Monthly Report – January 2021
Alphinity Sustainable Share Fund

Biden time

Market comment

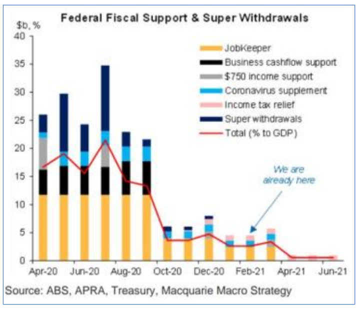
The inauguration of the new US President went with barely a hitch, or an audience, but it seemed to coincide with a collective outward breath by the rest of the world as the four tumultuous years under his predecessor came to an end. Getting elected was the relatively easy bit for Joe Biden, now comes the hard part: dealing with an out-of-control health crisis, a deeply divided populace and an enormous public deficit, all while managing with wafer-thin majorities in both the Senate and the House.

Not that you would think there was anything to worry about judging by the US equity market. While it finished the month fairly flat, it is only fractionally below its all-time highs despite some frothy behaviour in certain areas. The Australian market also marked time, rising just 0.3% (ASX300 including dividends), but still did better than most global markets. China and Hong Kong were both up solidly – around 4% – but almost all the other markets around the world were down by a few per cent. China seems to have emerged the winner from Covid. It did have to deal with a few minor outbreaks over its winter but nothing like what is still going on in the US or the UK.

In the commodity space, the Oil rose by about 8% while base metals were mostly a few per cent higher with the exception of Zinc, which fell 5%. Copper, the price of which is generally a precursor of future global economic growth, continues to be strong. The price of the major bulk commodities – coal and iron ore – were also strong during the month, particularly the variety of coal used in steel production. Notwithstanding, Resource stocks lagged the overall market in January, the big winners instead being in the Consumer Discretionary and Communications Services space. Industrials and Property were the worst performing sectors in the lead-up to the February reporting season.

Interest rates remain a driving force behind asset values, not just equities but also real estate, and there are signs that house prices are on the move, in capital cities and in the regions as well. With short term rates at zero and medium term bonds still very low, the investment case for anything that can provide some sort of yield becomes compelling. Australian shares have a forecast dividend yield comfortably above 3% with some upside possibly allowing our banks to resume paying more normal dividends this year, which is certainly better than zero. Bond yields have started to move up but are still close to historic lows.

The economic outlook for 2021 is particularly hard to read at present. While the local economy is trundling along reasonably well despite the disruption and uncertainty caused by ongoing closure of state borders at short notice, there has been a lingering concern that this has been largely because of government spending programs such as JobKeeper/JobSeeker, both of which are supposed to finish in March, resulting in an income "cliff". We were therefore pleased to see this chart which suggests that the worst of the cliff has already happened. When you consider the massive pool of savings that has built up over the past year it could be that those concerns are overdone, at least from a national perspective. Some individual states or industries might still struggle.



Source: ABS, APRA, Treasury, Macquarie Macro Strategy

Portfolio comment

The Fund underperformed in January, giving back a little of the strong returns generated in 2020. It benefitted from holdings in waste management company Bingo Industries and conglomerate Wesfarmers; and not owning either Sydney Airport or accounting software company Xero helped. Against that however were its holdings in iron ore exposures Fortescue Metals and Deterra Royalties, industrial property developer Goodman Group, Macquarie Group and Qantas which all held performance back. Not owning Afterpay or BHP were also impediments.

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)	-0.9	9.6	1.3	11.1	11.8	9.6	10.1
S&P/ASX 300 Accumulation Index	0.3	12.1	-2.7	7.1	10.1	7.8	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, 31 January 2021.**
^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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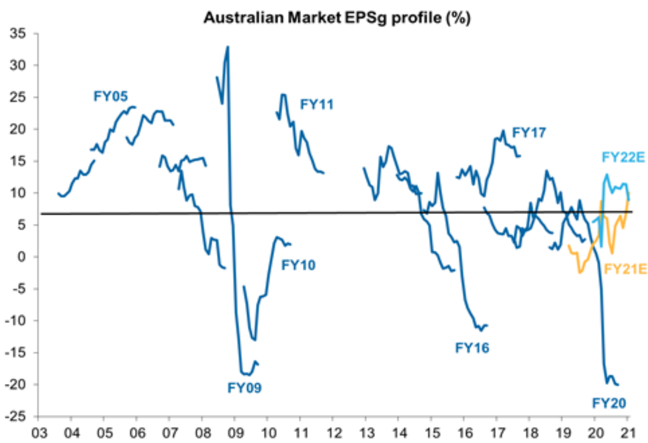
Market Outlook

The much-publicised battle between hedge funds and a new generation of retail investors has had some noticeable short term impacts on equity markets around the world but these appear to be largely technical and are unlikely to have enduring effects on the broader market. Earnings growth and bond yields are likely to remain the key determinants of market outcomes also in 2021, in our view.

