Monthly Comment – April 2020
Alphinity Australian Share Fund

Winter is Coming

Market comment

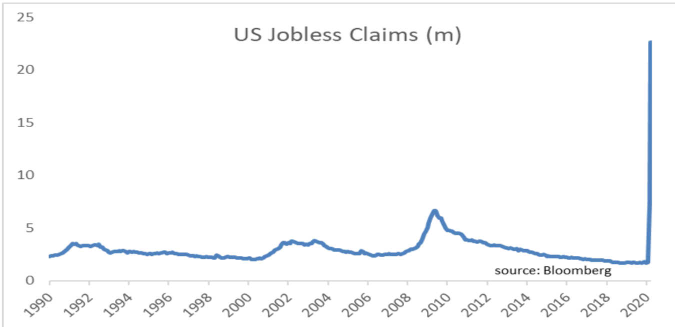
We are well into Autumn, although it was hard to believe it considering the sensational beach weather that still prevailed in most parts of the country in April. This made it all the more frustrating that we were mostly unable to go there, instead being stuck inside, self-isolated. We know what's coming, and it's not far away. In Game of Thrones "Winter is Coming" was the start of a very bleak journey.

Despite all the bad stuff going on around the world, markets rallied strongly in April: the ASX300 (including dividends) rose 9%. In fact, from the worst point of the sharp sell-off (22 March) to the end of April the ASX300 rallied 20%. This is hard for many to understand, and we struggle a little with it ourselves. Yes, markets are forward-looking and might well have baked in more than 100% of the virus-inspired bad news in those terrible first few weeks in March. Yes, the medical impact of the virus looks like it might have peaked in many places in the world, and new infections are growing at a slower rate and largely being exceeded by recoveries, so maybe the peak of the health crisis is over. But, in our view, the full economic and financial impact is yet to be truly felt.

Global markets didn't fare quite as well as ours as the $A appreciated by 6% in April, going from $US0.61 to $US0.65. European and Asian markets were generally flat to down a few percent in $A, while the UK, Canada and USA were all up 4-5%. Year to date returns are a lot more even with the exception of US tech stocks: Nasdaq is still actually up 7% for the year in $A.

March saw a lot of companies suspend dividends and walk away from previous earnings guidance, even that which had been given as recently as February, but April turned out to be a month of share issuance. There was a deluge of equity raised as many companies looked at their financing structures and determined that more permanent capital was desirable. Thus far credit markets appear to be functioning fairly well, unlike during the Global Financial Crisis (GFC) in 2008-09, so the need for fresh equity isn't always obvious. A number of boards, probably with the GFC fresh in mind, still decided that it was best to act early as the worst thing a company can do is be forced to issue shares as a last resort: existing shareholders tend to come out of that very poorly. Only time will tell if that was the best thing to do but it's hard to criticise boards for being cautious in the current environment.

Some shocking statistics are starting to be released in various parts of the world, and this is set to continue for some time. Probably the most dramatic has been Jobless Claims in the US (below) which, having been well below 2 million as recently as February, rocketed to 23 million in April, a level far in excess of the ~7 million at the worst point of the GFC. The speed with which this happened begs the question: is there the potential for an equally quick reversal when things open up again? These statistics will hopefully prove to be temporary, but it is unrealistic to expect it to get back to the 30-year average of 3 million any time soon: this could take some years to recover from. Some employers will just not survive, and those that do will be very cautious about rehiring.



Resource prices were generally lower in April. Thermal Coal for energy generation and Coking Coal for steel making were both sharply lower in April, although the price of Iron Ore was relatively unchanged. Energy fluctuated wildly considering very weak demand and excess supply; Brent crude oil in Europe was up 5% but West Texas Intermediate in the US was down 13%. Gold was firm in $US terms but flat in $A, and base metals flat to slightly lower, the worst being Lead (-13%).

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)	7.7	-19.5	-8.0	2.8	3.8	5.6	7.6
S&P/ASX 300 Accumulation Index	9.0	-20.4	-9.1	2.0	3.5	5.4	6.9

*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, 30 April 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

While the Fund captured most of the upside of the strong market in April, it did give back some of March's strong outperformance as a number of companies we don't own bounced back strongly, most notably shopping centre owner Scentre Group, buy-now-pay-later financier Afterpay Touch and gas producer Woodside Petroleum. The positions which contributed most positively were global asset manager Macquarie Group, data annotator Appen, insurance broker Steadfast and gas producer Santos. Offsetting these however were positions in global insurer QBE and breathing device maker Fisher & Paykel Health.

