alphinity INVESTMENT MANAGEMENT

Monthly Comment – November 2020
Alphinity Concentrated Australian Share Fund

A shot in the arm

Market comment

Markets rallied sharply in November despite the rather messy US election and its aftermath. There were a few things going on here: the election took place without significant strife despite a contested result which could have been awkward in a country with more guns than people; and Australia's cash rate was slashed from almost nothing to even closer to nothing and our central bank said it would remain at nothing for years to come. The biggest news however was that several highly-effective vaccines have been developed in different parts of the world. This was a huge shot in the arm for equity markets, raising the hope that maybe all of the bad things that have happened over the course of 2020 might be reversed: life as we once knew it could be on its way back. Of course the pandemic is still running amok in some countries and it will take considerable time for enough of the vaccine to be produced and distributed to make a difference, but it was enough to send the share market a little over 10% higher (ASX300 including dividends) in November alone, taking it back to the level at which it started the year.

It triggered a big swing within the equity market too, with a lot of companies whose shares had been beaten up earlier in the year bouncing substantially. The logic seems to be that if a company had fallen a lot because of the virus, a vaccine against the virus should allow it to get back to where it was. This is overly simplistic of course, it ignores any changes that have taken place in the companies in the meantime, but nuance tends to go missing in times like these. The corollary of this thinking is that companies whose share prices have done very well this year despite the virus should be sold down, even if their resilience was unrelated to the virus itself.

In any case, the market being up so much is positive for investors in the Fund, and our market did appreciably better than the US market in $A terms: it only managed to go up 5%. European markets were extremely strong, rising between 11% (Germany) and 21% (Spain), despite a third wave of Covid taking hold across much of the continent. It didn't seem to matter to the markets though: vaccines will fix all that eventually. Asian markets also rose but not as much, with rises of between 2% (Shanghai) and 9% (Japan). All things considered it was a good month for equity investors pretty much everywhere.

The $A appreciated by about 5% in November and commodity prices were generally strong, led by energy. The price of Oil rose by more than 20% even in $A and thermal coal was up by 15%; metallurgical coal however was 4% lower after being caught up in the trade spat with China. The Iron Ore price was virtually unchanged. Gold fell by almost 10% but base metals were generally stronger, the bigger movers being Copper +7%, Lead +11%, Zinc +6% and Aluminium +4%.

In a strong month like November pretty much all sectors were higher. Energy performed the best, not surprisingly considering the oil price move detailed above. Energy rose by 28%, followed by Financial companies which were up 16% overall. These were all bought at the expense of Consumer Staples, Utilities and Healthcare companies. Gold companies struggled as the gold price softened.

Portfolio comment

The Fund rose nicely in November but lagged the extremely strong market somewhat. It was a month during which many companies which had underperformed sharply since the pandemic hit had large bounces, regardless of any investment merit. The best contributions came from holdings in major bank NAB, gas producer Santos, global insurer QBE, and not owning a bunch of companies including Coles, Afterpay Touch, or gold exposures Northern Star and Evolution Mining. Positions in domestic retailer Super Retail Group, gold producer Newcrest, supermarket Woolworths, industrial property developer Goodman Group, supermarket Woolworths and medical exposures Sonic Health and CSL all detracted, as did owning neither ANZ Bank nor Woodside Petroleum.

Performance*	1 Month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception^ % p.a.
Fund return (net)	7.2	4.9	-3.9	7.0	9.6	9.4	9.9
S&P/ASX 200 Accumulation Index	10.2	8.2	-2.0	6.9	9.0	8.1	8.4

*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 November 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

Following one of the best monthly equity market returns on record and a classic "risk-on" rally, a number of indicators suggest a short-term pullback is due. However, last month's positive vaccine news only adds further momentum to the economic recovery already underway, helped by large fiscal and monetary stimulus. Getting the majority of Australia's and the world's population vaccinated will take some time but doing this for frontline health workers and others most at risk over the next few months, at least in developed countries, should be achievable. And knowing that a solution is underway should further strengthen business and consumer confidence.

The impact on equity markets from the outcome of the US election is more difficult to predict. For now, a split Congress suggests that while some things will be very different after the inauguration on January 20, much will remain the same. What could spoil the party? For Australia, the stronger $A will certainly dampen the earnings momentum of some sectors. The strength in some commodity prices, such as iron ore and copper, look like more than compensating for the currency headwind at this stage, but the translation impact on $US earnings for some of our healthcare companies, chemical companies and financial institutions will be meaningful if the $A holds at current levels or strengthens further.

