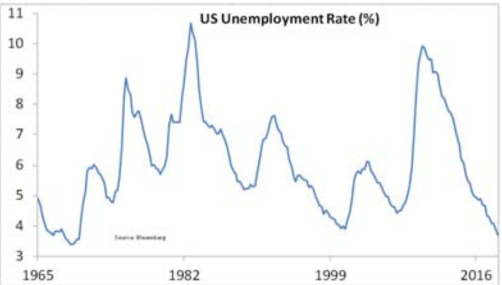
Quarterly Comment – September 2018
Alphinity Sustainable Share Fund

Sprung

Market comment

The advent of Spring is generally associated with feelings of optimism and hope. The local market resisted those feelings in September, demonstrating a decidedly dour mood for much of the month. Notwithstanding that we'd had six consecutive months of rising share prices, and that the Trumpbo-charged US equity market was making still more all-time highs, our market (ASX300 including dividends) dipped 1.2% in September. This isn't a huge move, and it felt worse than it was, but it was still enough to take away much of the September Quarter's return. Including dividends, the Australian share market returned only 1.5% for the quarter. The weakening $A flattered global equity market returns but even so there was an unusually wide global variance, the best returns coming from Japan (+10%), Europe (Sweden and Switzerland both +10%, France +5%) and North America (US +8% and Canada +3%) while markets in some of the more troubled economies struggled (Turkey -21%, Argentina -7%, Greece -6%).

Our market could have been a lot worse considering some shock-horror stories in the media about impending doom in the domestic housing sector, the more tangible lift in trade tensions between global gorilla economies US and China, and even more uncertainty around whether and/or how Brexit will proceed. The powerhouse US economy however apparently remains resilient for the time being, with its rate of unemployment reaching new long-time lows: it reached 3.7% in September, the lowest level since the 1960s. The US Federal Reserve Bank (Fed) lifted short term interest rates a further 0.25% in September, to 2.25%. US ten year bond yields continue to move upwards, finishing the month above 3% and tracking even higher into October.



Commodity prices were mixed during the September quarter although those most important for Australia held up pretty well, especially given the soft $A. Prices of Iron Ore, Metallurgical Coal, Thermal Coal, Gas and Oil all rose over the quarter; base metals however were quite weak, particularly Lead, Nickel and Cobalt which were all off more than 10%. Despite the implication low unemployment has for US inflation Gold did not act as an inflation hedge, falling 5% in $US terms and 2.5% in $A.

Domestic economic news remains nervously positive despite the turmoil that has been going on at the political level. The Reserve Bank's cash rate remains at 1.5%, and appears to be stuck there for the foreseeable future. Household consumption, government expenditure and exports were all net contributors to economic growth in the most recent national accounts. Business Confidence remains positive but is softening and Consumer Confidence is neutral. Australia's unemployment rate remains reasonable at 5.3%, with good numbers of full-time jobs being generated in recent months.

The biggest domestic negative is the slump in the housing market, with low auction clearance rates in Sydney and Melbourne and increasing evidence of falling house prices. For the moment it appears to be a modest correction to a market that a year ago had been quite overheated, but should it become more entrenched there might be more cause for concern.

Portfolio comment

The portfolio outperformed the market in the September quarter. The best returns came from positions in waste recycler Bingo Industries, gas producers Beach Energy and Woodside Petroleum, global registry Computershare, and not owning either gas producer Origin Energy or supermarket operator Woolworths, both of which reported disappointing results. Partially offsetting those were our positions in berry, avocado and mushroom grower Costa Group, plumbing supplier Reece, and being underweight Telstra.

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)	-1.3	2.3	21.7	13.3	9.5	12.9	10.3
S&P/ASX 300 Accumulation Index	-1.2	1.5	14.0	12.2	8.2	11.2	9.0

*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.

Quarterly Comment – September 2018

Alphinity Sustainable Share Fund

Market outlook

Another month, another set of records for the US equity market. So what is there to worry about, aside from the fact that the Australian equity market has been struggling to keep up? Quite a few things, in our view. While an end to the run in the US market would be unlikely to be positive for global equities, a continuation of the run potentially also creates its own problems.

