Quarterly comment – March 2012
Alphinity Wholesale Socially Responsible Share Fund

Alphinity Socially Responsible Share Fund

Market Comment

The March quarter overall was positive for Australian shares: including dividends, the ASX300 rose by 8.6%. This pleasing result lagged some global markets a little even taking into account the modest $A appreciation during the period. The major catalyst of the global share rally was the seeming resolution of Greece's impasse over bond maturity refinancing which allowed it not to formally default, at least for now. 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 more subdued: Shanghai and Shenzhen both rose less than 3%. The $A was 1.3% stronger against the $US but 2% weaker against the Euro which staged a modest recovery over the quarter. The sharpest move was against the Yen: the $A gained a little over 9% during the quarter which will no doubt relieve the car importers somewhat.

Monetary policy in Australia remained on hold for the quarter, although in its most recent statement the Reserve Bank essentially admitted that the economy is weaker than it had previously thought, and that as long as inflation remains subdued it is likely to ease rates further in coming months.

Gold rebounded from its soft finish to 2011, rising by almost 7% and base metals were volatile but generally stronger over the quarter. Oil was sharply higher as geopolitics – mainly involving Iran's nascent nuclear program – more than offset flat US and Chinese demand but Saudi Arabia obliged by increasing supply late in the quarter which brought the price down from its highs.

Portfolio Comment

The fund performed well over the March quarter, appreciating by 9.2%. The largest contributions to performance were from blokey retailer Super Retail Group, diversified miner BHP Billiton, industrial products manufacturer Bradken, property funds manager Goodman Group, mining services company NRW Holdings and from

Fund details

Alphinity Wholesale Socially Responsible Share Fund	
APIR code	HOW0121AU
FUM (AUD million)	15.3
Asset allocation	Australian equity: 98.6%, Cash: 1.4%

Fund performance* – as at 31 March 2012

	Quarter (%)	1 year (% p.a.)	Since inception (%)
Alphinity Wholesale Socially Responsible Share Fund	8.9	–6.0	3.7
S&P/ASX 300 Accumulation Index	8.6	–6.3	–3.8

*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 Socially Responsible Share Fund

	Index weight (%)	Active weight (%)
Rio Tinto Limited	2.7	2.3
Goodman Group	0.4	1.8
Bradken Limited	0.1	1.8
Australian Infrastructure Fund Unt/Ord	0.1	1.6
Insurance Australia Group Limited	0.7	1.5

not owning diversified conglomerate Wesfarmers. The only meaningful detractor over the quarter was from not owning iron ore miner Fortescue Metals.

Market Outlook

The month of March capped off a solid first quarter for global equity markets, including the Australian market. 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 are 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 Fed Reserve stimulus is a positive in our view!

On the second issue, it is more difficult to be enthusiastic. In fact number of companies – including Leighton, Metcash, Qantas, Stockland, and Transfield Services – have already provided unanimously negative updated H2 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 Chinese companies during 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.

Portfolio Outlook

The SRSF portfolio is run along the same lines as Alphinity's Australian Share Fund, with adjustments to holdings and position sizes to optimise social outcomes. The February reporting season was positive for the SRS Fund, 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. Here we discuss some of our broader conclusions.

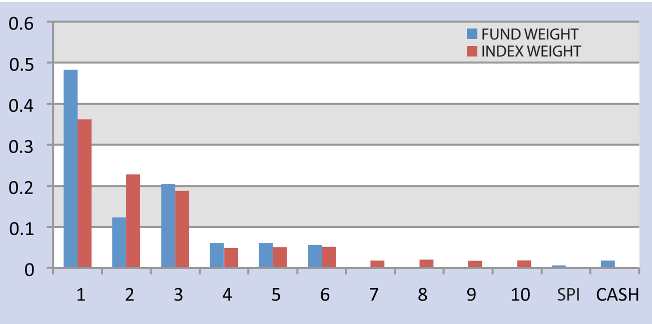
As mentioned above, Stephane came back more positive on China. This was in marked contrast to our last visit in November last year when we concluded that investors expecting a rapid easing of monetary constraints with a peak in inflation and even economic stimulus programs would be left disappointed. 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.

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. We are pleased to report that as at the end of March the Fund had Environmental factors 26% better than the market; Social factors 38% better than the market; and Governance factors 26% better than the market. The Fund's overall Sustainability Score was 68%, which compares with the ASX300 of 50%.

Portfolio and Index by SRI Deciles



As at 31 March 2012

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

BTW continued

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.

Alphinity Investment Management

Level 15, 255 Pitt Street
Sydney NSW 2000

T 02 9994 7921

F 02 9994 6693

W www.alphinity.com.au

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