Higher interest rates for longer-dated bonds also requires close monitoring. It is easy to forget that only 12 months ago the US 10 year Government bond yield was almost double the current level of just under 1%. While higher bond yields are not always bad – after all they typically also signal stronger economic conditions – a rapid rise would likely pose a challenge for equity markets in general, or at least for some sectors of the market. Which leads us to the other feature of the November 2020 market rally, the extraordinary sharp rotation from previous winners to stocks that had been the hardest hit by the Covid pandemic. Will it continue?

That will of course depend on to what extent and how quickly the world goes back to how it was pre-Covid, including the level of interest rates. A broadening of the economic recovery and corporate profit growth will make some of the more defensive and expensive sectors, which have primarily benefited from a rerating, vulnerable to further profit taking. However, it seems likely that some sectors and companies will have experienced structural changes as a result of Covid, especially where those changes were already underway. Online shopping, logistics, telehealth, remote working are some of the trends that are unlikely to return to their pre-Covid status, in our view.

We also suspect that some shifts in consumer behaviour will take longer to normalise than many expect. So while some traditional cyclical sectors might stand to benefit from stronger economic growth in the next phase of the recovery (e.g. Resources) and some of the previous winners are likely to lag as their premium ratings moderate, we don't think all will, and believe that some companies (e.g. office and shopping mall owners, bricks & mortar only retailers) are unlikely to return to their former glory. All up, we expect equity markets to be higher in 12 months' time, but this will not necessarily be the case for all sectors.

Portfolio Outlook

The portfolio currently has a strong exposure to stocks experiencing earnings upgrades: this is the core of our investment process. Company updates at this season's AGMs, interim results for those with March year ends and stronger commodity prices have all been drivers of positive revisions to consensus earnings for the majority of positions in the portfolio, and there have been no significant earnings or guidance disappointments.

This mattered little in November when the companies that had been most negatively impacted by Covid were those that rallied the most on the news that vaccines had been developed. While there is undoubtedly some logic to this we think the future will be a little bit more complicated than that, as discussed in the preceeding section. Earnings leadership is likely to shift to some extent and we have been positioning the portfolio for this primarily by increasing our overweight to Resource stocks and, for the first time for some years, moving to being overweight Banks. Both sectors should do well in a stronger economic environment, especially if this also results in higher bond yields.

However, we are also of the view that a number of the previous winners will continue to perform if they also continue to surprise positively, as long as their valuations are still reasonable. We view the IT sector, to which the portfolio has little exposure, as the most vulnerable to further selling due to elevated valuations. For most other sectors we think earnings leadership will be the key driver for relative outperformance. In our experience, this typically becomes more evident over time as only those which can deliver on expectations of better earnings outcomes can maintain the momentum. We will no doubt make further adjustments to the portfolio but, as always, only where we can see fundamental evidence of that shift in earnings leadership.

Top five active overweight positions as at 30 Nov 2020	Index weight %	Active weight %
BHP Group Limited	6.2	3.8
National Australia Bank Limited	4.2	3.3
Commonwealth Bank Of Australia	7.7	2.6
CSL Limited	7.5	2.6
QBE Insurance Group Limited	0.8	2.2

Asset allocation	30 Nov 2020 %	Range %
Securities	98.9	90-100
Cash	1.1	0-10

Source: Fidante Partners Limited, 30 November 2020.

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BTW

We seem to write about Tesla in this column a lot and apologise if it bores people but there is always something going on with company itself and its colourful founder. It is an interesting mix of old-world industry (making cars is about as heavy as manufacturing gets) and high technology. Tesla is a true disruptor to the established industry, using new thinking to come up with a better product. Although it has been a frustrating and costly journey to get to this point, it has had the benefit of the deep pockets of Elon Musk – who is now the second-richest person in the world – and all those understanding share-holders who can see the vision and don't worry too much about valuation.

The point of profitability is happening this year: US brokers are forecasting that in the year just about to finish Tesla will earn about $2 a share, making it a mere ~250 times earnings. We'll know in a couple of months what the real number is but in the first nine months of the year the company managed to earn 39c a share so it needs a good fourth quarter to get to $2. Regardless of the multiple, we do know that the operating leverage of a company experiencing 40% sales growth moving from losses into profits can be large indeed, so $2 a share is quite possible.

