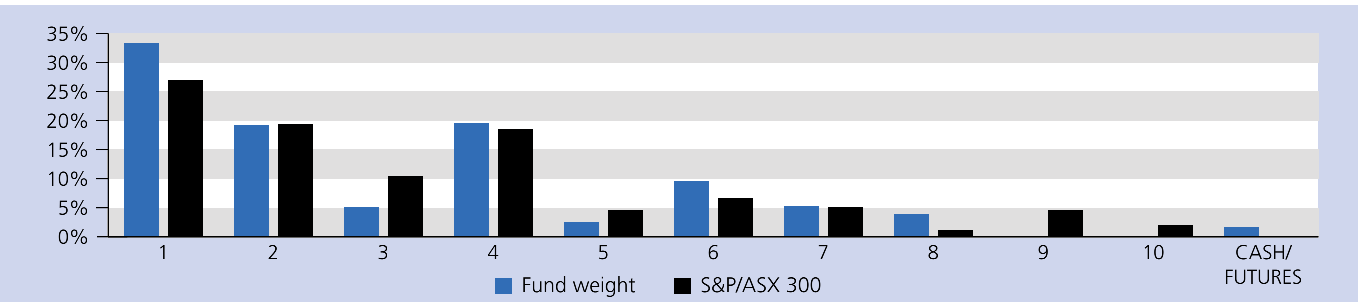
While only cautiously optimistic about the strength of the economic recovery in the US, we have also added some stocks to the portfolio that we expect to benefit directly from the inevitable normalization of interest rates in the US, or indirectly through the flow-on effect of any recovery in the US dollar. Two such stocks are QBE Insurance and healthcare products manufacturer CSL. Again, we see strengthening industry fundamentals for these companies in addition to a potentially supportive macro-economic backdrop.

Traveller's tales…

Johan headed to the USA in March to take the pulse on its economy. His travels took him from technology-dominated California, through the 'rust belt' of Kansas City and Chicago, to energy-dominated Dallas and Houston in Texas then on to New York City. He met with 18 companies across a variety of industries.

Even though the majority of recent economic data suggests that the US economic recovery is gathering strength, he came away with a more cautious view. Things certainly are improving but it looks like the recovery will be slow. New York appears to be on a solid footing as the strong financial markets have boosted the fortunes of the more affluent part of the population. However, low to middle income earners across the country are still struggling and have so far seen little improvement in job prospects. Surveys of corporates' hiring intention have turned positive but consumer sectors are yet to see a meaningful impact.

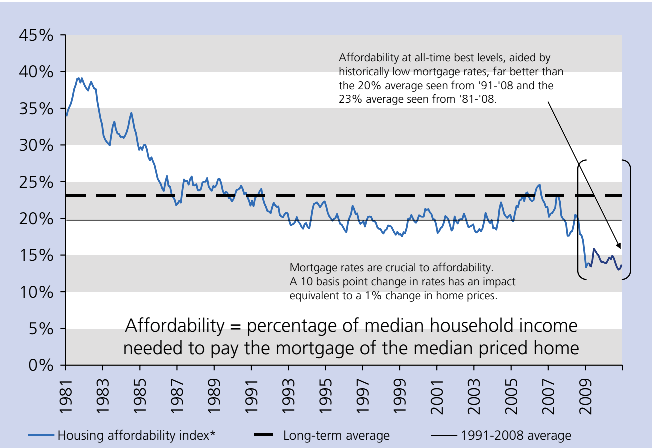
Portfolio and Index by SRI deciles



Source: CAER

The recent steep rise in petrol prices looks to have put the brakes on the economic upswing. On the other hand, Texas reminded him of the two-speed economy back home with the oil price and recommencement of drilling in the Gulf of Mexico lifting activity levels in that state.

US Housing affordability



Source: Credit Suisse

Johan's trip reinforced our view that market estimates for US residential housing starts are overly optimistic at this point in time. We have little exposure in our portfolios to the US housing market however believe it is a sector we need to monitor closely. Decade-low house prices combined with low interest rates (how does a 30-year fixed-rate mortgage below 5% sound?) have resulted in affordability levels not seen in a generation. While not showing up in any statistics, one can't help but think that many potential house purchasers have stayed on the sidelines not wanting to buy into a falling market. This pent up demand should be released once the market shows signs of stabilising and/or the record low interest rates start heading higher.

US manufacturing had been struggling for decades. Recently, however, the weak US dollar and emerging market demand for everything from excavators and planes to power turbines has seen a revival in what is left of many manufacturing industries. With healthy demand and limited supply, margins look set to improve. This should benefit, for example, our investment in Bradken which reported a strong improvement in its US earnings in its recent result.

Capital expenditure in the oil and gas industry looks set to rebound strongly in 2011, a key reason for our investment in engineering services company WorleyParsons. Exploration activity in the US had lagged the rest of the world largely due to the BP disaster in the Gulf of Mexico last year. However, after several meetings with industry representatives it seems to us that the lifting of the moratorium on drilling in the Gulf is gradually translating into activity, adding to global momentum.

While he detected few signs of wide spread inflation, companies with a high level of exposure to commodity costs, soft as well as hard, are likely to face some challenges over the course of the year. The price of raw cotton is now more than twice that of last year and with the consumer having to deal with the recent spike in petrol prices, companies' ability to raise selling prices will be limited. Levi Strauss volumes took a hit when the company recently raised the price of a pair of denim jeans from $32.99 to $38.99. Australian companies may be cushioned from similar issues due to the strength of the Aussie dollar but it is yet another headwind for our local apparel companies which are already suffering from subdued consumer spending.

Some other observations:

- Detroit's city population has fallen by a quarter over the last ten years – back to levels last seen in 1910 – as the US auto manufacturing industry struggled with chronic over-capacity, international competition and a weak economy.
- US manufacturing capacity has by some measures declined by 75% since the 1980s.
- New distribution technologies of streaming TV shows over the internet is rapidly being taken up by the US consumer. The largest streaming company Netflix has 20 million customers and is reportedly responsible for 30% of the internet traffic in cities such as Chicago. The days of chronic over-capacity in broadband may be coming to an end.
- If we didn't know it already, social media marketing is becoming mainstream. Mass market department store JC Penney – or as they like to call themselves these days **jcp** (to appeal to younger shopper) has 1.6 million Facebook 'friends' and are making new friends every day.

BTW...

Pirate economics: Somali pirates have discovered the practical implications of price elasticity of demand. According to the Reuters news agency, one pirate leader named Hussein said that his group was presently holding more than 30 ships, and that dealing with that number was affecting their ability to hijack more ships. By lowering the ransom demanded for the release of the ships, he figured that they would be able to increase turnover. Hussein also seems to have grasped the concept of utility, stating that high ransoms will remain high for captured ships carrying high value bulk commodities. (*NZ Herald* 16/3/11)

BTW...

Former CEO of Royal Bank of Scotland Sir Fred Goodwin has been granted an injunction stopping newspapers publishing information about him, and even identifying him as a 'banker'. And not just an ordinary injunction, but a 'super-injunction': one in which even the existence of the injunction is not to be published. Goodwin's super-injunction was only revealed under the protection of parliamentary privilege. The penalties for breaching this injunction were not made clear, and we know that we're probably well outside the UK court's jurisdiction, but let us make it clear that Alphinity is NOT referring to Sir Fred as a banker. (*The Telegraph* (UK) 10/3/11)

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