The driver behind the US market's strength has been its economy firing on all cylinders: this has been driving strong corporate earnings growth, and received further turbocharging from Trump's tax cuts earlier this year. The problem is that the rest of the world, especially emerging markets, are feeling the effect of the Fed raising interest rates to keep the US economy from overheating. So far only a few countries are looking particularly distressed, such as Turkey, Argentina and South Africa, but increasing funding costs and weakness in some commodity prices could end up being a problem for a broader group of countries, Australia included. To date the global economic slowdown has been fairly orderly (though investors exposed to emerging markets may disagree!) and economic growth rates are still largely positive, but the risks are rising and the trade war, even if it increasingly looks like it's targeted at China alone rather than traditional friends and foes alike, is not helping.

So is it time to go defensive, sell cyclicals, raise cash, buy consumer staples and secular growth companies? Maybe, but apart from the fact that this type of market timing is incredibly difficult to get right, the strength of the US economy and the prospects of higher US inflation as labour markets continue to tighten is typically associated with cyclical leadership of equity markets. Cyclical companies, and especially raw material producers, generally provide a good hedge against inflation until tighter monetary conditions curbs economic growth, and that tends to be the point at which investors favour earnings certainty.

The Australian Resource sector is also supported by strong balance sheets across the board after three years of strong cash generation and asset rationalisation. The problem with "secular growth" companies is that they already trade at record premiums after a decade of ultra-low interest rates. While it's never easy to pick the winners or even the general direction of the equity market, it does feel as if the risks are building. It's increasingly difficult to point to any particular part of the market that doesn't face increased uncertainty.

Portfolio Outlook

Following solid outperformance and absolute returns over the last year or so, the last couple of months have provided a few more challenges. A combination of a few owned stocks that disappointed in the August reporting season, a few previous losers (that we don't own) that have rebounded so far FYTD as investors try to anticipate the bottom in these stocks together with the ongoing momentum in the burgeoning Australian Tech sector despite already lofty valuations have proved difficult to offset despite our fair share of winners.

As we discuss in the Market Outlook, the market is currently struggling to work out which sectors and stocks will provide leadership in the months and year ahead. While we continue to monitor and form our own view on these issues, our main focus remains on identifying quality, attractively-valued companies in an earnings upgrade cycle. Of course, broader macro issues are always an important factor in providing headwinds and tailwinds for certain sectors and companies. However, over the years we have found that focusing on an individual company's earnings outlook has enabled us to identify the winners from both a company and a sector perspective.

So, where are we currently seeing earnings upgrades? The energy sector is clearly leading, boosted by the strong oil price and we continue to see room for consensus expectations, and thus share prices, to move higher. The Resources sector is a bit more mixed but the prices of bulk commodities, iron ore and coal, have been largely stable to rising, especially in $A. Typically it's proven correct to be overweight this sector when China stimulates its economy as is presently happening. While the stimulus is occurring because of the trade war and some indications of a slowing economy, we continue to see the sector as attractive, not the least when also considering the inflation outlook previously discussed.

Banks continue to look underwhelming to us, with the Royal Commission only adding to the broad-based slowdown in credit growth that was already underway. Individual stocks with unique earnings drivers are typically behind consistent outperformance, and Computershare, Macquarie Group, Goodman Group, Suncorp and Woodside Petroleum are some companies that presently display the characteristics we're looking for.

Quarterly Comment – September 2018
Alphinity Sustainable Share Fund

ESG Spot

We at Alphinity spend a lot of time thinking about ESG, that is the Environmental, Social and Governance risks and opportunities of the companies we are considering investing in. At this time of year, the "G" side is most prominent. The next couple of months is the season of the Annual General Meeting (AGM), and we make sure that we vote at every opportunity.

The AGM is when boards of directors have to stand before the shareholders they represent and answer for the strategy and performance of the company, justify their own positions as well as the remuneration of the managers they have appointed. Corporations law requires that directors stand for re-election every few years, and that any director appointed between meetings (for instance to replace one who has resigned or retired) be put to the vote at the next meeting. AGMs are also the place where board and management remuneration is disclosed and discussed.

Directors are the representatives of shareholders and are meant to represent all shareholders equally. This can become problematic when there are large or controlling shareholders involved, as is the case for many companies in Australia, but regardless directors are supposed to have the interests of minority shareholders at the forefront of what they do. The majority of directors are aware of their responsibilities and exercise them diligently.

