alphinity INVESTMENT MANAGEMENT

Quarterly Comment – December 2018
Alphinity Sustainable Share Fund

A Tale of Two Markets

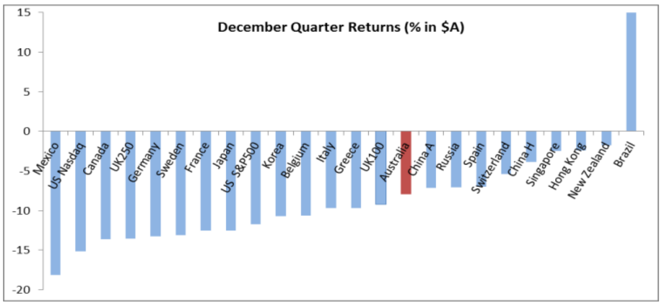
Market comment

"It was the best of times, it was the worst of times." So wrote Charles Dickens in his book A Tale of Two Cities. That was 160 years ago but he could have been talking about financial markets in 2018. Everything was going swimmingly up to the market's peak in August. We'd have been pretty happy to close off the year then and avoid the final third of the year – unfortunately that wasn't an option and we had to deal with the fairly nasty market as it evolved. And it wasn't just share markets: Deutsche Bank tracks 70 types of assets across stocks, bonds and commodities and 63 of them – 90% – fell in value in $US terms in 2018. Only one asset class fell in value in 2017.

2018 will probably not be remembered with much fondness in business or in politics: it seems everyone everywhere was feeling a bit fractious by the end of a tough year. The two cities Dickens was writing about were Paris in the French Revolution and London a few decades later: in December one of those was in flames. The Gilets Jaunes movement in France brought Paris to a standstill several times and caused the French President to back down on fuel tax increases, not before some serious damage to public infrastructure. In the other, the Brexit debacle stumbled along towards some sort of finality but not before the UK Prime Minister was challenged for leadership and forced to go back to Brussels cap-in-hand seeking more concessions the EU was never going to grant. Long-time German Chancellor, Angela Merkel, resigned from her party's leadership and announced that she would retire at the end of her current term. The US President's former lawyer was sent to jail amidst scurrilous allegations and furiously-tweeted refutations. US short term interest rates were once again raised, to the President's chagrin, and the year finished with many US government departments shut down for lack of agreement on funding. China reported its slowest economic growth rate in the modern era as US tariffs began to bite. A senior Chinese executive was arrested in Canada; soon after two Canadian execs were arrested in China in what could be a concerning trend. Japan's economy once again went backwards and even that generally reliable economic powerhouse, Switzerland, reported negative third quarter economic growth and a subdued outlook.

The outcome of all this was extreme volatility in most equity markets, particularly that of the US, in a period during which normally there is not much going on.

Australia by comparison was a relative haven of stability and sanity, even with all the end-of-year political positioning ahead of a 2019 federal election. Our share market, too, did a little better than most although it still followed them lower. The ASX300 (including dividends) was flat in December but fell 8% for the quarter, 3% for the whole of 2018. The quarter's 8% seems like a lot but ours was actually one of the better performing major markets even after the impact of a weak $A, which fell 9.5% against the $US for the calendar year. This inflated the US market's return; in $US terms it returned -9% for the month, -14% for the quarter and -5% for 2018. This was despite what should have been good news of continuing strong employment growth and a sharply falling oil price: oil was down 38% for the quarter. The growing evidence of political dysfunction outweighed that.



The price of Iron Ore was strong, rising 9% in the quarter, and Brazil's ore-oriented equity market performed very well as a result but it was the only one of note to keep its head above water. BTW on page 4 expands a little on market returns for the year.

To continue with Dickens: "…it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way – in short, the period was so far like the present period…". And today's present period.

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)	-0.7	-10.1	-0.1	6.6	6.4	10.8	8.6
S&P/ASX 300 Accumulation Index	-0.2	-8.4	-3.1	6.6	5.6	9.4	7.6

*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.

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Portfolio comment

The Fund underperformed the market in the December quarter but retains strong numbers for the year and over longer periods. The quarter saw the partial unwinding of a few positions that were strong contributors earlier in the year. In some cases we have adjusted the positions and in others, where we feel the investment case remains robust, we have held firm.

The best contributors for the quarter were our positions in global industrial property specialist Goodman Group, global diversified resource company Rio Tinto, renewable energy owner New Energy Solar and horticulturalist Costa Group. Not owning gambling company Aristocrat also contributed: this is pleasing as Aristocrat had been a strong performer in recent years and not owning it has been a decent headwind for the Fund. There were more and larger detractors however, including recycling company Bingo Industries, gas producer Beach Energy, property developer Lendlease and UK bank Clydesdale. Not owning supermarket operator Woolworths, toll road company Transurban and gold miner Newcrest also hurt returns.

