Alphinity INVESTMENT MANAGEMENT

Quarterly Comment – June 2015
Alphinity Wholesale Concentrated Australian Share Fund

A Big Fat Greek Problem

Market comment

Greece was the word on everyone's lips as the financial year ended on a sour note. The GDP of Greece is a fraction of Australia's, and the market capitalisation of its entire stock market is only $A19 billion, about the same as Australian-listed shopping centre company Westfield. For such a small economy then, Greece is having a big impact on markets.

The Australian share market (ASX300 including dividends) slipped 5% in June, washing away almost half the prior 11 months' return, and it was little consolation that in $A some markets did as poorly (Sweden, Hong Kong and Switzerland) as ours or even worse (New Zealand -7%, Shanghai -12%). It was surprising that the stock market in the country causing much of the global anxiety was virtually unchanged for the month, although it was probably saved by the Greek government closing the stock exchange and all the banks just as things started to get really messy towards the end of June. Even the better-returning markets didn't do very well. Singapore was the best at +0.1%, Japan -0.7%, the US, UK, France and Germany all between -3.5% and -4%. So there wasn't much joy in share markets in June.

The quarter wasn't much better: Australia was down 6.5% and not many markets made positive returns despite the lower $A. China was the notable exception where the Shanghai market was up 13%, even after the -12% it experienced in June. Greece amazingly was up 6% for the quarter – although again had it been trading for the final few days this could easily have been wiped out. The $A was fractionally stronger, rising from 0.76 to 0.77 against the $US over the quarter, and 63.3 to 63.8 on the Trade Weighted Index.

Brent crude oil rose by about 12% over the June quarter and iron ore by about 15% but most other commodity prices were generally soft. Copper, lead, zinc and aluminium all fell by about 5%, and nickel was down 4%. Gold was about 1% lower and silver 6% lower.

Over the year ending June these commodities were all tales of woe: the best was zinc at -9% but nickel, iron ore and crude oil were all down by about 40%. The 19% fall of the $A over the year partially offset these moves.

Portfolio comment

The portfolio performed roughly in line with the overall market in June and fractionally below for the quarter. Investment bank Macquarie Group, building materials companies James Hardie and industrial property developer Goodman Group and were the best contributors to the portfolio's performance in the June quarter, and the most meaningful detractors were major banks CBA and Westpac and media company Nine Entertainment.

Source: Bloomberg

Market outlook

The new financial year has started with global equity markets facing increased volatility from Greece's debt problems, a sharp selloff in Chinese equities and continued uncertainty around the timing of the US Federal Reserve's intention to start "normalising" US interest rates. These may hardly seem like reasons for optimism but, as we wrote last month, we do think the spill-over from Greece to the rest of Europe and global equity markets should be relatively limited. Most Greek debt is already with Government institutions such as the ECB or the IMF, and the ECB's increased mandate to buy European countries' bonds should also help to contain the issue.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	-5.5	-7.3	5.7	12.5	16.9	10.9
S&P/ASX 200 Accumulation Index	-5.3	-6.5	5.7	11.4	15.1	9.3

*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. 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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What's going on in China is probably of more relevance to Australian equity investors. Our assessment of China to date has been that growth is the slowest for some years but not collapsing. We've had a cautious view on Australian miners, not only due to the slow growth in China but also because there is still a lot of new supply of commodities coming to the market, not the least from Australia. We have also thought that the volatility of the Chinese stock market should have limited impact on the real economy. Recent extraordinary intervention by the Chinese Government to support the stock market has however surprised and may have greater implications for the real economy through reduced business confidence and foreign investor demand. Finally, the US Federal Reserve is still likely to raise interest rates before too long but it has become increasingly clear it will take a very gradual approach in order to not derail the steady, if slow, economic recovery in that country.

On the whole we think that current global macro issues will fade in importance in coming months. That leaves us with the Australian economy and here it gets a bit more difficult, as there are few signs of improving activity across the economy. For equity market support therefore we need to rely on the usual combination of low interest rates and an attractive dividend yield. Following the recent market pullback the Australian equity market is again trading within its range of recent years and, while earnings growth remains low, reasonable valuation together with the dividend yield should provide a base for positive returns in the second half of 2015.

Portfolio outlook

Global macro events have strengthened the view we discussed last month, that while the direction of bond yields both here and globally is likely to be up, the move will not be in a straight line. We thus remain comfortable with our moderate underweight to yield sensitive stocks rather than a more significant negative skew. Telstra and APA remain our largest stock positions in the "yield" part of the market, while we have sold our position in Transurban which we see as expensive in comparison.

Banks have recovered slightly since the sell-off in April following an underwhelming reporting season. With reduced earnings tailwinds from falling credit losses and moderate credit growth, we expect Banks will struggle to outperform, especially as they need to address increased capital requirements in one form or another.

As we're preparing for yet another reporting season the portfolio remains focused on companies that can deliver positive earnings surprises. The renewed weakness in the Australian dollar should provide support for companies with overseas earnings, however only for those that have their main exposure to the US dollar rather than the Euro, and that are also performing well operationally.

We have the greatest confidence in that being the case for James Hardie, Goodman Group, Aristocrat and Macquarie Group, but the last two are not reporting in August. On the domestic front we expect solid results from amongst other Adelaide Brighton Cement, Spotless, Qantas, Veda and Covermore. The diversified miners are again expected to deliver impressive cost reductions, however commodity prices will inevitably drive their earnings trajectory and we remain cautious on that sector.

