Alphinity INVESTMENT MANAGEMENT

Quarterly comment – June 2012

Alphinity Wholesale Concentrated Australian Share Fund

Unhappy old year

Market comment

There was a lot of scope for a big move in June to finish what has been a tough financial year for most major equity markets, and in Australia a continuation of the downgrades seen in recent months, in some cases joined by capital raisings to shore-up stretched balance sheets.

The most closely watched event over the past month was probably the Greek election, perceived to be a referendum on that country's place in the Euro. As it turned out, the party that won enough to put together a workable coalition was the centre-left New Democracy. It is perceived to be more supportive of the austerity program and remaining in the Euro, however the task ahead of it is immense, and Greece's new Finance minister resigned after a week citing health concerns. One would be forgiven for speculating that any existing medical condition might have been exacerbated by his greater appreciation of the task ahead of him! Later in the month, attention turned to the fairly dire fiscal positions of Spain and Cyprus – which many were surprised to find is in the Euro. Cyprus' major trading partner is Greece.

Despite the wide range of potential outcomes, the ASX 300 (including dividends) turned out to be fairly flat, rising by less than 1%. Global markets were generally up 3-5%, and the $A appreciated about 5% against the $US, or 4% on a trade-weighted basis. Over the quarter to the end of June, the ASX 300 (including dividends) was down by 4.7%. Major global markets fell by 3-11% during the June quarter and the $A fairly flat.

Portfolio comment

The portfolio performed strongly in June, with positive contributions from global logistics property developer Goodman Group, global media conglomerate News Corporation, domestic bank Westpac, automotive sales website carsales.com, and not owning gold producer Newcrest. Detractors included iron ore exporter and steel manufacturer Arrium (aka Onesteel) and not owning Commonwealth Bank. For the June quarter, best contributors were Telstra, News Corporation, Goodman Group, Carsales and being underweight Newcrest and Santos; detractors were Bradken, Rio Tinto, Arrium and not owning Commonwealth Bank.

Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	16.6
Asset allocation	Australian equity: 97.5%, Cash: 2.5%

Fund performance* – as at 30 June 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	2.4	–3.7	–6.2	1.7
S&P/ASX 200 Accumulation Index	0.7	–4.7	–6.7	0.5

The Fund's return in June was positively impacted by the successful resolution of a proposed class action which was settled by Transpacific Industries, in which Fidante Partners Limited as Responsible Entity participated on behalf of unit holders. The Fund owned Transpacific shares in 2008.

*Returns are calculated before 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).

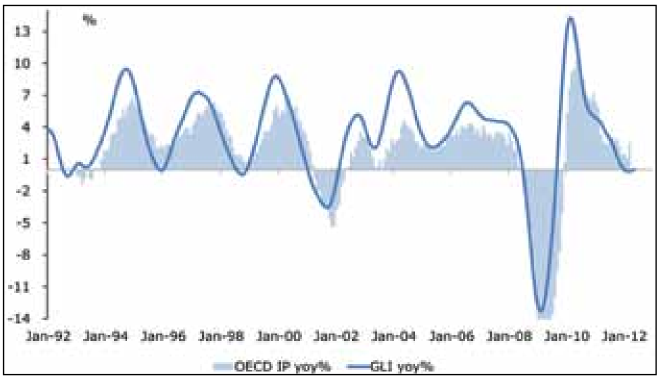
Top 5 active overweight positions as at 30 June 2012

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	6.6%	5.6%
Rio Tinto Limited	2.5%	4.3%
Goodman Group	0.5%	3.4%
Woodside Petroleum Limited	2.0%	2.9%
Insurance Australia Group Limited	0.7%	2.6%

