**Quarterly comment – December 2014**
Alphinity Wholesale Concentrated Australian Share Fund

# Santa Delivers - Eventually

## Market comment

One of the few predictable things in financial markets is what has become known as the "Santa Clause Rally" – a run up in the market in the approach to Christmas. This time, it appeared that Santa might be missing in action with the market in the first half of the month looking decidedly soft, having fallen by about 3% in the first part of December. Then it happened: led by the U.S. market, as is often the case, the S&P/ASX300 (including dividends) rallied by about 5% from its lows, recovering its losses and finishing the month a couple of percent higher.

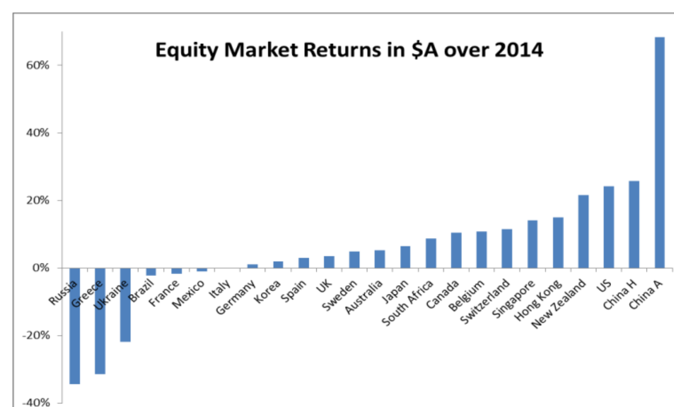
Despite the strong finish, the year was not a particularly satisfying one for local equity investors. A total return for the year of slightly over 5% is not stunning even if it is more than double the domestic cash rate, and one also needs to add another couple of percent of tax benefit from dividend franking. However, it is worth bearing in mind that this modest positive just builds on past years' performance: over the three years since the end of 2011 the Australian equity market is up by 49% and your Fund by 63%.

Among the panoply of global markets, Australia appears in the middle of the pack. The best place to be this year, with the benefit of hindsight, would have been China A-shares (i.e. those traded on the Shanghai market) with almost 70% return, although all of this took place in the final four months of the year. Interestingly, China H-shares (on the HK market) and until recently the only way foreigners could get exposure to Chinese companies, were up by less than half as much: +26%.

The US market finished the year at all-time highs, up a stunning +24% (+14% before the impact of the crumbling $A). Wooden spoon went to the Russian market which, although flat in Roubles, lost 34% in $A. Sparring partner Ukraine also fared poorly at -22% even though in ₴ (Ukrainian Hryvnia) it rose by 37%. Global economic pariah Greece was almost as bad as Russia at -31%.

Most markets however were modestly positive. The $A really only fell noticeably against the $US and US-linked currencies last year. Against other trading partners such as Europe and Japan it actually gained value.

Source: Bloomberg

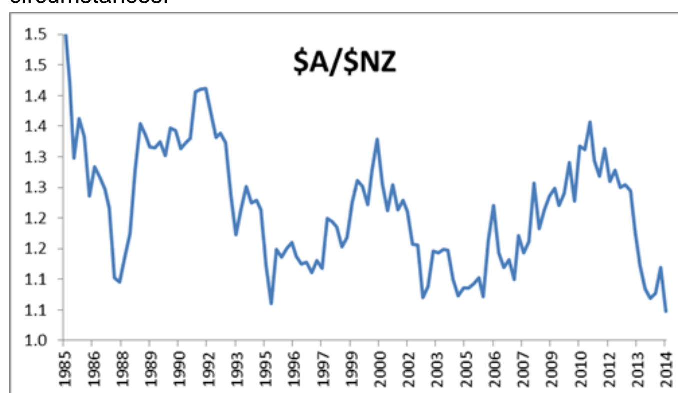



Source: Bloomberg

| Performance* | 1 month % | Quarter % | 1 year % | 2 years % p.a. | 3 years % p.a. | Since inception^ % p.a. |
|---|---|---|---|---|---|---|
| Fund return (net) | 2.5 | 4.3 | 5.4 | 14.7 | 17.6 | 11.4 |
| S&P/ASX 200 Accumulation Index | 2.1 | 3.1 | 5.6 | 12.7 | 15.1 | 9.7 |

*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 relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 (during Sydney business hours).

But it was plucky little NZ that provided the best return: +17% in its own currency and a very creditable 21% in $A. The $NZ finished the year at long-time highs against the $A and our Kiwi friends are dusting off their plans for a "parity party". After several attempts at achieving parity since currency floatation, maybe this time they will make it. Part of the reason for such a robust equity market is the relatively strong performance of its economy but also helping has been the make-up of its share market, which after a number of government privatisations is more heavily weighted than most towards high-yielding utilities, the share prices of which have thrived in the current uncertain economic circumstances.




Source: Bloomberg

We spent the early part of 2014 bemoaning the lack of volatility in markets, but now that has been well and truly rectified it has reminded us how unsettling volatility can be! Having said that, however, volatility can provide great opportunities to those with clear heads and a robust investment process, and provide the basis for potential future outperformance.

