Quarterly comment – December 2012

Alphinity Wholesale Concentrated Australian Share Fund

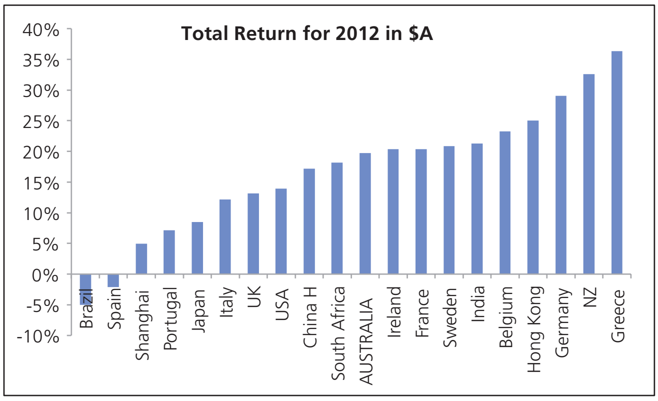
The Mayans were wrong!

Market comment

The world did not expire along with the Mayan calendar, instead Santa delivered quite nicely and the market finished 2012 on a strong note. December's +3.3% marked its seventh consecutive monthly rise.

Over the December quarter, the Australian market (S&P/ASX300 including dividends) rose 6.8%, outperforming all major global markets other than Japan. Japan's stunning 17% rise, however, was largely offset by the Yen depreciating by 12% against the $A during the quarter.

It has been encouraging to see that, unlike during much of 2010 and 2011, stock selection was rewarded in 2012 as the wild moves resulting from macro forces, unrelated to individual company fundamentals, dissipated. Despite some Greece-induced wobbles mid-year, the market rose by almost 20% over calendar 2012, and the Fund did considerably better than that. Compared to global markets, Australia has performed quite well. There were some rather surprising – performances from some markets (see chart below). The best was last year's big underperformer: Greece. It rebounded 36% in 2012 after a 53% fall in 2011 (which still leaves it 36% lower over the two years). After that it was NZ, which benefited greatly from the large number of 'utility'-style stocks on its market which were sought in the yield-hungry environment, and returned 32% including modest currency appreciation. The strong man of Europe, Germany, climbed 29%. A number of countries were bunched around Australia. The UK, USA, Japan and Shanghai all lagged but were not disgraced. Brazil disappointed: its resource-dominated market rose slightly in local currency but suffered a 10% currency depreciation which was engineered by government policy.



Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	16.1
Asset allocation	Australian equity: 98.4%, Cash: 1.6%

Fund performance* – as at 31 December 2012

	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	8.3	23.6	4.7	8.7
S&P/ASX 200 Accumulation Index	6.9	20.3	3.7	7.1

*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 31 December 2012

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	7.2%	6.4%
Rio Tinto Limited	2.6%	5.2%
ANZ Banking Group	6.0%	4.8%
Telstra Corporation	4.8%	3.9%
Lend Lease Corporation	0.4%	3.8%

The $A did not move much against the $US in 2012 and has now been only a few cents either side of parity for more than two years despite the US economy doing better than ours in 2012 – a situation that would normally see the $A sold off sharply. The difference this time is that the US (and many other countries) has been aggressively debasing its currency through various forms of quantitative easing, while Australia has not. The $A is also supported by Australia being one of the few remaining AAA-rated sovereign credits, and with a (comparatively) high bond yield of 3.4% to boot.

Commodities were mixed over the quarter. Iron ore soared almost 40% as sentiment around China's future turned from negative to positive. Base metals and precious metals both fell a few percent however, and oil (TAPIS) was flat.

Portfolio comment

The portfolio performed in line with the very strong market in December, performed well over the December quarter and very strongly over the year and longer periods. For the month, the best performers were mining company Rio Tinto and property company Lend Lease, although not owning gold miner Newcrest also helped. The only notable detractors were industrial property owner and developer Goodman Group which had been strong recently, and being underweight BHP.

Over the quarter, the best performers were the same as in the month of December and the only meaningful detraction was from not owning Commonwealth Bank.

Over the full year, retailer Super Retail Group, property company Goodman Group, insurer IAG, bank Westpac, travel company Flight Centre, telco Telstra, and global media company News Corporation all added, as did not owning Santos or Newcrest. Resource-exposed Rio Tinto, Fortescue Metals, Arrium, Whitehaven and New Hope all detracted.

Market outlook

After a near 20% return in 2012 the equity market is no longer as attractively valued as it was a year ago. With very modest (or negative depending on the time period measured) overall market earnings growth, the strong returns of the past year have been driven almost exclusively by a market re-rating and – for the first time in a while – our internal valuation models point to the market being closer to fair value than outright cheap. We would thus expect more moderate gains in 2013, but gains nonetheless. Investors appear to be slowly regaining their confidence in equities as some of the uncertainty around Greece global risks ease, at the same time as the high price paid for the safety (or what may well just turn out to be perceived safety) of government bonds seems to have peaked. While only modest earning growth looks likely for Australian companies in 2013, earnings should be supported by a trough in global growth at the same time that the lower domestic interest rates provide some relief to the Australian economy. The weight of money presently sitting in bank deposits and annuities, which may be reluctant to roll into the lower rates prevailing on maturity, has the potential to drive a further rerating of the share market which, in addition to the chance for capital growth, still offers a reasonable yield of around 5% on top of which franking benefits must be considered.