Market outlook

Are we there yet? Regular readers of Alphinity's monthly reports would be familiar with our view that the Australian equity market on the one hand is cheap, but on the other hand is being held back by the paucity of overall earnings growth. Various stimulus or policy measures, such as rate cuts in Europe and/or China, QEIII in the US etc., may boost market sentiment to varying degrees but in the end we need earnings growth to resume for markets to make sustainable gains. Given the present attractive valuation metrics, once earnings bottom and start growing the upside is likely to be substantial. So the question is, how close are we to this point? In our view the answer both from a top-down perspective and a bottom-up perspective is that earnings risk is still firmly to the downside. As highlighted in the chart below, global leading indicators (GLI) of industrial production (IP) in OECD countries have been slowing for some time, and are approaching levels that in the past have been associated with declining IP. While this chart does not include Asia and many of the other faster growing parts of the world, global growth is unlikely to surprise positively in the near term.



Source: Goldman Sachs

What about the effects of the domestic rate cuts? It is now more than six months since the first rate cut in the current cycle and by now we would typically have expected to start to see some positive impact. At this point, the most positive interpretation of the data is that things are mixed. Retail sales are showing some tentative signs of stronger growth, though given the heavy discounting there must be considerable risk to retail margins. Construction activity is showing no signs of improving, albeit some of the weakness may be weather related, and both consumer and business sentiment remain low. There may be multiple reasons for this: the banks not having passed in full the Reserve Bank cuts, political uncertainty, the carbon tax; but the result still appears to be disappointing.

From a bottom-up perspective we reach a similar conclusion. At Alphinity, we spend a lot of time talking to company management and industry contacts to understand company and industry trends. While management does not always have a better understanding of what the future holds, they do (in most cases) know what current trading conditions are and what their order books look like. After talking to well in excess of 50 companies over the last couple of months, it is difficult to identify many companies or sectors where the operating environment appears to be improving. For sure, there are individual companies that are continuing to do well and some sectors, such as insurance, where the earnings cycle looks to have turned, but there are not enough of them to get much comfort around the earnings outlook for the overall market.

With the lack of positive factors to point to, other than that the market is 'cheap' and perhaps that bonds are 'expensive', a range-bound market seems a reasonable assumption.

