Alphinity INVESTMENT MANAGEMENT

Quarterly comment – March 2015
Alphinity Wholesale Socially Responsible Share Fund

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Market comment

The Australian share market (S&P/ASX300 including dividends) marked time in March, falling early in the month and recovering at the end, but for the quarter it rose by a healthy 10.3%. But much of the action was happening offshore: the financial world was waiting expectantly for the outcome of US monetary policy (see BTW) and chiefly the appearance of the word "patient" which could end up determining the direction of many markets over the balance of the year. As it turned out, the reality turned out to be quite unexciting.

Most markets performed in a fairly lacklustre fashion in March but showed good returns for the quarter, at least in $A. Markets in the Americas were generally soft in March while the better European countries achieved modest low- to mid-single digit gains. China was very strong (+17%) after soothing noises emerged from the central government about possible stimulus. For the quarter, Australia's 10% shaped up pretty well compared to most other major markets, although Hong Kong and some of the better quality European and Scandinavian markets achieved 14-18%. China raced away with a 25% gain in the three months.

Commodity prices continued their downhill run during the quarter. Iron Ore fell by 28%, compounding the woes of prior quarters: at $US51 it is now down 73% from its 2011 peak of $US190/ton; the $A price is down a less bad but still terrible 66%. Base metals were generally weak with nickel and tin down 18% and 15% respectively, copper and zinc down 5% and 4% and aluminium down 2%. The $A depreciated 7% against the $US although a little less against most other currencies and actually appreciated by 5% against the Euro.

Portfolio comment

The Fund matched even the very strong market in the March quarter. The best contributors during the period were financial services company Macquarie Group, retailer Super Retail Group, gas pipeline operator APA and not owning supermarket operator Woolworths or financial services company Suncorp. Partly offsetting those however were our positions in health insurer Medibank Private and double-glazed window maker Metro Performance Glass, both of which underperformed the market slightly during the quarter.

Market outlook

No longer patient but not impatient; bad data is good data? Financial markets appear to have taken US Federal Reserve (Fed) watching to new heights in recent months. And while the ever-changing interpretation of economic data in which weak growth is concerning one week but welcomed the next (as US rate rise expectations are pushed out) can be a bit frustrating, we do at least know that low interest rates have been good for the US economy and for equity markets worldwide.

How equity markets will react to the reality of higher US interest rates when it finally occurs is more difficult to say. Recent market reactions suggest not that well but the real answer is, to use the Fed's language, economic data-dependent. The conundrum however is that as monetary policy since 2008 has been very unconventional, history gives us very little indication of how the economy and markets will actually react to higher interest rates. While the final date for "lift-off" is still being debated it should at least not come as a surprise to equity markets that rates are likely to go up. And it may be that the economy and equity markets come through relatively unscathed, just as they did with the end of the Fed's Quantitative Easing program last year. However, this is far from a certain conclusion and, given that markets are trading above recent years' valuation range, in our view risks for disappointment have increased.

Domestic data remains sluggish with the iron ore price setting new post-GFC lows, albeit with some offset from the lower $A for the miners and corporate earnings in general. The federal budget in May should, based on comments out of Canberra, hold fewer surprises this year so it looks like the domestic factor that will have the greatest influence on the direction of the equity market is the same as that driving global markets: interest rates. The silver lining for the Australian equity market is that the Reserve Bank of Australia still has plenty of room to take rates lower if required, and that the dividend yield of Australian stocks remains highly attractive to global investors who appear more comfortable with the present level of the Australian dollar.

Performance*	1 month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	Since inception^ % p.a.
Fund return (net)	0.8	10.3	14.3	14.3	17.1	12.3
S&P/ASX 300 Accumulation Index	-0.1	10.3	13.9	13.4	15.3	11.2

*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 relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 (during Sydney business hours).

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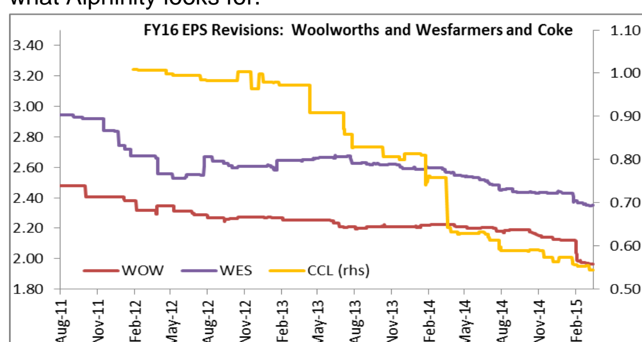
Portfolio outlook

Broader portfolio themes in place at the end of the March quarter remain largely unchanged: we are underweight Resources (Mining and Energy), moderately overweight Banks (although we have trimmed some after some solid outperformance), slightly underweight other "yield" sectors (utilities, Infrastructure) and overweight $US earners. However as regular readers of our reports would know however we favour investment cases built on company-specific earnings drivers rather than macro themes. This we believe is especially valid in the current uncertain macro environment discussed above, but it does not mean that we won't take sizeable overweight or underweight sector positions: rather our views of individual companies generally determines our sector positioning.