Commodity prices proved a headwind for the Australian economy in 2014. Gold was unusually one of the better performers, falling only 2% in $US. Base metals generally fell in $US: Copper and Lead were lower by 15-17% and Zinc a more modest 5% although Aluminium bucked the trend by rising a few percent. The big falls were reserved for Iron Ore (-47%) and the various classes of Oil which pretty much halved. Even with the buffer of a lower $A these moves will have a meaningful impact both on companies and on State and Federal Government revenues.

The $A really only fell against the $US and US-linked currencies last year. Against other trading partners such as Europe and Japan it actually rose a little (see BTW).

## Portfolio comment

The portfolio performed quite well against the market in December. Positives included property company Goodman Group, major bank CBA and being underweight diversified miner BHP. Positions in gas producer Oil Search and travel company Flight Centre detracted modestly, partially offsetting the positives.

The Fund performed very well over the quarter. CBA and telecoms company Telstra were significant winners, on top of which not owning supermarket operator Woolworths or gas producer Santos and being underweight BHP added. Oil Search and fellow gas producer Woodside both cost some performance, as did not owning blood fractionation company CSL.

Contributors for the calendar year were positions in BHP, Goodman Group, Santos, Telstra and CBA but also gaming machine company Aristocrat Leisure, and not owning Fortescue Metals, Origin Energy or Woolworths; ANZ Bank, Oil Search, fund manager Henderson Group and not owning CSL all detracted.

## Market outlook

The Australian share market traded in a narrow range in 2014 compared to the recent years. This reflects that for some time now the market has on the one hand been supported by an attractive dividend yield, especially compared to traditional income assets, but also faced a difficult corporate earnings outlook.

This yield support is, in our view, likely to remain in place again in 2015, although we would expect the outsized returns achieved in 2014 from typical "yield stocks" (infrastructure, utilities, property and banks) to be more measured.

The strength of the US and Australian bond markets over the last 12 months, which have largely driven the performance of these stocks, has been remarkable and is unlikely to be repeated. While the US economy has largely continued on its recovery path, the US 10 year bond yield declined for most of last year. And even though that yield (a little over 2%) is still a higher than the 1.5% low reached before the 'taper tantrum' 18 months ago, most observers would have expected it to have kept more in pace with the US recovery: this still seems logical to us. Timing the turn in longer term trends is always difficult but higher interest rates in the US at some point over the next 12 months looks likely. After all, US unemployment, a key target for the US Federal Reserve, is now below 6% and still trending lower. The Australian 10 year bond has a strong correlation with its US counterpart so when forecasting its outlook, it almost matters more what is going on in the US economy than here in Australia. So higher US rates should be enough for some of the heat to go out of the domestic yield stocks sometime in 2015. We would expect this to coincide with better earnings growth, however.

Alphinity INVESTMENT MANAGEMENT

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The continued slide in the $A has already improved the earnings outlook for corporate Australia. The sharp decline in the oil price following OPEC's decision to not cut back on production but leave it to the higher cost producers in North America to balance the market, has added an interesting twist to both the interest rate and the earnings outlooks.

Lower oil prices, if sustained, will contribute to the already benign inflation outlook and the "lower for longer" interest rate argument. However, while the initial earnings impact will be felt keenly by oil producers and associated industry sectors, the lower oil price will also provide welcome relief to input costs for many other industries and add meaningfully to the disposable income for consumers in Australia and elsewhere.

The boost from the A$ and the oil price should support corporate earnings growth in the second half of the financial year and offers the potential for a sustained lift in equity returns in 2015, above what is on offer from a pure dividend yield perspective.

| Fund details | |
|---|---|
| Manager inception date | 1 September 2010 |
| Fund inception date | 1 November 2004 |
| Fund size | $13.7M |
| APIR code | HOW0026AU |

| | Fees |
|---|---|
| 2013/14 ICR | 1.23% |
| Management fee | 0.90% p.a. |
| Performance fee | 15% of the Fund's daily return (after fees and expenses and after adding back any distributions paid) above the Performance Benchmark |
| Buy/sell spread | +0.20%/-0.20% |

| Asset allocation | As at 31 December 2014 % | Range % |
|---|---|---|
| Securities | 99.1 | 85-100 |
| Cash | 0.9 | 0-15 |

| Top 5 active overweight positions | Index weight % | Active weight % |
|---|---|---|
| Westpac Banking Corporation | 7.6 | 6.2 |
| Telstra Corporation Limited | 5.4 | 4.6 |
| Commonwealth Bank Of Australia | 10.3 | 4.3 |
| Goodman Group | 0.6 | 3.3 |
| Aristocrat Leisure Limited | 0.3 | 2.7 |

## Portfolio outlook

2014 was a bit of a mixed year for the Alphinity portfolio. The Concentrated fund matched the market return in 2014. Our longer term performance (3 years) including 2014 comfortably exceeds the benchmark return. However, we aim to outperform in each individual year as well. Every year we have several winners and some detractors and 2014 was no different except that the winners matched rather than outweighed the detractors. Our adherence to price discipline (i.e. trimming positions and eventually selling out as the shares approached what we believe them to be worth) cost us as some stocks, the so called yield stocks in particular, went on to levels we found difficult to justify. While "the market is always right", we have found that staying in stocks once they become expensive is usually the wrong strategy in a longer term perspective. Low volatility was a feature of the market, especially in the first three quarters of the year.

