Monthly Comment – February 2020

Alphinity Concentrated Australian Share Fund

Going Global

Market comment

Markets turned decidedly bearish in the final week of February as Covid-19 escalated in scope and impact. The number of people infected grew exponentially, and although most are still in the Wuhan/Hebei region of China, the emergence of significant clusters of infections and deaths in a number of cities outside China caused concern that the virus was on the verge of becoming uncontainable. The implications for markets of it becoming a global pandemic are not well understood so the initial reaction was one of caution.

February also contained reporting season and it's fair to say the dominant themes were bushfires and the virus, the combination of which provided companies with ample scope to explain away any poor performance in the half just completed or uncertain outlooks in the half we are currently in. To make things more complex, a new accounting standard regarding the way leases are treated was put into effect which triggered widespread earnings downgrades to many companies, even though there was no change to the financial reality of many companies. Our market (ASX300 including dividends) held up fairly well until the final week, when it followed global markets sharply lower. The final result was a fall of 7.8% for the month, leaving the ASX300 down 3% for the year to date.

Global markets generally did worse than ours in their own currencies but the lower $A made them look a bit better. The $A fell 3% to finish at $US0.65, the lowest level since 2008. While this might feel like a blow to our national pride, having a flexible $A is actually very helpful as it acts as a natural buffer to our economy in harsh economic times. UK markets were off 9% in $A terms, with the Pound falling even further, but the US S&P500 only fell 5%. China's bourses (Shanghai and Shenzhen) were closed for a fair bit of January and at the start of February, initially for the Lunar New Year although this was extended for virus-related reasons, but they remain higher this year despite all that has been going on.

The rest of the world was mostly lower, with Brazil and Greece both down particularly sharply. The chart below shows market movements for the first two months of the year. At -3% Australia is about middle of the pack: not great but could have been a lot worse.

We are now finding out just how critical China has become to global trade. With the country all but closed down for much of the month, shortages of some products or components were starting to be noticed. It is a day to day proposition as to how fast factories will come back and whether logistics networks will be able to get the products or components where they need to go in a timely manner. That there is disruption is undisputed, the question is how severe it will be and how long it will last.

Portfolio comment

The Fund outperformed the down market nicely in February. The positions which contributed most to performance were blood fractionator and vaccine maker CSL, global logistics property company Goodman Group, global insurer QBE, language tester IDP Education, medical device product maker Fisher & Paykel Health and not owning gas producer Woodside Petroleum. Gas producer Santos was the biggest detractor after a sharp fall in global energy prices as a result of the shut-down of China; global resource group BHP also detracted somewhat as did being underweight major bank Commonwealth.

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)	-6.9	-4.4	10.2	9.9	8.1	9.8	10.6
S&P/ASX 200 Accumulation Index	-7.7	-5.2	8.6	8.6	6.2	8.0	8.8

*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, 29 February 2020.**

^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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Market outlook

The impact of the Coronavirus on financial markets is certainly following Act 1 of the traditional health scare playbook: a sharp contraction in economic activity and a broadly-based market selloff. It remains to be seen whether the normal Act 2 will follow, that is a sharp rebound in the markets as the virus comes under control. Our feeling is that it will, but that the economic downturn is first going to be worse with earnings growth likely to go negative in Australia.

We are seeing a strong response from central banks and governments with both monetary and fiscal stimulus underway, here and elsewhere in the world. This type of stimulus has historically been an important element of the script for recovery. One challenge however is that in most of the developed world the monetary tools available for authorities to use are limited, possibly with the exception of the US. Fiscal stimulus is therefore needed much more. Encouragingly, it is now coming.

