Alphinity INVESTMENT MANAGEMENT

Quarterly comment – March 2015
Alphinity Wholesale Australian Share Fund

The Importance of Being Patient

Market comment

The Australian share market (S&P/ASX300 including dividends) marked time in March, falling early in the month and recovering at the end, but for the quarter it rose by a healthy 10.3%. But much of the action was happening offshore: the financial world was waiting expectantly for the outcome of US monetary policy (see BTW) and chiefly the appearance of the word "patient" which could end up determining the direction of many markets over the balance of the year. As it turned out, the reality turned out to be quite unexciting.

Most markets performed in a fairly lacklustre fashion in March but showed good returns for the quarter, at least in $A. Markets in the Americas were generally soft in March while the better European countries achieved modest low- to mid-single digit gains. China was very strong (+17%) after soothing noises emerged from the central government about possible stimulus. For the quarter, Australia's 10% shaped up pretty well compared to most other major markets, although Hong Kong and some of the better quality European and Scandinavian markets achieved 14-18%. China raced away with a 25% gain in the three months.

Commodity prices continued their downhill run during the quarter. Iron Ore fell by 28%, compounding the woes of prior quarters: at $US51 it is now down 73% from its 2011 peak of $US190/ton; the $A price is down a less bad but still terrible 66%. Base metals were generally weak with nickel and tin down 18% and 15% respectively, copper and zinc down 5% and 4% and aluminium down 2%. The $A depreciated 7% against the $US although a little less against most other currencies and actually appreciated by 5% against the Euro.

Portfolio comment

The portfolio performed well in March and overall returns for the quarter have been pleasing. Financial services company Macquarie Group, gaming machine maker Aristocrat Leisure and gas pipeline company APA were the biggest winners in the quarter, and not owning insurer Suncorp also contributed. Detractors included alumina producer Alumina Ltd and health insurer Medibank Private, which was a strong positive in the prior quarter.

Market outlook

No longer patient but not impatient; bad data is good data? Financial markets appear to have taken US Federal Reserve (Fed) watching to new heights in recent months. And while the ever-changing interpretation of economic data in which weak growth is concerning one week but welcomed the next (as US rate rise expectations are pushed out) can be a bit frustrating, we do at least know that low interest rates have been good for the US economy and for equity markets worldwide.

How equity markets will react to the reality of higher US interest rates when it finally occurs is more difficult to say. Recent market reactions suggest not that well but the real answer is, to use the Fed's language, economic data-dependent. The conundrum however is that as monetary policy since 2008 has been very unconventional, history gives us very little indication of how the economy and markets will actually react to higher interest rates. While the final date for "lift-off" is still being debated it should at least not come as a surprise to equity markets that rates are likely to go up. And it may be that the economy and equity markets come through relatively unscathed, just as they did with the end of the Fed's Quantitative Easing program last year.

However, this is far from a certain conclusion and, given that markets are trading above recent years' valuation range, in our view risks for disappointment have increased.

Domestic data remains sluggish with the iron ore price setting new post-GFC lows, albeit with some offset from the lower $A for the miners and corporate earnings in general.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	0.7	10.2	13.0	14.5	17.6	12.7
S&P/ASX 300 Accumulation Index	-0.1	10.3	13.9	13.4	15.3	11.2

*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 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 relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 (during Sydney business hours).

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The federal budget in May should, based on comments out of Canberra, hold fewer surprises this year so it looks like the domestic factor that will have the greatest influence on the direction of the equity market is the same as that driving global markets: interest rates. The silver lining for the Australian equity market is that the Reserve Bank of Australia still has plenty of room to take rates lower if required, and that the dividend yield of Australian stocks remains highly attractive to global investors who appear more comfortable with the present level of the Australian dollar.

Portfolio outlook

Broader portfolio themes in place at the end of the March quarter remain largely unchanged: we are underweight Resources (Mining and Energy), moderately overweight Banks (although we have trimmed some after some solid outperformance), slightly underweight other “yield” sectors (utilities, REITS, Infrastructure) and overweight $US earners. However as regular readers of our reports would know we favour investment cases built on company-specific earnings drivers rather than macro themes. This we believe is especially valid in the current uncertain macro environment discussed above, but it does not mean that we won’t take sizeable overweight or underweight sector positions: rather our views of individual companies generally determines our sector positioning.

