Alphinity INVESTMENT MANAGEMENT

Quarterly comment – March 2013

Alphinity Wholesale Concentrated Australian Share Fund

Two steps forward, one step back

Market comment

The market took a breather in March from its recent break-neck speed as investors contemplated the past few months' large and rapid rise in the market, the outcome of the February reporting season and compared it to the economic data being released. Surprisingly little attention was paid to the US government's 'sequester': instead, as March progressed, bank solvency in a small country at the edge of Europe started to cause global financial markets some concern. It wasn't Greece this time, but its close neighbour Cyprus whose banks had been lending rather large amounts to Greece. Those loans had been written down sharply in value, meaning the Cypriot banks went to the European Central Bank (ECB) for support. A year ago this might have caused a rout in financial markets but, such is life in a bull market, this time it did not.

Unlike in the cases of Ireland, Spain, Italy, Portugal or Greece, the ECB initially insisted that all bank depositors (subsequently settling on only large depositors) take a 'haircut' by forfeiting a portion of the money they had deposited. This was strangely unpopular with depositors and initially rejected by the Cypriot parliament, but one of the nuances of that country's financial system is that it had become a recipient of large Russian deposits, attracted no doubt by the nicer weather in Cyprus much of the year, and the northern European providers of bail-out funds were not keen to be seen by their constituents to be saving Russian oligarchs. While officials are playing down the haircut as a one-off, it ran the risk of triggering further runs on banks elsewhere in Europe and must surely raise concerns in other countries with vulnerable banks that similar measure may be one day taken.

The Australian market was soft in March. After two consecutive +5% months, the S&P/ASX 300 Accumulation Index (including dividends) fell by a little over 2%: 8% in three months is a very solid return and compares very favourably to even a whole year's return from term deposits or annuities. Global markets were mixed, and the firm $A exacerbated the falls for Australian investors. The US S&P500 was up 1.8% in $A (+3.6% in $US) while the major European markets were generally down. The UK was down about 1%, France and Germany both down about 3%. The weaker European markets were worse: Spain and Italy were both off almost 8%, and the Greek market was down

Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	16.6
Asset allocation	Australian equity: 98.2%, Cash: 1.8%

Fund performance* – as at 31 March 2013

	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	10.0	24.6	7.9	11.9
S&P/ASX 200 Accumulation Index	8.1	20.0	6.2	9.7

***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 Fidante's Investor Services team on 13 51 53 (during Sydney business hours).

Top 5 active overweight positions as at 31 March 2013

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	7.9%	6.8%
ANZ Banking Group	6.5%	5.0%
Rio Tinto Limited	2.1%	3.7%
Insurance Australia Limited	1.0%	3.6%
Lend Lease Corporation	0.4%	3.3%

20% – it seems some locals had moved money out Greece into Cyprus for security. Asian markets were mixed: Chinese shares also dropped about 7% but Japan continued its recent strong run, rising a little over 3%.

So far in 2013, Australian investors would have done best in Swiss, US, Australian and Swedish shares (all +8-10%), followed by Japan (+6%) but any of the Euro-denominated markets were best avoided.

Portfolio comment

The portfolio outperformed nicely in March with positions in department store chain Myer and major bank Westpac and being underweight global resource company BHP more than offsetting global resource company Rio Tinto not owning major banks Commonwealth Bank of Australia or National Australia Bank, which all cost a little.

The Fund also did very well over the March quarter, with positives from Westpac, insurer IAG, Myer, major bank ANZ, global travel company Flight Centre, online car site Carsales.com and being underweight global resource company BHP and gold producer Newcrest. Negatives were from owning Rio tinto and not owning banks National Australia Bank and Commonwealth Bank of Australia or retailer Woolworths.

Market outlook

In our February report we wrote that a degree of consolidation was likely in the next few months following the strong runs in the Australian and global equity markets since the middle of last year. It appears that this consolidation period may have begun in March and, notwithstanding that April has often been a strong month for equities historically, the new quarter has started with a soft tone. While we also wrote that the market is now close to fair value rather than cheap, we believe there are enough signs of an improving earnings outlook in several sectors to avoid a sharp sell-off, and for the market to move higher as the year progresses.

For example, after several years of consistent earnings downgrades for consumer-related stocks, some of these now look to have turned the corner. We saw some encouraging signs already in the February reporting season from discretionary retailers such as JB Hi-Fi and Harvey Norman, and these were followed up in March by the interim results of department stores Myer and David Jones and mass market apparel retailer Premier Investments (Just Jeans, Jay Jays, Portmans, Jacqui E, Peter Alexander, Dotti). All have resulted in positive revisions of full year earnings expectations by broking analysts, something we haven't seen for at least three years. While the scorecard for other domestic cyclical companies e.g. building materials are more mixed, leading indicators such as housing approvals are also pointing to some improvement in the outlook and lends credibility to the RBAs assessment that the rate cuts over the last year or so are starting to positively impact the Australian economy.

