Monthly Comment – August 2020
Alphinity Sustainable Share Fund

Be in IT to win it

Market comment

August is Reporting Season, the month during which companies with June or December balance dates publish and explain their operating results and financial accounts. With all that has happened so far this year – fires, floods and of course the pandemic – this season was always going to be a hard one to forecast or anticipate. But despite everything, the market continued its recovery from that sharp drop back in March by rising a further 3.3% (ASX300 including dividends). This marked its sixth consecutive monthly rise and making a total gain of from the bottom of 35%, which has reduced the loss in calendar 2020 to "only" 7%.

This reporting season was marked by a larger-than-usual number of surprises as the Government had suspended the rigorous continuous disclosure requirements dictated by corporate law back in May. Market expectations had become very pessimistic during the lockdown so many of the surprises were positive. Earnings revisions were the best for IT and Mining companies while the worst came from those operating in the Industrial, Telecoms, Utilities and Media sectors.

Australia's August shaped up pretty well in global terms, partly thanks to the $A which rose 3% against the $US and 2% against the Euro. The US S&P500, Germany's DAX and Japan's Nikkei matched our 3% and the only one that did much better was the US Nasdaq at +6%; in fact, both the S&P500 and Nasdaq finished the month at all-time highs despite all that is going on over there. US IT stocks were on fire – ours did well too but nothing like theirs. Much of the leap was due to a small number of companies, the usual suspects of Amazon, Facebook, Tesla, Netflix, Apple, and so on. Shares of Covid-winner Zoom rose by more than 40% to $US325 in August, up from $US67 at the start of the year. Most other markets were flat or declined with Brazil being the worst at -11% as the virus took firm hold; and now down 41% for the eight months so far of 2020.

The Coronavirus' grim global toll passed 25 million infections and 850,000 deaths, although the trend mercifully appears to be starting to moderate. Its toll was also grimly evident in Australia's June quarter GDP numbers with a 7% fall in the value of economic activity, the largest single quarterly fall since the Depression more than 80 years ago. Combine that with the small fall in the March quarter and the country is in a recession, using the classic definition of two consecutive quarters of economic contraction, to the surprise of no one. The only parts of the economy that were revealed to be growing strongly were Mining and Government spending. The current September quarter was looking like it would be back to positive until the extended lockdown in Victoria; another negative quarter is now quite possible.

Commodity prices in $A held up reasonably well considering all that was going on. The price of Iron Ore was up 10% although the coking coal required to convert it to steel fell 7%. Base metals were mostly firm with Cobalt up 10%, Nickel up 8%, Zinc up 5% and Copper up 1%. The Gold price was flat in $US terms but fell 3% in $A although Silver continued its recent strong run, climbing a further 12%. Energy prices crept higher with oil up close to 3% over the month.

Portfolio comment

The Fund outperformed nicely in August. It benefitted primarily from holdings in tech exposure Megaport, mineral sands producer Iluka, waste management companies Cleanaway Waste and Bingo Industries, auto parts wholesales Bapcor, affordable retirement housing provider Lifestyle Communities and not owning infant formula maker A2 Milk. The biggest detractor was from not owning consumer credit provider Afterpay Touch although our exposures to energy company New Energy Solar, telco Telstra and gas infrastructure company APA also detracted 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)	3.9	7.3	1.1	10.9	10.0	8.8	9.5
S&P/ASX 300 Accumulation Index	3.0	6.2	-4.8	6.2	7.6	6.9	7.7

*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 August 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 August reporting season provided some individual company highlights and further evidence of a swifter than expected rebound in sales activity for some sectors, primarily consumer retail exposed categories, but little light was shed on the outlook for the current financial year. Aggregate earnings changes for both the year just gone and for FY21 were close to historical averages, with downgrades of 1-2% for both years. Forecast earnings growth for the new financial year of 5-7% doesn't seem particularly aggressive at first glance but must of course be seen in the context of being compared to a year with only four Covid-impacted months.

Despite, or perhaps because, only half the number of companies that typically provide earnings guidance did so this year, investors were more forgiving than normal when companies missed consensus forecasts. Viewing FY20 as a lost year, and a unique year, is of course reasonable given the events of the last six months or so. However, factoring in resumption of normal economic activity within the next 12-18 months, or simply paying more for a smaller amount of earnings, appears overly optimistic to us, especially as Government stimulus to date has been largely focused on limiting the damage rather than forging long-lasting reforms.