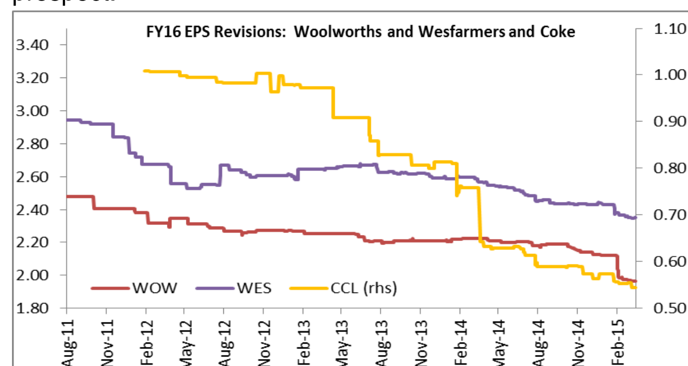
One example of this is the Consumer Staples sector. The sector is dominated by supermarket heavyweights Woolworths and Wesfarmers, followed by much smaller beverage companies Coca-Cola Amatil and Treasury Wine Estates. This sector has been a major underweight in Alphinity’s portfolios for several years. While we are conceptually attracted to what should be stable consumer demand, historically solid cash flows and high ROEs, we have for some time been concerned about how these factors will develop in the future.

For Coca-Cola Amatil our concerns were centred around a strategy reliant on high pricing despite changing consumer preferences towards healthier beverages at the expense of carbonated soft drinks. This has been playing out over the last couple of years with major earnings disappointments as a result. A new CEO is now in the process of revamping the company’s strategy and we are following developments there with interest.

Woolworths’ share price has fallen sharply recently, although we would argue that the warning signs have been evident for some time. It has had the highest margins of any supermarket operator in the world, a resurgent competitor in Coles, the gradual emergence of Aldi as a meaningful threat, a large but as-yet unproven investment in Masters hardware and a struggling Big W.

This has all culminated in an earnings downgrade cycle – just what Alphinity looks to avoid.

It might seem obvious to own Coles’ parent company Wesfarmers instead but, it is a conglomerate with a much more diverse mix of businesses than just supermarkets, some of which are challenged, and it’s had its own downgrade cycle. Combined with an expensive multiple, neither it nor Woolworths has seemed an attractive prospect.



Source: Bloomberg

So while we are not opposed to being overweight the Staples sector in principle, we need to have an appealing company in which to invest – to us that means one that is in, or is about to enter, an earnings upgrade cycle. That will happen at some point but is not in sight yet.

Asset allocation	As at 31 March 2015 %	Range %
Securities	98.1	90-100
Cash	1.9	0-10

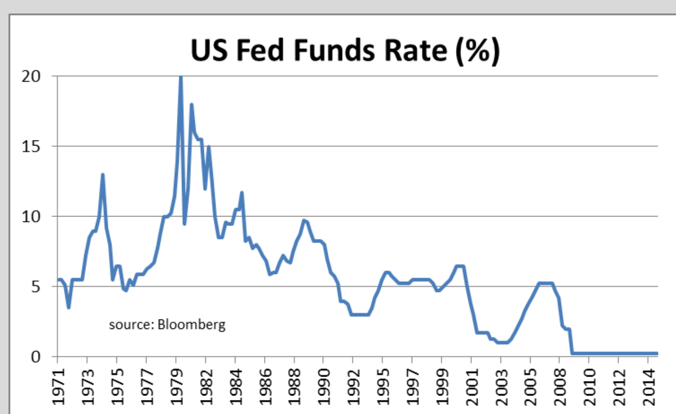
Top 5 active overweight positions as at 31 March 2015	Index weight %	Active weight %
Goodman Group	0.7	1.9
Aristocrat Leisure Limited	0.3	1.9
Macquarie Group Ltd	1.7	1.8
APA Group	0.7	1.5
Westpac Banking Corporation	8.1	1.3

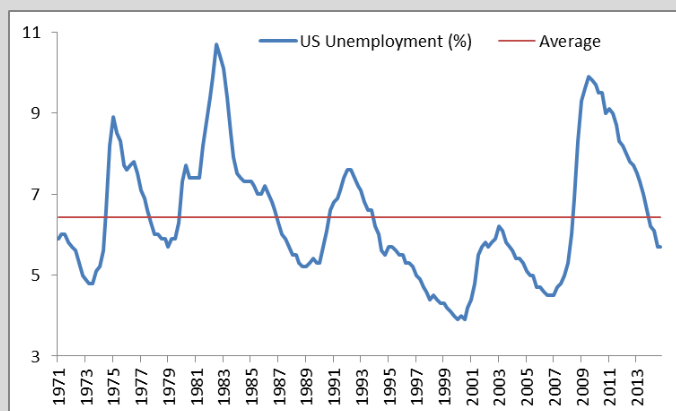
Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size	$131.7M
APIR code	PAM0001AU

	Fees
2013/14 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%

BTW

The financial world was waiting expectantly for the appearance (or non-appearance) of one little word which could end up determining the direction of many markets over the balance of the year. The US Federal Reserve Bank's Open Markets Committee is the body that sets US interest rates and has been responsible for the ZIRP (Zero Interest Rate Policy) in place there for a number of years. But zero rates must surely come to an end one day, and with unemployment currently at levels well below the long-term average and economic activity reasonably robust in most sectors, the market has been looking for hints as to when that might be.





