Quarterly Comment – December 2020
Alphinity Sustainable Share Fund

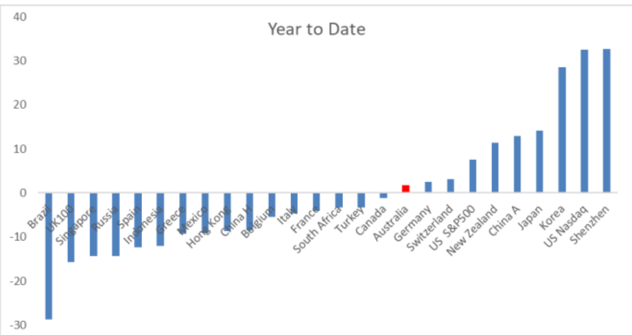
Vale 2020

Market comment

2020 is now over and we expect that it will not be looked back on with great fondness by many of our readers. It started with large parts of the country choking in a pall of smoke from the dreadful bushfires. Then the virus infiltrated the country and changed life as we knew it. We learned new ideas, such as R0 and curve flattening, and new practices like mask wearing. We all suddenly became experts in epidemiology, a word many would have struggled to even spell in 2019. We watched as the federal government effectively mandated a recession by shutting down large parts of the economy, and as state governments closed their borders, something not seen since the Spanish Flu pandemic a hundred years ago.

The local share market (ASX300 including dividends) was quite volatile this year, selling off viciously in the first quarter before climbing all the way back to end the year fractionally higher than it started. Its return was essentially all from dividends, the price index finishing slightly below the level at which it started. The December quarter alone produced 14% returns.

In a year of mostly negative returns in global markets however Australia fared reasonably well as the chart shows: not as well as the US, Japan or China admittedly but certainly better than the UK, much of Europe, Hong Kong and Brazil. Our relative position was boosted by the $A appreciating by 10% against the $US for the year, 3% against the Chinese Yuan and 7% against the UK Pound. It was flat against the Euro.



The standout returns came from "tech-heavy" markets, Nasdaq and its Chinese equivalent Shenzhen, both of which rose around 40% in their local currencies and more than 30% in $A (more about Nasdaq on p3). Even the broad S&P500 index was up 7.5% in $A and 18% in $US despite the escalating health and political crises there.

Commodity prices were mostly stronger across 2020 despite everything, with the exception of Oil which was down around 30%. Iron Ore rocketed, rising 64% even in $A terms as the Chinese economy went into post-Covid stimulus mode. Thermal Coal was up a more modest 10% but Coking Coal, used in steelmaking, was 34% lower largely due to the China embargo. Base metals were higher over the year led by Copper which rose 16%. Zinc and Nickel were both up almost 10%.

Portfolio comment

The market put on almost 14% in the December quarter, much of it in November when Covid vaccines were announced. Fund did a little better than this, delivering a very strong absolute return for the quarter. It benefitted primarily from holdings in resource plays Fortescue Metals, Oz Minerals and Iluka, affordable housing provider Lifestyle Communities and not owning gold producer Newcrest, infant formula maker A2 Milk or the stock exchange, ASX. On the negative side, the biggest detractors were IT infrastructure provider Megaport and health exposures CSL and Ramsay Health; not owning consumer credit provider Afterpay or miner BHP also hurt performance somewhat.

The Fund outperformed strongly over the whole of 2020, best contributors again being Fortescue, Oz Minerals and Lifestyle as well as industrial property developer Goodman Group, data annotator Appen, and auto parts wholesaler Bapcor. The key impediments were renewable energy generator New Energy Solar, water treatment company Fluence, QBE, Qantas and not owning Afterpay or accounting software provider Xero.

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)	2.0	13.8	7.2	11.2	10.8	9.7	10.3
S&P/ASX 300 Accumulation Index	1.3	13.8	1.7	6.9	8.8	7.7	8.5

*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 December 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 portfolio to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2010. Therefore, the inception date for the return 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

A new year, a new market? While we are pretty sure we won't see an exact repeat of 2020, not everything is likely to change. The key will be to understand what might change and what might not.

The earnings outcome in 2020 turned out to be better than we initially feared but the strong market rebound that has taken place since March has so far primarily been driven by a re-rating of the market in anticipation of an earnings recovery in 2021 and beyond. Of course, ultra-low interest rates also supported higher equity valuations but even so, further upward re-rating looks unlikely so it will likely be the pace of earnings growth that determines market returns in the year ahead. Fortunately, economic indicators have remained positive despite the resurgence in Covid cases globally, especially in the US and Europe, as well as the setbacks in Australia, which of course have been on a very different scale. The vaccine rollout and diminishing "fear of the unknown" should mean that the current economic recovery has a good chance of staying more or less on track, supporting further market gains.

