

2020 Vision

Market comment

What a year. In December 2018, when the markets were crumbling all around us, who'd have thought that 2019 would turn out to be such a good year for share market investors? Remember back then the US Federal Reserve Bank was still tightening interest rates despite the sage advice of its President that it should be easing? And the Trade War between the US and China seemed to be getting out of hand, providing a real threat to global economic growth? And Brexit uncertainty was going on and on, seemingly without end? Who would have put money into equities in such circumstances?

As is often the case, when the news was at its worst was exactly the time to put money in: as the old saying goes "it's always darkest before the dawn". The ASX300 (including dividends) ended up returning about +24% for the year. Why such a big move? It's much easier to predict market moves after the event (see BTW over the page) but sometimes just taking away some of the negatives is enough for the market to become positive. The best sectors to be in in 2019 were Health Care and Information Technology which returned 42% and 35% respectively, followed by Consumer Discretionary with 28%. Financials was the laggard with Banks returning a paltry 3%, Insurance 15% and Real Estate 17%. Consumer Staples returned only 18% after suffering a sharp downturn in December.

Some global markets did even better than ours, we were about middle of the pack (see chart). The best major market in \$A terms was the technology-focused US Nasdaq which returned close to +40%, and quite a few exceeded 30%. The laggards were Korea (+6%), Singapore (+11%), and Hong Kong (+14%). But it's a pretty good year when even the worst markets are largely up. Argentina's was the stand-out: its market was actually 35% higher in its local currency, it's just that the Argentinian Peso halved in value over the course of 2019.

The \$A started the year at US70.5c and finished virtually unchanged at US70.2c, although it went as high as 72c in January and as low as 67c in September. Commodity

prices had some big swings over the course of 2019, not least the bulks which are so important for Australia. Iron Ore was up more than 22% over the year, which was great for our major miners, although the price of Coking Coal used in steel making was down 13%. The price of Thermal Coal, used in power generation, fell by 33% but Oil rose by between 23% and 35%, depending on the grade. Gold was also strong in 2019, rising by 19%, and base metals moved only modestly other than Nickel which was up by 32%.

Portfolio comment

The Fund performed well in the December quarter and indeed across the whole year. The companies which contributed most to performance were blood products maker CSL, waste manager Bingo Industries, education provider IDP Education. Not owning gold producer Newcrest Mining was a considerable positive and there were no positions that detracted noticeably during the quarter.

The best companies over the year were audio technology developer Audinate, IDP Education, gas explorer Beach Energy, data centre connector Megaport, affordable retirement village operator Lifestyle Communities, CSL, and iron ore producer Fortescue Metals Group. Not owning diversified resource company South32 helped but a number of positions cost performance, including renewables player New Energy Solar, registry company Computershare, and steel producer Bluescope Steel.



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)	-1.2	2.7	28.5	13.4	10.7	11.5	10.6
S&P/ASX 300 Accumulation Index	-2.0	0.7	23.8	10.3	9.1	10.0	9.2

*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. Source: Fidante Partners Limited, 31 December 2019.

^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.

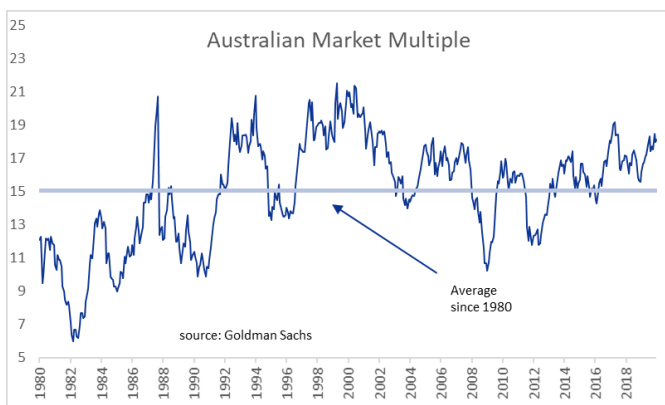
Quarterly Comment – December 2019

Alphinity Sustainable Share Fund

Market outlook

Global equity markets ended 2019 at another high. The first phase of the US-China trade deal and increased certainty around Brexit after the Conservative Party's solid win in the UK election have increased optimism about the potential for stronger economic growth in 2020. This contrasts with the noticeable economic slowdown that took place during 2019, when global manufacturing was effectively in recession.

With equity market returns well ahead of earnings growth over the last 12 months many bourses ended the year trading at valuation metrics well above long-term averages. Of course, the prices of various other asset classes are also above long-term averages: Australian government bond yields at 1.4% are not far from historic lows and property prices – residential and commercial – are also at or close to new highs. Maybe it isn't surprising that equities were bid up too.



