alphinity INVESTMENT MANAGEMENT

Quarterly Comment – June 2019
Alphinity Sustainable Share Fund

Winter Wonderland

Market comment

As the weather turned chilly here, relations between the leaders of the two most important economies in the world, US and China, also grew increasingly frosty. This sparked a hasty revision of the game-plans of global monetary authorities, pivoting back to an easing stance. This was particularly noticeable at the US Federal Reserve Bank (Fed), which had been an inflation hawk and was raising interest rates as recently as late 2018. The Fed seems now to have turned quite dovish and, according to those supposedly in the know, could drop short term US interest rates imminently.

The irony is that the move to dovishness probably implies a full-blown trade war which would not be a great outcome for corporate earnings and therefore company valuations. However the prospect for lower rates set the US market alight, helping the S&P500 to finish the quarter at new all-time highs. The month closed out with the G20 meeting in Japan, and a degree of rapprochement seemed to be in the air.

Our market (ASX300 including dividends) rose for the sixth consecutive month, lifting 8% for the quarter and an astounding 19.8% over the first six months of 2019, leaving the ASX300 Accumulation Index at another all-time high. Of course the prior six months was poor: July to December 2018 saw our market fall by 8%, but even so equity returns for the financial year to June were an appealing 12%. As usual, there was a wide range of outcomes for other countries' markets, from -14% (Turkey) to +27.5% (Switzerland). Australia shaped up well in a global context.

The $A trended down for the quarter, meandering between $US0.69 and 0.72 and finishing a fraction above $US0.70 despite the lowering of official cash rates during the month to a new record low 1.25%. The $A is now ~5% below its level of June 2018.

There was a fairly constant progression of profit warnings from companies in a number of industries during the quarter, especially those exposed to the domestic consumer, and while the share market reaction to many of these was quite savage, our portfolios traversed this tricky environment largely unscathed. Most commodity prices fell, the exception being those related to steel-making. Metallurgical Coal held its value, unlike its counterpart used for electricity generation which fell 23% over the quarter, but the big winner was Iron Ore, which jumped almost 40% over the quarter. This was a result of a combination of factors: Chinese stimulus boosting demand for steel, falling Chinese Ore stockpiles, and supply disruptions due to weather in Australia and the ongoing fallout from the terrible tailings dam collapse in Brazil earlier in the year.

Other commodities were mostly soft: Oil fell slightly but Gas was down 12%, Aluminium was down 5%, Copper down 7%, and Zinc -14%. Gold was a rare bright spot, rising 10%.

Portfolio comment

The Fund performed strongly in the month of June and over the quarter. The companies which contributed most to performance were audio technology company Audinate, waste recycler Bingo Industries, language and university placement company IDP Education and affordable retirement living provider Lifestyle Communities; not owning diversified miner South32 was also positive. On the opposite side of the ledger were renewable energy company New Energy Solar, gas producer Beach Energy, steelmaker Bluescope Steel and copper miner Oz Minerals which all detracted, as did not owning gold producer Newcrest or gaming machine company Aristocrat, both of which are excluded under the Fund's Charter.

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)	4.6	9.3	14.1	16.2	10.5	13.6	10.8
S&P/ASX 300 Accumulation Index	3.6	8.0	11.4	12.9	8.9	11.8	9.4

*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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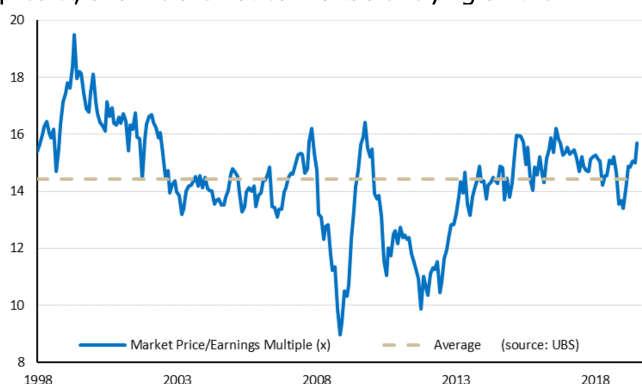
Alphinity Sustainable Share Fund

Market outlook

Bad news is sometimes good news. Global equity markets continued to move higher despite economic growth and corporate earnings growth continuing to slow. While one might argue that the markets are being forward-looking and focusing on the potential boost to economic growth from easing monetary conditions around the world, that is probably too optimistic an interpretation. Instead, it is more likely that ultra-low interest rates have renewed investors' search for yield and further reduced the discount rates they are applying to long-duration equities.

That is not an illogical reaction, but it is one that is difficult to be fully comfortable with given the lack of support from an earnings growth perspective, and also one that is subject to future investor sentiment shifts in the interest rate outlook. Perversely, if the current environment were to apply, a breakthrough in the US-China trade war, which would be undeniably positive for global economic growth, might actually have a negative impact on financial markets as it would make future interest rate cuts viewed as less likely.