Remuneration has become quite a contentious issue in recent years. Small and large shareholders alike often struggle to understand why CEOs and senior managers of some companies receive large and often seemingly random salaries and bonuses, and the AGM is really the only forum for them to express a view. That view has been strengthened in recent years with the "two strikes" rule – a requirement that if a company has two consecutive instances of 25% of votes being cast against the adoption of its remuneration report, a "spill motion" can then be put to the meeting. Should the spill motion succeed, it would mean that all board positions were declared vacant and a new board could soon after be appointed by shareholders.

This seems a dangerous and reasonably impractical option to us. Would it really be in shareholders' best interests for the whole board to be sacked at the same time, draining from the governance structure any corporate memory or insight about the company? From where would suitable directors be sourced should a spill take place – the floor of the meeting? Who would coordinate it – the company's management, potentially putting the foxes in charge of the henhouse? In practice, the outcome would most likely be that pretty much the same board that would be re-appointed should a second strike occur.

The good thing however is that we can't think of any instance of it happening since the two-strikes regulation was instituted in 2011: the threat of a spill has been too powerful. A first strike is generally seen by directors as such an existential threat that they move heaven and earth to avoid a second. It is amazing how consultative boards become when faced with a second strike.

Assessing the appropriateness of remuneration is a difficult task. Alphinity has a policy of opposing excessive pay, but we concede that "excessive" is almost entirely in the eye of the beholder: what might seem excessive to someone struggling to get by on the age pension might seem paltry to a high-performing executive capable of working anywhere in the world and being paid far more. This is the most common argument made by those in favour of high pay, and in some cases it would be true.

We are prepared to vote against Remuneration Reports and any other unacceptable resolution put to shareholders, and have done so numerous times over the years, but we generally find that the companies we invest in usually don't need to be voted against: considering ESG as part of the stock selection process has already weeded out the most poorly-behaving companies.

We find it much easier to accept high executive pay, however you might define it, when the company is performing well, when the directors are able to point to actions management has taken to create value, and when this value is reflected in strong share price outperformance. That's how everyone wins.

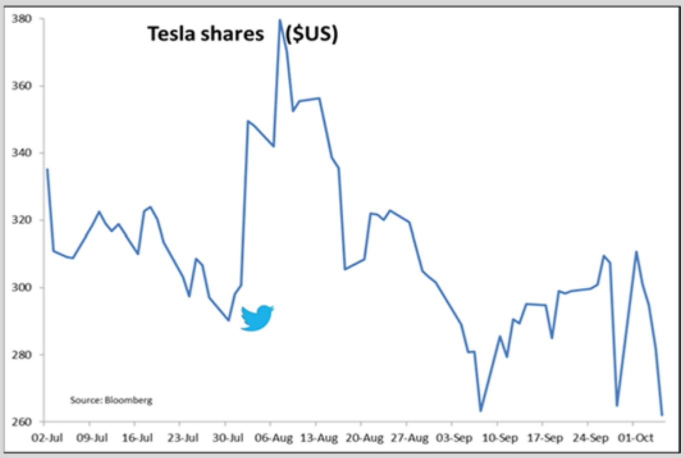
Quarterly Comment – September 2018
Alphinity Sustainable Share Fund

BTW

Elon Musk is a force of nature and, so he seemed to think recently, a law unto himself. Musk co-founded PayPal and reaped a small fortune when eBay bought it in 2002. He parlayed that into a large fortune by establishing several highly-innovative new businesses. His most famous is Tesla automobiles but he's also started SpaceX (right), brain engineering company Neuralink and even come up

with a whole new mode of transport, Hyperloop (left), which proposed using vacuum tubes to move people vast distances at high speed. Tesla has been a disruptive player in the very traditional automobile manufacturing industry, however it can't be said to be a financial success as the company has not yet turned a profit. The market is expecting Tesla to become profitable in the 2019 financial year. (This picture, by the way, is of a musk-scented Elon Musk air freshener you can buy for your Tesla, or any other car really.)