Over 2018 the best returns came from language testing group IDP Education, blood and vaccines company CSL, Goodman Group, Green Investment Bank owner Macquarie Group, resource companies Rio Tinto and BHP and not owning financial services company AMP. The detractors were largely the same as for the quarter.

Market outlook

There's a saying on Wall Street: "As January goes, so goes the year" and the statistics seem to agree. Statistics of course are all based on long term averages so not only is it too early to say how January will pan out, what it implies for the full year should not be relied upon either. What we have seen this early in the new year is that volatility and mixed economic data will likely be with us for some time. Not only has this been evident in the first few days of January, we've been seeing it for several months now. It also appears to be happening in the US where the weaker-than-expected purchasing manager survey suggested that the US is joining the slowdown that has been seen in much of the data coming from Europe and many of the Emerging Markets for some time. Equally however, another stronger-than-expected employment report and solid wage growth indicates that, as has been the case globally, things in the US are just slowing rather than collapsing.

Following the significant selloff that occurred in late 2018, most equity markets are now trading at or below their long term averages. Earnings expectations may still be too high, more so in the US than Australia, and there will no doubt be some companies caught out by the increasing cost of borrowing. For much of the last couple of years we were in an environment in which there have been many winners and few losers, although since about August it had switched around to being many losers and almost no winners. The situation in early January increasingly looks to us like a more normal equity environment with a more normal distribution of winners and losers. In other words, we expect an equity market in 2019 where wholesale selloffs, such as we've recently experienced, will be replaced by movements based on company-specific news flow. This is clearly not without its challenges, as growth is likely to remain on a slowing trajectory, but should be a lot more manageable than the last few months have been.

And while he was possibly only stating the obvious, the US Federal Reserve Chairman's recent comments that its policy is flexible and it is listening carefully to financial markets should be supportive, and may have acted as the catalyst to what would be a welcome change in market behaviour.

Portfolio Outlook

Now that 2018 is done and, after negative returns from the Australian equity market although Fund outperformance offset pretty much all of that, the question becomes: what does 2019 hold for us? Our reasoning above about the general market environment should support renewed outperformance in the coming year, presuming we are correct. We have reduced the overall risk to the portfolio of a worse global growth slowdown and are largely invested in companies which, in general, have below-market levels of gearing and thus should be less susceptible to increasing corporate credit costs. However, the Fund also remains exposed to a number of companies whose earnings trajectories we believe are being underestimated by the market.

In an environment in which growth will be more challenging to find, and with risk to that growth elevated by cyclical factors, we expect that investors will become more willing to reward companies which can even modestly outperform consensus expectations, and also be willing to pay more for earnings certainty. If this is the case quality companies, as defined by profitability and cashflow, should continue to do well. Consistent with this view we have recently increased our exposure to the Healthcare sector by adding slightly to our position in CSL and buying back into Resmed. Both companies score highly from the perspective of financial strength as well as potential to deliver better earnings than the market expects from a solid pipeline of recently-launched and future products. Continued price strength of some commodities, our view that growth in China will, like global growth, moderate rather than collapse, and cheap valuation also justifies a continued overweight to the bulk commodity sector, particularly BHP and Rio Tinto.

The Sustainable Share Fund Compliance Committee made a principled decision at the start of the year not to invest in companies whose main purpose was gold mining as it could not identify any meaningful contribution this precious metal makes to achieving the Sustainable Development Goals, and when we considered the substantial environmental impact of Gold mining, even in countries like Australia which have quite stringent controls in place let alone third world countries which in many cases do not, we determined that companies whose primary purpose was mining gold should be excluded from this Fund. We are however willing to keep exposure to a company like Oz Minerals which produces some gold as a by-product of it primary purpose which is copper mining, as copper is an essential element in achieving sustainable development.

Having said that, outperforming gold stocks have held back the relative performance of the Fund somewhat since the market sell-off began in late August. The gold price, and share prices of gold companies, have been supported by investors seeking a safe haven from the market downdraught. Outperformance of gold companies from here would, in our view, require further overall market declines. While this is something that cannot be ruled out, it does appear less likely following the savage December quarter selloff. So notwithstanding the cost to performance in 2018, we stand by our decision not to invest in gold miners.

