alphinity INVESTMENT MANAGEMENT

Driving Sustainability

Alphinity has re-launched its long-standing Socially Responsible Share Fund as the Sustainable Share Fund. The name change represents a subtle shift in the focus of the fund towards achieving, to the greatest extent possible within our universe of investable companies, a portfolio of companies with strong environmental, social and governance (ESG) characteristics, or which contribute to achieving the aims of the United Nations' Sustainable Development Goals (SDGs) – preferably both. There has been little change required to the constituents of the portfolio but future new positions will be assessed through a slightly different lens. We have engaged external data providers CAER and Sustainalytics to assist with the assessment of companies' activities that might support the SDGs. CAER also continues to provide us with input on ESG matters as it has since 2010.

Additional changes have been introduced to put in place a more stringent list of allowable activities of companies we've invested in on your behalf, with a cumulative 10% revenue tolerance, and to introduce a committee with two eminent and independent experts in the field of sustainability to help interpret the external data providers' information. There is more information about the experts on p3.

While it is virtually impossible for any company to operate without at least some negative externalities, we are endeavouring to minimise these as much as possible. One thing that will not change is Alphinity's investment process, which seeks attractively-valued companies in an earnings upgrade cycle. This process has produced strong returns since management of this Fund was assumed in September 2010. Fees charged for managing the Fund have also been reduced. Alphinity has also adopted a new logo!

We are very excited about the changes to the Fund. We look forward to continuing to provide strong returns for our existing investors and to new investors wanting to join in the innovation to introduce the SDG focus, the first we know of in the Australian market.

Market comment

War seemed to be breaking out everywhere we looked at the end of the March quarter. There was an increasingly ugly trade war between the US and China. The Cold War re-emerged between Russia and pretty much everyone in the West, especially the UK, with defected spies, tit-for-tat diplomat expulsions, nerve agents; in fact pretty much everything short of poison-tipped umbrellas. And of course there was continuation of the regular shooting wars we've become inured to in places like Syria. The one potentially bright spot was a possible easing of tensions on the Korean peninsula after the Winter Olympics, which was held almost in the demilitarised zone between North and South Korea. The quarter finished with steps towards rapprochement between the two Koreas and the possibility of the North's Kim Jong Un meeting up with US President Donald Trump – a meeting we'd love to witness. This aside however, the world looked like a somewhat less friendly place to be and that was reflected in the share markets.

The market was volatile in the March quarter, at least more volatile than we've been accustomed to in recent years. It started in January when the US market started to suffer the wobbles, the S&P500 falling 10% in a few days before clawing much of it back over the balance of the quarter – it finished down less than 2% in $US but flat in $A terms. The $A suffered a modest 2% depreciation against the $US but 4% against the Euro.

The Australian market (ASX300 including dividends) fared better during the sell-off, falling by only about half as much as the US, but also lagged the recovery and was down almost 4% for the quarter. We are pleased to be able to report that a solid January followed by a very strong February reporting season saw the Fund's portfolio do much better than the market for the quarter.

Global markets generally did a little better than Australia but even so most were flat to down overall. There weren't too many investable markets that actually rose in $A terms

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Since inception^ % p.a.
Fund return (net)	-3.5	-2.1	7.6	4.7	8.4	8.2	9.2
S&P/ASX 300 Accumulation Index	-3.7	-3.8	2.9	3.9	7.6	7.1	8.3

*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. 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.

for the quarter: Singapore and New Zealand were pretty much it. Commodity prices were very messy however: some bulk commodities important to Australia were very weak in the quarter with iron ore falling sharply (-12%) as well as coking coal (-24%). Oil was up between 5 and 9% depending on the grade, and gold edged higher (2% in $US; 4% in $A) but not as much as one might expect considering all the geopolitical tensions: gold is meant to thrive under such circumstances. Aluminium fell 10% but the Base metals were mixed : copper was down 6% and lead 2%, while Nickel and Tin were 6% and 7% stronger respectively.