The decade-long debate about when we will see the end of low inflation has once again heated up in recent months. This is understandable considering the enormous amount of monetary and fiscal stimulus policy makers have provided. The strength of many commodity prices also suggests that we should remain alert and, even if we're reluctant to call a resurgence of inflation as the biggest risk to equity markets this year, it is likely that higher yields – especially for longer dated bonds – will provide some offset to the better earnings picture. A stronger Australian dollar is also looking like a headwind although, as with the risk from interest rates, our currency is only likely to continue to be in favour if the Australian economy, especially commodity prices, remains strong. This should also be supportive for overall earnings growth.

In summary, we expect earnings growth to more than compensate for any potential interest and currency headwinds. Of course, from a sector perspective these macro factors will have larger impacts on some sectors than others. To us, the Technology sector continues to look the most vulnerable to higher interest rates due to its large valuation premium. At the same time, the already substantial recovery in many cyclical sectors would suggest investors will have limited patience with any companies that fail to deliver on the well-anticipated earnings recovery, meaning that stock selection will remain important in 2021.

Portfolio Outlook

The rebound in economic growth in Australia and globally has resulted in upgraded earnings expecations across large parts of the market. The portfolio has benefited from these upgrades, particularly in Resources but also in discretionary retailers. However, a number of other stocks in the market have also rallied in recent months even without the support of improved earnings expecations. This improvement might come with further reopening of the economy but would, in many cases, require that the world post-Covid looks much the same as it did before. This is a big assumption to make, in our view.

Furthermore, it also requires that this normalisation comes pretty soon. While we are encouraged by the better economic outlook it's important to remember that fiscal and monetary stimulus have been critical drivers so far. How long this remains the case will impact on where and how fast the earnings recovery can take place. We also expect that consumer and corporate behaviour will take some time to readjust and that some changes will be more permanent. For these reasons we remain underweight property, in particular office and retail property. We are also underweight Information Technology companies due to concerns about overly optimistic growth forecasts and valuations: these are our largest sectoral underweights as we enter 2021.

In addition to our overweight to Resource companies we continue to see some opportunity for Banks to recover some of their underpeformance of the last couple of years as the risk of a more signficant bad debt cycle has been reduced. Our move back overweight in Healthcare in the second half of last year appears to have been a bit premature at this stage. While we continue to see earnings upside in all our positions in the Healthcare sector the strength of the $A, together with investors' preference for cyclical exposure at this point in the cycle, has created some shorter term challenges. However, the structural growth opportunities in Australian Heathcare remain strong and we expect it will continue to be rewarded over the medium term.

Asset allocation	31 Dec 2020 %	Range %
Securities	98.4	90-100
Cash	1.6	0-10

Source: Fidante Partners Limited, 31 December 2020.

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Emissions

The estimated carbon intensity of the portfolio, using emissions data supplied by MSCI, is shown in the table below and is substantially below that of the ASX300 benchmark. Almost any economic activity involves the emissions of CO_2 and while emissions data is estimated by MSCI for a large number of companies, rather than being their actual emissions, the fact that our negative screens exclude eight of the ten largest emitters in the benchmark (who make up around half of the market's total emissions) makes us confident that the fund is achieving its aim of minimising carbon emissions while still promoting Sustainable Development.

Carbon Exposure Metrics

Scope 1 & 2	SSF	ASX300
Carbon Intensity*	123.9	223.6

* Weighted average tonnes of CO_2 equivalent emissions per $USm revenue

Source: Alphinity, MSCI. Data as at 31 December 2020.

SDGs

The chart below shows a measure of the Sustainable Development Goals addressed by the portfolio as at 31 December in a format that was developed by Citi Research. On average each position in the portfolio positively addresses one Goal, which compares favourably to companies across the Citi universe coverage, which address on average 0.4 of a Goal. This measure only captures revenue-related goal applicability: we are currently developing a measure which will give companies credit (or a penalty) for ways in which goals are worked towards (or against) in areas not measurable by revenue.