At close to 16 times earnings for the year to June 2020 the Australian equity market is now trading well above long term averages, as the chart below shows. With short- and long-term interest rates at record lows at the same time as earnings expectations continue to be pared back, the Australian market is fairly typical of equity markets around the world. Other than for some Resource companies, whose earnings expectations still appear too low, additional gains in our equity market probably continue to rely on further multiple expansion driven by money flows and investor sentiment. These are factors that are inherently difficult to predict, and we are not comfortable relying on them.



External Experts on the SSF Compliance Committee	
Elaine Prior	
Mark Lyster	
Service Providers	
ESG	Vigeo Eiris, MSCI
SDGs	Vigeo Eiris, Sustainalytics, MSCI

Asset allocation	30 Jun 2019 %	Range %
Securities	96.2	90-100
Cash	3.8	0-10

Portfolio Outlook

A market environment in which much depends on the outlook for, or investor sentiment towards, interest rates is never one that is entirely comfortable for stock-pickers like ourselves. However, we have generally found that our focus on companies that can deliver earnings growth ahead of market expectations is effective in most market environments and has delivered solid outperformance in the long term. 2019 has been no exception, with strong absolute and relative performance year to date, including the month of June.

While the contributors to the Fund's performance has been well diversified, the performance of some of our smaller companies exposures have been significant, and have been more than enough to offset the drag from not being able to own a number of well-performaing companies excluded by the Charter. Performance has been assisted by strong stock selection in Resource (particularly Fortescue Mining and Rio Tinto) and Real Estate (Goodman Group and Mirvac) companies. These have benefited from favourable tailwinds in the form of iron ore prices and interest rates respectively, but each has also outperformed its peers for stock-specific reasons. In the case of Fortescue it has been the sharp improvement in the ore price it has been able to achieve; for Goodman and Mirvac it has been strong execution of their respective industrial and office property strategies that has been the key differentiator.

In the current environment in which negative earnings news has been far more prevalent than positive news, it has also been important to avoid the long list of companies making profit warnings. We've counted more than 50 company announcements in the last couple of months where earnings expectations have been trimmed. While the reasons have been quite varied, a weak Australian consumer and cooling construction market has been blamed by many. Of all the companies downgrading, the Fund's only exposure was to cautious comments by Wesfarmers relating to its Kmart and Target discount department store businesses. Other than Wesfarmers, the Fund's exposure to the Australian consumer is limited.

We remain comfortable with our overall portfolio exposures although we have trimmed positions in some of the stocks mentioned above following strong performance, as is consistent with our thinking around limiting risk in the portfolio.

Top five active overweight positions as at 30 Jun 2019	Index weight %	Active weight %
IDP Education Ltd	0.1	1.9
Audinate Group Ltd	0.0	1.9
Mirvac Group	0.7	1.8
CSL Limited	5.4	1.8
Beach Energy Limited	0.2	1.7

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Sustainability Metrics

Carbon

We spent a lot of time trying to come up with a meaningful way of putting metrics around the Fund's attributes. Carbon emissions are ostensibly simple but can be difficult to interpret, and suffer from the ongoing problem of data reliability considering the relative lack of hard data available. For instance, only about a third of the companies in the ASX300 benchmark disclose their own carbon emissions, the rest are estimates made by our data provider, MSCI. Portfolio emissions for this Fund are markedly below that of the bencchmark, which reflects the fact that several of the companies with the highest emissions intensity are excluded from the Fund. The table below shows that the intensity of the portfolio (tonnes of CO_2 equivalent emitted per $USm of revenue) is running about 60% of the benchmark, and that for every $US1m you had invested in the Fund, you would be responsible for 43.4 tonnes of emissions.

Carbon Exposure Metrics

Scope 1 & 2	Sustainable	ASX300
Weighted Average Carbon Intensity	145.5	247.1
Carbon Footprint (tonnes/$m invested)	43.4	104.3

On our analysis of MSCI data six companies (AGL, Origin Energy, South 32, Alumina, Newcrest Mining and Santos) account for almost 45% of the emissions intensity of the ASX300. So while there are debates about the merits and accuracy of portfolio emissions calculations, we are confident that the Fund has a materially lower level of emisisons than the overall market, and that this will be sustained into the future.

