**Quarterly comment – September 2012**

Alphinity Wholesale Australian Share Fund

# On the up

## Market comment

The Australian share market continued on its upward trajectory even though the three previous months had added more than 10%. The ASX300 (including dividends) rose by 2.2% in September. Most of the major global markets performed similarly, with the US up 3%, UK +1%, and Germany +4% and last month's laggard, Spain, up almost 6%. Asian markets were generally a little better although Japan was flat; Taiwan up 4%, Hong Kong up 7%, but the various Chinese indices were generally up 1 to 4%. New Zealand rose by 4.5%.

European markets benefitted from an ongoing policy by the European Central Bank to help countries whose bond yields are so high as to cause major fiscal issues, and an important court decision in Germany effectively allowing the European stability mechanism (ESM) to continue supported the Euro.

The US Federal Reserve Bank also helped markets and some commodities by announcing another round of Quantitative Easing: this time smaller but essentially for an unlimited period of time. Iron ore rebounded in September which, in combination with the monetary easing, saw resource companies mostly finish the month up.

The Australian dollar ($A) did better than one might have expected given the deterioration in Australia's terms of trade over the last few months. Normally during these circumstances the $A acts as an adjustment mechanism by depreciating, and the currency did fall a little in September, but countering this force has been an increasing view of Australia as a 'high yielding safe haven' – just about the only AAA-rated country with 'reasonable' bond yields and which is not progressively debasing its own currency.

## Portfolio comment

The portfolio lost ground in September following its strong August performance, but remains well ahead of its benchmark over the last year. There were few meaningful contributors or detractors in what was overall a month of consolidation, however gold miner Medusa Mining, diversified resource player Rio Tinto and automotive online advertiser carsales.com did well, while owning property company Lend Lease and coal miner Whitehaven, and being underweight gold producer Newcrest all detracted slightly.

## Fund details

| Alphinity Wholesale Australian Share Fund | |
|---|---|
| APIR code | PAM0001AU |
| FUM ($A million) | 113.4 |
| Asset allocation | Australian equity: 98.7%, Cash: 1.3% |

## Fund performance* – as at 30 September 2012

| | Quarter (%) | 1 year (% p.a.) | 2 years (% p.a.) | Since inception (% p.a.) |
|---|---|---|---|---|
| Alphinity Wholesale Australian Share Fund | 8.8 | 17.2 | 3.4 | 5.2 |
| S&P/ASX 300 Accumulation Index | 8.7 | 14.5 | 2.2 | 4.4 |

*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 for previous periods please contact Fidante's Investor Services team on 13 51 53 (during Sydney business hours).

## Top 5 active overweight positions as at 30 September 2012

### Alphinity Wholesale Australian Share Fund

| Issuer name | Index weight | Active weight |
|---|---|---|
| Lend Lease Corporation | 0.4% | 1.9% |
| Insurance Australia Group | 0.8% | 1.9% |
| Goodman Group | 0.5% | 1.6% |
| Resmed | 0.3% | 1.5% |
| Westpac Banking Corporation | 7.1% | 1.5% |

## Market outlook

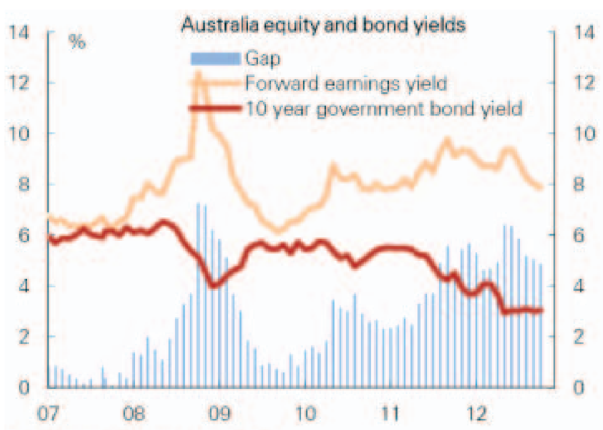
Over the last quarter, global equity markets' strength has been predominantly driven by monetary easing and reducing fears of a full-blown financial crisis in Europe. These forces have offered welcome relief and should remain in place for some time. Lower interest rates in Australia should further support the Australian equities market from a relative valuation perspective, however global economic conditions continue to weaken and there are few signs of any meaningful improvement here.

For the recovery in equity markets to be maintained, a clearer path to stronger earnings will be required. Without this it is reasonable to assume that markets will lose some of their momentum over the next few months despite the support from easier monetary conditions.

For Australian industrials, the August reporting season saw the first signs of industrial earnings stabilising somewhat. While too early to conclude with any certainty, the Reserve Bank of Australia's recent rate cut and subsequent softening of the $A may provide the trend break that is required for stronger earnings in non-resources Australia. For resources, our last visit to China indicated that underlying demand there remains subdued. The recent bounce in the price of steel and iron ore appear to be more driven by restocking ahead of winter.

