Quarterly Comment – March 2020
Alphinity Sustainable Share Fund

PANdemIC Stations

Market comment

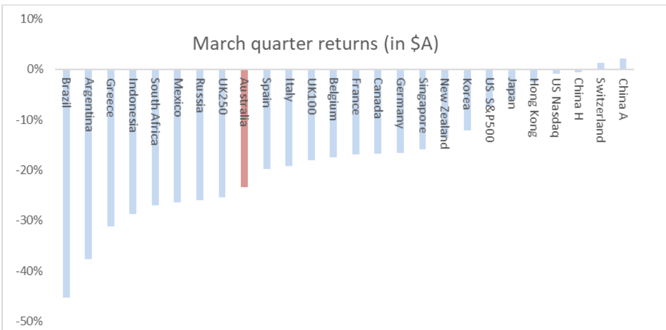
It is hard to believe that only three months ago we were chiefly concerned with surviving bushfires and drought. At that time no one was thinking much about a nasty virus that was starting to spread in Wuhan. Now we are facing the prospect of a global economic slump of a magnitude that may well surpass the Global Financial Crisis in 2008-09. Australia's record of uninterrupted economic growth – already looking at risk before the virus – is certainly finished and the Federal Government's hope to deliver a budget surplus this year left in tatters by the twin forces of sharply lower future tax receipts and immensely higher spending in order to stave off the worst of the impacts of the containment efforts on its citizens. This is as it should be, and it is pleasing to have a national balance sheet able to accommodate this.

The Government announced a series of rescue packages which dwarf anything seen in 2008. The Reserve Bank is also undertaking unprecedented steps to do what it can, although monetary policy was already almost tapped out. Cash rates were cut from almost zero to even closer to zero, but more significantly it seems to be kicking off a form of Quantitative Easing, effectively injecting cash into debt markets that had become congealed. While QE has been widely used around the world since 2008, this is the first time it has been put into place in Australia.

All markets did poorly in the March quarter, equity markets in particular. Australia was not immune and an amazingly quick 36% pull-back from the all-time high on February 22nd to the trough a month later; it bounced a little to close out the quarter 23% lower. The magnitude of the fall was similar to that experienced in previous downturns but the speed was quite shocking. It took almost a year for the market to fall 30% in 2008; this time it took just four weeks. Pouring salt into an already painful wound, a number of companies cancelled or deferred dividends that had already been declared, conserving their precious capital as we enter what could be a capital-scarce period. In times like these companies become more focused on survival than growing earnings, and as such equity owners in troubled companies can be hit with highly-dilutive equity issuance at steep discounts to already low share prices. Our focus on owning companies with strong balance sheets has so far held us in good stead, and we expect they will continue to do so.

One victim of all this disruption has been the $A. It had closed out December a fraction over $US0.70 but fell sharply in March, hitting 20-year lows in the mid-50c region, before finishing the quarter 13% lower at 61c. This might have been a problem if you were planning to go overseas but this won't be an issue for anyone any time soon with the borders closed. There are even border closures between Australian States, something that has not happened since the Spanish Flu a century ago. A low $A is net positive for the economy though, as our exports become more competitive and imports less so.

Global share market movements were negative over the March quarter, especially when translated into the much-devalued $A. China's markets were only modestly lower in its own currency, and for Australian investors it was actually higher. It seems odd that the region where the problem started is doing so much better than the rest of the world but it probably just reflects its progression into the recovery stage earlier than the rest of the world and the extent of government willingness to re-boot its economy.



It was a memorable quarter, and we hope we don't see too many more like it. The world is probably in for an extended period of disruption. We are living in interesting times.

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)	-19.0	-20.8	-10.3	3.8	3.6	6.5	7.6
S&P/ASX 300 Accumulation Index	-20.8	-23.4	-14.5	-0.6	1.4	4.7	6.0

*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. **Source: Fidante Partners Limited, 31 March 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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Portfolio comment

The Fund outperformed the market substantially over the March quarter, although we accept that this is small consolation considering the absolute return was so negative. In times like these, "success" is sometimes more about salvaging value than creating it. The positions which contributed most to performance over the quarter were blood products and vaccine maker CSL, breathing apparatus maker Fisher & Paykel Health, logistics property developer Goodman Group and health device producer Resmed. Not owning shopping centre owner Scentre Group or gas producer Santos was also positive. The positions that cost returns were in small audio technology play Audinate, global asset manager Macquarie Group, lightweight auto parts producer Carbon Revolution, gas producer Beach Energy and airline Qantas. The biggest headwinds to performance however were not owning either of the national supermarket operators, Woolworths or Coles, who appear to be two of the rare winners from the current crisis: both are precluded from investment due to their exposure to gambling. It is inevitable from time to time that companies with negative ESG characteristics outperform – the current environment is typical. We are pleased that, notwithstanding our inability to invest in these companies, in the March quarter at least, the Fund was still able to outperform.

