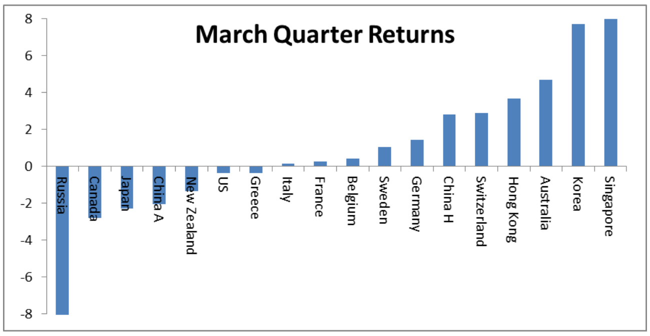
Quarterly Comment – March 2017

Alphinity Wholesale Socially Responsible Share Fund

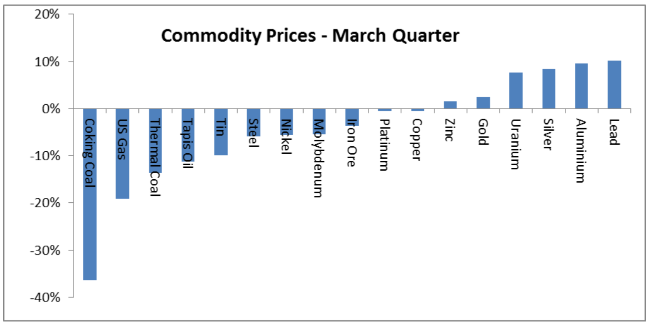
Alphinity Socially Responsible Share Fund

Market comment

The March quarter started softly but turned out to be a quite pleasing one, the market (ASX300 including dividends) rising by almost 5%. This stacks up quite well compared to major global markets. In $A terms a couple of Asian markets did better (Singapore and Korea +~8%) but Hong Kong was only +3% and Japan and China were both down about 2%. Most major bourses lagged Australian returns in $A in the March quarter: Canada was 3% lower, the UK, US and most European markets were all about flat.



The main reason for Australia's outperformance was a strong $A, which rose from $US0.72 to just over $US0.76. Unusually, this happened in an environment of generally lower commodity prices over the quarter. After finishing 2016 at fairly elevated levels, coal prices in $A terms have moderated somewhat with Hard Coking Coal (used for steel making) falling 37% and Thermal Coal (used for power generation) falling 14%. Iron Ore was about 4% lower.



The sectors that performed well in the quarter were an eclectic bunch: Health Care, Utilities and Consumer Staples did well with 14%, 10% and 9% returns respectively. The laggard was Telecommunications (-7%).

The quarter also featured an increase in the official short term interest (aka Fed Funds) rate by the US Federal Reserve. The first in this cycle was in December 2015, and the second in December 2016; the third was in March. Although no one could accuse the Fed of rushing things, the pace of change has clearly picked up and reflects a desire by the Fed for a more "normal" level of rates for this point in the US economic cycle, which has now been in expansion since it troughed in the June Quarter 2009. As always, how high the Fed Funds rate goes and how quickly it gets there will depend on the economic data coming out in the US, and the most recent points have been a little on the soft side. The market is presently expecting another two or three similar 0.25% hikes this calendar year. There was no change to Australian official interest rates, and no change is likely for some time.

Portfolio comment

The Fund underperformed the market somewhat in the March quarter. Strong performance from the likes of energy Provider AGL Energy and English-language testing firm IDP Education, and the benefit of not owning shopping centre play Scentre Group, were more than offset by our two NZ building exposures – Metro Performance Glass and Fletcher Building – which both lagged the market.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	2.8	3.4	16.0	6.8	11.3	9.5
S&P/ASX 300 Accumulation Index	3.3	4.7	20.2	7.5	10.8	9.1

*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 Fund and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2010. The inception date for the returns for the Fund 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.

Alphinity INVESTMENT MANAGEMENT

Quarterly Comment – March 2017

Alphinity Wholesale Socially Responsible Share Fund

Market outlook

Not too hot, not too cold? The Australian equity market seems to keep finding more reasons to move higher. Our market's performance in March was impressive considering the flat US equity market and falls in the prices of important commodities such as oil, coal and iron ore. Investors took these negative leads in their stride and instead focused on the positive valuation implications of lower bond yields, pushing up other sectors such as Healthcare, Utilities and Financials. Global bonds have been range-bound so far in 2017, with the latest rally triggered by the US Fed's future rate hike plans being interpreted as benign and further impetus perhaps added by the failure of US President Trump's healthcare bill. This appears optimistic to us as the debate within the Fed still seems to be whether to raise interest rates two, three or four times this year, not whether to pause or change direction. Much can still happen that might lead to an outcome at the upper end of that range, not the least Trump now turning his focus on pro-growth tax cuts. Higher bond yields thus still seem more likely than status quo or lower yields.