Our positions in Aurizon and Asciano have also had to deal with the negative sentiment from falling bulk commodity prices, especially for east coast coal. Operationally, these businesses have held up well as mining volumes and contract prices have largely remained intact thanks to so called take or pay contracts. Canadian infrastructure group Brookfield's indicative bid for Asciano has highlighted the value inherent in Asciano, and we believe also in Aurizon. Overall, the portfolio continues to demonstrate attractive earnings momentum with superior quality characteristics such as return on equity and balance sheet strength.

Asset allocation	As at 30 June 2015 %	Range %
Securities	98.2	90-100
Cash	1.8	0-10

Top 5 active overweight positions as at 30 June 2015	Index weight %	Active weight %
Westpac Banking Corporation	7.2	5.5
National Australia Bank Limited	6.3	5.0
Macquarie Group Ltd	2.0	4.8
Telstra Corporation Limited	5.4	4.7
Goodman Group	0.7	3.7

Fund details	
Manager inception date	1 September 2010
Fund inception date	1 November 2004
Fund size	$13.1M
APIR code	HOW0026AU

	Fees
2013/14 ICR	1.23%
Management fee	0.90% p.a.
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions paid) above the Performance Benchmark
Buy/sell spread	+0.20%/-0.20%

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BTW

Inflation was an endemic problem in many countries in the 1970s and 1980s which required some effort and a significant degree of pain to overcome. It is therefore a bit of a surprise to many who were scarred by that era to now be in a situation where inflation is thought to be too low, with a risk of negative inflation and even deflation in some places. Even countries like Germany, with its memory of the 1920s when hyperinflation took hold and created the economic and social turmoil that ultimately led to the rise of extreme and unhelpful ideologies, is concerned about low inflation and willing to cede control of its monetary policy to the ECB in an attempt to get inflation off the mat.

You might think that if inflation is bad, then deflation must be good, but it's not: if the value of assets are falling but your debts are not then any equity you have in an asset can get wiped out fairly quickly. The best situation appears to align with the RBA's inflation target: 2-3% pa over the cycle is very comfortably dealt with by pretty much everyone.

One country that has not been struggling with the prospect of deflation is Zimbabwe. Hyperinflation has been in place there for many years, with the result that its money is not worth very much at all. In fact, as the picture shows, by last month a hundred trillion Zimbabwean Dollars (that's a 1 with 14 zeros after it) would only buy you two small bread rolls.

Source: Xinhua

This was clearly an absurd situation, and the country has effectively been running on $US and South African Rand for years anyway. But in June the Zimbabwean government instituted a process of "demonetisation" - officially retiring its own currency. According to the Xinhua news agency, people whose bank accounts had balances up to 175 quadrillion Zimbabwe dollars would be paid a flat $US5, while those above 175 quadrillion dollars would be paid in $US1 for every 35 quadrillion Zim dollars. The benefit to bank account holders is that their money has been stuck in their accounts for years, unable to be withdrawn. Even with a sharp haircut to the value, at least it will now be accessible. The government has allocated $US20 million for the demonetization scheme, which to us doesn't seem like a lot for an entire country's monetary system.

So when it comes to inflation, be careful what you wish for. Once the inflation genie gets out of the bottle it can be hard to re-capture. A little bit of inflation is a good thing and can cover up any number of economic issues, but you don't want it to get out of hand. We hope that Central Bankers around the world will be skillful enough to keep inflation low and positive, and not let it get back to the concerningly high levels of the 1980s.

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Traveller's Tale

Bruce made a quick trip to London with a side trip on the continent in June as part of his research on the issues facing supermarket retailing. This has been a source of alpha for the portfolio in recent years thanks to the underperformance by Woolworths, Wesfarmers and grocery distributor Metcash. The thing about underperforming stocks is that at some point it reaches its nadir and has the potential to start outperforming. The trick is to identify that point.

International travel sounds glamorous but rarely is. After a full day of meetings in London he boarded a plane (cheap airline, no meal) and headed for Madrid for a meeting the next day with Spanish supermarket group Dia and didn't arrive at his hotel until 11pm. In a lot of places would mean resorting to a club sandwich from room service - but not in Madrid.

It is usual to have dinner very late at night in that part of the world and Plaza de Santa Ana, just outside the hotel, was pumping. Spain is the home of tapas, perfect for that time of night. When you don't feel like a full meal, small plates hit the spot. Spain is also the home of *Jamon Iberico*, dry-cured, aged meat of the black Iberian pig. The tapas bar had two ham legs set up in special stands on the front counter – one almost finished the other yet untouched.

The chef preparing the plate of ham was a true artiste. He sliced the ham at the counter in ten different ways using a number of specialised knives, under the watchful and admiring eyes of his apprentices, and gave strict instructions as to the order in which it must be consumed in order to experience the correct progression of tastes. It was a bit of Spanish/Asian fusion including flavours such as ginger, wasabi and ultimately toasted sesame seeds.

Spain was until recently one of the Eurozone basket cases but it appears to be now improving – and unemployment falling from 26% to 23% is an improvement. Speaking to people actually living there, there is a degree of cautious optimism creeping in after a very long period of recession. It was the fastest-growing region in the Eurozone last year (admittedly only 2%) and the government is predicting 4% GDP growth this year. Having said that, an election is to be held by the end of the year which will likely end the majority rule of the existing moderate Popular Party government. There is a risk that a Greece-style hard-left anti-austerity government might result and this is scaring businesses somewhat. The alternative outcome is a coalition between the present administration and a minor party with good economic credentials which business thinks would probably be the best outcome.

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