alphinity INVESTMENT MANAGEMENT

Monthly Report – February 2021
Alphinity Sustainable Share Fund

Lowe expectations

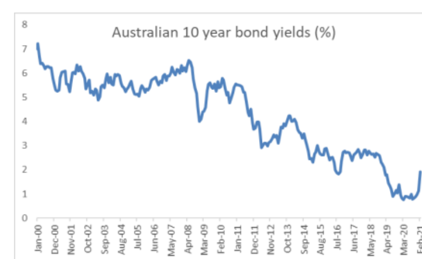
Market comment

Warren Buffett's offsider, Charlie Munger, was once asked the secret of his long and happy marriage. His answer (paraphrased) was "low expectations". This was pretty much the story of the long and mostly happy reporting season just completed, during which a surprising number of companies surprised positively. The first recession in 30 years now appears to be firmly in the rear-view mirror and, thanks to immense government largesse, the financial outcome wasn't too bad unless you were in certain badly-impacted sectors such as air travel, tourism or hospitality. But brokers' earnings expectations had been largely set during the depressed and depressing conditions of 2020, replete with its pandemic, social restrictions, and random lockdowns, so their earnings expectations were for the most part easily exceeded by actual results. The Australian market (ASX300 including dividends) however was up only 1.6%, perhaps suggesting investors were already anticipating some of the earnings "beats". Sectors that did best in February were Mining, Materials and Financials; Utilities, Technology and Consumer companies however were out of favour.

February was a period of intense activity. Most of the month was dominated by results although there was a rather uncomfortable shift higher in bond yields towards the end. This put pressure on some share prices, including a small number in the Fund's portfolio that had already reported strong results and made good gains. The launch of the national vaccine program also gave a fillip to companies which had been beaten up over the past year, with optimism around the implications for travel and tourism particularly evident, even though actual recovery could still be some time away.

Resource companies were the undisputed stars as the prices of commodities headed to new highs. BHP, one of our biggest companies, rose by 13% in February alone, adding $16 billion to its market capitalisation. Others did extremely well too in percentage terms even if the dollar value added was less extreme: Fortescue put on 10% ($7 billion) Rio Tinto 15% ($6 billion) and Oz Minerals 20% ($1.2 billion).

Bond yields, and interest rates generally, have been a significant factor in equity market returns in recent years. Local and US bond yields have been at historically low levels, well below 1%, recently but in February they headed sharply higher, reaching 1.9% at the end of the month. This move is noticeable even with the perspective of 20 years.



The reason for the move in yields is not clear but the same thing happened in the US at the same time. The most plausible explanation is rising fears of inflation although there are thus far few tangible signs of inflation happening. Whether the spike in yields is a short-term phenomenon or the start of a more significant and sustained move higher is yet to be determined but it certainly gave the market a fright and reminded a few people of some of the macro risks lurking out there.

We have high expectations of our central bank's ability to manage inflation but Reserve Bank of Australia Governor Lowe could have a task ahead of him if things start getting out of control, even with the $200 billion worth of quantitative easing already announced and under way.

Portfolio comment

The Fund outperformed the market nicely in February. It benefitted from holdings in resource exposures Oz Minerals and Iluka as well as affordable housing provider Lifestyle Communities, global insurer QBE and global asset manager Macquarie Group. Not owning consumer finance provider Afterpay, supermarket Coles or gold producer Northern Star also helped. Major detractors from performance were IT security company Nuix, retailer Wesfarmers, lightweight parts maker Carbon Revolution, industrial property developer Goodman Group, medical device company Fisher and Paykel, and IT exposure Megaport; not owning resource company BHP also hurt.

