Monthly comment – January 2012
Alphinity Wholesale Concentrated Australian Share Fund

Out of the blocks

Market comment

January started with a bang and ended up rising by more than 5%, erasing almost half of the losses sustained in the whole of 2011. Just as Europe had been a force for bearishness during much of 2011, hints that some sort of resolution was close – even if it ends up being just a temporary one – were enough to get global share markets running strongly. It was a bifurcated market though with materials (largely resource companies) up 10%; energy stocks up 8%; and industrials (many of which have significant exposure to resources) up 6%. Everything else limped along.

Most major markets put in decent gains: Japan +4.1%, USA +4.3%; France +4.4%; Taiwan +6.3%. Germany was up 9.5%, beaten by Hong Kong (+10.6%) and Brazil (+10.9%). Shares in Chinese companies listed in Hong Kong for mainly international holders, H-shares, rose by a massive 13.7%, however were still down 10% over a year. Credit rating agency S&P downgraded the ratings of a raft of European counties during the month. France, one of the supposedly stronger countries, suffered the indignity of losing its AAA rating however there was no adverse impact on its bonds: yields in pretty much all the countries affected by S&P actually fell sharply during the month, suggesting that investors were well ahead of the ratings agencies. Germany maintained its AAA rating, but there was never any doubt about that. Other remaining AAA-rated sovereigns are Canada, Denmark, Holland, Singapore, Sweden, Switzerland and, of course, Australia.

The AAA-rated Australian dollar, which as we have previously noted is treated by some global investors as a proxy for global growth and has become in many eyes something of a safe place to hide when so many other currencies are progressively being debased, rose four cents to almost $US1.07 in January, and to €81, the highest since the Euro has existed. This brings great joy to travellers and importers, but hardship to Australian manufacturers and tourism operators. This year we have already seen a small wave of job cuts in manufacturing, primarily in the

Fund details

Alphinity Wholesale Australian Share Fund	
APIR code	PAM0001AU
FUM ($A million)	124.5
Asset allocation	Australian equity: 98.9%, Cash: 1.1%

Fund performance* – as at 31 January 2012

	1 month (%)	Quarter (%)	1 year (% p.a.)	Since inception (%)
Alphinity Wholesale Concentrated Australian Share Fund	4.8	0.4	−7.4	2.1
S&P/ASX 200 Accumulation Index	5.1	0.1	−6.2	1.9

*Returns are calculated before 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 January 2012

Alphinity Wholesale Australian Share Fund

Issuer name	Index weight	Active weight
News Corporation	0.8%	1.7%
Transurban Group Stapled	0.8%	1.5%
Oil Search Limited	0.7%	1.5%
Goodman Group	0.4%	1.5%
Amcor Limited	0.8%	1.4%

automotive sector where they are struggling against not only cheaper imports but also a shift in consumer preference away from the larger cars in which we have traditionally specialised.

Gold bounced back from recent falls, rising by 10.5% over the month. This is impressive on the face of it, however silver was up by 21% and less exciting base metals like lead, nickel and copper also all rose between 10 and 15%.

It is obvious that there was a scramble for risk by investors in January.

Portfolio comment

The portfolio contributions lagged the benchmark slightly in January, with good contributions to performance from travel operator Flight Centre, recycler Sims Metal Management, property company Goodman Group and underweight positions in insurer QBE and supermarket retailer Woolworths. Main detractors, as you would expect in such a strong month, were defensive holdings such as toll road operator Transurban, global packaging company Amcor, and our underweight in iron ore miner Fortescue Metals.

Market outlook

The strong rally in global equity markets in early 2012, especially after such a weak 2011 raises some obvious questions – what has changed and is the rally sustainable? In our view, the largest positive change is the significant increase in the European Central Bank's Longer Term Refinancing Operation (LTRO) announced in December which, to all intents and purposes, gives European banks access to almost unlimited cheap medium term funding.

The increase in the LTRO appears to have provided a circuit breaker for Europe to get out of the vicious spiral of rising Government bond yields, leading to countries being unable to meet their debt repayment obligations, in turn leading to large bad debts for the European banks. While the LTRO doesn't solve all problems, it appears to have bought Governments and banks some time to sort out their problems and, most importantly, restored some confidence in the financial system. The European Central Bank is not alone in having eased monetary conditions in recent months. China has started some (selective) easing, India has cut interest rates after a number of increases, and Australia – perhaps less important from a global perspective but vital for us – has joined in with two cuts so far. With the Fed in the US having stated that it will maintain its low interest rate policy until 2014, global liquidity is likely to be a boost for equity markets in 2012. As markets are undoubtedly 'cheap', supportive liquidity conditions have the potential to see markets re-rate even if earnings growth remains lacklustre and at risk of further downgrades. An improvement in leading indicators (such as the ISM in the US) is also supportive for global growth and the US economy in particular. Tempering our enthusiasm at this point however, in addition to the expectation of further downgrades to Australian corporate earnings, is that we see further risk to market expectations for a strong upturn in the Chinese economy after a Government policy-led slowdown in 2011. Property markets in China remain vulnerable to disappointing sales activity with important flow on effects to China's steel production and consequent demand for Australian iron and coal. Property sales activity and steel production has been subdued so far in 2012. However, the market expects there will be a substantial pick up in coming weeks as Chinese workers return from Chinese New Year celebrations.