The bank reporting season is only a few weeks away and while credit growth remains modest by historical standards, lower funding costs and (despite earlier market concerns) improving rather than deteriorating credit quality should be supportive for aggregate bank earnings and thus the overall market earnings outlook. Following the substantial expansion in the price to earnings multiple that has taken place over the last year, an improved earnings picture is key to further equity market gains.

Portfolio outlook

The portfolio performed well in March and in the first quarter of 2013. While we have gradually shifted the portfolio to stocks that will benefit from a more confident consumer and stronger financial markets in general, we have been fastidious in our endeavor to focus on companies where we can see tangible evidence of an improved earnings outlook. Companies such as Myer Holdings and JB Hi-Fi fit this bill. We believe this approach will continue to deliver favourable investment results. This may particularly be the case over the next quarter or two as the market, following its strong run, may have reached a level where companies need to deliver on what are now some demanding expectations implied in their share prices.

BTW

One question you may have pondered late at night is, 'How much energy does the US military consume? And, if it were its own country, where would it sit in the ranks of energy consumers?'

Well the answers are, 'a lot' and 'alongside Nigeria'. According to the US publication Daily Energy Report, despite the massive energy savings that had been achieved in recent decades (made possible by the end of the Cold War), the War on Terror reversed all of that and more.

The US has a famously energy consumptive economy, yet the military uses – per capita –35% more energy than even the average US civilian. The Department of Defense is the single largest user of energy in the US, and in the latest period for which data were available – 2009 – consumed 932 Trillion BTU (that's British Thermal Units, the global standard measure of energy), as much as the entire country of Nigeria which has a population of 140 million. 80% of its energy comes in the form of oil and 11% from electricity while renewables make up less than 4%.

It emitted 73 million tonnes of CO_2 which is about 4% of total US emissions. Using 360,000 barrels of oil a day, it is the biggest single oil consumer in the world: only 35 countries use more, and the Air Force is most oil-intensive branch of the military. Almost half of its oil (almost $10 billion-worth) is used outside the US itself, in places where US military has operations, which seems like pretty much everywhere. The cost to the US economy is staggering: even though US motorists pay only about $1 a litre to fill their cars, high-grade jet fuel required for fighters can cost more than $11 a litre (including delivery) for mid-air refuelling! The Report notes that the US military is 'aware of its dependence on energy' and that it has now been recognised as a 'strategic issue', but the solution to reducing that dependence has as yet been elusive.

Traveller's tales

Stephane attended a resource conference in London in March where he found the mood of fellow investors definitely gloomy. Attendance was sparse despite a good show-up from some of the largest UK-based miners. What a shift from a few years ago! Investors are now hoping, somewhat naively we think, that the miners will have learned a lesson from the past and that, instead of reinvesting most of their earnings into growth projects, they will now start returning a large portion back to shareholders which would mean resource stocks might at last offer a decent yield.

The volatility of earnings linked to the commodity prices makes such a prospect unlikely in our view. Overall, investor confidence in China and that commodity prices will start surprising positively was low despite what was generally a more upbeat outlook from the mining companies themselves. Stephane is off again to China in April to hear the latest from end users on whether demand is picking up, a key requirement to drive earnings and share prices higher.

Alphinity Investment Management

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

Unless otherwise specified, any information contained in this publication is current as at the date of this report and is provided by Fidante Partners Limited (ABN 94 002 835 592, AFSL 234668) the issuer of the Alphinity Australian Share Fund (ARSN 092 999 301) and the Alphinity Concentrated Australian Share Fund (ARSN 089 715 659) (Fund). References to Alphinity Wholesale Australian Share Fund and the Alphinity Wholesale Concentrated Australian Share Fund are to the wholesale class unit in the relevant fund and references to the Alphinity Australian Share Fund and the Alphinity Concentrated Australian Share Fund are to the retail class unit in the relevant fund. Alphinity Investment Management Limited (ABN 12 140 833 709, AFSL 356895) is the investment manager of the Fund. It should be regarded as general information only rather than advice. It has been prepared without taking account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on any such information, consider its appropriateness, having regard to their objectives, financial situation and needs. Each person should obtain the relevant Product Disclosure Statement (PDS) relating to the Fund and consider that PDS before making any decision about the Fund. A copy of the PDS can be obtained from your financial adviser, our Investor Services team on 13 51 53, or on our website www.fidante.com.au. If you acquire or hold the product, we and/ or a Fidante Partners related company will receive fees and other benefits which are generally disclosed in the PDS or other disclosure document for the product. Neither Fidante Partners nor a Fidante Partners related company and our respective employees receive any specific remuneration for any advice provided to you. However, financial advisers (including some Fidante Partners related companies) may receive fees or commissions if they provide advice to you or arrange for you to invest in the Fund. Alphinity Investment Management, some or all Fidante Partners related companies and directors of those companies may benefit from fees, commissions and other benefits received by another group company.

15131/0413