Alphinity INVESTMENT MANAGEMENT

Quarterly Comment – September 2015
Alphinity Wholesale Australian Equity Fund

If not now, when?

Market comment

The September quarter was a particularly tough one for share investors: lots of ups and downs but more downs than ups, and the net move was definitively down. The local market (ASX300 including dividends) was down almost 3% in the month and -6.5% for the whole quarter. This was enough to give away the previous nine months' returns: the market was down a little less than 1% for the year ending September even after dividends.

Australia was actually one of the better performing markets for the quarter in local currencies but the soggy Australian Dollar ($A) meant that returns of some other markets looked better when translated into our currency. Brazil the worst, with its mix of a struggling economy, struggling currency and poor resource prices it was off more than 26% in the quarter. China was next worst, down nearly 23%. Hong Kong was down "only" 12% but the US and some European markets had modestly positive returns in $A despite all except Russia being negative in their own currencies.

There was a big focus on US monetary policy during the September quarter – after having virtually zero interest rates since 2008, would the United States Federal Reserve (Fed) finally start on the process of "normalising" (i.e. lifting rates to levels you would normally expect for this point in the economic recovery)? The answer was "no" – it was spooked by jitters in global markets in the lead-up to the meeting in September and decided to hold off for another couple of months.

We're not sure that this was the right decision. If not now, when? The economic recovery in the US is now quite mature, and at 75 months so far it is already one of the longest periods of consistent expansion on record. It is almost getting to the point in the cycle at which the Fed should be preparing to cut rates in order to provide stimulus – but with rates already at zero that option is not available. We suspect that global markets might have reacted positively to a rate rise: the decision to hold off seems to have increased uncertainty and caused further agitation around the globe.

"If not now, when?" was also the question asked by Malcolm Turnbull but he came up with a different answer and seized the day, challenging the incumbent and prevailing to become Australia's new Prime Minister. While this move provided his government with an early bounce in opinion polls and business and consumer sentiment, we hope that he can build on that and provide a little more leadership and direction for industry than his predecessor seemed to be able to.

Commodity prices continued to struggle in the September quarter as further evidence of the Chinese economic slowdown emerged. In fact, China cut official rates and tweaked reserve requirements in an attempt to stimulate the economy but forecasts of its economic growth continue to be downgraded.

Base metal prices suffered in the quarter with zinc off 17%, nickel down 13%, copper down 10% and lead and aluminium both 5% lower. Iron ore also fell 5%. An almost-casualty of these trends was highly-leveraged Anglo/Swiss resource trader Glencore PLC whose shares at one point in September had fallen by 75% from the level at which they started the quarter. Although they had bounced back somewhat by the end of the month, there was a degree of collateral damage inflicted on Australia's more conservatively-geared resource majors, BHP Billiton and Rio Tinto.

Portfolio comment

The portfolio outperformed the market nicely in the quarter, with positions in gaming machine maker Aristocrat Leisure, credit rating company Veda Group and ports owner Asciano contributing nicely. Not owning gas producer Origin Energy also helped. The only detractor of note was from not owning global shopping centre operator Westfield Corporation.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	-2.5	-5.6	-0.1	2.7	10.9	10.3
S&P/ASX 300 Accumulation Index	-2.9	-6.5	-0.7	2.5	9.1	8.5

*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 to a single manager investment strategy on 12 August 2011, at which time Alphinity Investment Management commenced managing the Fund and started the transitioning of the portfolio to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2011. Therefore, the inception date for the return for the Fund is 1 September 2011.For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 (during Sydney business hours).

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Market outlook

Not too much has changed since our outlook comment last month other than a further 3% share market decline in September: growth continues to appear subdued and valuation support continues to look good. The issues in Europe are well known, except for any possible flow-on effects of the VW scandal.

European industrial production and the slowdown in China is now fact rather than a potential concern. The weakness in recent economic data in the US is probably the most noteworthy development, and the greatest risk to global equity markets. Industrial production, jobs growth and inflation data have all been pointing to slower growth in the world's largest economy, adding to global growth concerns.

We have not been too concerned by fluctuations in monthly and even quarterly economic data in the US over the last couple of years, as the overall direction has still been positive and consistent with the sort of grinding economic recovery typical after a recession caused by a financial crisis. However, after six years of extreme monetary policy with effectively zero interest rates and strong asset price inflation, it is concerning that the Fed apparently still feels that the US economy is not yet strong enough to even begin the normalisation of interest rates. And zero rates leaves policy makers with little ammunition to stimulate in any subsequent downturn.