Volatility returned to the market in the final few months and though increased volatility means increased uncertainty it also means increased opportunity. Pleasingly, the fund outperformed with in the last quarter of 2014. The fund benefited for most of the year from its underweight to the Resources sector and while the dramatic slump in the oil price took us somewhat by surprise, our stock selection and focus on stocks with strong balance sheets and cash flows (Woodside Petroleum and Oil Search) allowed us the avoid the more significant share price falls in the Energy sector (in Santos and Origin).

We have reduced our exposure to the sector as further earnings pressure looks likely.

As discussed in the market outlook segment, the search for yield is likely to be a continuing theme but we expect that like the Bank sector came back closer to market performance in 2014, after exceptional performance in the prior year, we would expect yield stocks to perform more in line with the market in 2015 and that the risk for a more significant sell off in this part of the market has increased. Thus we will continue to focus on identifying stocks aligned with the underlying thesis of our investment process: stocks that can experience enduring positive earnings surprise generally also experience ongoing share price appreciation. Gaming machine manufacturer Aristocrat, Credit score provider VEDA, alumina producer AWC, hearing aid company Cochlear and building materials producer CSR are some examples of companies already in the portfolio that we believe fit the bill.

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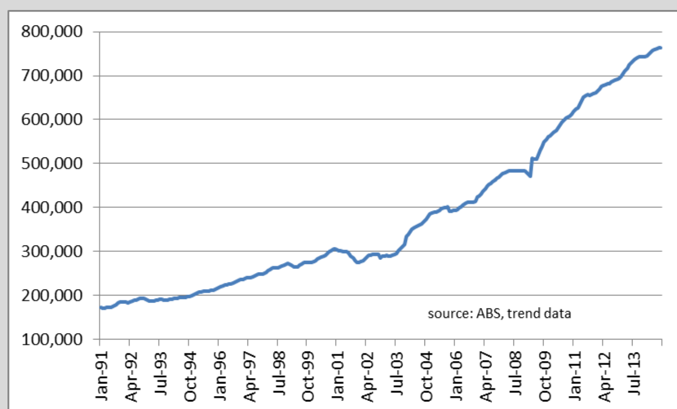
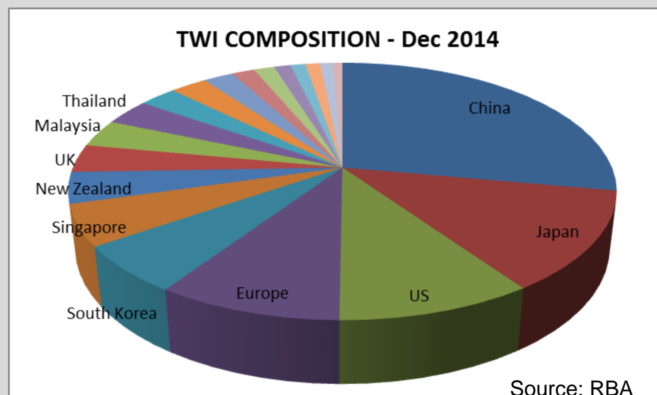
## BTW

Australians are inveterate travellers, and ABS airport departure stats show an increasing propensity to travel overseas. This chart shows a strong upward trend, the only pauses occurring when scary major events happen, such as the World Trade Centre in 2001 or the Global Financial Crisis in 2008. The person on the street would think they have an acute awareness of the value of the $A, but do they really? Certainly they would versus the $US, as it is reported tediously by news reports, but how important is it really to Australia?




The Reserve Bank calculates a Trade-Weighted Index – a value of the $A relative to a basket of other currencies weighted according to the proportion of merchandise goods and services trade over the recent past. Its composition is quite revealing: at just under 10% the U.S. is only our third largest trading partner, and about the same as Europe.




China represents a massive 28% (30% if you include Hong Kong); next closest is Japan at 12.5%. Korea, Singapore and NZ are all smaller than the US and Europe with the UK in 8th place and Malaysia and Thailand rounding out the top ten, which constitutes 85% of our trade. All others are individually immaterial.

So is the $US unimportant? Well, not as much as those raw figures might suggest. Although it alone is below 10%, a number of other currencies have a close link with the $US, either formally or roughly, including many of our larger Asian trading partners. You could say that China, Korea, Singapore are effectively pegged to the $US which would make the total amount of our trade about half. So the US is not unimportant by any means, but to focus on it alone is only half the story. Of the other majors, the $A has appreciated against most.

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