One example of this is the Consumer Staples sector. The sector is dominated by supermarket heavyweights Woolworths and Wesfarmers, followed by much smaller beverage companies Coca-Cola Amatil and Treasury Wine Estates. This sector has been a major underweight in Alphinity's portfolios for several years and completely absent from the SRSF portfolio due to its restrictions on alcohol-producing or gambling-operating companies. While we are conceptually attracted to what should be stable consumer demand, historically solid cash flows and high ROEs generated by staples companies, we have for some time been concerned about how these factors will develop in the future.

For Coca-Cola Amatil our concerns were centred around a strategy reliant on high pricing despite changing consumer preferences towards healthier beverages at the expense of carbonated soft drinks. This has been playing out over the last couple of years with major earnings disappointments as a result. A new CEO is now in the process of revamping the company's strategy and we are following developments there with interest.

More recently, Woolworths' share price has fallen sharply although we would argue that the warning signs have been evident for some time. It has been earning the highest margins of any supermarket operator in the world, has had a resurgent competitor in Coles and Aldi becoming a meaningful threat, a large but as-yet unproven investment in Masters hardware and a struggling Big W. This has all culminated in an earnings downgrade cycle – the opposite of what Alphinity looks for.



While the staples companies are all underperforming and it has served the portfolio well not being able to invest in them, we remain alert to the fact that this will not always be the case. As such, we are always looking for ways to ameliorate any future negative impact from the absence of these stocks, including by finding attractive companies with similar industry or return characteristics to own instead.

Sustainability score

Alphinity's external advisor, CAER, assesses the Alphinity Socially Responsible Share Fund portfolio on a monthly basis to ensure that it complies with the Fund guidelines, and tests the Fund's holdings as to the sustainability of the companies held according to ESG criteria. Their most recent assessment is that the Fund had Environmental factors 29% better than the market; Social factors 28% better than the market; and Governance factors 28% better than the market. The Fund's overall Sustainability Score was 72%, which compares favourably to that of the ASX300 of 53%.

Asset allocation	As at 31 March 2015 %	Range %
Securities	98.2	90-100
Cash	1.8	0-10

Top 5 active overweight positions as at 31 March 2015	Index weight %	Active weight %
Aconex Ltd	0.0	2.1
Telstra Corporation Limited	5.1	2.1
Goodman Group	0.7	2.0
Westpac Banking Corporation	8.1	2.0
GDI Property Group Ltd	0.0	1.9

Fund details	
Manager inception date	1 September 2010
Fund inception date	30 June 2000
Fund size	$15.3M
APIR code	HOW0121AU

	Fees
2013/14 ICR	1.15%
Management fee	1.15% p.a. of the net asset value of the Fund
Performance fee	Nil
Buy/sell spread	+0.20%/-0.20%

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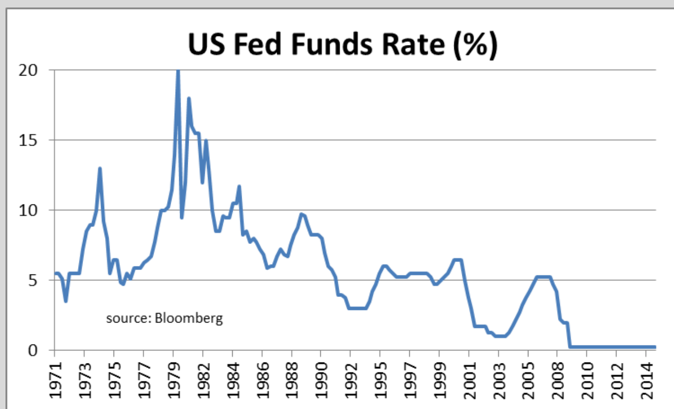
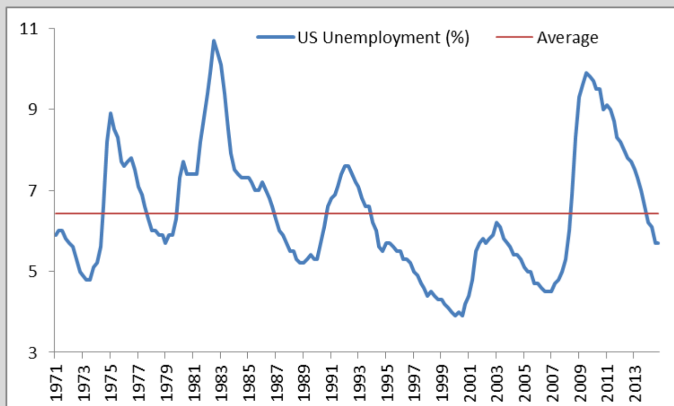
BTW

The financial world was waiting expectantly for the appearance (or non-appearance) of one little word which could end up determining the direction of many markets over the balance of the year. The US Federal Reserve Bank's Open Markets Committee is the body that sets US interest rates and has been responsible for the ZIRP (Zero Interest Rate Policy) in place there for a number of years. But zero rates must surely come to an end one day, and with unemployment currently at levels well below the long-term average and economic activity reasonably robust in most sectors, the market has been looking for hints as to when that might be.