The Fed had previously indicated that it would hint that the end of ZIRP is nigh by removing the word "patient" from its minutes at least two meetings before the decision to increase rates was made.

Consequently the markets were watching the Fed like hawks (or doves as the case may be) for the appearance or otherwise of that word. When the Fed Funds rate finally does rise it will be the first increase since June 2004.

So when Fed Chair Janet Yellen produced the statement without the word patient in it, did she elaborate on the Fed's intentions? She did, although not very helpfully. In her inscrutable central banker manner, she said "Just because we removed the word 'patient' doesn't mean we are going to be impatient" and dovishly suggested that any rate rise would be dependent on the Fed being "reasonably confident" about progress of employment and inflation trends. We really shouldn't be surprised about the cryptic nature of her comments, after all one of her predecessors, Alan Greenspan, once said " I know you think you understand what you thought I said but I'm not sure you realise that what you heard is not what I meant", and another time: "I guess I should warn you, if I turn out to be particularly clear you've probably misunderstood what I've said".

While on the topic of former Fed governors the most recent ex, Ben Bernanke, has started up a blog as part of his work as a fellow of the prestigious Brookings Institution think tank in Washington DC. AKA "Helicopter Ben" for his practice of throwing around unbelievable amounts of money to address the structural problems arising from the GFC (mainly QE, QE2, and QE∞ which combined to cause the Fed's balance sheet to grow from a mere $US869 billion in 2007 to its present $US4.5 trillion), it was fairly predictable that his first blog would be at least in part a justification of his actions. You can find his musings on this and other topics at www.brookings.edu/blogs/ben-bernanke.

Fed officials are not particularly well paid: in the context of US financial markets where some of the more egregious players can receive tens of millions of dollars a year, Bernanke was paid a mere $US199,700. Given the enormous responsibility the position entails it would be easy to feel sorry for him: even if he only worked a 40 hour week, which is likely way too low, that would work out to be $1.60 per minute. However he seems to be making up for it now: as an ex-Governor a single 40-minute speech will earn him as much as $US250,000, which equates to $6250 per minute. Nice work if you can get it!

![Alphinity Investment Management]

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Traveller's Tales

London? Paris? New York? No, Bruce went to Adelaide in March to look at supermarkets and beverages. Not that there's anything wrong with Adelaide – it is a fine city, close to home and although some Victorians might dispute it, the epicentre of the Australian wine industry. Wine has been one of Australia's export success stories although, like many agricultural pursuits, it can suffer from manic highs and depressing lows. It is capital intensive, water-intensive in a land where water is often scarce, potentially a loser from climate change in most regions, suffers from very long lead-times in product planning, and is subject to the whims of fashion in both home and export markets.

There is only one wine company of any scale listed on the Australian market: Treasury Wine Estates (TWE). It is a global company with outposts in Italy and California, but most of the action happens here. It owns some of the best vine-bearing land and wine brands in Australia as well as some impressive assets maturing in its cellars, and some choice assets offshore. However it has struggled to make even a reasonable return on the capital it has employed in the business, with meaningful improvement always a year or two in the future. The company has been through a fairly radical series of incarnations being gradually assembled in the 1990s by various parties. Fosters spent more than $8 billion in the 1990s and 2000s accumulating the assets before realising that the cash cow that was brewing was being consumed by wine without any great benefit to its shareholders. TWE was de-merged from Fosters in 2011 with a pristine balance sheet and a mandate to take on the world, but until recently it has seemed to only take on itself, and lose. It has undergone significant management change in the past year, the outcome of which as yet uncertain.

Alphinity is not starry-eyed about its companies. To fall in love with a stock is short-sighted and usually not good for your investors. Much as we appreciate the halo that a brand like Penfolds provides to the company, it is quite a small part of the overall story and when it comes to the numbers TWE struggles to stack up. It is expensive on 28x the market's estimate of current year earnings and 24x FY16; it has been getting consistent earnings downgrades ever since the demerger (although these seem to be dissipating). It doesn't pay a good dividend yield, and what it does pay has no franking.

Alphinity has not owned TWE it in its current form for all those reasons but one day we might so we follow it as closely as we do any other prospect. Companies like this often have a long period of earnings downgrades before the market becomes too pessimistic and factors in more than 100% of the bad news. If the stock then offers good enough upside to a sensible valuation, we'll consider it.

In the meantime however we can report that the current release of Grange, from the superb 2010 vintage, is drinking beautifully now even though it is not meant to peak until many years in the future. Although if we had $875 to spend on wine, we'd probably buy five bottles of the excellent 2012 RWT instead. Or quite a few cases of something much more modest!

Alphinity Investment Management

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