One month into the new year not much has changed in this respect. Leading economic indicators have come off their highs in some regions although they remain at levels associated with strong economic growth. Bond yields have inched up, despite the RBA's increased bond buying program, and the Australian dollar remains stubbornly high. These two factors are creating some valuation and earnings headwinds, but primarily for specific sectors rather than the market as a whole.

As such, while price to earnings multiples remain at historically elevated levels and it would be reasonable to expect these to come down, earnings growth should be comfortably double digit this year and this should provide scope for both some contraction of the market multiple and positive equity market returns. The chart below, courtesy of Macquarie, shows that earnings growth has averaged about 7% per annum across the market and that the trend for revisions is down more often than up. It shows just how steep the EPS downgrades were last year (FY20), approaching those of the Financial Crisis more than a decade ago. It also shows the unusual situation we are currently in where earnings are on average being revised up across the market, partly a result of strong commodity prices.



Australia's interim reporting season is about to get underway so we should get a good read over the course of February as to how companies are tracking. While the reporting of December quarter results in the US is yet to conclude, results there to date have been encouraging with more companies than normal beating market expectations and, importantly, issuing broadly positive outlook commentary.

Portfolio Outlook

Despite the on-going debate over which type of investment style is best positioned to outperform, we continue to find that sectors or companies which can provide earnings leadership through positive changes in their current outlook tend to outperform, regardless of whether they happen to be classified as growth or value stocks. We identified a number of those over the course of 2020 and remain confident in our ability to do so as we go through 2021.

Given the cyclical tailwinds and the likelihood of bond yields moving higher we remain overweight Resources, although we have taken some profits in the iron ore producers and instead increased our steel exposure.

We went overweight Banks in the second half of last year. While we know that lending margins remain under pressure, credit losses – and as a result the banks' capital positions – are likely to provide a tailwind for now. We also see earnings upside in select Industrials, Consumer Discretionary and Building Materials companies such as plumbing products manufacturer Reliance Worldwide, retailer Super Retail Group and building materials producer CSR.

We are underweight Real Estateand Infrastructure stocks. We think the demand/supply outlook for office and retail property looks challenging and higher bond yields will be another potential headwind. We are also underweight Technology. The sector has performed strongly in recently but valuations look very stretched.

Our main exposure to higher earnings multiple stocks is in Healthcare. Notwithstanding the fact that the sector has been out of favour in the last few months, our holdings in the sector have a number of underappreciated earnings drivers. Some of these are structural but some should also provide strong earnings leverage in the current environment.

Top five active overweight positions as at 31 Jan 2021	Index weight %	Active weight %
Fortescue Metals Group Ltd	1.9	3.0
Oz Minerals Limited	0.3	2.4
Lifestyle Communities Ltd	0.1	2.4
Steadfast Group Ltd	0.2	2.1
Goodman Group	1.6	2.0

Asset allocation	31 Jan 2021 %	Range %
Securities	99.7	90-100
Cash	0.3	0-10

Source: Fidante Partners Limited, 31 January 2021.

BTW

Some people hold the view that the share market is just gambling, no better than going to a casino or the races. We strongly disagree with this but, of course, we know people can use it that way. Shares are actually part-ownership of companies which employ people and carry out economic activity, and in our view should be used for investing, not speculation. Some however like to do that: buy shares and sell them again after an extremely short period – hours, days or weeks.

We've written previously about the Robinhood app which provides Americans with zero-cost share trades, and that platform has been at the forefront of recent events. Day-traders have been around for ages but the confluence of free trading and the recession in the US has meant that people could sit around at home all day and turbocharged that activity. The frothy market conditions that have been in place since the initial panic last March also made it look really easy to make money punting shares all day, gambling on short term price movements.

There is a saying that if someone is providing a product you're not paying for, then you are the product. The unspoken promise of Robinhood is that it is taking from the rich and giving to the poor, enabling the little guy to get back at those in power. Robinhood however is only able to provide transactions for free because it sells the information and flow of its customers to financial services company Citadel LLC, which operates a large hedge fund. The events around US company GameStop have already been well covered in the media and we don't intend to go over it here. The company was highly shorted by hedge funds, which seek to identify struggling companies and sell shares they don't own in the expectation that they can profit from buying them back more cheaply in the future. How can someone sell something they don't own? We go into this briefly on p4.

