Alphinity INVESTMENT MANAGEMENT

Monthly comment – August 2013

Alphinity Wholesale Concentrated Australian Share Fund

Campaign chaos

Market comment

August was a significant month. Alphinity celebrated three years managing this Fund at the end of August. More on this later.

August was Reporting Season, during which companies with June or December year-ends announce the financial results of the most recent six months trading and usually give some idea of outlook. It is a period of frantic activity for us as we mine and refine the rich seam of data released, look for confirmation or disproval of our various investment theses, and meet with management of most of the companies we own. More on this later too.

August was also Election Campaign month. Most companies we spoke to were desperate for the election to be held: not necessarily for a change of government but for certainty of government. Since the minority government has been in place, there has been a perception – rightly or wrongly – of drift, exacerbated by the need to cobble together a coalition of disparate forces (independents of various shades) in order to have legislation passed.

The market however has been remarkably unperturbed by the election. With a return of 2.5% for the S&P/ASX 300 Accumulation Index (including dividends), Australian shares performed better than most markets. The downward currency pressure has dissipated and the $A was virtually unchanged over the month. China's Shanghai Composite Index (up 6% in $A) was the only major market that did better than ours but most were fairly muted: offshore markets were generally between flat and -2%. Macro concerns re-emerged during the month, particularly fears around tapering. We discussed this phenomenon in our May monthly ('Taper Tantrum'): with the ongoing recovery under way in the US economy, the likelihood of this phenomenon occurring has increased and we may know more during September.

Commodities generally rose along with perceptions of an improvement in the Chinese economy. Geopolitics raised its ugly head in the shape of escalating unrest in Syria, which was a factor behind oil being up 5%. Iron ore rose 6%, base metals were generally a couple of percent higher and gold rose 5%. Resource stocks consequently performed quite well in August, as did those exposed to Energy. The high-yield sectors such as Telcos and REITs struggled after a number of months of strong performance. Consumer discretionary stocks also did well, thanks to decent results from a number of retailers and the feeling that perhaps the end of a nine month (some would say three year) election campaign might provide a fillip to the domestic economy.

Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	15.9
Asset allocation	Australian equity: 98.0%, Cash: 2.0%

Fund performance* – as at 31 August 2013

	1 month (%)	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	3 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	2.1	4.4	26.6	17.6	11.9	11.9
S&P/ASX 200 Accumulation Index	2.5	5.3	24.3	14.5	10.1	10.1

* **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 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 August 2013

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	7.8%	5.4%
Australia and New Zealand Banking Corporation	6.5%	5.0%
BHP Billiton	9.1%	4.9%
Insurance Australia Group Limited	1.0%	3.1%
Goodman Group	0.6%	2.4%

Portfolio comment

The portfolio lagged the market a little however there were few individually meaningful plusses or minuses. The largest wins were from holding casino company Crown Resorts Ltd and being underweight insurer QBE, while our ANZ position and not owning supermarket retailer Woolworths cost slightly.

Market outlook

The August domestic reporting season confirmed what most of us probably already knew: the corporate landscape remains challenging during the economy's transition phase from mining investment to a more diversified set of growth drivers. Financial year 2013 (FY13) company earnings in aggregate finished 1-2% lower than FY12, fractionally lower than expectations at the start of the month. However there were some redeeming features in the underlying numbers. Non-resource earnings grew as forecast by about 5% in FY13 and, encouragingly, FY14 expectations also largely survived intact. Confirming the tough environment, much of the earnings growth was achieved through cost savings rather than revenue growth.

Looking ahead there are some signs that lower interest rates are starting to have a positive impact on the housing market, especially in NSW. Coupled with the impact of a lower $A (if sustained), the prospects for stronger earnings this year are likely to be better than they have been for some time. While consensus earnings expectations of +14% will probably again be too optimistic due to an overly-aggressive rebound expected in Resource company earnings (from down 25% in FY13 to up 40% in FY14), earnings growth of 6-8% – or in line with historical averages – appears reasonable and should be supportive of positive market returns.