While both short term and long-term interest rates remain supportive of equity markets, a pick-up in corporate earnings growth both in Australia and globally is increasingly becoming required to sustain the record long run of positive equity market returns. Some of the leading indicators, such as global purchasing manager indices, are beginning to suggest that a degree of optimism is perhaps warranted, and a US presidential election year is typically associated with positive economic growth – or at least not having a recession.

Following the stellar returns in 2019 that were arguably anticipating some of these things, the fact is that any real improvement to come from the US-China trade deal or Brexit (assuming it is a positive) is likely to still be many months away. So even though comparisons to the poor conditions of last year will become increasingly easy, we enter 2020 as we left 2019: feeling increasingly in need of evidence of improved earnings growth before markets can move meaningfully higher.

Asset allocation	31 Dec 2019 %	Range %
Securities	99.1	90-100
Cash	0.9	0-10

Source: Fidante Partners, 31 December 2019.

Portfolio Outlook

The year 2019 provided the Fund with the usual number of opportunities and challenges but overall results were pleasing, with good relative performance adding to the unusually strong absolute market returns. While the current elevated market valuations and fairly modest magnitude of expected earnings growth make us cautious about the short-term overall market outlook, we expect that we will be able to keep identifying individual companies which can deliver an earnings trajectory ahead of what the market is currently expecting. We believe this will remain a more reliable way to add alpha to portfolios than trying to pick the broad macro outlook which, as always, has a large number of difficult-to-predict elements to it.

The portfolio remains well-diversified but with underweights to Resource companies (despite positions in BHP, Fortescue Metals and Oz Minerals) and to the major Banks, where we see further challenges to earnings. High conviction calls remain in health care, particularly CSL, and diversified financials, particularly global asset manager Macquarie Group. These are companies for which we expect further upward earnings revisions.

We also have a solid position in Technology companies, including Audinate, Appen, Computershare and Megaport, and we note that each has a different theme in its investment case. We remain underweight Consumer companies and don't own any Staples at all: those that are not excluded by the Fund's Charter, in our view, have unappealing earnings prospects or valuations.

Over the last few months we have increased our positions in medical device maker Fischer & Paykel Healthcare and hospital operator Ramsay Healthcare. While both are in the same broad industry sector as CSL, each company has different earnings drivers. Most importantly they all have, according to our research, one thing in common: underestimated earnings growth. As the potential of each becomes increasingly realised by the rest of the market we expect that they have good prospects for further outperformance.

Top five active overweight positions as at 31 Dec 2019	Index weight %	Active weight %
Macquarie Group Ltd	2.4	2.7
CSL Limited	6.8	2.5
BHP Group Limited	6.2	2.4
Mirvac Group	0.7	2.1
Lifestyle Communities Ltd	0.0	1.9

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

Quarterly Comment – December 2019
 Alphinity Sustainable Share Fund
Sustainability Characteristics

2019 was the second full year that we applied the lens of the Sustainable Development Goals to the Australian share market, and we hope you are pleased with the outcome. The Fund has produced strong returns and the companies that have provided those returns, according to our research and that of our data provider, are making strong contributions to achieving the Sustainable Development Goals.

Despite the fact that small cap stocks underperformed large caps over the year, the smaller companies in our portfolio as a group actually performed a little better. This is not because Sustainable companies by their nature outperform. We credit it more to the Alphinity investment process which seeks earnings leadership: if you can find companies in an earnings upgrade cycle (or, in the case of early-stage companies such as some of ours are, a revenue upgrade cycle) they have a good chance of outperforming.

We present some portfolio characteristics below with caveats. We are using externally-sourced data for ESG and Carbon emissions. We do not necessarily agree with every single piece of that data but, notwithstanding this, present the output for your consideration.

ESG Risk Factor Metrics

	SSF	ASX300
Environment	6.4	5.8
Social	5.9	5.4
Governance	6.7	6.7
Overall	6.3	6.0

Source: Alphinity, MSCI. Data as at 31 December 2019.

