Quarterly comment – June 2013

Alphinity Wholesale Socially Responsible Share Fund

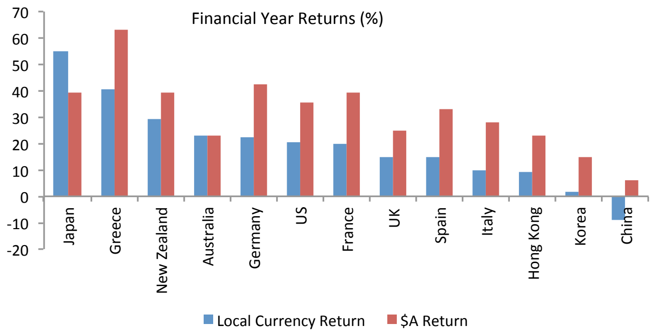
Alphinity Socially Responsible Share Fund

Market comment

Share markets were volatile in the final quarter of the financial year as bond yields rose sharply in Australia, US, UK and many other places. Rising bond yields cause capital losses for investors and the 1% rise in ten year bonds – as has happened in Australia since mid-May – equates to about a 10% capital depreciation, roughly equivalent to the fall in the share market over the same period. The $A fell sharply against the $US and more modestly against other currencies during the quarter. Part of this was related to Australia's fundamentals (lower cash rates, soft commodity prices, China concerns, weakening economic activity), but part also to a strengthening US economy which drove the $US higher against the Euro, Pound and Yen.

The Australian market put in a very strong performance in April but this was more than offset by a sharp fall in May and a modest fall in June. In aggregate, the market was down 2.8% over the quarter (ASX300 including dividends) and is now up only 5% for the calendar year to date. The Fund managed to outperform the market to the extent that its absolute gains are still reasonable. In the context of three year bonds yielding below 3%, an 8% return in six months is quite appealing and more than compensates for the volatility.

The financial year in aggregate was very good for Australian equities, notwithstanding the final two months. As the chart shows, the ASX300's 22% increase was towards the higher end of the local currency returns of many other markets. The falling $A however boosted foreign market returns: highlights included Spain (33%), the US (35%), Japan (39%), and Germany (42%), but the best was last year's worst performer, Greece (63%).



Portfolio comment

The Fund outperformed the market in the June quarter and continues to build on its strong relative returns over longer periods. The best contributors in the quarter included sleep device maker Resmed, global travel retailer Flight Centre, logistics property owner and developer Goodman Group and being underweight gold producer Newcrest. The largest detractors were gold producer Medusa Mining, engineering group Downer and property developer Lend Lease. Over the year to June, the greatest contributors to fund performance were Super Retail Group, IAG, Fonterra, Westpac and

Fund details

Alphinity Wholesale Socially Responsible Share Fund	
APIR code	HOW0121AU
FUM (AUD million)	14.5
Asset allocation	Australian equity: 98.8%, Cash: 1.2%

Fund performance* – as at 30 June 2013

	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (%)
Alphinity Wholesale Socially Responsible Share Fund	–2.0	25.9	8.3	9.0
S&P/ASX 300 Accumulation Index	–2.8	21.9	6.5	7.5

*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 30 June 2013

Alphinity Wholesale Socially Responsible Share Fund

	Index weight (%)	Active weight (%)
Insurance Australia Group Limited	0.9	2.2
ANZ Banking Corporation	6.6	1.9
Goodman Group	0.6	1.8
Westpac Banking Corporation	7.5	1.6
Super Retail Group	0.1	1.5

Resmed; detractors included Wesfarmers (excluded from the fund's investment universe due to social responsibility restrictions), miners Medusa Mining and Rio Tinto, and not owning QBE for part of the year.

Market outlook

Recent macro data and market behaviour suggest that the increased level of volatility recently seen in equity markets will continue in coming months. However the key positive development that we highlighted in our market outlook commentary last month – the positive impact on aggregated market earnings from a weaker Australian dollar – has continued to build with key AUD/USD exchange rate falling a further 4.5% during the month of June. The decline was just over 12% for the entire June quarter. We believe this rapid change in demand for the $A is yet to be fully reflected in market earnings expectations.

The decline in the exchange rate has of course largely been driven by the potential (not actual) tapering of monetary stimulus by the US Federal Reserve which has caused bond yields to climb and other consequences of excess liquidity in global financial market to partly go in reverse. Nonetheless, with the market now back at around 13× 1-year forward earnings and a dividend yield of 5%, downside to the equity market appears limited and we expect that the support from the currency tailwind and the strengthening US economic outlook – which in the end is a prerequisite for the Fed to taper – will ultimately win out.