Musk always seems to be convinced that Tesla shares are undervalued. In August, with the shares trading at a little over $US300, he tweeted "Am considering taking Tesla private at $420. Funding secured." The shares quickly shot upwards as buyers, who thought they had a hot stock tip from the horse's mouth, emerged and some with short positions in Tesla shares desperately tried to cover their positions. Later in the month Musk stepped back from the plan, and has since been subject to a US Securities and Exchange Commission (SEC) investigation, and is now facing several class action lawsuits, largely from hedge funds alleging stock manipulation. The shares also stepped back from their "manipulated" peak and are now trading below pre-tweet levels, as the chart below shows.



We don't have too much sympathy for the shorters: selling shares you don't own in the hope their prices will fall doesn't seem like a very constructive way of earning

a living to us. We accept to some extent the short sellers' technical argument that their practice can contribute to market efficiency through providing liquidity and price discovery, however the potential that the practice has to facilitate unhelpful or even unethical behaviour seems quite problematic to us. We sometimes witness companies' managment take pleasure in "squeezing the shorts" when announcing a better-than-expected result or undertaking market-friendly activity such as capital management, which can cause people with short positions to scramble to buy them back and send the share price of the company sharply higher.

However we can also see the difficulty a statement like Musk's presents to regulators. While maybe there really was a genuine plans to privatise the company, there is also the chance that some manipulation might have been going on. Twitter was not the right forum to announce such a move, and concerns about not keeping the market properly informed was the trigger for the SEC investigation. Musk subsequently stepped back from the takeover, citing feedback from investors that they overwhelmingly wanted it to remain listed.

Whether that is genuinely the case is moot, but after a brief negotiation with the SEC Musk stepped down as Chairman of Tesla (retaining his position as CEO) and agreed to pay a $US20m personal fine. Tesla was also fined $US20m and had to agree to increased controls around governance and communications. The SEC implied the board should muzzle his Twitter activity but Elon didn't seem to get that message. We can't imagine the SEC would have taken very kindly to Musk provocatively referring to it in another tweet as the "Shortseller Enrichment Commission" only days after the settlement.

Tesla is now in an interesting situation. It is undeniably the leader in its space but has also had the electric vehicle market pretty much to itself for some years. It is making cars with prices so high that most people can't afford them, no matter how good or disruptive they are. While the company might soon turn profitable, our choice of electric vehicles will increase massively over the next few years as European, Japanese and Chinese manufacturers all join in, most likely at prices that appeal more to the masses. Perhaps Musk was wise to step back from taking over the rest of the company.

Quarterly Comment – September 2018
Alphinity Sustainable Share Fund

Environment

The energy war has been raging in Australia for more than a decade, with political ideology seeming to outweigh rational and dispassionate thought in some cases. Australia has high per-capita CO_2 emissions, a function of our large land-mass, relatively small population and the carbon-intensive nature of many of our industries. The debate has been largely about what should replace the ageing coal-fired power stations which will gradually become defunct over the next decade or so.

It was intensified last year when the French owner of a large generator in Victoria decided, with little advance notice, to close that power station. While a win for the environment, as it used brown coal which the most polluting fuel in the country, the move also destabilised the national grid as a meaningful proportion of national generation was suddenly no longer available. Doubts around the future of a power station north of Sydney approaching its 50th birthday increased the political panic level further. One thing Australians seem to hate more than carbon emissions is not being able to turn their air conditioning when they want to!

The case for more fossil fuel generation however was dealt a blow recently with an announcement by the most fossil fuel-intensive country we could think of, Saudi Arabia. That place which to outsiders seems to consist mainly of liquid dinosaurs and sand has said that, along with Japanese tech company Softbank, it will spend as much as $US200 billion to build a 200 gigawatt solar power plant some time before 2030. Unless there is a major breakthrough in technology, a plant big enough to make that many watts with today's panels would cover an incredible 5000 square kilometres. That would be an area 70km by 70km.

Of course it still has to happen, and over the years we've seen plenty of pipe dreams announced that don't come to anything, but the involvement of the Saudi Crown Prince gives it a bit of extra credibility. 200 GW is an enormous amount of electricity, about three times as much as the Saudis presently make, primarily using the oil they have in abundance. Saudi Arabia admittedly has a fast-growing population but it must also have other plans for the energy.