Carbon Exposure Metrics

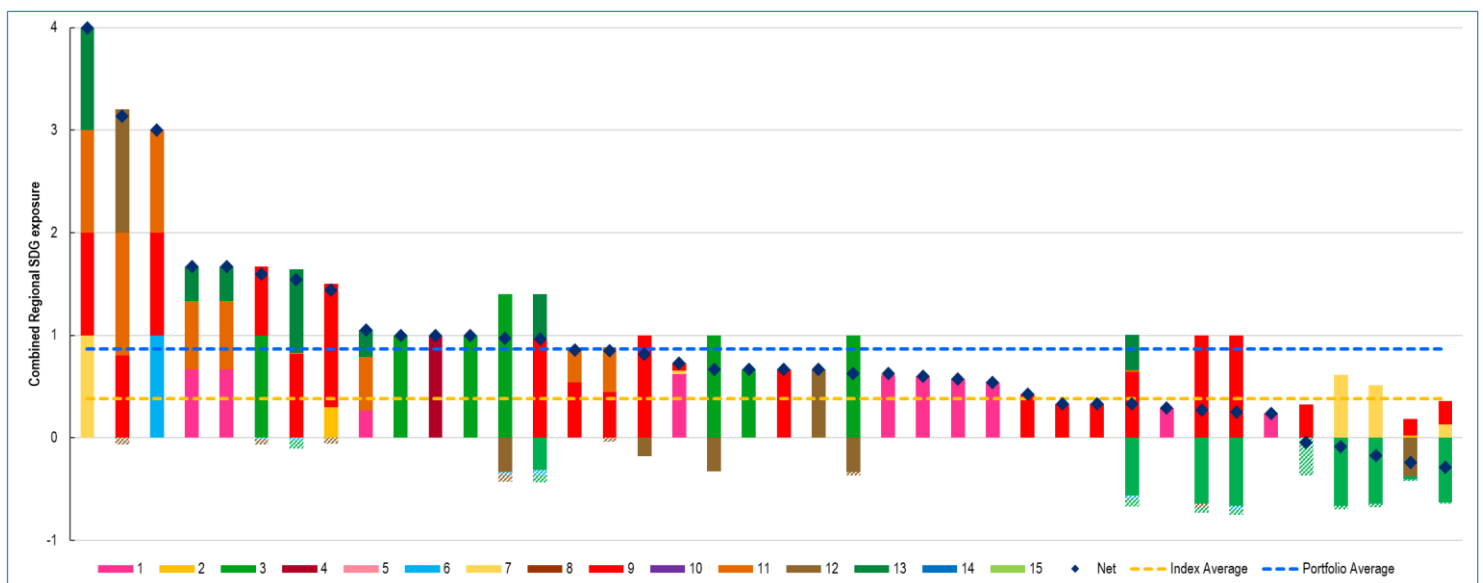
Scope 1 & 2	SSF	ASX300
Portfolio Intensity	115.7	244.8

Intensity: Weighted average tonnes of CO₂ equivalent emissions per \$USm revenue
 Source: Alphinity, MSCI. Data as at 31 December 2019.

The globally accepted metric is tonnes of CO₂ equivalent per \$US million of revenue. We are pleased to note that the intensity of the portfolio is substantially lower than that of the ASX300. This is largely achieved by not investing in some of the biggest emitters such as AGL, South 32, Alumina, Origin Energy, Santos and Newcrest, all of which are excluded under the Fund's Charter.

Measuring the SDGs

As the industry is still at a relatively early stage of developing of research into the Sustainable Development Goals there hasn't yet been a generally accepted way of measuring the extent to which a portfolio addresses the Goals. Considering the number of Goals and the number of companies in a portfolio there are a large number of possible variables. We have adopted the framework developed by Citigroup which we consider to be the best so far, which is shown in the chart below. It represents the extent to which the companies in our portfolio address each goal on a net basis (i.e. positives less negatives). It shows that across Citi's coverage universe companies on average address +0.38 Goals (yellow dotted line), while the Fund's holdings however are considered to address +0.86 Goals (blue dotted line). We note that companies are not selected for investment primarily on the basis of the number of goals they address, but we still find it a useful tool in assessing where there might be possible gaps in the portfolio.



Source: Citi, Alphinity

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Alphinity Sustainable Share Fund

BTW

A frequent theme in our publications is the inherent difficulty in predicting the magnitude and direction of movements in equity markets, particularly over periods as short as a year. It's much easier to predict the market after the event and we point to our quarterly report from December 2018, at the end of a year during which the market had dropped 3% (thanks to a nasty -8% in the final quarter), when we concluded: "Each year has its own unique conditions and characteristics so we can't at this point predict with 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. With the Australian share market starting the year at the lowest earnings multiple since 2006, there would need to be some pretty significant earnings disappointments ahead for the market to be lower again at the end of this year."

As it happened there were earnings disappointments for some companies in 2019 but if you managed to avoid most of those, as we largely did, you would have had a pretty good year. We didn't expect the market to be up by almost a quarter last January but that just proves our point: if anyone tells you with certainty what is going to happen to the market you should take it with a very large grain of salt. We try to focus on the fundamentals, the earnings and valuations of individual companies, and let the overall direction of the market look after itself.

