Alphinity
INVESTMENT MANAGEMENT

Quarterly comment – March 2012

Alphinity Wholesale Concentrated Australian Share Fund

Marching About

Market comment

March was a mixed month on global markets. The ASX300 (including dividends) rose by 1.2%. The US was firm, up 2%, as was Germany (+1.3%) and Japan (+3.7%) however the UK and France both fell by 1-2% and the wider China group fell fairly sharply (Taiwan –2.3%, HK –5.2%, Shanghai –6.8% and China H-shares –10%) as the fears of a China slowdown we identified late last year became mainstream. Interestingly, Stephane's trip to China this month came back with a different conclusion, that there are some emerging signs of recovery.

Resource prices were hit by those China fears, which resulted in most base metal and precious metal prices falling between 5 and 10%, while oil was also down 4%. Iron ore held up nicely, counter to the fears of a China slow down and coal prices trended lower during the month.

The $A was a few percent softer against major currencies, except for the Yen. Interest rates remained on hold, and our recent comments by the Reserve Bank of Australia suggests they may have misjudged the weakness in the economy, and will probably ease rates in May as long as inflation remains subdued.

The March quarter overall was positive for Australian shares: including dividends, the ASX300 rose by 8.6%. This result lagged some global markets a little even adjusting for the modest $A appreciation during the period. The US S&P500 was up 12%, Germany's DAX up 17.8% and Japan's Nikkei225 up almost 19%. However non-German European stocks were less bullish: +3.5% for the UK's FTSE100, France's CAC40 +8.5%. Italy's MIB was up less than 6% and Spain's IBEX35 actually fell 6.5% as concerns again built around its sovereign debt. Hong Kong was up a strong 11.5% but its mainland counterparts were relatively flat: Shanghai and Shenzhen both up by less than 3%. Currency moves would have detracted from returns slightly in most places apart from Europe, where they added a little.

Portfolio comment

The portfolio performed solidly during March. The biggest contribution was from not owning gold producer Newcrest which fell sharply during the month, although our holdings in resource company BHP, bank ANZ, and blokey retailer Super Retail Group also contributed nicely. The largest detractors were gold producer Medusa Mining, gas producer Woodside Petroleum which fell in line with oil prices, and not owning global insurer QBE.

Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	19.1
Asset allocation	Australian equity: 98.8%, Cash: 1.2%

Fund performance* – as at 31 March 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	1.5	9.1	–6.5	4.5
S&P/ASX 200 Accumulation Index	1.2	8.4	–6.1	3.7

*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 Challenger's Investor Services team on 13 35 66 (during Sydney business hours).

Top 5 active overweight positions as at 31 March 2012

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
ANZ	6.0%	4.3%
Rio Tinto	2.8%	4.3%
Telstra	4.0%	3.8%
Goodman group	0.5%	2.9%
Westpac	6.5%	2.9%

Over the March quarter, the best contributors were Super Retail Group, travel agency Flight Centre, industrial products manufacturer Bradken, and property funds manager Goodman Group. Not owning major bank CBA also helped. The largest detractors were miner Rio Tinto, and not owning blood products company CSL.

Market outlook

The month of March capped off a solid first quarter for global equity markets, including the Australian market. As we wrote about in our last report, we see two requirements for positive market returns going forward: firstly, increased risk appetite as investors become more comfortable with the financial risks associated with the Euro debt crisis; and secondly better earnings growth.

On the first issue, markets still trading below long term valuation metrics, particularly in Australia, are likely to benefit from further evidence that a full-blown debt crisis has been avoided. Somewhat ironically, markets weakened towards the end of the period on disappointment over a reduced likelihood of further quantitative easing in the US, as that economy appeared to continue its steady path onto firmer ground. That the US economy can continue to grow without renewed Federal Reserve stimulus is a positive in our view!

On the second issue, it is more difficult to be enthusiastic. In fact, a number of companies including Leighton, Metcash, Qantas, Stockland, and Transfield Services have already provided unanimously negative updated earnings guidance, so soon after the February reporting season. It looks like the steady march towards no earnings growth for the market in FY12 continues.

On a brighter note, our visits to the US and China during March have made us more positive on the outlook for the two largest economies in the world. In the US, steady progress appears to be made with unemployment reducing and the housing market finally showing definite signs of life. Perhaps most noteworthy for investors is our increased confidence in the Chinese economy. While acknowledging that its medium term growth is likely to slow somewhat, and that the commodity intensity of its next five-year plan is likely to reduce, our visits to about 30 companies there in March indicated that the seasonal upturn and some improvement from the gradual easing of financial constraints has at last arrived. This should provide support to the resources part of the market which has been coming off due to the slowdown in the Chinese property market that we have commented on extensively over the last few months.

Portfolio outlook

Following a positive reporting season for Alphinity's portfolios, which makes us feel well positioned for the balance of the financial year, we spent much of March on the road, seeking out ideas and themes that will impact on stocks and markets over the balance of the year. We had two trips to Europe, two to the USA and one to China, not to mention a number interstate. We have come back travel-weary but also re-energised with lots of insights that are being applied to the portfolios. We will eke out some of our stories in more detail in coming months but here we discuss some of our broader conclusions.