While we think it's probably too early to position for a broad-based recovery, drawing parallels between the current situation and the Global Financial Crisis of 2008-9 also appears too drastic. Spreads between high and low risk debt has risen meaningfully, and it will be important that measures to maintain liquidity are taken by officials, but we take comfort from the fact that corporate Australia is entering this period of uncertainty in a stronger position than a decade ago. Banks today are much better capitalised, most property trusts have significantly lower debt levels and most resource companies also have much stronger balance sheets than was the case back then. That's not to say that we won't see more companies in financial distress in coming months, especially companies on the smaller side, but on the whole we see the current market challenge being one mainly related to earnings and valuations (with the latter quickly being corrected), and less around financial leverage and balance sheets. This should be a more manageable situation.

To state the obvious, a contraction in the spread of the virus would clearly be a trigger for a market recovery but we think that we could also see markets stabilise should the community start to accept that a gradual broader spread of the virus is inevitable and not a reason to panic. This appears unlikely in the short term however. While companies are shutting their premises or schools closing their doors, markets are likely to remain under pressure. For now, select buying of individual companies would be the most we would be comfortable doing rather than wholesale changes to portfolio positioning.

Portfolio Outlook

Our February monthly outlook is typically dominated by our conclusions from the domestic reporting season. This time around however the results and outlook statements for many companies became outdated even before the end of the month! Suffice to say that the reporting season was pretty much as we had expected and by the end of the month aggregate earnings growth for the whole market in FY20 had been downgraded from about 4% to around 2%. This now looks highly optimistic and overall market earnings growth is now almost certain to be negative for the financial year.

While the overall earnings picture has deteriorated, with obvious implications for market returns, the changes to earnings leadership on a sector basis has been less pronounced with most of the stocks and sectors that were doing relatively well from an earnings perspective before the Covid-19 hit still likely to show the best earnings outcomes. The situation is fluid though. Banks were, for a short period of time, seen by the market as relatively less exposed due to their domestic focus and the improving housing market. Following the RBA's rate cut in early March however earnings risk has instead intensified for the sector.

The current environment will no doubt present further challenges but there will also be opportunities. While each company needs to be analysed individually, we take comfort from the fact that the Alphinity portfolio had a solid reporting season with only one major disappointment. We also believe that our focus on balance sheet quality will be of even more importance than usual over coming months.

At this stage we still expect any portfolio changes to be incremental. We remain underweight Banks, overweight Healthcare and also modestly overweight the bulk commodities that should benefit from any stimulus China brings to bear once the virus is fully contained there. Key overweights in the portfolio remain global health exposure CSL, global asset manager Macquarie Group, global insurer QBE, domestic gas pipeline operator APA and diversified resource company BHP. In most of these cases a falling $A will also translate into some earnings benefit.

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BTW

In a month like this, with a viral pandemic threatening the globe, we yearned to think about something on the more light-hearted side. Light-hearted to us anyway, less so for the person impacted.

We've about written before Bitcoin and its ilk and concluded that, while cybercurrencies might suit certain people with certain beliefs and/or certain proclivities, it was not particularly relevant to most people and not well placed to fulfil the functions government-issued paper currencies currently do. Cryptocurrencies are great for anonymous funds transfers, particularly across borders, but they also have serious limitations, including very volatile prices, expensive and inflexible transactions and the need to keep your "wallet" secure, at the risk of losing everything. Its advantages, in our view, are way outweighed by it limitations, as a story we stumbled across in the Irish Times demonstrates.

One of the features of Bitcoin is the need to store any coins you own in a digital wallet, essentially a highly-encrypted computer file that is unopenable without the right password. If you lose your wallet or forget your password, you're in deep trouble: as with a physical wallet, if you lose it you also lose what's inside. The coins are lost to everyone forever. If someone comes across your digital wallet with the password they can do whatever they like with your bitcoin. The difference is that while you might generally keep a bit of cash in your wallet – a few hundred dollars max – a digital wallet could potentially contain your entire worldly wealth. So if your forget your password or hard drive becomes corrupted and the file unreadable, you could potentially lose everything.