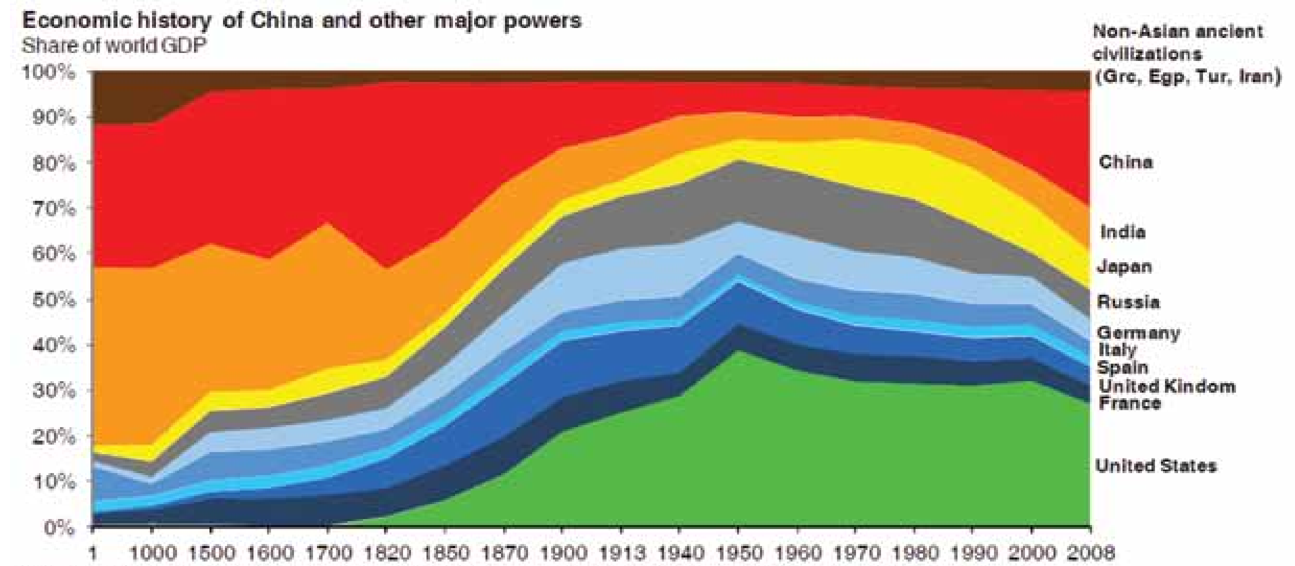
Portfolio outlook

As is often the case in uncertain times, cyclical companies with earnings risk are getting increasingly cheap, and companies with more stable earnings (and in many cases those with higher yields) are getting increasingly expensive.

Our portfolio is positioned for an overall cautious earnings outlook with exposure to stable cash generators such as Transurban, Sydney Airport, Duet and Telstra while also maintaining some exposure to the more cyclical parts of the market, especially in companies where we see company specific drivers. These include Fortescue's and Whitehaven's strong production growth profiles; and Oilsearch's and Woodside's leverage to a resilient oil price and growth from gas projects coming on stream. However, the core of the portfolio – and where most of the relative outperformance has been generated over the last year – is built around companies which have generated solid earnings growth ahead of market expectations. Companies like Goodman Group, News Corporation, Carsales.com, and Super Retail Group are in different sectors but all have unique market positions and/or strong operational execution in common. We will continue, through our research and stock selection, to pursue these opportunities.

BTW

JP Morgan recently came up with an interesting chart which we thought we would share, with their permission. It looks at the contribution to global economic output of various counties or regions since the time of Christ. Note that the X-axis is not a linear scale, so the most recent decades are given much more prominence than they probably should be. And obviously data collection must have been an issue going back that far so a fair bit of latitude must be given for the earlier years but the trend is probably fairly accurate. It shows that the 'Chindia' growth story is not a new phenomenon: what has been happening for the past couple of decades is really just re-asserting previous trends. Up until the industrial revolution, China's and India's economies relative to the rest of the world were much larger than they are now: about 70% of global GDP was produced by them at one stage. India alone has been much larger in the past – it was at one point as much as a third of the world's production – but has a long way to go to make that position up. Europe has largely maintained its position over the two millennia, and although the 'cradle of civilization' countries were much larger years ago, given Greece's issues since 2008 the chances of them regaining their previous position any time soon seem slim, notwithstanding some chunky oil reserves lying under some of the others. The largest emergence is of course the USA, which didn't have much of an economy 2000 years ago but now accounts for about a quarter of world GDP. What are the chances of USA going back to zero? Zero: although they still face a few serious issues, the US remains a large and creative economy which will bounce back.



Source: *"Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD"*, Angus Maddison, University of Groningen.

Traveller's tales

Shane travelled to the USA and Canada recently to see a range of Australian companies and their competitors, and his trip into Cowboy country coincided with one of the warmest starts to their summer on record. The economy in the south of the US is being helped by strength in the US energy sector. Texas is headquarters to many large energy and energy services companies, and with the emergence of Shale Gas and the recovery of deep water drilling in the Gulf of Mexico, the energy sector and associated services, and the general economy in this part of the US are benefiting strongly. While in Houston, Shane was honoured to be chosen as 'guest of the day' by the modest hotel in which he was staying. The plaque awarded will be treasured by him forever.

The temperature was much cooler in Vancouver, but he was able to warm up near the blast furnaces at the world's largest minerals testing laboratory, which is owned by Brisbane-based company Campbell Brothers. While impressed with the scale and efficiency of this part of Campbell's business, he found more attractive value in Ausenco, an engineering consulting firm also focused on the mining sector. Shane's meeting with its Canadian management reaffirmed the substantial project pipeline that exists in both North and South America, as well as Ausenco's potential to grow along with these.

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