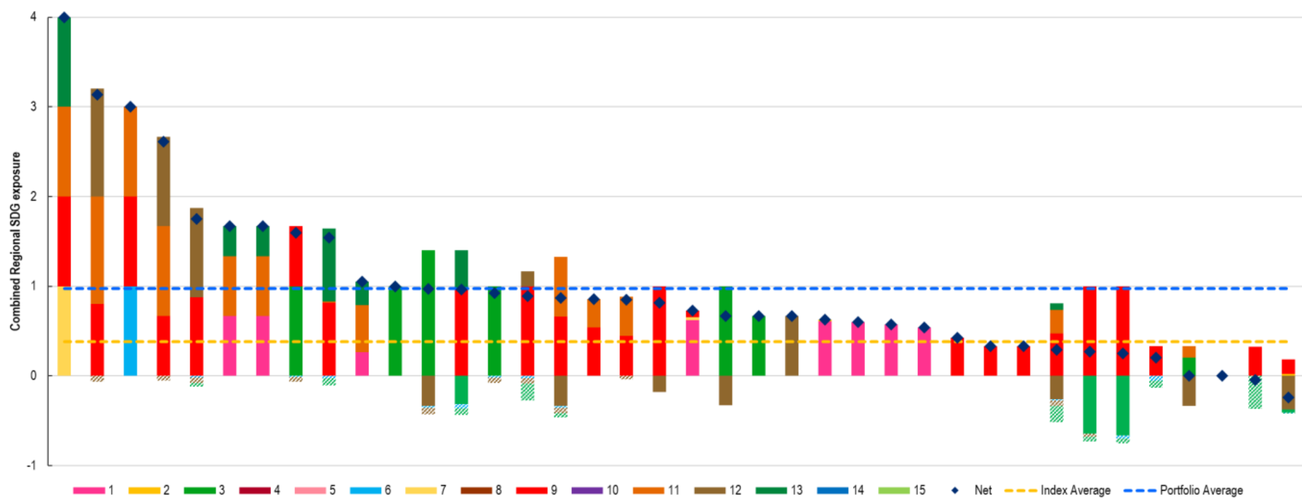
Mining Exposure

When we excluded companies with a material exposure to producing Fossil Fuels there were some significant implications for holdings in the portfolio, the biggest being an inability to own BHP shares. BHP is a substantial producer of iron ore and copper, elements critical to infrastructure that will help to achieve sustainable development. But it also earns revenues from mining fossil fuels: a very small amount of thermal coal but a meaningful amount of oil and gas.

We were enthusiastic about the positive aspects of BHP but not its fossil fuel exposure, so we sold out of BHP completely but increased the Fund's investment in Fortescue Metals and Iluka (for iron ore) and Oz Minerals (for copper) over and above our other funds. The listing of the biggest active exposures below might make it appear that it is a resource fund, but it is not: the Fund overall is actually underweight resources relative to the ASX300, bearing in mind that BHP is around 7% underweight. It holds no companies in the Energy sector and no pure gold miners.

Top five active overweight positions as at 31 Dec 2020	Index weight %	Active weight %
Fortescue Metals Group Ltd	2.0	3.4
Oz Minerals Limited	0.3	2.7
Lifestyle Communities Ltd	0.1	2.3
Steadfast Group Ltd	0.2	2.0
Goodman Group	1.7	2.0

Source: Fidante Partners Limited, 31 December 2020.



Source: Citi, Alphinity

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Our alignment with the SDGs

The UN's Sustainable Development Goals are a blueprint for the world to achieve a better and more sustainable future for all people. They address many of the global challenges we face, including poverty, inequality, climate change, and environmental degradation, and they set clear targets we should all be aiming to achieve by 2030.

Unfortunately, and for some people this might be surprisingly, Australia still has some major challenges when it comes to the SDGs. According to the online 2020 Sustainable Development Report, which assesses various countries' performance against the 17 goals, Australia still has a way to go to address the full suite of goals and actions. In fact the assessment shows we still have major or significant challenges in addressing 11 of the 17 SDGs! These include SDG2 (Zero Hunger), SDG9 (Industry, Innovation and infrastructure), SDG12 (Responsible Consumption and Production), and SDG13 (Climate Action).

The Sustainable Share Fund portfolio aims to invest in companies that are doing good, which we define as contributing to the SDGs through their products, services and operational practices. We've analysed the contribution our current portfolio makes across the goals and have strong alignment with six of the 17 goals, including several of those Australia needs to address. A snapshot, with examples of some of the relevant companies, is provided below. Note that some companies can contribute to more than one goal.

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BTW

The world's premier benchmark for technology companies is the Nasdaq Composite Index. Nasdaq used to stand for the (US) National Association of Securities Dealers' Automated Quotation system and its index includes most of the technology companies listed in the US, as well as many of those elsewhere in the world. Launched in 1971, Nasdaq was the first ever computerised platform although it was initially only used for prices: actual trading didn't take place on Nasdaq until 1998, more than a decade after Australia went electronic. The NASD itself no longer exists, that body is now FINRA, but the Nasdaq acronym lives on.

There are around 3000 securities in the Nasdaq Composite Index. They are not all tech however; Nasdaq has various sub-indices which include Healthcare, Banks, Transport etc. But technology accounts for the bulk of the market cap and pretty much all of the market's attention. The Nasdaq Composite Index rose by more than 40% in $US terms in 2020, although a bit less in $A when you take into account the strong $A/soft $US. This huge rise took place despite the poor economic environment around the world: high unemployment, the rampant virus causing much disruption, an enormous number of deaths in many countries, and a runaway public debt situation pretty much everywhere.