Clearly it would be unreasonable to expect >20% returns to happen very often; a better way of looking at things is over longer periods to strip out some of the volatility. Including the 3% fall in 2018, the two-year return of the ASX300 Accumulation Index (which includes dividends) averages out to be 9.5% pa. It was a 10.3% over three years and a little more than 9% over five years. In fact over the 20 years of the 2000s the index is up almost five times, which equates to just under 9% per annum. This includes 2008, the worst year of the Financial Crisis, when it fell 40%.



A market return of around 9% per annum makes intuitive sense: companies have generated on average 4-5% pa in earnings growth, you add 4-5% in dividends

and you get to that number. It's really not a bad outcome in an economy in which inflation is almost absent and short-term interest rates have been cut to below 1%. There will always be years when the market move is much bigger or smaller than that but if you'd panicked and exited the market at the end of 2018 – which after that alarming final quarter might have been very tempting – you would have missed out on a lot of performance in 2019.

It's fair to ask how can the market grow earnings at a higher rate than the overall growth of the economy, but it's not really very different. Economic growth is generally forecast to be about 2% in real terms, which means 2% plus whatever inflation is, currently also about 2%. So if the nominal economy is growing at about 4% it would be reasonable to expect companies to achieve that much revenue growth, and some might get a bit of operating leverage on top (i.e. costs growing more slowly than revenues) which would improve the outcome a bit further.

You also need to remember that our companies are not tied to the growth rate of the Australian economy, most Australian companies also have exposure to offshore markets, and some are quite large exposures too. For instance, our second biggest company and the Fund's biggest position, CSL, derives most of its revenues from offshore, and so do the big mining companies. Against that however is our Bank sector where profits are under pressure and we don't expect them to achieve much earnings growth at all.

How will 2020 pan out? The normal caveats apply, but unlike the situation this time last year the market is not cheap. As the chart on the previous page shows the market is trading on about 18 times earnings: not the highest it's ever been but it is still much higher than the under 16 times it was a year ago. This reflects the fact that even though earnings growth in 2019 was fairly modest, companies' share prices on average were up more than 20%.

It doesn't necessarily follow that 2020 therefore will be a year of poor returns: earnings might still surprise positively and/or strong offshore markets could keep our market bubbling along. 2020 is after all a US election year and they generally turn out to be pretty good for equity markets. The current US President, despite his recent impeachment, sees the market as a symbol of his own success so he will be doing whatever he can, and pressuring the institutions of government to do what they can, to keep it on the up. Lots of swings and roundabouts but, everything else remaining equal, a high single-digit total return for equities in 2020 wouldn't be out of the question.

Traveller's Tale

As part of our ongoing quest to obtain insights on the latest industry dynamics, Stephane travelled to Hong Kong, Shenzhen and Singapore in December to meet with LNG participants and China-exposed infrastructure and property players. His trip was initially meant to be just to Hong Kong and Singapore but Shenzhen was added at the last-minute when escalating unrest in Hong Kong forced organisers to shift a conference he was attending to a safer place, just across the border in mainland China.

40 years ago Shenzhen was just a fishing village with 30,000 residents, then China made it into a Special Economic Zone. As this picture shows it's now a thriving metropolis of about 13 million and was



rated by Lonely Planet in 2019 as being the second-best city to visit in the world; Copenhagen was number one. It is an amazingly innovative place: this one small city (by Chinese standards) is responsible for more than half the patents granted to Chinese organisations. Telecom giants ZTE and Huawei are both based there, along with a large proportion of the world's semiconductor industry.

Stephane did conduct some meetings in Hong Kong. The impact of the demonstrations was not obvious to a brief visitor like him, other than the hotels being significantly discounted, restaurants being half empty and traffic being almost non-existent. The famous Hong Kong night life also seemed to be hibernating.

The contrast between the city-states, Hong Kong and Singapore, was striking. Singapore was buzzing and felt if anything



strengthened by the destabilisation and unrest in Hong Kong. Some predict that Singapore will ultimately become the dominant financial centre in Asia as it does not have the same pressures resulting from a government conflicted between the ideals of democracy to which so many Hong Kongers aspire while trying to be faithful to those in Beijing who appointed them.

Singapore has had very stable government since it was created as a state in 1959. It has had only three Prime Ministers in that 60-year period, all from the same political party and two from the same family.

While it may not have the type of democracy we're accustomed to and has some laws and practices that seem quirky to those from the West (for instance its famous prohibition of chewing gum, possession of which is punishable by hefty fines) Singapore is far removed from the governing style of China and, for this reason alone, has a good chance of ending up being the financial capital of Asia. It will be the giant Western financial organisations who will ultimately determine which city wins out.

For further information, please contact:

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