We would be cautious about extrapolating the rebound in some yield proxy stocks from here. Importantly however, while hard economic data in the US has underwhelmed a little so far in 2017, even though leading indicators remain very strong, economic activity in Europe seems to be picking up ahead of expectations. Coupled with an improved outlook for many developing markets, global growth appears to be on track to accelerate somewhat in 2017. So while the equity market's support from bond yields looks vulnerable, its support from economic growth looks more robust.

The Australian economic outlook continues to be mixed. On the positive side we are probably now through the Resources capital expenditure (capex) bust, with the headwind of declining new project investment spend being replaced with a pick-up in maintenance capex following the rebound in commodity prices. On the other hand spending on residential construction activity which, at least on the east coast, has been a substantial offset to the fall in Resource capex, looks set to slow. Increased infrastructure spending, predominantly on roads, should pick up some of the slack but the net outcome is likely to be a continuation of modest growth which suggests prolonged low rates of wage growth and consumer spending. Meaningful political initiatives to change this picture are difficult to envisage. From a share market perspective, this may be a reasonable outcome. Modest growth most likely means a continuation of the current low domestic interest rates and, apart from the risk of a disorderly end to the east coast housing boom, the Australian equity market is likely to grind higher from here.

Asset allocation	31 March 2017 %	Range %
Securities	98.6	90-100
Cash	1.4	0-10

Portfolio Outlook

Following dramatically divergent sector performances in 2016, when Resource stocks rallied sharply in line with commodity prices but the more defensive stable earnings growers, in which investors had previously been seeking shelter in a low growth environment, retreated, we have recently been suggesting a more balanced outcome will take place in 2017. This appears to be playing out so far even though the recovery in some of the yield-sensitive sectors has been surprisingly strong, and the reaction to softening iron ore price from recent lofty levels has been noticeable.

We reduced our overweight to resources in February as the sector looked vulnerable to a pullback in commodity prices. We also shifted our exposure more towards steel companies, as we see steel prices – or at least the spread between the price of steel and its inputs (iron ore and coking coal) – will be supported not only by solid demand but also by structural reductions in Chinese steel capacity. Resource stocks still have the strongest support from both valuation and earnings upgrade potential. As spot commodity prices still remain well above market expectations, especially for 2018, it wouldn't take much in the way of prices appearing to stabilise for the sector to perform better again, in our view. We are thus sticking with a moderate overweight to the Resource sector at this point with a view to possibly increasing the overweight at a later stage should our expectations of decent global growth and a solid Chinese economy prove correct.

Equally, we are staying with an underweight to yield-sensitive sectors, especially Real Estate Investment Trusts and infrastructure, slightly offset by an overweight to Banks as this sector has seen some improvement in its earnings outlook and hence reduced risks to dividends. The valuation of high quality, stable growth companies has become more appealing over the last six months or so, and we have increased our weighting slightly to these where we have identified companies that are also showing upside to current earnings expectations. CSL and MYOB are some examples of this. Overall, both the market and the portfolio direction in the near term are to some extent, as the US Fed likes to say about its interest rate settings, data dependent. We would expect a clearer picture to emerge over the next few months.

Top 5 active overweight positions as at 31 March 2017	Index weight %	Active weight %
National Australia Bank	5.6	2.1
Macquarie Group	1.9	2.0
IDP Education	0.0	1.9
Goodman Group	0.8	1.8
GPT Group	0.6	1.5

Quarterly Comment – March 2017
Alphinity Wholesale Socially Responsible Share Fund

Traveller's Tale

Bruce managed to briefly escape Sydney's sweltering January heat to visit some rather pleasant farms in the idyllic north of Tasmania, around Devonport, which are operated by company that is small by listed standards but a giant in its field, and which contributed nicely to the Fund's returns last year, Costa Group.

Costa is one of the few Initial Public Offerings from the 2015 vintage that has prospered, and is now trading about 50% above its listing price. It grows and markets a wide range of produce – citrus, tomatoes, mushrooms and so on, but the focus of this trip was its berry operations. Costa grows a large percentage of the blueberries, raspberries, strawberries and more recently blackberries in Australia. This is a growth industry, thanks to berries' "superfood" status. Some are very high in antioxidants, which is apparently a good thing. And they are superfoods that are nice-to-eat too, unlike some others.

