Quarterly Comment – June 2020

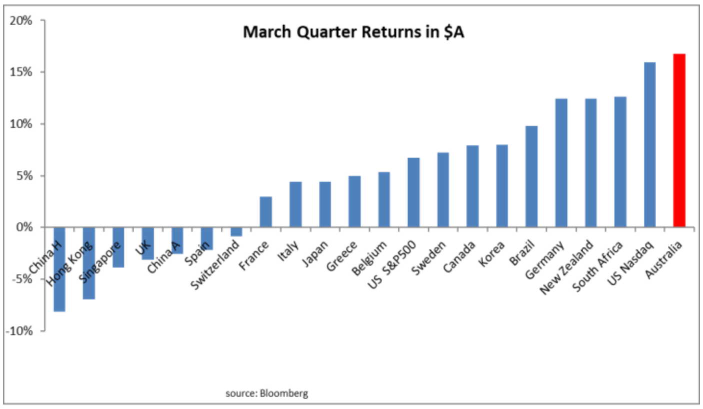
Alphinity Concentrated Australian Share Fund

Bustin' Out All Over

Market comment

The June quarter started with a bang, with massive market returns in April and May, but ended with more of a whimper, finishing only 2% higher in June. Overall it was an impressive quarter with the ASX300 (including dividends) rising about 17%, a much-needed recovery from the sharp slump in the prior quarter.

Australia shaped up well in global terms, outperforming every other major market and recouping much of its relative underperformance in the March quarter. Some of this was due to the $A, which rose 12% against the $US, which largely offset the previous quarter's slump. Shares in Asia were soft in $A terms for the quarter, HK shares falling as political tensions there continue to escalate; Chinese shares were also lower. Most other markets managed gains however with the broad US market (S&P 500) up 7%. The tech-focused NASDAQ returned more than double that with extreme strength in a narrow group of very expensive companies.



If you'd slept through the first half of 2020, woken up and looked at the markets on July 1 you might have been fairly unsurprised as to where things ended up. The share market was soft, having fallen about 10%, as was the $A, down a little from US70.5c to 68.5c. You would have missed all the stress and emotion: the panic, fear and greed that caused the large movements in between: the 30% fall in the $A to $US0.55 and the 27% fall in the ASX300 in March.

Some grim milestones were reached in June: 10 million identified cases of Covid-19 infections around the world and 500,000 deaths attributed to it, and little sign of infection rates letting up in many places. Australia's cases appeared to be petering out before a resurgence in some areas but it pales in significance to what's still happening elsewhere in the world where the first wave still appears to be going strong. It would be reasonable to expect the same thing happening elsewhere in our country in coming months and each one will be an impediment to us returning to life as we used to know it.

Commodity prices were mostly soft over the quarter with the notable exception of Oil, which had slumped sharply in the prior quarter as the impact of Covid-19 on global economies became apparent. It rebounded to around $US40 per barrel, up about 60% in $A terms but still at a level at which many operators are loss-making.

Coal prices fell by 20% and 30% for Metallurgical and Thermal Coal respectively, although the gradual opening of the Chinese economy meant demand for Iron Ore surged, resulting in its price rising about 10% across the quarter. Base metals were mostly lower however Copper bucked that trend, rising 20% in $US and 8% in $A. This is a positive sign as demand for Copper is generally seen as a precursor to global economic demand. If that's the case now, it might be a sign that the virus-related economic slump could be short-lived.

Portfolio comment

The Fund underperformed the very strong market a little in the June Quarter. We benefitted from holdings in global asset manager Macquarie Group, iron ore miner Fortescue Metals, building materials company James Hardie, diversified resource company BHP, gas company Santos, mining services company Seven Group and insurance broker Steadfast; not owning major bank Westpac also helped. Against that however were our positions in blood fractionator CSL, which we sold down markedly during the quarter, and insurer QBE. Not owning millennial payment platform Afterpay Touch or gold miner Newcrest held back performance somewhat.

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)	2.4	15.7	-7.4	5.9	7.7	9.0	9.3
S&P/ASX 200 Accumulation Index	2.6	16.5	-7.7	5.2	5.9	7.5	7.6

*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 June 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.

Quarterly Comment – June 2020

Alphinity Concentrated Australian Share Fund

Market outlook

Equity markets have continued their impressive recovery, turbo charged by monetary stimulus and expectations of a rapid earnings recovery here and in much of the developed world. The rally has been even more impressive considering that global Covid-19 cases are still not showing many signs of peaking and US cases continue to climb. Investors instead appear focused on the fact that politicians, with few exceptions, are reluctant to revisit the lockdown measures from March due to the massive impacts they had on their economies. Victoria is one of only a few places in the world to have reinstated lockdowns.