As a cannabis grower in Ireland has found. Clifton Collins' life of crime allowed him to accumulate around 6000 bitcoin in the period leading up to his arrest in 2017; those bitcoin are now worth about €60 million (about $A80m). Collins fell into the clutches of the law when an officer of the Irish police force, the Garda, stopped to investigate his up-market vehicle parked in a suspicious place and found him tending his cannabis crop.

Clifford went to prison for five years and the Garda was looking at collecting the biggest proceeds of crime seizure in Irish history, but it was unable to cash them in without the passwords to his wallets. Being a smart criminal he had spread his coins across a number of different wallets and hid the passwords, which are a long and complex series of letters, numbers and symbols, in a safe place, somewhere no one would ever look. This was inside an aluminium fishing rod case which he stored in the basement of his rented house. The problem was that once he was sent to jail his landlord cleared out the house and much of the contents – including the rod case – went to the tip and can't been located.

Collins appears to be quite a philosophical person. He told the Garda that over the three years so far he's been in prison he has come to terms with the loss of the money and now regards it as punishment for his own stupidity. Of course it's also possible that he has secreted the codes elsewhere and is waiting for his release to reactivate the wallets and access his loot. But for now the Garda seems to have accepted his story and is hoping that one day there will be sufficient advances in technology to allow them to break the passwords and access the juicy amount involved, at the same time hoping that a Bitcoin is still worth something when that happens. Seeing it's traded as low as $US800 and as high as $US18,000 over the past three years, that's anyone's guess!

Top five active overweight positions as at 29 Feb 2020	Index weight %	Active weight %
CSL Limited	8.1	4.9
BHP Group Limited	5.7	4.1
Macquarie Group Ltd	2.5	3.9
QBE Insurance Group Limited	1.1	3.0
APA Group	0.7	2.8

Source: Fidante Partners Limited, 29 February 2020.

Asset allocation	29 Feb 2020 %	Range %
Securities	97.7	90-100
Cash	2.3	0-10

Source: Fidante Partners Limited, 29 February 2020.

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Non-Traveller's Tale

A combination of reporting season and increasing concern around the Coronavirus/Covid-19/Wuhan Flu – whatever you want to call it – kept us at our desks during February. This will be rectified over the next few months with a number of research trips planned for various people in the team to various parts of the country and the world, all the time avoiding viral hot spots. Instead we will make an observation about "ringing the bell".

It is a market aphorism that no one rings the bell at the top (i.e. indicating it's time to sell) or bottom (to buy) of the market. It would be a very helpful thing if someone were to do that, and in fact 21 February would have been one such time as the market pulled back sharply from that level over the remainder of the month, making it one of the quickest reversals since the financial crisis a decade ago. The "ring the bell" saying probably stems from the tradition of ringing a bell on the trading floor of the New York Stock Exchange when a new company is admitted to the official list. This tradition has been aped by our own market, with a much nicer bell, even though there is no functional reason to do so: New York still has individuals on the trading floor operating on open outcry but our market went electronic decades ago, and data centres don't tend to need an audible signal to signify it is OK to trade.

Anyway, in a masterpiece of timing, February saw the launch of a new technology index designed to showcase Australia's high-tech sector, of which there are about 50 companies. These include what have colloquially become known as the WAAX stocks (high-growth companies Wisetech, Altium, Afterpay, Xero), trying to emulate the US FAANG (Facebook, Amazon, Apple, Netflix, Google) and a large number of other real or tangential tech exposures. They are largely highly-valued stocks, some of which often seem to trade more on hope than reality, and they tend to be the most vulnerable in a market downturn. As it has turned out.

The S&P ASX All Technology Index was launched with a rather prescient ringing of the bell, shown here being operated by federal Science and Technology minister, Karen Andrews. It launched on the 24th February – the first trading day after the US market had its first significant virus-related dislocation – and the index proceeded to go only one way: down. By the end of the month, just a few trading days afterwards, it had fallen by 15%, which was almost twice the fall of the overall market.

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