Adding to Australia's dilemma is that renewable energy generation at scale now costs less than building new coal power stations, albeit with a lower level of reliability due to the issue of intermittency, periods during which the sun's not shining or the wind's not blowing. But this issue will no doubt be solved with time and technology, and the country's transition away from coal to a mix of lower- and zero-carbon alternatives will take place as a result of the market rather than government diktat. Which is probably a better way for it to happen anyway.

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

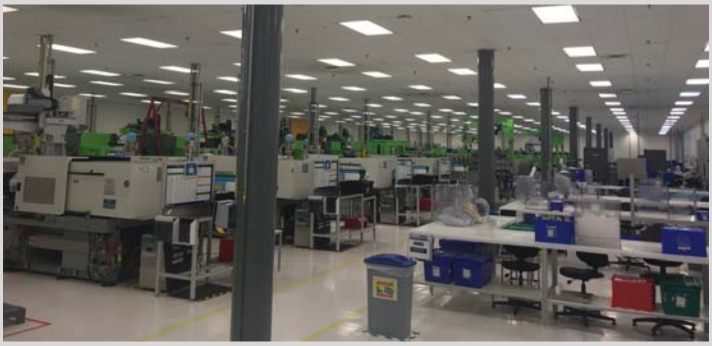
Asset allocation	30 Sept 2018 %	Range %
Securities	96.8	90-100
Cash	3.2	0-100

Top five active overweight positions as at 30 September 2018	Index weight	Active weight
Bingo Industries	0.1	2.4
Computershare	0.6	2.3
IDP Education	0.1	2.0
Macquarie Group	2.3	2.0
Woodside Petroleum	2.1	1.8

Quarterly Comment – September 2018
Alphinity Sustainable Share Fund

Traveller's Tale

Stuart went to the US and Mexico in September, to San Diego to see medical device company Fisher & Paykel Health and its Maquiladora in Tijuana (right). US companies have long been establishing manufacturing operations in Mexico, known as Maquiladora, attracted to the large pool of relatively cheap labour and its proximity to the home market. Tijuana has the largest concentration of medical device manufacturers in all of North America with more than 40 firms operating there, employing around 40,000 Mexican workers.



Maquiladora growth in Mexico accelerated in the 1990s following the implementation of the North American Free Trade Agreement (NAFTA). NAFTA created a sufficiently stable operating environment to allow for long term manufacturing investments and while Tijuana is already dotted with large manufacturing facilities, there are many cleared and levelled sites intended for new plants down the track. This was thrown into some doubt when one of President Trump's first actions in office was to issue an executive order to withdraw from NAFTA, followed by the implementation of tariffs on steel and aluminium. Not to mention the wall.

The Trump administration has since renegotiated the trade arrangements, which are now renamed the "US Mexico Canada Agreement". Apparently Trump liked that the acronym matched that of the United States Marine Corps, until they added the A for Agreement. A number of changes were made, largely relating to the auto and dairy sectors, but probably the most important change for Mexico was to Chapter 11. Chapter 11 provided protections for investors in Mexico or Canada should one of the NAFTA governments change the rules, and contributed to the stable investment environment. However these protections will be eliminated entirely for Canada and mostly for Mexico other than for some key industries such as energy (big oil obviously lobbies better than most) and telecoms (better to have Mexican than Chinese).

With increasingly erratic US policy decisions coming from the White House, losing Chapter 11 protections is proving somewhat concerning. After all, nervously watching Twitter for US policy gyrations is hardly conducive to making large, long term investment decisions. It is probably wise for some of those companies to be considering geographically diversifying their manufacturing exposures. We suspect many of the large vacant lots in Tijuana may look much the same a few years from now.

FUND MANAGER OF THE YEAR 2018
MONEY MANAGEMENT Lonsec
WINNER
Responsible Investments

For further information, please contact:
Fidante Partners Investor Services | **p:** 13 51 53 | **e:** info@fidante.com.au | **w:** www.fidante.com.au
Fidante Partners Adviser Services | **p:** 1800 195 853 | **e:** bdm@fidante.com.au | **w:** www.fidante.com.au
Alphinity Investment Management | **w:** www.alphinity.com.au