Portfolio comment

The Fund performed very well in the March quarter, as a number of its positions responded positively to strong results during February. The strongest contributions came from a diverse group of sectors: education provider IDP Education, waste recycler Bingo Industries, infrastructure play Wagners Holding Co, global registry company Computershare, global investment bank Macquarie Group. NZ dairy operator A2 Milk, which the Fund doesn't own was the only stock that detracted noticeably.

Market outlook

There has been much comment about the return of volatility to financial markets thus far in 2018. An end to the rather unusual "Goldilocks" environment of the past couple of years has perhaps not come as that much of a surprise, but the cocktail of factors bringing that end about has had some unexpected elements to it. First among those are of course US President Trump's announced plans for import tariffs on a range of goods, primarily from China, and the potential this brings for an escalation in global trade tensions. Second has been the data-mining scandal surrounding Facebook which has dented confidence in the whole US and global technology sector. Third has been the much greater rise in US short term interest rates compared to long term rates. Such a flattening of the yield curve has historically often been associated with economic recessions.

While clearly unhelpful we don't see any of these factors in isolation, or even collectively, as likely to determine the direction of equity markets for any sustained period of time. There's a lot of rhetoric in the current tariff announcements and, while the numbers appear large, as we've already seen with the steel tariffs the actual impact is likely to be considerably less. The flattening of the yield curve also appears to have more to do with the current "risk-off" sentiment in equity markets than the other way around. Of more significance to us is the slowing in a number of leading indicators of economic growth: at this point however these seem to indicate a levelling-off in growth rates rather than anything more sinister.

Following our recent visit to China we also concluded that growth rates there are stable rather than slowing significantly, and that a number of transitory factors have combined to delay the usual pick-up after the recent Chinese New Year. All in all, we continue to expect that 2018 will be a year in which constricted liquidity as central banks gradually tighten - led by the US Federal Reserve - will represent the real headwind for markets. This should however be balanced by solid earnings growth. We will be able to test this proposition in coming weeks as US and European companies start to report earnings from the first quarter of 2018.

Portfolio Outlook

The portfolio has performed very well over the last 12 months and so far in 2018. This has been primarily driven by successful stock selection, manifested through solid consensus earnings upgrades for the majority of our positions in February, but also partially through a pro-cyclical sector skew. We largely believe that this overall positioning will remain valid but acknowledge that global growth prospects have moderated somewhat. We have therefore trimmed our Resource overweight slightly and added to some of our more defensive and yield-sensitive stocks.

The February reporting season also triggered some portfolio changes. We were disappointed by the poor margin performance in the US operations of Brambles Ltd. Although management is taking corrective action through a combination of cost efficiencies and price increases, the earnings outlook is likely to be less favourable than we had previously thought. Qantas was in the portfolio for most of 2017 before we exited late in the year on concerns about the impact of higher fuel costs. Qantas has also been working hard to find alternative fuel sources to aviation gas and recently flew across the Pacific on oil from mustard seeds, reducing the flight's carbon emissions by 80%. Following a pullback in the Qantas share price and a pleasing interim result which indicated that management is being effective in offsetting the fuel cost increase through other measures, not least through higher domestic airfares, we have re-established the position. At face value this might suggest a more cyclical exposure countering some of the earlier portfolio commentary. More importantly however it underscores that specific company factors, often driven by strong management execution, are generally the key drivers of stock performance.

Top five active overweight positions as at 31 March 2018	Index weight %	Active weight %
Macquarie Group	2.1	2.5
Bingo Industries	0.1	2.4
Rio Tinto	1.9	2.4
Woodside Petroleum	1.7	2.1
Netwealth Group	0.0	2.1

Meet the Experts

Alphinity is pleased to advise that two leaders in the sustainable investment community have agreed to be part of Alphinity's Sustainable Share Fund Compliance Committee. The purpose of this committee is not to select stocks in the portfolio, rather it is to ensure that the Fund is "true to label" – i.e. that the companies in which it has invested really are appropriate for a fund aiming for strong ESG and being able to contribute to attaining the UN's sustainable development goals.