Market outlook

A lot has changed since our last monthly report but some important matters have not. A month ago we said that overall corporate earnings growth in Australia would likely go negative; a few weeks on that is now fact, and the earnings decline will be much more significant than we were expecting given the breadth of government restrictions that have been put in place.

We also said that this would likely be predominantly an earnings recession rather than a financial crisis. While the distinction between the two may seem like a too fine a point to make, given current circumstances, it has, in our view, significant implications for both the impact of the current situation and for the eventual recovery. Even though corporate debt markets were at one point looking shaky, debt deals are now being done and most companies are still able to use this channel to fund themselves. Undrawn credit facilities are also not being cancelled by the Banks; this was something that made matters worse during the Global Financial Crisis in 2008-9.

Equity raisings, as we are currently witnessing, will still be part of overall funding requirements as many companies face an annihilation of their earnings for an unknown period of time. This will present both challenges and opportunities for equity investors in the months ahead but it is positive that equity is not the only funding avenue open to corporates. We were encouraged by the extent of the monetary and fiscal stimulus that was announced by the Government and the Reserve Bank a month ago. While the scale of the earnings downturn, and most likely also its duration, has worsened significantly since then, the stimulus has also been significantly increased. With the market's current earnings forecasts unreliable and still too high, it is reassuring to see that several longer-term valuation metrics such as Price to Book Value and Price/Earnings multiples (using 10 year average earnings rather than forecast earnings) are starting to look interesting.

While the human and economic impacts of the Coronavirus have deepened, there are good reasons to believe that markets will recover from this crisis as well. Recent indications of a peak in key Covid-19 indicators in several countries are encouraging, although we don't pretend to know whether the subsequent sharp bounce in equity markets in late March/early April can be sustained or will turn out to be just that, a bounce. However, equity markets remain, as was shown in the downturn, ahead of the curve and will likely recover well in advance of the general economy this time too.

Portfolio Outlook

Alphinity's investment process revolves around identifying and investing in companies that will achieve better earnings outcomes than is anticipated by the market, both in an absolute sense and relative to the rest of the market. We refer to this as investing in companies with earnings leadership.

Earnings leadership is now decisively with companies which exhibit a more defensive earnings profile and/or strong balance sheets. This is likely to become even more evident in coming weeks and months as the full impact of the sharp rise in unemployment, decline in consumer spending and Government-imposed restrictions becomes evident. While events are unfolding at a rapid rate we believe a relatively cautious portfolio profile is warranted. There are few catalysts for a change in earnings leadership and sustained outperformance by the more cyclical sectors, in our view.

We are however also fully aware of the valuation dispersion between defensive companies and those more impacted by the economic downturn, and we need to make sure we don't overpay for earnings certainty. We are likely to take profit in some of our more richly-valued companies in the not too distant future.

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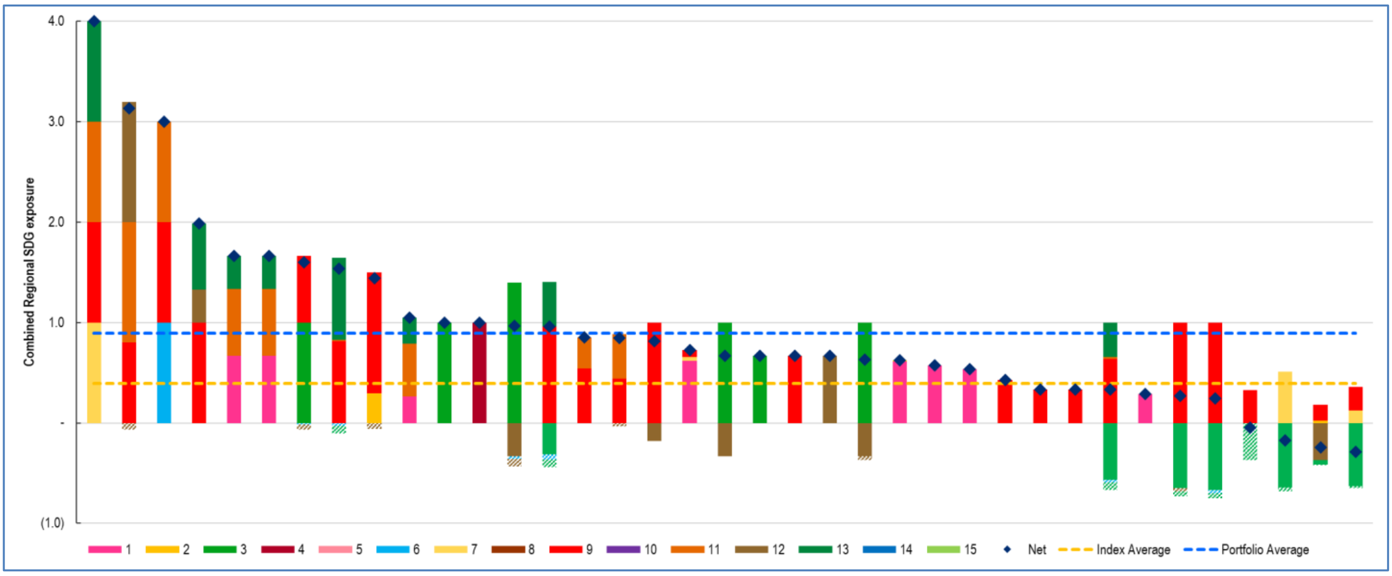
We are confident that our research process will, as has been the case in previous market upturns, enable us to identify companies that are poised to benefit disproportionally from a more solid economic backdrop. We have so far taken advantage of some large share price falls in some companies we already owned, and in a select few new positions. Just as economic downturns often turn out to be more significant than initially anticipated, the same is true for the recovery, with companies that are able to demonstrate positive earnings revisions and relative outperformance continuing to do so for an extended period of time. This allows us to approach the eventual recovery in a disciplined manner and not rush to conclusions in what remains a highly uncertain economic and market environment.