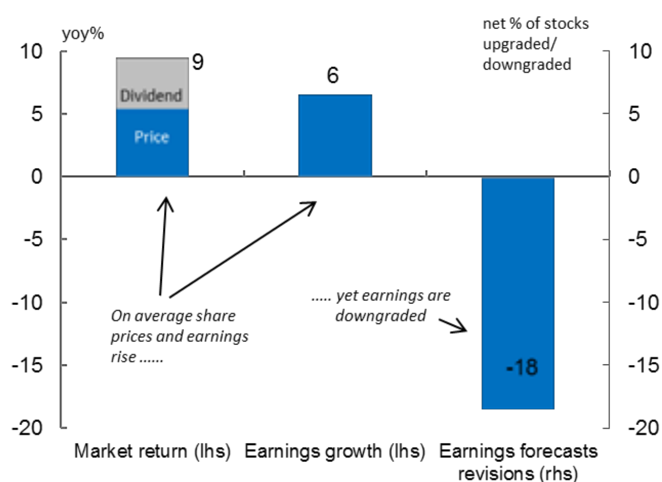
As we have frequently highlighted, negative earnings revisions are a normal feature of analyst expectations. The adjacent chart suggests that down-grades to earnings forecasts is quite normal and that the market can still rise providing earnings overall are growing. The biggest issue for the market recently has been the lack of EPS growth at the end of the year: once analysts have finished revising down their estimates, EPS growth has ended up being zero or negative. This year EPS growth should be positive.

The one-year forward PE is now close to the historical average of ~14x and the market's dividend yield is just under 5%. As noted later (see Report Card), equity markets in a single 12 month period seldom perform in line with longer term historical annual averages: notwithstanding this, another year of double digit returns looks achievable.

Portfolio outlook

Our portfolio thinking remains largely unchanged following the reporting season. FY14 company earnings growth is likely to be predominantly driven by companies that are able to offset sluggish demand with efficiency gains, are benefiting from the lower A$ or are in a structural growth industry. Lower interest rates have so far failed to stimulate the economy in a noticeable way, however there are now definite pockets (like NSW housing) where the impact has

Average market returns, earnings growth and earnings revisions, 1988-2013



Source: Deutsche Bank, IBES, IRESS, Datastream

been more meaningful. We are continuing to position the portfolio in companies that we see as likely to deliver earnings growth ahead of expectations as a result of these dynamics. We are also continuing to gradually deemphasize yield stocks as the rise in bond yields and potentially better market earnings growth reduce the appeal of these stocks. Following a strong rebound in the bank shares we have again reduced our Bank weighting. Our report card from the August reporting season was solid. Of our top 15 active positions 8 had positive earnings revisions for FY14, two were unchanged, two had relatively small downgrades and three are yet to report. The earnings outlook for the Energy sector is increasingly appealing, and we have been adding to our exposure. The oil price has been very stable in US$ (before the recent spike due to the situation in Syria) translating into a five year high in A$ terms: this is not fully reflected in company share prices, in our view. Furthermore, the long awaited startup of some of the large LNG projects in PNG and on the Australian east coast is getting closer. While further cost overruns cannot be ruled out, project execution appears to have improved over the last six months.

