Alphinity INVESTMENT MANAGEMENT

Quarterly comment – December 2012

Alphinity Wholesale Socially Responsible Share Fund

Alphinity Socially Responsible Share Fund

Market comment

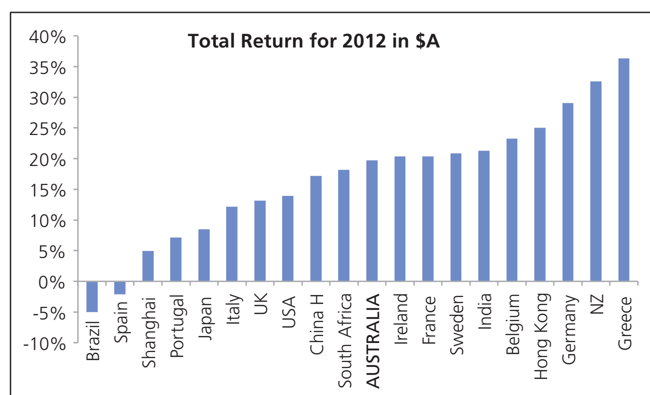
The Australian market (S&P/ASX300 including dividends) rose 6.8% over the December quarter, outperforming all major global markets other than Japan. Japan's stunning 17% rise, however, was largely offset by the Yen depreciating by 12% against the $A during the quarter.

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.

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.



Fund details

Alphinity Wholesale Socially Responsible Share Fund	
APIR code	HOW0121AU
FUM (AUD million)	14.3
Asset allocation	Australian equity: 98.7%, Cash: 1.3%

Fund performance* – as at 31 December 2012

	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (%)
Alphinity Wholesale Socially Responsible Share Fund	8.2	23.0	4.9	8.0
S&P/ASX 300 Accumulation Index	6.8	19.7	3.2	6.9

*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 Socially Responsible Share Fund

	Index weight (%)	Active weight (%)
Lend Lease Corporation Limited	0.4	2.4
Insurance Australia Group Limited	0.8	2.1
Westpac Banking Corporation	7.0	2.0
Super Retail Group	0.1	1.9
Rio Tinto	2.5	1.9

Portfolio comment

The Fund outperformed even the strong ASX300 significantly and with good contributions from a diverse range of companies including retailer Super Retail Group, resource company Rio Tinto, property company Lend Lease and mining services company Monadelphous and milk processor Fonterra. There were no individually meaningful detractors in the quarter. Fonterra listed on the NZ and Australian exchanges in November and has so far lived up to our expectations but will, as with all positions, be closely monitored for its financial performance and governance.

Over the calendar year, the best contributors were Super Retail Group, industrial property company Goodman Group, Fonterra, insurer IAG, asset owner Australian Infrastructure Group, online advertiser Carsales, and blood fractionator CSL. The major detractors for the year were industrial manufacturer Bradken, steel producer Arrium, and not owning diversified conglomerate Wesfarmers, which is excluded from the Fund's investable universe due to its ownership and operation of poker machines.

Market outlook

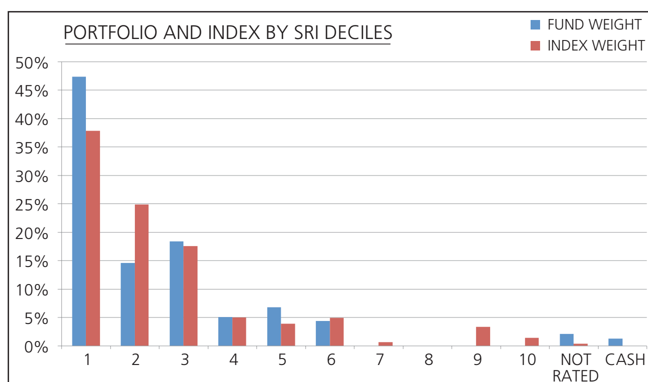
After a near 20% return in 2012 the equity market is no longer as attractively valued as it was a year ago. With very modest (or negative depending on the time period measured) overall market earnings growth, the strong returns of the past year have been driven almost exclusively by a market re-rating 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 in 2012 market commentaries 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 what 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. The strong performance of many of these stocks and some tentative signs of life in a number of domestic consumer stocks and 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 strong investment results.

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. As at the end of December the Fund had Environmental factors 39% better than the market; Social factors 35% better than the market; and Governance factors 22% better than the market. The Fund's overall Sustainability Score was 68%, which compares with the ASX300 of 50%. The chart below shows the portfolio's weighting by sustainability deciles relative to the market.



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

Bruce went to Japan and China in November looking at sheds. Big sheds. Really big sheds actually. Goodman Group has contributed nicely to Alphinity's funds performance during 2012, and the company organised a day in both Tokyo and Shanghai to show investors what it does – develop and own modern warehouses – and allow them to get some idea of the remaining potential in those regions. In addition, he spent a day in each city with Goodman's major competitor in the region – Global Logistics Properties (GLP) – and met with a smaller unlisted competitor in order to test what everyone was saying.

Land is scarce and valuable in Japan, and multi-level warehouses have become commonplace: four or five stories with spiral ramps to get the trucks up. The quality of construction needs to be extremely high to withstand not just the weight of the goods and trucks, but also include extra features to withstand the regular seismic activity. Despite an economy which has been stagnant for some years, the issues of obsolescence and increasing two-way trade means there is significant demand for modern logistics facilities there.

The differences just across the sea in China were stark. Chinese contruction tends to be, as is often portrayed, a bit 'rough and ready' and much of the existing space is therefore not usable for modern logistics: installing nine-metre high pallet racking on an undulating concrete floor is a recipe for disaster. Goodman, GLP and others are in the process of building millions of square metres of modern space in order to fulfil demand, which is largely being driven by online shopping both in China and offshore.

There is increasingly emerging a value distinction between 'warehousing' (i.e. a shed in which to store stuff) and 'logistics' (a building to facilitate the rapid movement of goods) and Goodman is well positioned to benefit from this. The remaining opportunity is so large that there is plenty of room for a number of players to do very well.

One GLP warehouse in Shanghai was occupied by a Chinese online apparel company: in keeping with the funky online image, the workers zoomed about the large expanse of smooth concrete floor on rollerblades!

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