Recent data releases have also confirmed that economies around the world are recovering from the April lows, and that the rate of earnings downgrades have stabilised. The latter is typically a reliable early sign of better times ahead. We cannot help however but feel somewhat uncomfortable about the speed and extent of the market rebound. It's clear that at least some of the improvement in many sectors of the economy is being driven by work which was delayed during the lockdowns that is now being done. The question is to what extent this is being replaced with new orders and projects? In other words, what does the pipeline look like? We are probably a few months away from having a conclusive answer to that question.

Company commentary to date paints a fairly mixed picture and it's unlikely that many companies, after having withdrawn earnings guidance a few months ago, will be too definitive when making outlook statements in the upcoming reporting season. The Australian equity market is currently trading on a multiple of 17.5 times even next year's (i.e. FY2022's) earnings, well ahead of historical levels. Some of this premium can perhaps be justified by the ultra-low interest rates presently in place meaning there are few alternatives to equities. However, it also seems to reflect almost a best-case economic recovery with few of the large risks that are still present taken into account.

Top five active overweight positions as at 30 Jun 2020	Index weight %	Active weight %
BHP Group Limited	6.5	4.1
Commonwealth Bank Of Australia	7.6	3.2
Goodman Group	1.5	2.7
Macquarie Group Ltd	2.4	2.4
QBE Insurance Group Limited	0.8	2.4

Asset allocation	30 Jun 2020 %	Range %
Securities	98.8	90-100
Cash	1.2	0-10

Source: Fidante Partners Limited, 30 June 2020.

Portfolio outlook

Investors typically don't initially ask many questions about individual stocks during large selloffs and recoveries. The well-known "fear versus greed" psychology tends to be fairly indiscriminate, although of course cyclical stocks generally lead in the downturn as well as the upturn. The market volatility in 2020, while somewhat unusual in terms of the cause and also the size of the monetary and fiscal response, has been no different.

As is also typical, 4-5 months into the current market environment we are now starting to see a bit more discrimination with the different earnings outcomes being delivered by companies also reflected in their different share price performances. This is very welcome as it has historically been positive for our earnings leadership-based investment process. Accordingly during the quarter we continued to position the portfolio towards companies for which we see upside to the market's earnings expectations, and this has been funded by positions that are now either looking less attractive from a valuation perspective or appear to have increased earnings risk – sometimes both.

A new position in carsales.com was added to the portfolio in June. While not immune to the effects of Covid-19 on the Australian economy, we believe it has managed the downturn relatively well and is showing early signs of being able to deliver better than expected earnings outcomes in the coming 12 months as sales rebound and cost management surprises positively.

We also added a little to our gold holdings Saracen and Newcrest Mining as the continued strength of the gold price appears underappreciated in consensus earnings forecasts. We took further profits in CSL, taking it to an underweight position, due to our concerns that FY21 will experience more challenging conditions for plasma collection. We also reduced our overweights in iron ore miner Fortescue Metals and gas pipeline operator APA Group following strong share price performance.

Quarterly Comment – June 2020
Alphinity Concentrated Australian Share Fund

BTW

Robin Hood was a popular English hero from the 1300s famous for "taking from the rich and giving to the poor" and has been greatly loved by storytellers and film/TV makers over the years. There have been no fewer than 37 movies or TV shows about him, some serious, some less so, starring a spectrum of actors from Errol Flynn to Sean Connery to Kevin Costner to Russell Crowe to Cary Elwes (pictured) and many in between. Resentment of the rich is so ingrained in many of us that someone who tries to even the score a bit is bound to be well-regarded.

Robinhood (one word) however is a finance app which has recently become famous for other reasons. It allows Americans to trade shares for "free". It hasn't hit Australia yet but we're on the radar, after the UK later this year. Anyone giving away something of value (brokerage has fallen to fairly negligible levels in recent years but there is still a cost to transact shares) is also bound to be well liked. Robinhood has allowed a whole class of people to trade shares easily and without the friction of brokerage, and in recent months, when millions of Americans have been shut in their homes with nothing else to do, there has been a massive increase in the number of Robinhood accounts in use.

We're certainly in favour of people owning shares as it allows the opportunity to exercise one's intellect in searching out good companies to invest in and then participate in their success. However that power in the wrong hands can have poor outcomes, especially in the prevailing market environment in which many shares were rebounding from massively over-sold levels after the February/March Coronavirus panic. The large gains made by some people in a very short period of time might have given them an over-inflated view of their stock-picking ability, setting them up for future troubles. As the old market aphorism goes: "Don't confuse brains with a bull market".

It would be fair to ask the question "How can Robinhood provide such a valuable service for free?". It seems, like many internet companies, that Robinhood is at least partly an information play. You provide them with rich data about who you are and what you are going to do, they then sell that data to parties who don't necessarily have your best interests at heart.