Sustainability

2018 has been a year of intense activity for the portfolio managers as well as the independent members of the Sustainable Share Fund Compliance Committee. Having determined that the Sustainable Development Goals (SDGs) were valid and worthy aspirations, we rethought the Fund and started reshaping it towards companies which are positively and sustainably contributing to society through their ESG practices and whose activities could support the achievement of the Goals. We engaged with various external organisations such as Sustainalytics, CAER, the PRI, RIAA, Climateworks, various broking houses and Dutch pension fund APG (a global leader in SDG investing).

We also actively engaged with many companies, both in the portfolio and not, to better understand how they contribute to achieving the Goals. This activity will continue in 2019 as we increasingly understand what the companies in our investment universe, i.e. companies listed on the Australian Securities Exchange with a market capitalisation greater than $100m, can and are doing to assist in the achievement of various SDGs. We have been heartened by the number of companies now thinking about their activities through the lens of the SDGs although we also recognise that this is at an early stage and that some companies have a tendency to put an unwarranted positive spin on what they are doing.

We were honoured to be named Fund Manager of the Year for Responsible Investments in May, and to receive provisional certification by the Responsible Investment Association of Australasia late in the year. We thank and pay tribute to our external experts, Elaine Prior and Mark Lyster, who have provided wisdom and counsel to the Portfolio Managers and helped us to engage robustly with many companies, spurring us and them on towards different ways of thinking and improved execution for the betterment of their staff, customers, society and the environment.

Investing along the lines of SDGs is not easy to achieve in a market like Australia, which is possibly why no one else is doing it yet. Some goals are not particularly relevant to developed countries like Australia and some are not easily or practically addressed by the set of companies we are able to invest in. All companies engaging in economic activity will have a degree of negative impact. The Fund's aim is to invest in companies which not only can provide a reasonable return but that also do more good than harm. This is and always will be a work in progress but now, a year into the journey, we are heartened by the progress we are seeing. Each iteration of SDG research we receive from our service providers and brokers is better and more practical so we remain hopeful that our Fund can, in a small way, help to make the world a better place to live.

External Experts on the SSF Compliance Committee
Elaine Prior
Mark Lyster

Service Providers	
ESG	CAER
SDGs	CAER, Sustainalytics

Asset allocation	30 Dec 2018 %	Range %
Securities	97.0	90-100
Cash	3.0	0-10

Top five active overweight positions as at 31 Dec 2018	Index weight	Active weight
Goodman Group	1.1	2.3
IDP Education	0.1	2.2
Macquarie Group	2.2	2.0
New Energy Solar	0.0	2.0
Bingo Industries	0.1	1.9

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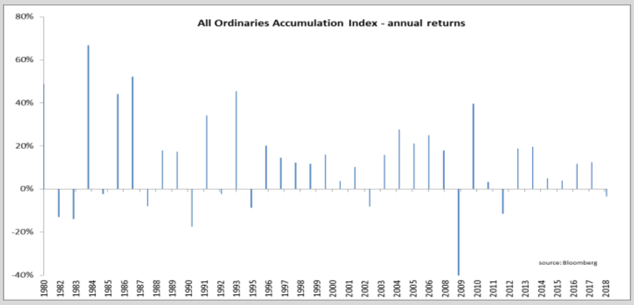
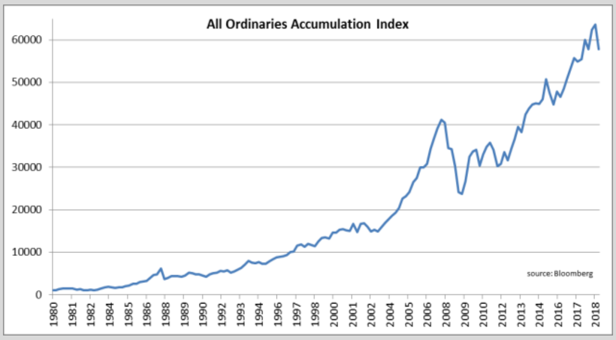
BTW

2018 was not a great year for equity investors in most parts of the world, as the chart below shows. Pretty much everywhere in the world experienced negative returns, and the only reason the US was positive was because the Australian dollar fell by 10%.

In this context –3% for the year for Australian shares wasn't too bad. Negative returns happen from time to time, as the next chart shows, but thankfully not frequently. The All Ordinaries Accumulation Index, which has a longer history than our preferred ASX300, has sustained 11 negative years since it was established in 1980. Three of the negatives, including this year, were smaller than -5% and only once in 39 years has there been two consecutive negative years: they were 1981 and 1982. These were preceeded by a +49% in 1980 and followed by a +67% in 1983.