Portfolio outlook

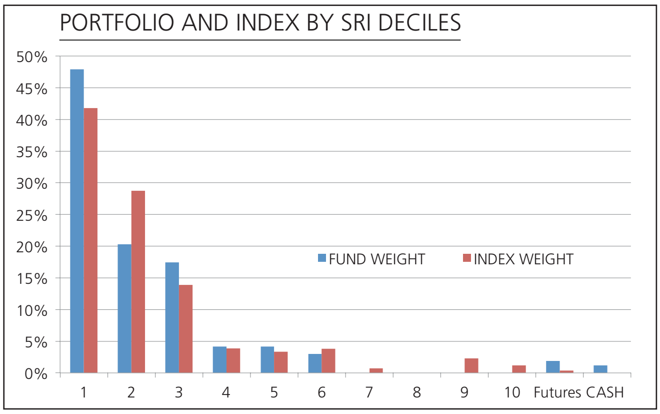
Higher bond yields (although still low compared to historical levels) and the beginning of the end of quantitative easing (at least in the US) will, in our view, continue to favour companies able to deliver earnings growth – especially those that can deliver earnings growth above market expectations. As always, which companies are able to do so is an evolving narrative. Companies with unique earnings drivers should continue to do well, and we believe the Fund's portfolio is well exposed to such companies, including insurer IAG, industrial property developer Goodman Group, travel operator Flight Centre, electronics retailer JB Hi-Fi and online advertiser Carsales.com.

The weaker A$ is, as discussed above, also looking increasingly as if it will be an important earnings driver for some companies. While making investment decisions on a currency view alone is risky, due to the inherently unpredictable nature of FX movements, we have increasingly been positioning the portfolio towards companies that are executing well operationally, but have the currency as an additional tailwind. We have maintained our longstanding exposures to a number of $A beneficiaries including healthcare companies CSL and ResMed, and have added to investment bank Macquarie Group and fund manager Henderson Group. We have also in recent months added steel manufacturer Bluescope Steel and oil & gas producer OilSearch to the portfolio and increased our position in global insurer QBE. These are all companies that have good potential but will also benefit from the weak A$ should it be sustained or fall even further. Our key sectoral underweight remains consumer staples, in which many of the companies have expensive valuations, low earnings growth and ongoing earnings downgrades. In addition, most are excluded from the Fund's investment universe for social responsibility reasons.

The overall portfolio is trading at a slight discount to the market's earnings multiple but with stronger earnings momentum, higher profitability (return on equity) and lower gearing: these are all characteristics that we believe should continue to perform well even in the current climate.

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. The most recent data shows that the Fund had Environmental factors 34% better than the market; Social factors 29% better than the market; and Governance factors 26% better than the market. The Fund's overall Sustainability Score was 67%, which compares with the ASX300 of 51%. The chart below shows the portfolio's weighting by sustainability deciles relative to the market. We are pleased that the Fund has been able to achieve comparable returns since inception to our Australian Share Fund, which is unconstrained by ethical considerations and itself has been one of the best-performing equity funds in the market.



ESG Spot

Coal Seam Gas has become very topical in recent years and Alphinity has exerted a lot of effort to conclude whether or not it is a good thing. There are a number of ASX300 companies exposed to the CSG theme – producers, consumers and transporters – but none are presently in the SRSF portfolio other than maybe APA Group. This company owns gas pipelines which, although largely used for conventional gas, will presumably also carry some CSG from time to time. The portfolio contains two conventional gas producers – Woodside and Oil Search.

That's not to say CSG is a bad thing, in fact there is a lot to like about it from an environmental point of view. It is a fossil fuel, so using it does emit carbon dioxide, but burning gas to generate electricity is far less damaging to the environment than burning even the cleanest of coals. The Australian Government's Productivity Commission estimates that Brown Coal emits 1.2t of CO2 per MWh of electricity; Black Coal 0.92t per MW/h and Gas "only" 0.54t per MWh. The only non-fossil lower-carbon base-load generation alternative is nuclear, which would be controversial to say the least in this post-Fukushima world. So in the Asia-Pacific region, where much of the power is still generated by coal, gas is to be encouraged.

However much of the debate around CSG has been influenced by other environmental and social considerations. The US movie Gaslands generated a lot of concern in this country even though local CSG producers vehemently assert that the fracturing methods here are very different: rather than toxic chemicals used to extract gas from shale in the US, much gentler products are used here on coal seams, primarily water and sand. Water table contamination is another factor to take into account: the industry is certain there is no risk from drilling through aquifers (using cement-encased stell sleeves) but is unable to prove that definitively; opponents say that unless it can give absolute assurances that are impossible to make that nothing should happen. Water use during gas extraction also creates tensions, although the volume needed is quite small and in some cases the recovered water can be treated and then used for irrigation.

Socially there have been issues around access to farm land in order to explore and extract gas as well as a degree of fear over the impact on residents of gas extraction from the ground below them. For example, gas retailer AGL was recently frustrated by the NSW government banning gas extraction from coal seams under houses on the fringe of Sydney, even though it would be done more than a kilometre below the houses and have no conceivable impact on residents.

It will be interesting to see how the debate develops from here. It seems that the companies, caught flat-footed by the resistance, have lost the public relations battle and it is not immediately obvious that they have worked out how best to respond.

BTW

The Organisation for Economic Cooperation and Development (OECD) conducts an annual survey of the quality of life in the 36 most advanced economies on 11 categories such as income, jobs, health, environment and so on. Its very funky interactive website www.oecdbetterlifeindex.org could occupy you for hours, providing a wealth of information and even allowing you to construct your own country ranking by weighting the categories according to their importance to you.