Growth in Australia also remains weak even though, as we discussed last month, we expect that a recession can be avoided. And while lower interest rates are not the answer to all problems, with rates still at 2% at least the RBA is not completely out of bullets. The "tug of war" in equity markets between low economic growth at one end of the rope and attractive valuations and dividend yields at the other look set to continue into 2016. After a few months during which the low growth worries have dominated, it would not be surprising to see valuation making a comeback.

Asset allocation	As at 30 September 2015 %	Range %
Securities	99.0	90-100
Cash	1.0	0-10

Top 5 active overweight positions as at 30 September 2015	Index weight %	Active weight %
Macquarie Group Ltd	1.9	2.4
Goodman Group	0.7	2.1
Caltex Australia Ltd	0.6	1.9
Aristocrat Leisure Group	0.4	1.8
APA Group	0.7	1.7

Portfolio outlook

The final quarter of the year has started with a rebound in global equity markets, including Australia, which has been led by previously-underperforming Energy and Resource stocks. As discussed above while we are not surprised to see a recovery in equity markets following the sell off over the last six months, we also don't see the recent outperformance of cyclical stocks, and the Energy and Resource sectors in particular, as being sustainable. While some of the concerns around the slowdown in China have faded, global and domestic economic indicators are signalling slowing, not accelerating, growth.

Given the ample supply of most commodities it is therefore difficult to see the sustained uptrend in commodity prices which would be a prerequisite for a lasting upturn in these sectors. Instead, we see the recent strength in commodity prices as having been caused primarily by the Fed's decision in September to maintain its zero interest rate policy for a little longer. Just as happened earlier this year, when the Fed pushed out the first rate hike the $US sold off and commodity prices strengthened. And just as then, we see the present reversal as temporary and maintain our underweight to cyclical stocks in general and the Resource sector in particular.

October and November encompass the Annual General Meeting (AGM) season for June year end companies, as well as the Bank reporting season, many of which have a September year-end. This will provide an important check-point for company performance so far this financial year. We were encouraged by the results and accompanying outlook commentary for most of our holdings in the August reporting season, and expect to get confirmation during AGMs that they remain on track. We have also added some new positions to the portfolio following strong results in August.

Sydney Airport Corporation is one. This company offers several attractive growth drivers that, combined with reasonably steady and predictable costs, in our view provide attractive earnings leverage. International passenger growth has held up well. Inbound passenger growth from emerging markets such as China and India continuing to boom and several international airlines are either using bigger planes or increasing the number of flights into Australia. There are also a number of new airlines flying into Sydney. Sydney Airport also recently concluded some important agreements: its five-year "Aero" agreement with the airlines was renewed at more favourable terms than expected, and Terminal 3 was bought back from Qantas in an earnings-accretive deal. Together, these developments should allow Sydney Airport to deliver solid earnings and dividend growth over the next couple of years.

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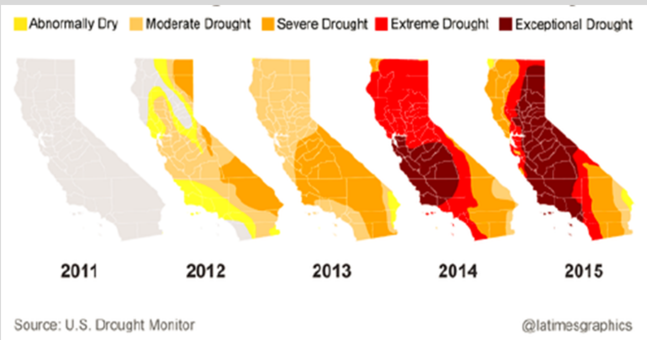
Traveller's Tale

Andrew had his own LA Story when he went to the US in September for a bunch of meetings in the wider Los Angeles area. Tales of Los Angeles' traffic issues are legendary so he made sure he left in plenty of time, an hour and a half to reach his first meeting, but after two hours sitting in traffic and being still some way from his destination he accepted that it was pointless and ended up doing the meeting by phone from the car. There is an enormous degree of frustration involved in flying 14 hours just to make a phone call. But at least he could get to the second meeting on time – or so he thought. After a further two hours in the car he finally arrived, more than a little late. Four hours in traffic to get to a meeting must be some kind of record.

It was the day for records to be broken. The reason for the heavier-than-usual traffic was that it was the wettest day in downturn LA all year, and even a record for that time of year with 10 times the average monthly rainfall happening in one day, all thanks to the tail of an ex-Hurricane in the Pacific. California is in the grip of a serious four-year drought at present, but this big dump caused flooding and chaos across the region. Apparently there were 527 reported motor accidents on the freeways that morning.