The next set of data points is annual general meeting (AGM) season in October and November. In addition to exercising our voting responsibilities for all our holdings, we also use AGM commentary (if not the meeting itself) to get a sense of how the business has been tracking in the first few months of the new financial year. AGM information is not as rich as reporting season, but the trends and degree of confidence expressed during the meeting can be quite informative. In recent years, this AGM season has provided a reality check for companies that the market had started to factor-in turnarounds. We would not expect that this year to be different but rate cuts and a potentially lower dollar may provide a better outcome for some companies later in the financial year.

While an uncertain outlook remains for corporate earnings, the significant valuation gap between equities and bonds (see charts) and historically low equity allocations by both institutional and retail investors are probably the strongest reasons for further gains in coming months.





Source: Datastream, IBES, IRESS, Deutsche Bank.

## Portfolio outlook

The recent weakness in the resources sector has masked what has been quite an impressive performance in many other parts of the market, especially those which pay high dividends. Banks, for example, have returned close to 30% (including dividends) over the twelve months to the end of September.

Lower interest rates may have the potential to revive activity levels in the more cyclical parts of the economy, and we are monitoring developments here closely but feel that it is too early to justify a significant shift. Lower interest rates are also likely to further underpin the performance of those stocks that have already benefited from the low bond yields and rate cuts we have seen to date.

While we have reduced the exposure to some of these stocks after strong performance, we believe they should remain a substantial part of the portfolio and hence we remain well invested in, for example, the banks, Telstra, Duet and Sydney Airport. Also at the core of the portfolio remain the individual companies with unique earnings drivers that we have identified. Included in this group are companies such as IAG (insurance), Carsales.com (IT), Super Retail Group, Flight Centre and Crown Casino (consumer discretionary) and Goodman Group and Lend Lease (REITs). On the flipside we retain our slight weight to resource companies following our recent China research trip, however we are monitoring developments there closely.

## Traveller's tales 1

One of the challenges of investing in companies which operate in developing economies is keeping track of how these companies are looking after the staff and the environment in those places. To this end, Stephane went to the Philippines in September to investigate the operations of Medusa Mining, a 'junior' gold company, in a remote part of that country. Medusa is aiming to lift its production from its current production of 60,000 ounces per annum to around 400,000 ounces by 2016. It has an existing underground mine and plans to bring in an open pit mine within the next few years. Almost the entire 3300 workforce is local and older than 20 years. The mine employs more people than is really required in order to provide employment for the community, a tacit agreement with the local government. While the pay is quite low by Australian mining industry standards, those wages allow the workers to afford a decent standard of living, as evidenced by the quality of housing around the mine. The unions have negotiated for their monthly bonuses to be paid in food (rice) rather than in money. Medusa also provides its employees and the local community with schools (pictured), scholarship programmes and hospitals. It has also invested in infrastructure in the region including roads, water supplies and non-mining livelihood projects such as plantations, fertiliser production programmes, and micro loans. This investment is seen by the company as part of its 'social contract' to operate in that part of the world: contributing to the local community and ensuring their ability to conduct peaceful operations.

## Traveller's tales 2

One of the challenges of investing is the frequent need to travel to remote places and endure unpleasant conditions in the attempt to eke out insights which will help us work out which companies we should own.

But it doesn't always pan out that way. While Stephane was in the jungles of the Philippines in September checking out the gold mine, Bruce went to the USA and encountered delightful early-autumn weather on both the west and east coasts, and remarkably little sign of election fever. The Napa Valley north of San Francisco must be one of the world's great tourist destinations and was particularly pleasant at this time, with many thousands of acres of vines laden with grapes about to be harvested. While there, he met with a number of players in the global wine industry in order to work out whether it had changed from being the capital-intensive and quite value-destructive industry it was in the 1990s and 2000s to something which might now be considered investable. After all, increasing affluence in Asia is creating new markets for established players.

Along the way he came across a story which possibly exemplifies the challenge and opportunity facing the wine industry in China. A party was recently held in a fancy apartment in Shanghai, to which guests were instructed to bring a bottle of a first growth Bordeaux wine. This would typically have a label like Chateau Latour and a price tag of many hundreds, possibly thousands, of US dollars a bottle and, given the importance of making a good impression in China, one imagines that it probably wasn't the 'cheap' Bordeaux that were brought. On arrival, to the horror of some of the guests, each bottle was opened and poured into a big tub, mixed with a big ladle and spooned into glasses.


While this might seem like sacrilege to connoisseurs elsewhere, it seems that in China so far the traditional wine experience is still secondary to exhibiting status and prestige. The higher the price and the more well-known the label, the more appealing it is. Penfolds, for instance, released a label above even Grange (Bin 620) to retail at $1000 a bottle and sold out its very limited run very quickly. Perhaps the international wine story does have some 'legs' after all. It's one that demands more research. Tuscany perhaps?

Alphinity Investment Management

Level 15, 255 Pitt Street
Sydney NSW 2000
T 02 9994 7200
F 02 9994 6692
W www.alphinity.com.au



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