GameStop shares aren't very liquid and essentially all the shares in the company had been lent out, making it a prime candidate for a short squeeze. No one knows who started it, but the WallStreetBets (WSB) forum (language warning!) on social media platform Reddit started to push GameStop shares and the crowd started buying them. This sounds a bit like collusion, which is illegal, but with many thousands of individuals doing the same thing and no one formally telling them to do it, it would be difficult to prove and impossible to prosecute.

So the squeeze started, with shares going up 25x during January, from $20 to $500. The pain was intense for at least one hedge fund, Melvin Capital, which lost 53% of its investors' money in the month of January alone, according to Bloomberg. Melvin was forced to raise several billion dollars from other hedge funds, Citadel being one.

Some companies perceive hedge funds as vultures who manipulate share prices lower for their own gain, so there wasn't much sympathy from CEOs of other companies whose shares had also been the subject of shorting. Tesla chief Elon Musk's contribution to the debate was a single tweet of support: #GameStonk, which encouraged WSBers even more. Many of the posts in WSB use similar language to that used in the post-election defence of Trump, employing the same trope that "we're rallying together in a noble cause to fight back against a great conspiracy and we need to hold the line and not let them get away with it". It is quite possible however that they were, and are still, being used as pawns in a bigger game with a fair bit of manipulation going on behind the scenes.

At the peak of the frenzy Robinhood stopped its clients buying GameStop for a few days. There was a valid reason to do this: it was required to raise a couple of billion dollars of fresh capital to satisfy regulatory requirements due to the massive volumes of business it was doing in the stock. But many Robinhood clients interpreted it as a huge betrayal, siding with the big guys when the platform should be sticking up for them. This added to the feeling of conspiracy. Some other brokerage houses also ceased allowing GameStop buys as they were concerned that some clients might not be able to settle the trades.

As with most manias, it will probably end with a few early people making a lot of money and most losing a lot. We don't think there will be too many ongoing impacts on equity markets but it has been a massive wake-up call for hedge funds. It is unlikely to destroy the whole model as there are thousands of companies out there to short and only so much attention span, mental bandwidth and capital available for this band of individual investors to fight them with. But you can be sure that the hedgies will now be keeping a very close eye on these sorts of forums, and no doubt making their own contributions to them, as having a whole lot of individuals gang up on you like this can really spoil your month.

Some other challenged and well-shorted companies saw the same thing in January including cinema operator AMC Entertainment: its shares went from $2 to $20 during the same feeding frenzy. Fundamentals generally win out in the end though: by early February AMC was trading back towards its lows and GameStop shares were $50. Many WSBers are now nursing hefty losses but also maintaining the rage, some even taking out billboards like this one all around the country promoting their loyalty to the cause! Strange days indeed.

Short Corner

Shorting shares has been around for hundreds of years but it has become very prominent with the rise and rise of Hedge Funds over the past 20 or so years. It is effectively a negative investment in a company – you sell the shares before you buy them and profit if the share price goes down. It is not possible (or legal) in most countries to make a "naked" short sale – i.e. sell shares that don't exist. You need to have access to the shares being shorted and you can do this by borrowing them from someone before you sell them. You will need to deliver those shares back to the lender at some point in the future, which you do by buying them back on the market and handing them over to the lender. If the shares have fallen between borrowing and closing out you make money. If they have gone up, you lose.

A big difference is that when you buy shares, the most you can lose is 100%, i.e. the money you outlaid. But when you short shares the potential for losses is virtually unlimited. GameStop a case in point: if you had borrowed and shorted shares when they were $5 and were required to cover those shorts at $100, you've lost $95 per share (plus whatever you've paid in borrowing fees). If you covered at $500 you've lost $495. If they'd gone to $10,000, you've lost $9950. That's why most shorting strategies employ stop-losses, a process of covering the short position when a certain level of loss is triggered. If those had been in place at, say, $20, the funds would have lost "only" $15 a share. It seems some didn't.

But how do you borrow stock in the first place? Who would lend their shares to another party solely so they can profit from their value going down? Fair question and one that we sometimes struggle with. We don't lend the shares owned by this Fund but some shareholders do. There is a financial incentive of course, the borrowing fee, however unless the stock is in very high demand for some reason the going rate is generally quite modest. And when borrow is in high demand and the rate is high, that's probably just the time you don't want to have it lent out.

It can work in favour of the lender too though. If the borrower's thesis is wrong, or events emerge that get in the way – a take-over bid for instance – the rising share price is good news for the lender, bad for the borrower. If the lender wanted to sell the shares it had lent out it would need to call the lent shares back from the borrower. The borrower would then have to either borrow the shares from someone else or close out the position by buying back on the market, which also pushes the price higher. So profiting from lending really requires the borrower to not be very good at shorting, and people/companies like that tend not to last very long. The risk/reward trade-off doesn't seem great to us, especially in the current low interest rate environment.

For further information, please contact:

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