Portfolio outlook

2012 was largely an environment that rewarded stock picking – we hope and expect that 2013 will be the same. Much has been written about the global investor search for stocks with strong dividend yields. Alphinity has also pointed to this thematic and, more importantly, our portfolios have benefited from it. We have been comfortable investing in these stocks as they have largely overlapped with our central investment philosophy of investing in companies that are likely to achieve stronger earnings than the market is expecting. In 2012, the 'earnings surprise stocks' from a sector perspective were largely found in REITs, telecoms, infrastructure/utilities and banks. In addition, our portfolios benefited from a number individual stocks with their own unique earnings drivers that we had identified in the consumer discretionary and insurance sectors. Some tentative signs of life in a number of domestic consumer stocks and the beneficiaries of a stronger equity market have seen us gradually include some of these stocks in the portfolios. We will be looking to the February half-year reporting season to get some good insights into the progress and prospects of companies we own or are considering owning, and whether further portfolio shifts are warranted. While the current economic outlook from a sector perspective may be at a turning point and requires vigilant monitoring, in our view there is no doubt that identifying companies that deliver better than expected earnings will continue to deliver outperformance.

BTW

With all governments facing fiscal pressures in recent years, it has become very popular to propose raising taxes on the rich in order to fill any budget hole they might be facing. Of course, defining 'rich' is more problematic: it seems a rich person is somone who earns a little bit more than whoever is making the proposition. If you're on welfare, even average weekly earnings looks pretty good and a six-figure salary would make you a plutocrat. The 'fiscal cliff' negotiations in the US were fascinating: the Democrat definition of being rich enough to bear a tax increase was initially anything above $250,000 but the Republicans said it should be $1 million. The Democrats seem to have won with their counter offer of $400,000 ($450,000 for a family).

The thing about the really rich, however, is that they generally have other options. This was demonstrated powerfully in December when 65 year old French film icon and entrepreneur Gerard Depardieu renounced his French citizenship, citing the decision by France's Socialist government to tax high earners at a 75% rate, increase capital gains tax and strengthen its wealth tax as the main reason. Depardieu initially proposed moving his residence and tax domicile to our favourite European country, Belgium (which with a 50% top tax rate is hardly a tax haven), but subsequently accepted Vladimir Putin's offer of Russian citizenship instead (it has a flat tax rate of 13%!).

Increasing tax was a 'courageous' move on the French government's part when one considers that it is surrounded so closely by countries with much lower or even zero tax (think Andorra, Switzerland, Monaco, Liechtenstein) and there have been a number of other high-profile defections including France's richest man, Louis Vuitton head Bernard Arnault.

Depardieu was called a 'pathetic loser' by France's Prime Minister but the quintessential Frenchman responded by returning his passport and pointing out that he had been working since he was 14, had paid more than 145 million euros in tax over the years and presently employs 80 people, yet had been forced to pay 85% of his income last year in tax. He retorted: 'I am neither worthy of pity nor admirable, but I shall not be called 'pathetic'!'. He accused France of 'spitting on success'.

The really rich will always have avenues to ameliorate any move made against them by government. What punitive taxes tend to do, in the attempt to increase the size of the 'slice' to government, is capture those with moderately high incomes who have no way of avoiding tax. Such moves can stifle initiative and reduce the incentive to innovate and create employment for others, who would then pay tax, which would instead have increased the size of the 'pie'.

Traveller's tales

Stephane, our resource specialist, went to Brazil and Chile in November to find out more about likely iron ore and copper supply from that part of the world over the next few years. Brazil ships 300 million tonnes of iron ore per year, and is the second-largest seaborne iron ore exporter after Australia. Chile is the world's largest copper producer, satisfying more than a quarter of global copper demand.

Stephane ventured into the middle of the Amazon to visit Brazilian largest resource company, Vale's famous Carajas northern system. This region is not only famous for its amazing setting in the otherwise lush and pristine Amazon, it also has one of the lowest operating costs in the world. Carajas is also renowned for its amazing lodge, on the edge of a cliff overlooking the mighty Amazon. Unfortunately Stephane was only there for a few hours as he had to get to meetings in Rio De Janiero with other large iron ore miners.

Stephane's conclusion on Brazilian Iron ore supply growth was that whilst it would be flat in 2013, expansion means that at least 40m tonnes per annum would flow in each of the following years, reinforcing his view that the iron ore price is likely to start trending down from the middle of 2013. Of interest also is that production from the non-Carajas Brazilian mines are relatively high cost and, combined with high shipping costs, require on average a landed price in China of $85-90 per tonne in order to be viable so are likely to be the next marginal players (after some of the high-cost Chinese domestic producers) should the iron ore price weaken again.

His Chilean meetings highlighted the challenges faced by their copper producers, especially cost pressures linked to the power and water requirements to mine and process the copper ore primarily located in the Andes, a few thousand metres above sea level. Falling ore grades adds to costs, as does ever increasing wage requirements. Chilean company Codelco, the world's largest copper producer, will have to spend $5 billion per annum over the rest of this decade just to keep its production volume flat, a target which in itself is already stretched! So whilst Stephane went expecting the copper market to move from a deficit into a small surplus over coming years, he came back with a view that the downside to the copper price should be limited in light of the volume and cost challenges the industry is facing. And contrary to iron ore, where new global production is coming mostly from lower cost producers, new copper projects are generally more expensive than existing mines. This steepens the cash cost curve and provides a better support to the metal price.

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