Tesla shares had a great month in November, moving up 46% from $US397 to $580. They troughed during the March panic at just $72. The market cap of the company rose from $360 billion to $538 billion in just one month, and it is now worth more than Ford, GM, Daimler Benz, Volkswagen, BMW and Toyota combined. We've speculated on the reasons for this before but such a valuation disparity is something we struggle to accept. The catalyst this month seems to be index-related. Standard & Poor's obviously concluded that the meteoric performance Tesla had been delivering warranted a position in its prestigious US S&P500 Index so Tesla will be added the week before Christmas. It will be the largest company ever to be added to the index; usually companies make it in there much earlier in their gestation.

It will cause issues for some in the market though. There are vast amounts of money in index funds linked to the S&P500 which will be forced to buy shares in Tesla regardless of whether there is an investment case to do so. And they will be doing so at inflated levels, after the shares have already gone up massively. The big jump in November might be at least partly attributed to various market participants front-running the upcoming change: they know that there will be a bunch of forced buyers soon so why not buy now and sell it to them at a higher price in a few weeks' time?

The Australian Financial Review estimates that adding Tesla to the index will create demand for as much as $US100 billion worth of stock from the trillions of dollars sitting in index funds which track the S&P500. Those funds will need to sell shares in other companies in order to fit the Tesla shares into their portfolios – again regardless of how good the prospects of the companies they are selling are.

This demonstrates, to us at least, the primary short-coming of index investing. Having someone at Standard & Poor's (or MSCI or one of the myriad other index providers) decide which companies go into your portfolio, completely without any fundamental analysis of those companies, doesn't on the surface seem to us to be a better outcome than engaging a fund manager like us to discriminate between the merits of different companies and only own a selection of the best. Index funds sure are cheap though…

Elsewhere in the world of Tesla, a New Zealand man named Merv has created his own Cybertruck. Last year Tesla unveiled the Cybertruck (↑), a utility vehicle with a stainless steel body, sharp angles, supposedly unbreakable windows and a claim that it could out-torque the huge petrol-powered trucks which dominate the US auto landscape. It is building a factory in Texas to make them and plans for the first deliveries to take place late in 2021.

Merv however couldn't wait for them to get to New Zealand so he bought a 20 year old crashed Toyota Yaris, a tiny hatchback, and did some home panel-beating to create a homage (↓) to Tesla's upcoming truck. It even seems to have gull-wing doors which might make it even better than the Tesla version. The story didn't say what's under that bonnet but we doubt that Merv's car has an electric motor or any of the cool self-driving or advanced safety features you would expect to find in a proper Tesla.

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Non-traveller's Tale

One of the blessings of managing equity funds is the need to get out and about on a regular basis to see assets and meet with people and find out what's really going on out there. It's great being able to travel the country and the world, see interesting things and quiz interesting people but since the start of the year that's been pretty much impossible, we've had to rely on electronic communication instead. That's worked well but it's not quite the same.

The benefit of not being able to travel however has been a less frenetic life for all of us at the coal face. Not needing to fit in a week and a half trip to Europe and/or North America and/or Asia several times a year in addition to a few days interstate each month has meant a bit more time at home with families which, for the most part, has been a good thing. Not so good for people working for airlines and hotels or for taxi drivers of course, but good for us.

One thing this year has done is to emphasise that society had probably become too accustomed to international travel. Air travel had become so cheap that you were able to hop on a plane at a moment's notice and pop over to the other side of the world for spurious reasons without thinking too much about it. From time to time you could get a flight to London or New York for not much more than $1000 – why not? It became normal. In the back of our minds we probably knew it was unsustainable but the environmental and social impact only really became evident when we were forced to stop.

It wasn't just Australians, although the tyranny of distance meant that we (and our Kiwi cousins) had become the kings and queens of long-haul travel. People all over the western world, and increasingly the more affluent east, were almost as guilty. Millions of people were getting on planes every day. We had become addicted to travel.

Covid provided the cold turkey we probably needed but some travellers have obviously struggled to adapt. We recently saw an article about Singapore Airlines trying to defray some of its massive operating losses by making a novel use of its aircraft. Famous for its large fleet of Airbus A380 super-jumbos, largely unusable for most of the year, Singapore started offering frustrated non-travellers the chance to experience the airline food and service for which they were pining, all served on a plane while it was sitting on the tarmac at Changi. For $A650 you could dine on the best food and wine in a First Class suite; Business Class seats/fare cost about half as much and Economy was much cheaper at $A60. We've consumed enough meals in economy to know that this is not good value!

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