Berries aren't that easy to grow in the quantities required to make an industry, and it is here that Costa's scale and access to capital is quite an advantage. It operates in several growing regions around Australia to maximise production and minimise its exposure to adverse natural events. These include the Atherton Tablelands near Cairns, Corindi on the mid-north coast of NSW, Tasmania and Western Australia. (Costa also has farms in China and Morocco). Such a geographic spread means that it can supply most berries pretty much year-round, as opposed to for just a couple of months of the year as most single-region growers do, and command premium prices.

Costa uses protective measures like netting, glasshouses or plastic sheeting (as with the strawberries shown below), which allows fruit to be grown in a relatively controlled environment and produces better quality and higher yield than when unprotected.

You might think that growing berries should be fairly simple but there is a lot of technology that goes into it. The gene strains of the best-tasting and best-lasting berries are patented, and only Costa has access to them in Australia. Strict quarantine combined with the product's fairly short shelf-life means that there is only minimal import penetration.

The growing is not only technical but also very labour-intensive: Costa employs more than 1000 people permanently although this rises to almost 7000 at the peak of picking season. It has become the employer of choice among seasonal workers as it pays them properly and treats them well. For instance, while strawberry pickers in many places spend the day on their hands and knees, Costa has invested considerably in installing "tables" upon which the plants sit, raising their level to waist height and greatly reducing the physical strain on pickers.

Although their berries are not classed as organic, they almost are as there are rarely any chemicals used in the growing process. Instead the inevitable pests (some of which actually assist in pollination) are controlled with natural predators, so the tunnels are abuzz with life even when no people were there. And there can be few pleasures simpler or greater than wandering down vast rows of raspberry bushes and occasionally testing for quality.

Costa's scale has also allowed it to invest in infrastructure which enables it to maximise the value it extracts from its fruit: chilled packing sheds and smooth logistics means the produce makes it to market in better condition than most, and command good prices. Having said that the nature of seasonal produce is to have large rises and falls in price, and the company's strategy has been to increase production massively in recent years to make berries more affordable in order to increase consumption. This seems to be working a treat: the extra volume you can sell for even a modest fall in price is substantial. This early in their growth plans, the prospects for Costa appear to remain positive.

Quarterly Comment – March 2017

Alphinity Wholesale Socially Responsible Share Fund

BTW

Many of us have credit cards linked to frequent flyer-style rewards programs. These can act as a powerful incentive to push as much spending as possible through a particular card to earn as many points as possible that you then can (or more often cannot) spend on flights or those elusive business class upgrades.

It works well for the issuing bank which takes a clip on each transaction and stands to benefit even more if you end up incurring the exorbitant interest rates that apply to most credit cards. It also helps that the schemes are popular with customers: happy customers tend to be sticky customers, and these are like gold for a bank. More importantly though, it is good business. People who use this type of card typically have higher-than-average incomes and spend more on their cards, which generates higher merchant fees for the banks. They also tend to pay their bills on time so the banks experience fewer bad debts.

However the banks have to buy the points from airlines, and those points don't come cheaply. There is a lot of variation around the world, and local airlines are very coy about the price of a point, but a recent Bloomberg article we saw suggests it typically costs around 2c, so your monthly $3500/3500 point credit card bill would probably cost the bank about $70. That could really add up.

But the real winners seem to be the airlines. Bloomberg also said these types of programs can be substantial profit centres in their own right for a lot of airlines, and that American Airlines which is the largest airline in the world makes more from its loyalty program than it does from flying people around. It reckons that the $US35 billion value of its loyalty program dwarfs the entire company's $21 billion market capitalisation.

When it comes to redeeming points, the seats airlines let you "buy" or upgrade to are generally unsold stock, so the cost of providing the reward is close to zero. Of course, not all the rewards are seats, Qantas allows you to redeem a wide variety of goods or services with those nebulous points. Probably the most reliable indicator of worth is the Woolworths gift card. For 3760 points you can get $25 of value, which works out to be about 150 points per dollar. $25 at David Jones is better value at 3100 points (124/$); Myer and JB Hi Fi are slightly more expensive 3380 points (135). Least generous is a Westfield gift card – this will cost you 4440 points (177). Or Qantas itself will sell you a pair of those Bose noise-cancelling headphones so beloved of long-haul travellers for a bit over 70,000 points: based on the $399 recommended price this is a Westfieldian 176 points per dollar.

The equation of issuing all those points for say $70 and then redeeming them for a $25 gift card looks like good business indeed for the airlines.

Alphinity Investment Management

Level 12, 179 Elizabeth Street
Sydney NSW 2000
T 02 9994 7200
F 02 9994 6692
W www.alphinity.com.au