With so few companies having provided earnings guidance, the upcoming October/November annual general meeting period, when companies typically give an update on trading conditions, is likely to take on even greater importance than normal. That is, of course, unless investors, who are faced with few alternative investment opportunities, continue to show the remarkable resilience we've seen so far to what remains a highly uncertain outlook for the economy and corporate earnings. Whether that optimism is well founded will also depend on the outcome of the most-progressed vaccine trials which are expected to be available around the same time.

Whether an effective vaccine will be available later this year is something we are in no position to determine. It would be great for both humanity and the economy if it were to happen but relying on it, as opposed to just factoring in a probability of it occuring, could lead to two very different investment outcomes. The latter seems more realistic to us.

Top five active weight positions as at 31 Aug 2020	Index weight %	Active weight %
BHP Group Limited	6.5	-6.5
Woolworths Group Ltd	2.9	-2.9
Iluka Resources Limited	0.2	2.8
Oz Minerals Limited	0.3	2.7
Goodman Group	1.7	2.5

Source: Fidante Partners Limited, 31 August 2020.

Portfolio Outlook

Top-down portfolio themes are likely to continue to be centred around the pace and sustainability of the economic improvement we've seen in recent months, and the potential for a successful vaccine to accelerate that improvement. While these are clearly important issues to consider they are also inherently difficult to be definitive about. We remain of the view that identifying individual company earnings leadership will be the best way to capture both company specific themes and potentially broader economic tailwinds, while minimising the risk that our positioning is relying too much on overly optimistic (or pessimistic) economic forecasts.

Of course, we need to be mindful of distinguishing between earnings leadership (by which we mean stronger earnings growth than the consensus is expecting) that is driven primarily by factors that are transient and unlikely to persist in a post Covid world, and more sustainable earnings upgrades. In our view it is likely that some of the factors that are presently generally perceived to be only short term drivers will end up surprising positively, both in terms of their magnitude and durability. And this can happen even if the global economy continues to improve.

For example is portfolio holding Sonic Healthcare, which we wrote about last month. We believe the market continues to underestimate the size and longevity of the Covid testing opportunity, the impact it will have on Sonic's earnings and, as a consequence, the dramatic strengthening of the group's balance sheet. This will ultimately facilitate capital returns and/or, more likely, further acquisitions which will underwrite additional future earnings growth. At the same time as it is experiencing high demand for Covid testing, Sonic's base pathology business has essentially returned to normal testing conditions in several countries and continues to improve even in Covid-laggard countries such as the US and the UK.

In summary, while we expect the Fund's portfolio to continue to progressively become more leveraged to economic growth, assuming the recovery remains on track, we will ensure that its well-diversified portfolio considers other good businesses with the potential to deliver positive earnings surprise.

Asset allocation	31 Aug 2020 %	Range %
Securities	97.3	90-100
Cash	2.7	0-10

Source: Fidante Partners Limited, 31 August 2020.

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Alphinity Sustainable Share Fund

BTW

We hope you will excuse us this bit of self-indulgence but August 2020 represents a significant milestone for Alphinity: ten years of managing this Fund. Alphinity was founded in 2010 and officially took over this Fund and its stablemates, the Australian Share Fund and the Concentrated Australian Share Fund, on 1 September 2010. Since then Alphinity has gone from a start-up, with just a few hundred million dollars under management to a substantial manager with well over $10 billion of Australian and Global Equities. Most importantly, we have turned around a group of poorly-performing funds, greatly improving the outcome for the unitholders who remained with us.

In addition to the Funds mentioned above we have gathered an impressive number of institutional clients who have also entrusted us with a portion of their equity allocation. These clients include investment platforms, retail and industry super funds, insurance companies, government instrumentalities and even a foreign sovereign wealth fund. The head count of Alphinity has trebled and we have even been employing people during this pandemic year. We can immodestly say that we have a high quality, tight-knit team which is solely focused on performing for our clients.

We have a market-leading proposition in this Fund, which uses the UN's Sustainable Development Goals to help frame its investments. It was the first large-cap Australian Equity fund to do this and is still, to our knowledge, the only one. It is certainly the only one to use the Aphinity investment process which seeks companies in an earnings upgrade cycle, which we have found are most likely to outperform. We also started a locally-managed Global Equity Fund, using the same investment process, which has produced good alpha both in absolute and risk-adjusted terms which, by the end of the year, will have an impressive five-year performance track record.

The most important thing is that we have been able to produce good results for the people who have entrusted us with their capital. Each of our Funds has a different risk and return profile but the common thing between them is that they have generated strong returns for the amount of risk that was taken. This is shown by the Funds' Information Ratio, which compares the volatility of the unit price of the Fund with the above-market returns achieved, which are among the best in the market.