Sustainable Development Goals

We present below a chart showing the goals addressed by the companies in the portfolio in a format developed by Citi, showing the goals addressed by companies in the portfolio. This is only illustrative and is not something we use to select companies for investment in the portfolio. Nevertheless we are pleased to report that companies in the portfolio address, in a net positive way, an average of 0.9 goals (blue dotted line), well in excess of the universe of 0.4 goals (yellow dotted line).

Carbon Intensity

We are also pleased to report that the emissions intensity of the fund is well below that of the benchmark, as the table below shows.



Carbon Exposure Metrics

Scope 1 & 2	SSF	ASX300
Weighted Average Carbon Intensity*	**111.1**	**229.3**

*Intensity: Weighted average tonnes of CO_2 equivalent emissions per $USm revenue
Source: Alphinity, MSCI. Data as at 31 March 2020.

Top five active overweight positions as at 31 Mar 2020	Index weight %	Active weight %
APA Group	0.9	2.2
BHP Group Limited	6.1	2.2
CSL Limited	9.6	2.2
Goodman Group	1.4	2.1
Macquarie Group Ltd	1.9	1.9

Asset allocation	31 Mar 2020 %	Range %
Securities	96.8	90-100
Cash	3.2	0-10
External Experts on the SSF Compliance Committee		
Elaine Prior		
Mark Lyster		
Service Providers		
ESG	MSCI	
SDGs	MSCI, Citi	

Source: Fidante Partners Limited, 31 March 2020.

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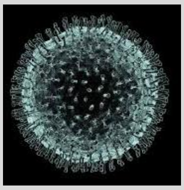
BTW

"Going viral" is a cliché in technology circles but the full horror of its real meaning is now being seen around the world. YouTube videos go viral when someone shares it with a bunch of friends, and they all do the same thing. One goes to ten, then to 100, then to 1000 and to 10,000 and so on; before you know it, the video has a million views. Covid-19 has gone viral in the worst possible way.



As we said earlier, it was only three months ago that we were more worried about bushfires and drought than microbial invaders. Since then the fires have been put out and, although we couldn't say the drought is over, large parts of Australia have received soaking rain which has started to repair some of the damage. This is very good news. The bad news is that the virus, believed to have first crossed to humans by eating the meat of animals not widely consumed elsewhere in the world, sold in the wet market in Wuhan, has gone global and completely interrupted life as we know it.

It is also only three months ago that we were witnessing some of the very best characteristics of Australians who were donating enormous amounts of money and goods to support those affected by the fires, opening up their homes to travellers stranded on country roads, and so on. Fast forward to March and we witnessed people fighting in supermarket aisles over toilet paper. One does wonder if there is any overlap between the donors and those who were fighting. We also have reports of busloads of people from the city roaming remote country towns like locusts, cleaning them out of their scarce supplies of toilet paper, meat and non-perishable foodstuffs. It would be easy to become a bit despondent at the way in which social cohesion seems to have fractured so easily.