As mentioned above, Stephane came back more positive on China. This was in marked contrast to our last visit in November last year when we concluded that investors expecting a rapid easing of monetary constraints with a peak in inflation and even economic stimulus programs would be left disappointed. This has now largely played out in Metals & Mining share prices and, with a more positive tone to our meetings as many companies pointed to an improvement in order books, we have reduced our underweight in the sector. Specifically, we have built on our position in Rio Tinto and entered OneSteel (soon to

be known as Arrium as the company accentuates its move away from steel manufacturing). Our US trips made us more confident in the strength of its recovery. In contrast to last year's visit at around the same time, when a spike in petrol prices and its impact on consumer spending came through as a caveat, our company meetings this time across a wide range of industries and geographies left us with the conclusion that things are improving albeit at a steady – rather than accelerating – rate. Perhaps the most incrementally positive news came from the residential housing sector which seems to have finally turned the corner, with increased foot traffic and order intakes for the leading home builders.

We remain enthusiastic about our investment in building materials company James Hardie. While James Hardie is well positioned to benefit from increased activity in US housing, the same cannot be said for companies exposed primarily to the Australian construction markets. Property group Stockland has already had to issue a profit warning due to soft residential activity and we expect more to follow. We believe this is still a part of the market to avoid.

BTW

While bonds have been in a bit of a bull market the last couple of years (falling yields = rising capital values), the possible bottoming out of the world economy thanks to Europe's long-term refinancing operation (LTRO) suggests that now is probably not a great time to be in the bond market.

A long bond in Australia is considered to be anything over ten years to maturity. In the US, which has had (and will have) more significant debt requirements for much of our lifetime, has routinely issued 30-year bonds. The UK is looking to go one step further: we were startled to see on the front page of the March 14 edition of the Financial Times that the UK government is considering issuing bonds that mature in 100 years in order to 'take advantage of the country's historically low interest rates'.

We like to think of ourselves as long term investors. In the share market, that means we look to hold a stock for a couple of years, maybe as long as five. A lot can change in the operating environment or even in the fundamentals of a company over that period, so it is rarely a good idea to put a stock in the 'bottom drawer'. But we do wonder at the confidence you would need to put money away for 100 years. Who would possibly have liabilities of that duration to match? You would want a pretty big risk premium to go out 100 years but history suggests that there would be no risk premium big enough.

The UK government last issued 100-year gilts (as they are known) in 1932 at a yield of 3.8%. Had you bought a £100 bond then you (or at least your descendants) will collect that £100 in 2032, having picked up £3.80 each intervening year, a total of £480 over that time, if you could have reinvested at 3.8%, you would have £1,900 now. It is sobering, however, to consider the insidious impact inflation has had on the purchasing power of that £100: measuringworth.com's calculator suggests that it would take £14,400 of today's average earnings to equate to that £100, and of course there's still another 20 years of inflation left before maturity. Even using a more charitable measure of inflation like the Retail Price Index, you would still need £4,950 today to buy what £100 would have bought in 1932 (the difference between the two measures also illustrates the massive benefit that technology and the globalisation of trade has brought to the living standards of people just about everywhere).

You do wonder who would accept that sort of risk. Of course most purchasers of long term bonds will sell them well before maturity, at which point they will realise a capital gain or loss. Should yields fall further there could be a handy capital gain on that 100-year bond. However the whole reason the UK Government is considering it is that it feels rates are at a cyclical low, and you'd think it would have an information advantage over most of us. Should yields rise from this point, as is quite likely, the capital losses could be significant. It appears to us that the upside (for a buyer) is minimal, but the downside enormous.

Contrast that with investing £100 in the UK share benchmark in 1932: that would now be worth £13,313 even before considering dividends. Assuming reinvestment of dividends at 2% pa would increase that total to about £60,000.

We have a natural bias towards equities, of course, but we do recognise that there are times when other asset classes have better prospects. Right now does not appear to be one of those times. The key message to potential bond investors at this point in the cycle is Caveat Emptor.

Traveller's tales

Waiting for a meeting with the Bank of England, we were surprised to see a functioning bank branch on the ground floor of that grand building, as well as a couple of ATMs. Intrigued by the novelty of this we attempted to withdraw some cash but to no avail: it was only for account holders and, unlike every other ATM in London, there was no global link-up. But we would have loved to get past the front screen just to see if there was an 'QE' option, enabling the odd multi-billion pound bond repurchase.

The Bank building was built in the 1700s but internally remodeled in the 1930s in grand style. Impressive Roman-style mosaics are inlaid into the floor depicting significant events in England's rich history. Most impressive, however, is an authentic Roman mosaic which was uncovered in the 1930s rebuilding, on a level which is now several floors below the street.

The Bank is famous for containing more floor space below ground than an adjoining 42-storey building. This includes the vault which contains all of its gold (presently 11% of the UK's total reserves), along with the gold reserves of a number of other countries which have been left with the Bank of England for safe keeping. The Bank would not reveal which countries they are but given the civil uprisings in various parts of the world in recent years, leaving your gold reserves with the Bank of England seems like a prudent move.

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