Quarterly comment – March 2013

Alphinity Wholesale Socially Responsible Share Fund

Alphinity Socially Responsible Share Fund

Market comment

The Australian market (S&P/ASX300 including dividends) rose sharply in both January and February and, despite March itself being a little soft, provided an impressive 8% return over the March quarter. Having had decent positive returns in two of the three previous three quarters, an annual return of almost 30% surely confirms that we are in a bull market (see p4 for a discussion of this phenomenon).

The market did well regardless of some challenging news from overseas. Had the US fiscal cliff/sequester or the Cypriot banking system implosion taken place a year ago there would probably have been carnage on the markets. It is indicative of the mood in the present bull market that this news has (so far at least) been absorbed by global markets with only a ripple.

The $A was essentially unchanged against the $US but rose about 3% against the Euro and 8% against both the Pound Sterling and the Yen, making it a challenging period for Australians investing anywhere outside Australia or the US. "Strong" economies (we categorise those as Switzerland, Sweden, Australia and increasingly the US) were all up between 8 and 10% in the quarter in $A. Japan was up a very impressive 19% in local currency but the sharply depreciating Yen halved that. European markets struggled: markets in the stronger economies were close to flat over the three month period but Spain, Greece and Italy all fell by between 7 and 9% and the Cyprus stock market, which was closed much of March, fell by more than 13%.

Commodities generally fell during the March quarter. Oil fell by 2%, iron ore, base metals and gold were all off about 5%. Considering the preponderance of resource companies in the Australian market, its performance was quite impressive.

Portfolio comment

The Fund did better than the strong market in the March quarter and built on its good relative returns over longer periods, despite the significant outperformance over the past year of Woolworths and Wesfarmers, two large-cap companies excluded from the Fund's investable universe due to the ownership by both of a large number of electronic gaming machines. The best contributors included retailer Super Retail Group, insurer IAG, department store chain Myer Holdings, major bank Westpac, car advertising website Carsales.com global travel agency Flight Centre, and not owning iron ore company Fortescue Metals. The largest detractors were global resource majors Rio Tinto and BHP, which struggled as commodity prices fell, and not owning Woolworths.

Fund details

Alphinity Wholesale Socially Responsible Share Fund	
APIR code	HOW0121AU
FUM (AUD million)	15.0
Asset allocation	Australian equity: 98.1%, Cash: 1.9%

Fund performance* – as at 31 March 2013

	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (%)
Alphinity Wholesale Socially Responsible Share Fund	8.7	22.8	7.5	10.7
S&P/ASX 300 Accumulation Index	8.0	19.2	5.7	9.5

*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 31 March 2013

Alphinity Wholesale Socially Responsible Share Fund

	Index weight (%)	Active weight (%)
Westpac Banking Corporation	7.7	2.5
Super Retail Group	0.1	2.3
Insurance Australia Group Limited	1.0	2.2
Lend Lease Corporation Limited	0.4	2.2
Goodman Group	0.6	1.6

Market outlook

Following the strong runs in the Australian and global equity markets since the middle of last year it appears that a 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 the market is now closer to fair value 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 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.

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 35% better than the market; social factors 31% better than the market; and governance factors 22% better than the market. The Fund's overall sustainability score was 65%, which compares with the ASX300 of 50%. 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 has been one of the best-performing equity funds in the market.

Governance spot

One of the challenges for companies based in Australia is having a limited domestic market: with only 20-odd million people it is easy for a successful company to run out of room to grow. It is usually pleasing to see Australian companies making it big in other countries, but only if they do it in the right way. One company that was very successful offshore for a time was Redflex, maker of automotive speed-detection cameras.

We have mixed feelings about speed cameras. While they can sometimes be effective in addressing the problem of speeding on our roads, they lack the powerful deterrence effect (so we understand) of actually being stopped by a policeman, reprimanded and handed a ticket. You have no doubt at all when that has happened, whereas if you are captured by a speed camera, you (apparently) often only find out weeks later: maybe you can't remember the context or even the event itself so annoyance rather than deterrence is the result.

Redflex had significant international success, to the extent that in the last financial year only 13% of its revenues came from Australia: 63% was from the US and 24% from elsewhere in the world. It was clearly an international success story, to the extent that – despite the Australian domicile – its CEO is based in Arizona. However the company went through its own metaphorical red light late last year when a series of newspaper articles in the Chicago Tribune alleged that it had achieved at least some of that success through bribery. Redflex's own subsequent investigation found that it had given inducements to a public official in Chicago over a considerable period of time.

The response of the State of Illinois was to pull the contract to operate speed camera away from Redflex. This represented about an eighth of the company's total revenue, so will have a meaningful negative impact on Redflex earnings in the future. It certainly had an impact of its share price: it had been trundling along at $2 for much of 2012 but after the Chicago news came out in October it dropped sharply, to the mid-$1s. Was this a buying opportunity? Maybe briefly, it started trending up again during January but in February the result of its investigation came out and it dropped again, this time into the low $1s. A buying opportunity? In late February its half-year result came out along with news of losing Chicago, and by the end of March it was languishing around 80c. A buying opportunity?

Maybe, but the risk profile even now is much greater than we would be prepared to accept. If bribery had taken place, how can we be sure there are no other instances yet to come out? How many other states or cities might choose not to engage with the company as a result of its rogue employee's actions? We don't yet know if it was its governance structures or the internal company culture that led to the bribery, but it is a clear illustration of the risks a company takes when it, or one of its employees, behaves in the wrong way. The impact on a company's business and reputation from an event like this are so great, it is not a risk we are prepared to take.

BTW

What is a 'bull market'? It defies official definition, but a few pundits have tried. Investopedia.com suggests that it is 'when prices rise or are expected to rise', although this seems a little vague for our liking. Can you have a one-day or one-month bull market? We think not. InverstorWords.com's 'prolonged period in which prices rise faster than their historical average' is a little better but still too vague.

In reality it probably occurs when investor sentiment shifts from being concerned for the security of the money they have tied up in the market, to being worried about missing out on the gains being made. This is also known as FOMO, or 'fear of missing out'.

On any definition, however, it appears that the current market is indeed bullish. The origin of a market being 'bull' is obscure. Some think it to be from the archaic expression 'bully' which meant excellent, although others point to the French term 'bulle spéculative' which is a speculative bubble in a market. To reinforce the analogy, a bull is a fast-charging animal which typically uses its horns when fighting, in this case uses them to toss the market in a upward direction.

By contrast, the bear is a (relatively) slow animal which hibernates from time to time. In a bear market it uses it front paws and claws to drag the market down. The etymology is as obscure as for bull, but one theory is that bear skin traders in London in the 1700s often used to sell hides in advance of receiving them in expectation of lower prices when the market was flooded by shipments coming in from North America – hence for prices to be falling is 'bearish'.

What's the difference then between a 'bear market' and a 'correction'? It appears that a correction is when share prices decline temporarily within a bull market, as can happen, but again interpretation is everything. A more cynical definition might be to say that when the value of shares owned by someone else falls, that's a correction. When shares owned by me fall, that's bearish.

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