Hertz, the venerable US car hire company, declared Chapter 11 bankruptcy in May. Hertz is at the pointy end of global travel so with US travel collapsing around the world – down 94% from this time last year – it is no great surprise that car hire was struggling. Hertz was already losing money pre-Covid: it lost $US356m in 2017, $225m in 2018 and $58m in 2019. Things had obviously been getting better but they were still pretty bad. Hertz's biggest problem was that it had $US19 billion of debt, $US14 billion of which was secured against its major asset, its fleet of cars. Chapter 11 in the US is different to the bankruptcy we know. It is an arrangement which allows the company to carry on trading while being protected from its creditors who (quite reasonably) might want some of their money back; equity holders however are generally left with nothing, or are massively diluted by the deeply-discounted capital raising required to put the company back on a sustainable financial footing.

Hertz shares traded at 40c at the time of bankruptcy but in the two weeks after it rallied massively to over $US6 per share. This move was attributed to tens of thousands of Robinhood account holders who piled in, perhaps not fully understanding the implications of Chapter 11. As one commentator said "You have all these guys sitting at home watching CNBC that look at that and say I don't want to pay 60 bucks for a stock. Hey, Hertz is just $2. That's a hamburger at McDonald's, you know?"

And they did make money, provided they were quick enough to exit in time. Hertz shares peaked two weeks later when the company announced a $1 billion capital raising. It was going to issue new shares to people who, by definition, would rank below even the $US19 billion worth of creditors. Who on earth would put fresh money into a company like that? Hertz's own lawyer told the bankruptcy court that the new shares "might ultimately be worthless, although it's impossible to know this as a point of certainty." Despite gaining the court's approval the US regulator, the Securities and Exchange Commission, stepped in to prevent the issue.

Since then reality has set in and the shares have fallen again, by the end of June they were back below $US1.50. Even at that "low" price it's probably still not too late to sell.

Money-Traveller's Tale

Fintech is the application of technology to the old and staid world of finance with the aim of producing new products and services that can serve us better and more cheaply than the incumbents. Australia has been a leader in some aspects of Fintech and was a pioneer of the BNPL (buy now-pay later) segment typified by Afterpay Touch and its ilk. We don't own Afterpay (requiring a justifiable valuation has always stopped us from actually buying it!) but sometimes it performs so well that it can be a noticeable cost to performance. During this quarter for instance.

One problem is that the value the markets accord to companies in their early stages of development is often starkly different to the earnings of the company. Afterpay, for example, has a market cap over $18 billion, despite expecting to make a loss this year and next. To be fair, part of the loss is due to the company expanding into new regions which are initially loss-making, but even on the most optimistic of forecasts it will be many years until Afterpay makes, say, the $300 million of post-tax profit that would bring the multiple down to "only" 60 times earnings.

This was brought home to us in June with the collapse of Wirecard, a German fintech company. Bloomberg described the company thus: Wirecard offers Internet payment and processing services. The Company provides software and systems for online payment, electronic funds transfer, fraud protection and enterprise solutions. Wirecard also offers call centre services. It too had a big valuation. At its peak in 2018 the market accorded a value to Wirecard of €23 billion, or around $A40 billion. Even in the middle of June it was still "worth" €12 billion. Wirecard was profitable, or at least its published accounts showed profits. At the time it went under the market thought it would make €500 million of profit this year.

It also apparently had a strong balance sheet, with more than €2 billion in the bank, so when its auditors couldn't find the bank in which the funds supposedly resided investors were disappointed to say the least. Wirecard shares fell from €100 to €34 that day and went as low as €3 in succeeding days before the company was suspended. This is apparently the first time a company that was in the DAX30 index – Germany's premier companies – had ever become insolvent. Its CEO has since been charged with fraud.

Schadenfreude is a fantastic German word but an ugly concept. We take no joy at all in the fact that lots of people lost a lot of money. As owners of a number of companies with quite high valuations, all of which we can justify but still sometimes feel a bit nervous about, we dread something like this taking place. It is not necessarily a failure of analysis: falsified accounts is simply fraudulent. Index funds, which buy companies indiscriminately purely because they happen to be in an index, were particularly prominent in the list of major Wirecard shareholders.

Let us be very clear: we are not suggesting that what happened at Wirecard might happen with Afterpay: they are two different companies, products, management teams and situations. There appears to be a lot of substance behind Afterpay which was obviously missing at Wirecard. We do however feel a bit alarmed at the love the market sometimes shows for some companies, mistaking tight supply and demand (i.e. lots of people wanting to buy the shares but not many sellers) for a dispassionate assessment of fundamental value. We spend a great deal of time and intellectual effort on research and due diligence to try to ensure your Fund is not exposed to an event like Wirecard.

For further information, please contact:
Fidante Partners Investor Services | **p:** 13 51 53 | **e:** info@fidante.com.au | **w:** www.fidante.com.au
Fidante Partners Adviser Services | **p:** 1800 195 853 | **e:** bdm@fidante.com.au | **w:** www.fidante.com.au
Alphinity Investment Management | **w:** www.alphinity.com.au