Market outlook

What a difference a month makes – again! "Unprecedented" has been an overused word this year when describing the fallout of the pandemic but signs of a peak in developed world Covid-19 case growth allows us to use the word in a different context. The large rally in the market in April was also unprecedented, and seems a bit too far and too fast in our view.

As we wrote last month, we could see the building blocks being put in place for the market to recover from this crisis. Large fiscal and monetary stimulus, open credit markets and attractive long term valuation metrics were all cause for optimism. And equity markets are usually forward-looking so it's not surprising to see investors looking beyond the current economic paralysis to better times in the future. It's just that we don't quite know what that future looks like.

The old saying "don't fight the Fed", referring to the ability of the US Federal Reserve (and other central banks) to support financial markets during economic downturns is as relevant today as ever, but ultimately the equity market needs to be supported by earnings growth. The V-shaped recovery many predict might seem logical given the speed of the decline, and growth rates will no doubt look impressive as we come out the other side, but that is more a consequence of the very low base from which the economy, and corporate earnings, will be growing than any confirmation that we're getting back to normal, let alone back to where we were before the downturn.

Of course, an intentional closing-down of the economy by authorities is highly unusual, as is the rapid and (dare we use that word again) unprecendented stimulus response, but activity levels at year end are still likely to be well down on last year and the same will most likely be the case a year from now. There is enormous effort around the world going into developing a vaccine or even a cure for Covid-19, and success would be a strong confidence boost, although the timing remains highly uncertain.

Encouragingly, the containment in Australia has been highly effective. Some industries will recover quickly and some, like on-line shopping and all the infrastructure that goes around it, will be structural winners with on-going tailwinds. However, the services sectors is a very large part of the economy these days, and it has been hit at least as badly as manufacturing industries. Combine this with lower population growth due to sharply curtailed immigration, and it is likely that some businesses will not survive. Given time, new businesses will emerge to replace them but the key word here is time. It will take time for the economy to recover. This will need to be reflected in equity market valuations and earnings expecations. We remain confident in the medium to long term outlook for the Australian economy and equity market, but further strong gains from this point look unlikely in the short term.

Portfolio Outlook

Despite strong portfolio returns in April, matching the rebound in the benchmark proved challenging as the market bid up many of the stocks that had fallen the most, and seemed to favour the V-shaped recovery we struggle to see as the most likely outcome. We know from experience that changes to consensus earnings expectations often lags market returns at major turning points as investors focus on improvement in broader leading indicators. However, at this point the only indicators thus far that have turned are the Covid-19 infection rate and the first easings of Government-imposed restrictions in a number of countries. These are very welcome, but are hardly reliable indicators of the shape of the economic outlook from here.

Despite the still high level of uncertainty, a number of companies in the portfolio have confirmed that they are performing well and, in some cases, appear to be in a select group that will derive a sustainable benefit from some pre-existing structural trends that have accelerated since the outbreak. Industrial property developer Goodman Group is increasingly looking like one such company. It has reconfirmed its existing earnings guidance with its core global tenants such as Amazon continuing to thrive. Tech company Appen is another whose earnings is so far unaffected. While still relatively early in its financial year (it has a December year end) management reported no slowdown in spending from its key customers such as Google, Facebook and other global IT giants.

Fortescue Mining upgraded its production guidance and is generating strong cash flow as the all-important Chinese iron ore demand has strengthened again. Amcor also lived up to its defensive profile and upgraded its earnings

BTW

We decided to make this piece (at least) a Covid-free zone, instead we'll talk about our favourite billionaire entrepreneur, Elon Musk. Not about his courageous decision to name his newly-born son X Æ A-12 (pronounced X Ash A 12), though that's probably worth a story in itself. Poor Ash will no doubt quickly learn how to defend himself when he eventually goes to school. No, this is about how he's going as CEO of $US140 billion US public company Tesla.

We've written about Musk before: how he is undoubtedly a visionary who has already made a huge mark on the world and is no doubt going to make even more. He made a fortune in the online payments field (PayPal) and has parlayed the proceeds of that into a number of multi-billion-dollar enterprises encompassing space, transport and health.

Tesla's board is notable for having an Australian in the chair. We got to know the extremely impressive Robyn Denholm a little when she was CFO of our national telecoms company, Telstra. Having grown up in the fairly humble south west Sydney suburb of Milperra, Denholm completed degrees at Sydney and UNSW before going to work for Sun Micro-systems and Juniper Networks in Silicon Valley in the 1990s. She returned to Australia to join Telstra in 2016 but reluctantly resigned to become Chair of Tesla last year after Musk, who was previously both Chair and CEO, was forced to step down by the US regulator for making misleading statements. Since then things have improved markedly for Tesla. Its losses have turned into profits and its share price has rocketed. But keeping a rein on Elon is quite a challenge, even for someone as capable as Ms Denholm.