ESG

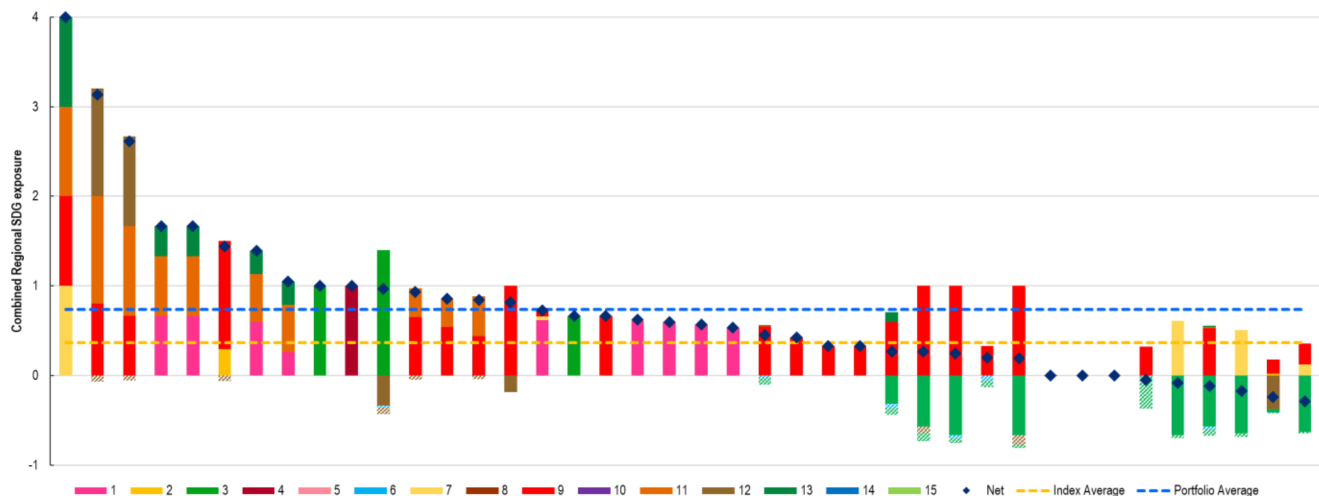
Based on raw MSCI ESG data weighted equally between factors and then weighted as to portfolio holdings, the Environmental, Social and Governance characteristics of the Fund's holdings as at the end of June were:

	Sustainable	ASX300
Environment	6.5	6.0
Social	5.8	5.4
Governance	6.9	6.8
Overall	**6.4**	**6.1**

SDGs

Measuring performance according to the Sustainable Development Goals (SDGs) is challenging however we have adopted an approach developed by Citigroup's ESG research team in identifying which goals are addressed by each company, the extent to which the products produced by those companies have positive and negative impacts on society, and also the damage done to society by producing those products.

We believe this is a balanced approach as it takes into account the negative externalities of each company rather than just looking at the positives. Citigroup does not analyse the entire ASX300 for SDGs but its coverage accounts for 91.5% of the benchmark so it should be reasonably repesentative. The chart below shows net SDGs addressed by each position in the portfolio and shows that each portfolio holding positively addresses on average 0.74 SDGs against 0.37 per company in the universe.



Quarterly Comment – June 2019
Alphinity Australian Share Fund

Traveller's Tale

Bruce ventured to the western suburbs of Sydney in June to look at landfills. It's all part of the glamour of the job. One chilly morning he boarded a bus and went to two recycling and landfill sites operated by portfolio holding Bingo Industries. One was newly completed, all shiny and new and as yet unblemished by any actual waste. The other (pictured) is one Bingo recently bought at Eastern Creek, near the car racing track. It was very large and well-established but it didn't smell as bad as one might expect.

Bingo specialises in dealing with construction, demolition and commercial waste and has been a beneficiary of the residential building boom (now sadly over) and infrastructure boom (still well under way) that has been taking place around Sydney in recent years. Bingo does not take in household organic waste which is why its sites didn't smell too bad; this also means it doesn't have the odour or gas emissons issues some landfills have to deal with, resulting from breaking-down organic materials. It was impressive to see truckloads of waste from demolition come onto the site and be emptied onto a big conveyor belt where it was sorted into reusable materials. There is a degree of manual handling involved but is automated as much as possible for safety reasons. The facility provides work for a large number of low-skilled workers. Timber goes to one place, glass to another, metal to another, brick and concrete elsewhere, and so on, where they are further sorted and processed into reusable form.

Timber gets mulched up and re-sold to garden centres; brick and concrete broken up into various sizes and sold as road base or aggregate to make back into new concrete. Metals go into a big pile and is taken off to be melted down and re-used. Bingo is able to re-purpose, re-sell and enable the re-use of about three quarters of the waste that comes through its gates. There will always be some things that can't be salvaged and that ends up in landfill, but the big benefit is their ability to re-use about three quarters of what they take in. Bingo is aiming to get this to 80% and beyond. This is not a glamorous operation. It is hot and dusty and potentially dangerous, but it is a win for the operation and progress of our society in a more sustainable way. Bingo makes good money by charging people to accept their waste, then earns revenue from selling some of the materials to new users which is a win for you, its shareholders.

alphinity INVESTMENT MANAGEMENT

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

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