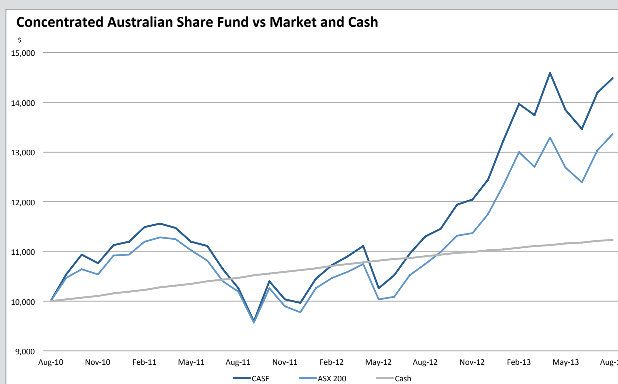
Three year report card

Alphinity officially assumed management of this Fund, with a portfolio pretty much as we wanted, on 31 August 2010 and have been diligently endeavoring to add value ever since. We are pleased to report that value has been added: the Fund outperformed its benchmark meaningfully. The Fund has also met its performance objective despite some challenging market conditions caused by disruptive macro factors from time to time. These conditions have included the Tsunami/nuclear crisis in Japan in 2011, the Greek debt Crisis in 2011, the Greek debt crisis in 2012, the Cyprus debt Crisis in 2013, and the talk of Tapering in the past few months. The Australian economy has also been suffering from a significant lack of confidence, not helped by the minority government or the high $A which had been making many local companies increasingly uncompetitive.

Despite all of this, the Australian share market has put in a decent return: 10.1% per annum over the three years (ASX200). On top of this, Alphinity's Concentrated Australian Share Fund has added 1.8% per annum for a total of 11.9% pa. A $10,000 investment on 1/9/10 would now be worth $14,000 – a 40% return. Compare that to investing in cash with a total return of $11,227 over that time (and reinvesting at 2.5% now). The chart highlights the strong relative returns.

As always with equities, that 11.9% pa performance didn't come in a straight line: the individual years were made up of +1%, +9% and +28% respectively so you would have been fractionally ahead in cash after one year but well behind in year two and massively so from then on.

Within the ups and downs, we are pleased with the relatively low volatility to which we have exposed our investors. Over the three years, in achieving top quartile performance, the ex-post tracking error of the fund was 2.7%, giving an information ratio of 1.1. This means that we have been getting most of our stock calls right and not exposing our investors to the risks some funds take in order to achieve similar returns – especially for a concentrated style type fund. This can be seen in our 'hit-rate' in the last three years which is in excess of 50%: the fund outperformed in more than half the months, and the ups have been bigger than the downs. We have not relied on single large 'bets' that may or may not pay off at some point in the future, to generate your returns. In a three-year period during which the market has been constantly buffeted the large macro swings mentioned above, which can cause large movements in stocks that are not company specific and hence make stock picking difficult, we are particularly satisfied with this stability.



Where do we go from here? We will continue to do what we have been doing: invest in companies in or about to enter an earnings upgrade cycle. While there are never any guarantees, we believe that companies in an earnings upgrade cycle are most likely to keep out-performing the market – just as they have in the past.

Reporting Season Wrap

Each listed company is required to report its financial earnings at least semi-annually within two months of each half-year end and those with June or December year-ends represent about 80% of listed companies, so February and August are replete with financial information. It's fair to say that while corporate earnings growth was again subdued in the last financial year, prospects for the year ahead are better than they have been for some time. This gives us some confidence that the equity market can keep going up from present levels. Some themes we noted include:

- Revenue growth is still challenged in most sectors
- Cost out is a major source of earnings growth
- Cost out for some companies will make revenue growth difficult for others (eg mining companies and mining services companies)
- Confidence, both consumer and business, was seen by many companies as the missing ingredient. Whether this was just hope or reality remains to be seen. The cost out focus at least suggests that companies have stopped just hoping
- There was a better ratio of positive earnings surprises to disappointments than in recent years
- Resource company earnings in FY13 (EPS –27%) fared worse than non-resource companies and banks (+5%); REITs were in line.
- Expectations of ~15% EPS growth for FY14 look unachievable due to an overly optimistic rebound in resource company earnings, but no more so than usual. FY14 earnings across the market are likely to be about 7-8% higher than FY13 – this should support the equity market into 2014.
- Lower A$, lower interest rates and stronger global growth are the three pillars for stronger earnings growth over the next 12 months.

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