So having a down year is regrettable but it's not the end of the world. 2008's -40% did feel like the end of the world, although we didn't know then that it would be followed by a +40% in 2009. Of course the maths is that falling 40% then rising 40% doesn't get you back to where you started, you'd still be 16% below the starting point. It took a few years for the market to fully recover from the 2008 experience – that didn't happen until 2013.



Each year has its own unique conditions and characteristics so we can't at this point predict with any great confidence what 2019 will bring. The first days of January were decidedly weak with a profit warning by Apple and poor manufacturing data in both China and the US, although this was followed by very strong US employment data and a degree of rebound in the market. However with the Australian share market starting the year at the lowest earnings multiple it has had since 2006, there would need to be some pretty significant earnings disappointments across the market in the year ahead for the ASX300 to be lower again at the end of 2019.

Portfolio metrics are apparently simple and tangible but arriving at meaningful metrics relies on the inputs being consistent and correct. We calculate ESG and Carbon metrics for the Fund and present them below, but ask that our investors understand that they are only as good as the inputs being used. Calculating carbon intensity is a particular challenge: some companies publish carbon emissions numbers using CDP standards, some using NGER and some using their own or an undisclosed method. This is not inconsequential: for instance Woodside Petroleum's emissions on an NGER basis are more than three times that of the CDP. Some companies don't publish emissions at all so estimates need to be made, and the bases on which those estimates are made varies widely. We have attempted to adjust for the most obvious anomalies but clearly variables such as these can make the calculation of a portfolio's carbon footprint very arguable. We do source market data from a major service provider but present the following numbers with these disclaimers. We are confident that the emissions intensity of the portfolio is materially below that of the ASX300 as we exclude from the Fund a number of the very large emitters in the benchmark, companies such as gas producers AGL Energy and Origin Energy, thermal coal miner South32 and aluminium producer AWC. We are less confident however that the metrics shown here are precisely correct.

Scope 1 & 2	SSF	ASX300
Weighted Average Carbon Intensity	**135.2**	**532.8**

Intensity is the market cap or portfolio value weighted tonnes of CO_2 emissions per $USm of revenue

	SSF	ASX300	min	max	median
Environment	38.7	38.5	0	78	15
Social	42.3	41.3	12	64	23
Governance	50.6	50.3	22	73	41
Overall	**43.7**	**43.0**	12	62	27

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Traveller's Tale

We have seen the future and we like it. Bruce went to the central west of NSW to check out an asset owned by Fund holding New Energy Solar. On a stunning late-spring day he drove four hours out of Sydney, across the Great Dividing Range to Manildra to see a newly-built solar farm. He met the land-owner and heard the story of the solar farm's development, which took about a decade from conception to commissioning.

Solar power generation has been booming in recent years although most has been on the roofs of houses. Large-scale commercial operations like this have been difficult to make stack up financially considering the high capital cost and lack of regulatory certainty at the federal level. This however has now been largely solved by the falling cost of solar panels. When this farm was first proposed in 2008 it was estimated that it would cost around $400 million dollars, and would have required huge subsidies to be viable. By the time it was actually built the total cost had come down to a bit over $100 million and only a relatively small subsidy was required. This is very different to what normally happens with construction projects, i.e. the cost goes up over time. The key difference was the enormous fall in the price of panels over the period.

The end result is a huge paddock covered with solar panels that adjust position to follow the sun during the day. In this sun-rich part of the world, it reliably pumps out 56MW of electricity in daylight hours, a little less when there's cloud cover. For context, even a small coal-fired power station like Collie in WA produces around 300MW so you do need a lot more solar projects, but a bit of geographic diversity is a good thing as it provides greater resilience to the network.

Manildra is a great location for solar: there's lots of sunshine, good local electricity demand with two power-hungry flour and canola mills nearby, and the national electricity grid runs right past the boundary so getting power into the network is relatively easy. This is not the case for some renewable energy projects.

The impact on neighbours is minimal: there is no mining required to fuel it so no truck movements, no noise, no smoke or any other types of emissions, and hardly any people movements either as only one or two people are needed on-site to deal with any physical issues that might arise. In fact most aspects of the farm can be remote-controlled from Sydney. The panels just sit there quietly with just the occasional "whirr" as they reorient themselves during the day. And the loss of productive land is minimal: once the vegetation grows back fully the paddock can again be used to graze sheep. The only issue becomes providing power when the sun isn't shining. There's an enormous amount of research going on around the world to develop cost-effective storage so surely it's just a matter of time before technology reaches the point at which this can be achieved.

For further information, please contact:
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