The Committee meets monthly, more frequently if necessary, to discuss the portfolio, issues emerging in the market and individual stocks. Our aim is not just to run a well-performing Fund that makes a solid social contribution, it is also to help companies we've invested in – or are considering investing in –improve their performance and/or disclosure and thereby advance sustainable investing in the Australian share market. Over time, it may even be that Alphinity's Global Equity team might take up the cause for even greater impact.

Elaine Prior: Elaine is an award-winning pioneer of ESG in Australia. She has extensive stock market experience over more than thirty years, spent time in the oil and gas industry, has several degrees germane to equity markets and sustainable investing, and is highly respected in the Australian finance industry for her knowledge and advice. Elaine recently retired from a decade as head of Australian ESG research at Citigroup, and has kindly agreed to share her deep knowledge of companies and markets with the managers of this Fund.

Mark Lyster: Mark was an early leader in sustainability in Australia. As a director of Net Balance and EY's sustainability practice until 2014 and, more recently, as co-founder and Managing Director of advisory firm, Action Sustainability Asia Pacific, Mark has been at the forefront of industry thinking on a number of issues pertinent to corporate ESG performance, particularly in the finance sector. He is also the inaugural Chair of the Responsible Investment Association of Australasia's Human Rights Working Group, has advised several large listed companies in assessing and mitigating adverse human rights impacts and actively supported progression of the Modern Slavery Act which is presently under consideration by the Australian Parliament.

Our experts are not employees of Alphinity, they are truly independent and deeply committed to contributing towards a Fund with integrity, one that is genuinely seeking companies with an edge in sustainable practices, but also companies that are also good investments in their own right. This is not an easy task, however it is essentially the same thing that we have been doing since Alphinity took over the Fund in 2010 and expect that we can continue to do this.

External Experts on SSF Compliance Committee	
Elaine Prior	
Mark Lyster	
Service Providers	
ESG	CAER
SDGs	CAER, Sustainalytics

Asset allocation	31 March 2018 (%)	Range (%)
Securities	95.6	90-100
Cash	4.4	0-10

BTW

The cause of autonomous motoring was set back in March after two fatal accidents took place in quick succession in the USA involving cars driving themselves. The first was in Tempe Arizona, a test bed for Uber's autonomous vehicle efforts. One of its cars, a Volvo driving at night, didn't "see" a cyclist who was pushing her bike across the road, running her down. The technology should have been able to identify the hazard despite that dark. There was a human attendant aboard who should have been ready to take over but she did not. In the video the crash the attendant is seen looking down at the time of impact, probably checking her phone.

Shortly after, a software engineer on his way to work in Silicon Valley with his Tesla on Autopilot (a glorified cruise control) steered into a road barrier. He also should have been sufficiently alert and in control to react to the hazard caused by some unclear road markings but for whatever reason did not intervene, with fatal consequences. The car's lithium ion batteries were crushed, causing a nasty and hard-to-extinguish fire.

We love technology but the assumption that society will immediately and enthusiastically embrace autonomous vehicles is optimistic. The primary argument in favour is safety: just think how great it will be when there are no humans involved in the driving process to stuff things up? No one breaking road rules, speeding, making silly maneuvers – in theory these can all be programmed out. However humans are also writing the code which will control the actions of the vehicle, and that code will only be as good as the ability of the people writing it to anticipate everything that can possibly go wrong and make the car respond appropriately. Autonomous vehicles are fantastic in controlled environments, but the world in which we live is a long way from being controlled: quite the opposite in fact. This is also the case in a lot of fields, particularly our own. There is a very human temptation to think that machines are able to do things much better and cheaper than humans, but their ability to anticipate every possible outcome is much more limited.

The Uber trial in Arizona has been suspended while officials try to work out how this accident happened. It is probably little consolation to the cyclist or her family that she was collateral damage in the quest for the advancement of autonomous driving technology, but the fact remains that if it were an inattentive human controlling the car the same thing could easily have happened.

An unresolved question is who will be held liable for the crash, Uber, or Volvo, or the "driver"? Local police haven't quite worked that out yet but, being the USA, you can be sure that it will be lawyers at ten paces and that a multimillion dollar settlement will be required to make it go away.

Alphinity Investment Management

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

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