In the continuum of droughtiness, the graphic below courtesy of the LA Times shows how much of California has now officially moved from 'Severe Drought', through 'Extreme Drought' all the way to 'Exceptional Drought'. What happens after 'Exceptional' we can't possibly fathom. As the Times noted earlier this year after a particularly poor 'wet' season over winter, "We're not just up a creek without a paddle in California, we're losing the creek too". Googling "California Drought 2015 images" will give some examples of the crisis California is facing.



It appears however that Andrew's one-day rain event in LA wasn't enough to break the drought: on the same day a State of Emergency was declared in the north of the state due to severe wildfires. California it seems shares more similarities with Australia than just Jarrod Hayne.

The drought has also provided opportunities for the inventiveness of Californians to come to the fore: some dams have started to be covered by huge numbers of black plastic balls, each a little bigger than a cricket ball. The balls float and protect the surface of the water. One dam near LA (below) took 96 million balls and authorities are not only looking to save 300m litres of water a year from evaporation but also $28,000 a month in chlorine costs, as there will be less algae in the water that will need to be treated. 96 million balls cost a lot, about $US35m, but putting a fixed roof on the dam would have cost up to ten times that amount.

There is potentially some weather relief of sorts on the way for LA. El Niño weather conditions that are feared to be about to exacerbate the drought on the eastern seaboard of Australia generally has the opposite effect on California, with predictions of a very wet winter to come for the region. In fact it is being described as one of the strongest El Niño systems ever recorded. It is not good to go straight from Exceptional Drought to a monster El Niño wet period: the lands is not well able to deal with large amounts of water as the ground is either baked rock hard by the sun or denuded of vegetation from drought and wildfires. It appears California is in for more interesting times.

Given Andrew's experience in LA traffic during heavy rain, we think it might be best to steer clear of driving there in the near future.

Fund details	
Manager inception date	1 September 2011
Fund inception date	7 November 2003
Fund size	$39.4M
APIR code	HOW0019AU

Fees	
2014/15 ICR	0.90%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	Nil
Buy/sell spread	+0.20%/-0.20%

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BTW

"Iconic" has become a cliché but one company that surely qualifies is Volkswagen. Literally the peoples' car, it had roots before World War II and was instrumental in German industry recovering from the depredations of that war. After several decades of M&A activity the group now encompasses basic transport like Spain's Seat and Czech Republic's Skoda all the way through to super-premium brands like Porsche, Lamborghini and Bugatti. At 10 million vehicles a year it vies with Toyota to be the biggest carmaker in the world. Its logo is recognised worldwide and its products had become a by-word for quality of engineering and construction.

Until a few weeks ago that is. The emissions scandal has hit VW's credibility even more than its share price. The share price was bad enough: from a high earlier in the year of €250 per share it troughed at €100 at the end of September, a 60% fall representing more than a hundred billion Euros of value lost. At least temporarily, as the shares have subsequently bounced back a little.

The apparent engineering excellence that allowed otherwise dirty diesel engines to achieve almost miraculous levels of cleanliness was a mirage, a function of software that made the emissions controls effectively switch itself off when the engine was in normal operation, and pollute a lot more than it would in a test environment. This can only be interpreted as a fraud on the regulators who tested the cars and the consumers who bought them, and it is not yet clear what an adequate redress will be. One certainty is that Volkswagen will find selling cars more difficult in 2016 than it has at any time since 1946.

One of the global economics research houses we follow, however, has suggested that there might be a silver lining for Europe from this scandal, and could even be the catalyst to lift Europe out of its current economic funk. Should the German government deem that the fraud and/or environmental impact be sufficiently serious then it could institute a "cash-for-clunkers"-type scheme to scrap say 10 million cars at say €10,000 per car across Europe.

The €100 billion involved could be part-financed by the fines that will inevitably be levied on VW and the German government, and its contribution would only represent a few months of Germany's trade surplus. It would effectively be sharing with its neighbours some of the huge benefit Germany has gained in recent years from the low Euro. The economic stimulus of such a move would be considerable and possibly enough to spark the upturn across several European countries that everyone has been waiting for. It would be surprising though if VW got its "fair share" of the new car sales.

This outcome seems a little too good to be true. More likely is that the trend towards diesel car engines that Europe has lead in recent decades will reverse, and companies like Silicone Valley-based Tesla's electric cars will no doubt claim the environmental high ground and salivating at the publicity free kick it has been offered.

Alphinity Investment Management

Level 12, 179 Elizabeth Street
Sydney NSW 2000
T 02 9994 7200
F 02 994 6692
W www.alphinity.com.au