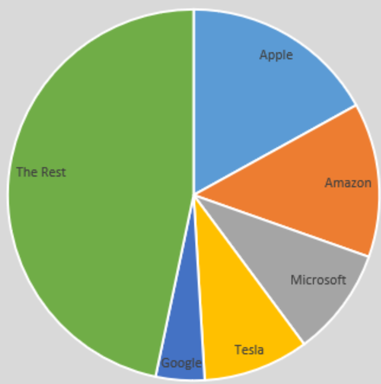
Many commentators saw it as a disconnect between what the US refers to as Wall St (the markets) and Main Street (the real world). In reality, it's probably just the outcome of the massive amount of liquidity that was pumped into the world's financial markets during the year, making fixed income investments like bonds unattractive compared to shares, and it could be a sign of things to come in 2021.

Nasdaq's stunning performance was not broadly-based though, as the adjacent chart shows→, much of the return came from a very small number of companies. Just five companies accounted for more than half of the total return of the Nasdaq. If you didn't own Apple, Amazon, Microsoft, Tesla or Google your outcome would have been significantly poorer. If you owned some or all of them, happy days. This explains why the other US indices didn't do nearly as well as Nasdaq. The S&P500 was up a decent 18% in $US terms (+8% in $A), less than half the return of Nasdaq, while the venerable Dow Jones Industrial Average (Dow) was up only 10% (zero in $A).

The market generally sees the S&P500 as representing overall US market returns as it includes the 500 largest companies. All indices have their issues though: as we reported last month, S&P didn't have Tesla shares in its key index until a few weeks ago, even though it was one of the strongest performers in the whole US market last year.

The S&P500 is far better than the Dow, however. The Dow has been around for a long time, having been set up in the late 1800s, but it was constructed in a way no sensible index compiler would even contemplate today. For a start it contains only 30 companies, which means it in no way represents the US economy or the US stock market. But the really weird thing is that its constituents are not weighted according to the size of the company, as is the case for pretty much every other index we've come across; they are weighted by the price of the company's shares. This caused an absurd situation in August when Apple conducted a 4:1 share split (i.e. if you owned 100 Apple shares, they gave you 300 more). Apple's share price fell from ~$500 to ~$125, an economically neutral and sensible outcome. However as its weighting in the Dow went down substantially as a result, from 12% to a little over 3%. All of a sudden Apple stopped being the largest company in the Dow and the index's total weighting to tech companies fell from 28% to 20%.

In our view, the best use of indices is as indicators of what went on in markets, but they now seem to be the objectives themselves: a natural outcome of the trend towards index investing. But that makes it really important that the index you are using makes sense for your purposes, and that the people putting the index together know what they are doing.



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Best of the Best Award

We were pleased that the Alphinity Sustainable Share Fund was awarded "Best of the Best Australian Share ESG Fund" by Money Magazine recently. Money Magazine looked at returns over short, medium and long periods up to 30 June 2020 as well as the degree of volatility in monthly returns of the Fund over time in making its assessment. Aside from the fact we don't consider the Sustainable Share Fund as just an ESG fund, it is always gratifying to be recognised in this way.

ESG – the consideration of Environmental, Social and Governance matters when making investments – is a core part of Alphinity's investment process. It is applied across all our Funds, not just the Sustainable Share Fund. This seems to be common sense to us: our experience is that ESG matters can at times have meaningful positive or negative impacts on companies' value: not to be considering them could be seen as negligent.

Some people use ESG as shorthand for funds that attempt to do something other than just maximising investment returns. We would prefer to use a collective term like "Socially Aware" rather than ESG as it might better describe funds operating in fairly similar spaces, like Socially Responsible, Sustainable, Ethical, Impact and so on. We are not big fans of calling the space "Ethical" as it is so difficult to define: whose ethics is it following? There is no right answer as to what is ethical, investors really need to do their homework to make sure the ethics of the fund and the manager are consistent with their own.

That's why in 2017 we chose to use the Sustainable Development Goals to as an impartial way to assess companies in the Fund. We figured that if a company can help the world move towards achieving one or more of the SDGs in a net sense (i.e. after taking into account the negative externalities that invariably take place as a result of any type of economic activity) then it could be considered to "do good". And if it also has good practices in managing its Environmental, Social and Governance risks, or can exploit opportunities in these spaces, then it could be considered "doing it well". That's what we want to end up with, within the confines of our allowed investment universe which is Australian listed companies: a portfolio of companies which do good and do it well.

For further information, please contact:
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