The 2012 report for Australia concludes that things here are still pretty good. Our overall quality of life is the highest in the survey, ranking a fraction ahead of Sweden, Norway, Canada and Switzerland. It is consistent high rankings across most criteria rather than any particular attribute that takes Australia to the top. Turkey was worst, and that was before the social unrest that flared up this year had taken place. When it comes to overall satisfaction, 84% of Australians say they have more positive experiences in a day than negative.

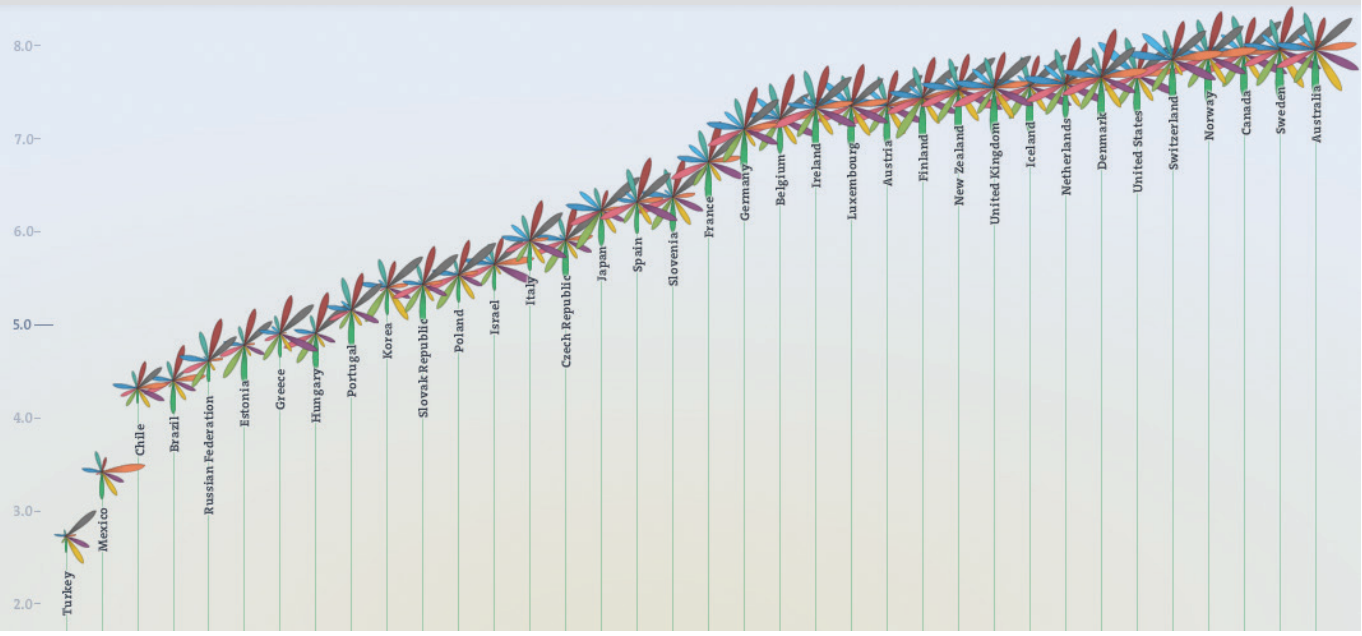
Civic engagement (ie peoples' involvement with democracy) seems to be our greatest strength, the only one where we come first among the nations – although maybe compulsory voting has something to do with this. 71% of people say they trust the country's political institutions – it will be interesting to see if the recent machinations in Canberra make any impact on the next report.

One of the better-rating categories is housing where we come fourth, behind (but essentially equal to) Ireland, Canada and the USA. Maybe that's because our dwellings average 2.3 rooms per person, the second-highest in the group and much more comfortable than the last-placed Russian Federation which has 0.9 rooms. We spend 19% of our disposable income on housing, which is surprisingly slightly below the cohort average of 21%. But 90% of Australian are apparently happy with their housing situation, above the OECD average of 87%.

Women, it seems, are more content than men in most places: the only countries where men's satisfaction is higher are Greece, Italy, Slovenia and Switzerland, although to be fair most of those differences are marginal. Women however are meaningfully happier than men in most places.

Work-life balance is Australia's weakest category relative to other countries: we rank 25th in the amount of time devoted to leisure (14.4 hours per day – this includes sleep time – half an hour less than average) while our working hours come out slightly below average (1693 per year: OECD average is 1776). While women and men are roughly equal in leisure time, men fared markedly worse in hours worked. 14% of employees work more than 50 hours a week – 21% of men and 6% of women – which is way over the OECD average of 9%. We're not sure this is a stat to be proud of.

Despite the negativity that seems to be so pervasive in Australia, it is sometimes helpful to be reminded just how good it is to be living here. All we need now is to work a little less and enjoy our lives a bit more to cement our position at the top. Don't worry, be happy!



Source: OECD

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