Over the past year the Tesla share price has been as low as $US200 and as high as $900, currently around $800, but Musk seems to be a bit nonplussed by this. In fact, he went on twitter tirade to express the view that the shares are now too high – something we never thought we'd hear any CEO say! He might have been tongue-in-cheek, it is difficult to get the right context from this distance, but whatever it was he seemed to be risking further action from US securities regulators. Although maybe they have bigger things to worry about at present.

His spray was likely caused by frustration that his California car factory has been closed down since March for viral reasons and he wanted it back in production. In a subsequent radio interview, he covered a number of other topics, including the way that *"Possessions kind of weigh you down. They're kind of an attack vector, you know? People say, 'Hey, billionaire, you've got all this stuff.' Well, now I don't have stuff. Now what are you going to do?".*

He said he was going to sell most of his possessions, including two of his homes in California, which will go some way towards making him like the rest of us. Although with a net worth currently around $US40 billion, we suspect he probably still has quite a bit of stuff.

outlook after a solid third quarter. While there will no doubt be opportunities in coming months to invest in companies which are more leveraged to an improving economy we believe these are good companies to have exposure to in the current environment and beyond.

Other companies have also benefited from Covid-19 but we are less sure if this is sustainable and perhaps more of a pull forward of demand which will potentially produce a headwind to future earnings growth. One such company is sleep apnea and ventilator equipment manufacturer Resmed, which has also seen its share price reach new records. While a great company, we took profits and reinvested the proceeds in other areas of the portfolio. We remain confident our stock-by-stock approach and our ongoing focus on companies able to deliver earnings ahead of market expectations will allow us to navigate this highly unusual environment.

Top five active overweight positions as at 30 Apr 2020	Index weight %	Active weight %
CSL Limited	9.2	2.7
APA Group	0.8	2.5
BHP Group Limited	6.2	2.4
Goodman Group	1.4	2.3
Fortescue Metals Group Ltd	1.3	1.7

Asset allocation	30 Apr 2020 %	Range %
Securities	97.1	90-100
Cash	2.9	0-10

Source: Fidante Partners Limited, 30 April 2020.

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Non-Traveller's Tale

April was dominated by the world's attempts to control the spread of Covid-19. The geographic isolation of Australia and New Zealand, often considered one of the challenges of living in this part of the world (a.k.a. "the tyranny of distance") suddenly became a huge advantage. Compared to countries with contiguous neighbours and hard-to-control movement of people, the ability of both countries to close their borders and isolate their populations has thus far resulted in a much less serious human impact from the virus than has been experienced in many otherwise similar countries.

Not having thousands of deaths from the virus locally has meant a much safer populace and much less strain on our health systems and medical staff, and this is something to be thankful for. The scale of human suffering in some places, including the major financial hubs such as London and New York which we know so well, has been epic. The economic impact will be considerable and the scale of that impact is yet to be seen, but it was quite confronting to see photos of bulldozers digging a mass grave in New York, and to see photos of the "city that never sleeps" with streets that are deserted would have been inconceivable just a few months ago. A country like the US, with some of the most advanced healthcare skills and technology in the world, has struggled to cope. Its unequal distribution of wealth, which means many people have no health insurance at all, hasn't helped.

So notwithstanding the bother it can sometimes be to have to endure day-long flights to get to the business capitals of the world, we should yet again be thankful that we live in the land down under. So enjoy it. A lot. Possibly for a long time. Because we don't exactly know when our borders will be re-opened, and even then when normal travel patterns will be able to resume.

In the short term, before a vaccine is discovered, there will be a lot more friction than we've been accustomed to in travelling. There will likely be constant health checks en route, a health passport certifying the traveller's Covid-free status might be required for some countries, the possibility of quarantine on arrival – all things that will make the task of travelling tougher. The days of, on a whim, spending a thousand or two dollars to fly to the other side of the world to go to a beach or a show or to go skiing are likely gone for some time: when flights do open back up they are likely to be more expensive as some airlines will not survive and those that do might no longer have the economies of scale that previously applied. It might be some time before Bali, Phuket, Zermatt or Aspen are again viable options for many people. Here again, we are well-placed. Australia is a huge place with a vast range of holiday destinations. If we can form a trans-Tasman bubble with New Zealand, as is presently being mooted, that gorgeous country will also be available to us.

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