The Fed had previously indicated that it would hint that the end of ZIRP is nigh by removing the word "patient" from its minutes at least two meetings before the decision to increase rates was made.

Consequently the markets were watching the Fed like hawks (or doves as the case may be) for the appearance or otherwise of that word. When the Fed Funds rate finally does rise it will be the first increase since June 2004.

So when Fed Chair Janet Yellen produced the statement without the word patient in it, did she elaborate on the Fed's intentions? She did, although not very helpfully. In her inscrutable central banker manner, she said "Just because we removed the word 'patient' doesn't mean we are going to be impatient" and dovishly suggested that any rate rise would be dependent on the Fed being "reasonably confident" about progress of employment and inflation trends. We really shouldn't be surprised about the cryptic nature of her comments, after all one of her predecessors, Alan Greenspan, once said " I know you think you understand what you thought I said but I'm not sure you realise that what you heard is not what I meant", and another time: "I guess I should warn you, if I turn out to be particularly clear you've probably misunderstood what I've said".

While on the topic of former Fed governors the most recent ex, Ben Bernanke, has started up a blog as part of his work as a fellow of the prestigious Brookings Institution think tank in Washington DC. AKA "Helicopter Ben" for his practice of throwing around unbelievable amounts of money to address the structural problems arising from the GFC (mainly QE, QE2, and QE∞ which combined to cause the Fed's balance sheet to grow from a mere $US869 billion in 2007 to its present $US4.5 trillion), it was fairly predictable that his first blog would be at least in part a justification of his actions. You can find his musings on this and other topics at www.brookings.edu/blogs/ben-bernanke.

Fed officials are not particularly well paid: in the context of US financial markets where some of the more egregious players can receive tens of millions of dollars a year, Bernanke was paid a mere $US199,700. Given the enormous responsibility the position entails it would be easy to feel sorry for him: even if he only worked a 40 hour week, which is likely way too low, that would work out to be $1.60 per minute. However he seems to be making up for it now: as an ex-Governor a single 40-minute speech will earn him as much as $US250,000, which equates to $6250 per minute. Nice work if you can get it!

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Apple Bites

Apple Inc* is an intriguing company and its incredible record of innovation has enabled it to become the largest company in the world by market capitalisation. It went through a rough patch a couple of years ago when it started getting earnings downgrades and its share price almost halved between September 2012 and April 2013, then its founder Steve Jobs died later that year. Was it all over for Apple?

As it turns out, no. The company responded by doing what it was good at: producing beautifully-designed pieces of consumer electronics desired by lots of people. The downgrade cycle ended and earnings upgrades resumed and its share price has since more than doubled. Apple's most recent quarterly result revealed some interesting factoids which, courtesy of businessinsider.com.au, we relate (with a few tweaks) below.

- Apple's market cap is US$740 billion. That is more than the GDP of all but 17 countries. Number 18, The Netherlands, had a GDP of US$720 billion in 2013, according to CIA estimates.
- Apple's quarterly revenue just from the iPhone was $51 billion, greater than Yahoo's entire market capitalisation of $40 billion.
- Apple's iPhone revenue was more than three times Google's $16.5 billion total revenue in the same quarter.
- Apple's iPhone revenue was almost twice Microsoft's total quarterly revenue of $26.5 billion.
- At 74.5 million units, Apple sold seven times as many phones as Microsoft's entire Nokia business. In fact, 74.5 million is more iPhones than Apple sold during its entire 2011 fiscal year.
- Apple has $178 billion in cash, more than enough to buy IBM at its current market cap of $152.3 billion.
- In fact, Apple could buy Ford, GM, and Tesla and still have $41.3 billion left over.
- Apple's iPad revenue alone, $9 billion, is more than enough to buy sports camera maker GoPro at its current market cap of $6.6 billion.
- Apple's post-tax profit last quarter was $18 billion, the largest quarterly earnings for any company ever, according to Wikipedia. The previous record was held by Gazprom, Russia's enormous oil and gas company, which booked a $16.2 quarterly profit in August 2011. In fact, every other company in the top 25 most profitable quarters of all time is an energy company.

Apple CEO Tim Cook on the way to the bank

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*Apple is a US-listed company and not eligible for inclusion in this portfolio.