You need to be able to tolerate some risk in order to put your money into the equity market. If you want "no risk" you need to leave your money in cash, which presently yields the grand total of 0.25% per annum. So a million would provide you with income of just $2500 a year before tax! Had you invested $1 million in the risk-free cash rate on 1 September 2010 and compounded the interest you would now have about $1,258,000, ignoring tax.

Individual shares are much more exciting than cash as their prices go up and down, sometimes by a lot. This risk is diminished when you own a portfolio of shares as the volatility tends to be smoothed out. This Fund typically has around 40 companies in it. Some will inevitably do better than others but when there's a bunch of them the risk of owning shares, as measured by the standard deviation of returns, is much lower. Still, the Fund will do a bit better or worse than the overall market depending on what the shares in the portfolio are doing.

Our aim (and we would hope that of most fund managers) is to do better than the market in order to justify the cost of employing us to do that. You can go into an index fund more cheaply, but then you miss out on the opportunity for excess returns that a decent active manager can provide. Australian fund managers have a pretty good record of doing that; generally the reports you see saying otherwise look only at US funds. Whether that has to do with the particular skills Australian managers have or the quirks resulting from the composition of our market (such as lots of banks and resource companies) which might allow us to exploit some trends better than in some other markets, is beyond the scope of this column.

Not all active managers will outperform all the time, and no one can promise they will outperform all the time – that comes down to the quality of your investment process. But if you can do better than the market most of the time, and if your wins are bigger than your losses, and this outperformance is compounded over a period of time then the benefit of a good fund manager is revealed. Alphinity's record is good, as you can see from the returns table on the front page.

Our earlier example of risk-free returns suggested a ~25% return over ten years. Investing that million in a fund just tracking the ASX300 would have resulted in a portfolio worth about $2,108,000 before fees, better than 100%. To us this seems a decent reward for taking the risk of investing in shares. Investing in this Fund would have given you about $2,478,000 after fees – surely that's worth paying for! Everyone is different though, only you know your own risk tolerance. But ten years in we're still energised, and we're proud to be moving into our second decade working on your behalf to generate good risk-adjusted returns.

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Non-Traveller's Tale

We've almost given up expecting to be able to travel overseas any time soon; our ambitions have now been reduced to hoping one day to be able to travel just to a different state without having to weight up the prospect of spending weeks in quarantine or being turned back at the border. But it has freed up some time to reflect on what's going on.

Alphinity has a highly-experienced and well-resourced investment team and sometimes we see things going on in the market that look quite familiar. Mark Twain is supposed to have said "History doesn't repeat, but it often rhymes": we're seeing a few couplets emerging at the moment which remind us of 1999, the period leading up to the 'tech-wreck'. At that time technology stocks were all that mattered, anyone investing in old economy stocks like resources and manufacturing just didn't get it. Tech was where all the action was and where all the money was to be made. It didn't matter about a company's valuation, if there were enough clicks or eyeballs involved you just had to be there.

For a while that was correct, in fact that type of thinking can be self-fulfilling for a period. It spawned the Greater Fool Theory: in that it doesn't matter how much you pay for a company because a greater fool will no doubt come along in the future and pay more. This works for a while, but one day you run out of fools to sell your shares to and it all starts to unwind.

At this point we might be starting to sound like a value manager – which we're not – defending poor performance – which we do not need to. The Fund's performance has been sound, and while of course we think about the value of the companies we invest your capital in, we're quite prepared to buy "growth" companies (i.e. those with apparently high valuations relative to current earnings) as long as we can see a way for greater value to be realised and exceeded.

Afterpay Touch however has been a challenge for us this year. We have not owned Afterpay but all of a sudden it became the 15th-biggest company on the ASX, despite not yet turning a dollar of profits. We have owned a couple of its techy peers which have performed almost as well.

The psychology behind Afterpay's share price goes something like this: its business model has the potential to be rolled out globally and it is in the process of doing this, now operating in the US, Canada and the UK. If it were able to repeat its Australian success in those markets and start making money from the service it offers (which, putting it harshly, is unsecured lending to people, many of whom have a poor or no credit record) it could one day be very profitable. But the share price in the short term seems more about a lot of money chasing a relatively small number of available shares, the main variable being price.

A similar thing is happening globally with a small number of companies including Apple, Amazon, Alphabet (Google) and Tesla. The difference between 1999 and now is that many of these hot stocks actually do have earnings, not just lots of clicks or eyeballs. Apple for instance makes more than $US50 billion in profit a year. We're not sure it justifies market cap of over $US2 trillion, but it certainly shows substance.

For further information, please contact:
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