While there is undoubtedly a strong seasonal pattern evident in historical monthly data, buyer enthusiasm appears lacking and property developers are sitting on increasing unsold inventory which is restricting their ability to fund new developments. The Chinese Government, as Stephane found on his visit late last year, is not in a hurry to ease restrictions introduced last year to slow the market. In summary, increasing global liquidity should have a positive effect on the demand for risk assets such as equities in 2012 but while some macro indicators are stabilizing or improving, the micro (i.e. what we are hearing on the ground from corporates) is providing a more cautious picture.

Portfolio outlook

The 'macro vs micro' discussed above is reflected in our portfolio changes. Cognisant of the improving macro we have added to companies with more cyclical earnings, such as industrial property owner and developer Goodman Group. We also introduced Medusa Mining to the portfolio. Medusa is a low cost gold producer with a solid production growth profile funded by internally generated cash-flow. We have been selectively reducing our positions in the banks after a good relative performance in 2H11. We sold our holding in CSL as the Australian dollar yet again poses a major headwind for its earnings, and GPT as it is now trading close to our valuation. We retain our underweight in the broader metals and mining sector in anticipation of disappointing steel numbers out of China, although this underweight is balanced by an overweight to the energy sector and mining services. We also have underweights to the normally defensive consumer staples, utilities and REITs sectors.

BTW

The imminent IPO of social networking phenomenon Facebook is all the buzz as we go to press. We last opined on internet multiples in our May 2011 monthly comment, that time sparked by the IPO of business networking company LinkedIn. This time, Facebook appears to be cheekily floating off only 5% of its issued capital, and the market will impute the scarcity value of those shares into the 95% held by others. On initial pricing, it looks like the company will be 'worth' a nice, round $US100 billion. Not bad for a company with $US3.7 billion of sales and around $US1 billion of earnings. Scarcity creates the illusion of value as there will be any number of people (maybe even some fund managers!) who want to own Facebook shares regardless of what the investment metrics end up being, just so they can say they do. Some will also see it as an appealing investment opportunity, and if you look at Google's performance since listing in 2004 (IPO $US85 → $US580 in January 2012), dominant internet properties can do very well indeed.

The Facebook IPO will create some significant paper winners, including 35-year old graffiti artist David Choe, who painted some colourful artwork on the walls of Facebook's Silicone Valley offices seven years ago. Even though he reportedly thought at the time that Facebook was 'ridiculous and pointless', he accepted shares in Facebook as payment for what would have been a job costing a few thousand dollars. Should the mooted $US100 billion capitalization prove correct, David Choe's shares will be worth about $US200m, putting the value of his art up there with Picasso and Monet. Having seen an example of Choe's art, we'd probably go with Monet.

Another winner will be, obviously, Mark Zuckerberg, the founder of Facebook. He will be an instant billionaire, but may also be the recipient of the biggest individual tax bill in history. According to CNN, he will exercise (for 6c per share) a large number of options which will realise a gain of between $US3 and 5 billion. At 35% federal tax (plus an additional 10.3% California state tax), his tax liability alone could be as much as $US2 billion.

BTW II

The recent 'Occupy Wall Street' protests (slogan: 'we are the 99%') spread to Sydney in a small way but perplexed a lot of people. While dispersion of incomes are (and always will be) unequal, the economic conditions and wealth disparities in Australia are nowhere near those in the USA. This was reflected by the inability of many of those protesting to articulate what they were actually there for. In any case, the final hard core of seven protesters, two of whom were apparently homeless teenagers – were removed from Martin Place by police in February for unauthorized camping, after 111 days of 'occupation'.

The New York Times (NYT) recently put some stats around the '1%' against whom Occupy Wall Street were protesting. The top 1% of income earners (i.e. above $US380,000) receive close to 20% of all income in the USA, however 22% of that income is from capital gains. They pay more than 25% of all federal income taxes and account for about 30% of philanthropic giving. They work longer hours, being three times more likely to put in over 50 hours a week compared to 'the 99%'. Almost all those surveyed by the NYT, regardless of political persuasion, said the wealthy could and should shoulder more of the economic burden than others. There are two disproportionate ethnic groups: 82% of the 1% are white and 7% are Asian, which compares with 66% and 4% of the overall population. The 1% is twice as likely to be married as the overall population, with more children but the same number of cars. 27% of 1%er couples both have advanced degrees. 40% of the 1% have inherited money, compared with only 20% of the overall population. The average income of the 1% is $US1.5 million, but that is skewed by the super-rich: the top 0.1% has an average income of $US6.8 million!

Not all in the 1% identify themselves as guilty of being 'filthy rich'. It takes a $US900,000 p.a. income to be in the 1% in Stamford Connecticut, but 'only' $US200,000 p.a. in Clarkesville Tennessee. After all, in most high income places, property values and local taxes tend to be so high that even a $US380,000 income can give you a very average lifestyle.

Traveller's tales

The first casualty of Alphinity's draconian travel policy appeared to have been incurred in January when Stephane was diagnosed with Deep Vein Thrombosis, a.k.a. 'economy class syndrome'. While this might cause him to agitate for the privilege of turning left when entering planes rather than right, his pleas will fall on deaf ears as the flights in question were to facilitate personal enjoyment rather than stock research. He'll be back on a shorter plane ride in March for more noble reasons, back to China again to get a feel for the progress of the challenging economic conditions he identified last time.

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