We've had plenty of disease outbreaks since the turn of the century but none has been quite like this one. The other viruses – swine flu, SARS, MERS, Zika, Ebola, H1N1 and so on – were harder to catch and relatively easily contained, but Covid-19's greatest attribute is that it is highly infectious, and because the symptoms are quite mild for a lot of people, they might be walking around spreading it without knowing.

Now we're all being socially distant, isolating ourselves in our homes, and some cases actually quarantined in hotels. This could be the case for an extended period of time, in an attempt to "flatten the curve" – another term unknown to us just three months ago.

There could be some really useful social learnings to come out of this, providing we can endure it with our sanity intact. Will we find it be a time of re-connecting with our spouses/ partners, or is there about to be a massive spike in the divorce rate? Will our children's education be damaged by not being able to go to school, or will it be enhanced by the use of more modern learning methods and greater individual responsibility? Will people with gambling addictions manage to break them, or will it just divert their activity onto illicit online venues? Will we find that we work remotely quite well, and do more of in the future? Will the National Broadband Network hold up under the strain of all the increased traffic as a result of whole families trying to do important things at the same time? It will be interesting to see what the country looks like when this is all over.

So, what do you do if you end up being stuck at home for a couple of months? If you can work from home, you need to keep doing so: the mental stimulation for yourself and the contribution to society through your effort is greatly needed in what will become a very challenging time for our nation and its economy. That's what we will be doing; fortunately, the nature of our work lends itself to remote activity.

But what happens if you end up not able to work? Early indications are that there should be reasonable levels of government support for the many left without an income as a result of increasingly stringent virus containment measures. If you do find yourself at home for a period maybe take this opportunity to sit back and think about your life. Don't sit around binge-watching trashy TV on Netflix. Ask yourself deep questions "Where am I going? What do I really want to achieve in my life?".

This period of confinement might turn out to be an opportunity to sit back and breathe. Our society has become one in which the time for quiet contemplation has largely been crowded out by long working hours and the shrill voice of social media. Read a classic book. Watch some classic movies. Learn a musical instrument from YouTube lessons. Go through all those digital photos you never look at, delete most and keep the good ones. Go through your old photo albums and do the same. Help a neighbour (from a safe distance). Get the garden in order. Clean out the garage. Learn a new skill: there are plenty of free courses out there, many produced by some of the best universities in the world. Use this troubling time to achieve something positive. The virus will be contained at some point. Life will go on and we need to be ready to make the most of it.

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Non-Traveller's Tale

All travel plans we had have gone out the window with everything going on around the world. However, it is in times like these that what is often thought of as the more tedious aspects of running a business like ours becomes really important. Most organisations with an eye on the medium term would have a Business Continuity Plan (BCP) describing how it would ensure it could still function in times of disruption. Disruption could be something like a terrorist attack – September 11 for instance when whole buildings in New York were destroyed – or an earthquake, a tsunami or something like the current pandemic. The robustness of BCPs will vary between organisations but our is enhanced by our association with large, ASX-listed Challenger Ltd. Challenger provides Alphinity with many of the business services we require, including IT, which allows our team to be wholly focused on investing your funds.

Challenger has extremely well-developed IT systems which enables it to not only operate in an environment of great security with respect to data integrity and cyber risks, but also allows remote access to the systems that allow us to carry on our work investing virtually unimpeded. We can log in from home, a library, on laptops, even on an iPad to continue modelling companies, placing trade orders and so on. The team has separated physically, most working from their respective homes, but the systems we have available to us to communicate with each other, with clients and with the companies we invest in, are first class and they are working well.

Our major concern is what happens with your Fund – in the good times it is maximising the opportunity but in tougher times, like the present, it is maintaining as much value as we can. When everything is falling, when there is massive global uncertainty with an uncertain timeframe, when governments around the world, and even those around our country, aren't able to agree on what is the best course of action it is difficult to have absolute certainty about what to do next.

Having said that, the Alphinity team has had a lot of experience of tough conditions. Some team members were working in the markets as far back as the Crash of '87 and survived the early 1990s "recession we had to have". The four founders of Alphinity worked together through the Global Financial Crisis of 2008-09. Each crisis is subtly different – for instance this one is the first one that has is being chiefly caused by deliberate and coordinated action by governments around the world – but the playbook so far is quite familiar. You need to focus on owning companies with strong balance sheets and strong franchises. That initially ensures they will survive the current circumstance and, when it ends, as it inevitably will, allow them to prosper in the rebound. They're also the companies which are less likely to need to resort to highly dilutive equity issuance to survive. Circumstances such as these always provide great opportunities for those who are prepared for them. We've seen in the past that rebounds are often large and swift. Regardless of the virus we're still on the case, working hard on your behalf.

For further information, please contact:
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