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)	2.1	3.2	10.9	11.1	13.3	9.6	10.2
S&P/ASX 300 Accumulation Index	1.5	3.2	7.1	7.5	10.9	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, 28 February 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

Economic macro data and corporate earnings news have both continued to surprise positively. Indeed, based on changes to earnings expectations for FY21 the February reporting season in Australia was the strongest in more than two decades. To some extent this reflected a pull-forward of the earnings recovery the market had been forecasting over the next 18 months rather than a multi-year cyclical upswing, which was evident from much smaller upgrades to FY22 consensus earnings than for the current financial year. Nonetheless, the fact that earnings growth of more than 30% is now expected for the current financial year is welcome news for the market. It had started the year needing strong earnings growth to justify the unusually large earnings multiple expansion that had taken place – to more than 20 times – since the current upturn started in March 2020.

As we have written about before, the degree of earnings growth and the trajectory of bond yields are likely to be key determinants of equity market returns this year. While earnings so far haven't disappointed, bond yields have started to react to the strong economic recovery both here in Australia and overseas. How far and how fast yields increase will have important implications for relative sector performance and overall market returns.

A gradual and steady rise in bond yields should be manageable at the overall market level but the implication for individual sector could still be significant, with the most highly-valued sectors such as Information Technology and so-called bond proxies like Infrastructure and Property most exposed. A sharper rise however could be more troublesome for the overall market as it might trigger a more broad-based correction. If this were to happen some of the more cyclical sectors that have so far done well in the recovery could be vulnerable to a more general "risk off" sentiment. While market returns were positive in February, the sharp rise in bond yields at the end of the month has arguably increased the risk of a more general correction occurring in coming months.

While the outlook statements of many companies highlighted the uncertainty associated with the upcoming end of the JobKeeper stimulus, an improvement in corporate confidence was evident in much better dividend outcomes. In fact, dividend forecasts were increased even more strongly than earnings. A dividend yield of close to 4% now is forecast for the next 12 months. Further dividend upside could be seen if the economic recovery continues to surprise positively, and this would provide solid support against a more pronounced market weakness.

Portfolio Outlook

We achieved a strong scorecard for the February reporting season with earnings expectations improving across a range of portfolio positions. Importantly, many stocks in the portfolio received earnings upgrades, not only for FY21 but also for FY22, for which upgrades across the broader market were less commonplace. This should position the portfolio well for further out-performance.

We have continued to invest in stocks and sectors where we see ongoing earnings leadership, and where new leadership is emerging. This has broadly meant increased exposure to more cyclical stocks and sectors which are positively correlated with rising bond yields. However, recognising that the cyclical recovery is no longer in its early stages and that some of the inflationary pressures are likely to be temporary, we have also taken some profits in Resources where many commodity prices are trading at multi-year highs. While the demand/supply outlook remains favourable and there are thus far only limited signs of the larger miners losing their much-improved capital discipline of recent years, history suggests that any broader equity market concerns could have an outsized impact on stocks in this sector.

The increase in the yield of longer-dated bonds has also caused a significant correction in many so-called long duration or high multiple stocks which for several years, and especially during the collapse in bond yields in 2020, rose in a manner that only those of us who were around during the late 1990s/early 2000s tech boom and subsequent bust would have seen in their careers. While this correction was in many cases long overdue and has further to run, in our view, it has made some stocks for which earnings growth expecations look too low considerably more attractive and under active consideration for the portfolio.

The market's enthusiam for companies with leverage to the economic cycle has also meant that some more defensive but reliable earnings growers have been left behind. We have taken the opportunity presented by the current market mood to add to our holdings of some of these.

Top five active overweight positions as at 28 Feb 2021	Index weight %	Active weight %
Fortescue Metals Group Ltd	2.1	3.2
Oz Minerals Limited	0.4	2.7
Lifestyle Communities Ltd	0.1	2.4
Iluka Resources Limited	0.2	2.1
Macquarie Group Ltd	2.5	2.0

Asset allocation	28 Feb 2021 %	Range %
Securities	96.2	90-100
Cash	3.8	0-10

Source: Fidante Partners Limited, 28 February 2021.

BTW

February saw the confluence of two of our favourite themes on this page: Tesla and Bitcoin. Both are fascinating case studies by themselves but their worlds collided in February when Tesla founder Elon Musk announced that the company had invested $US1.5 billion dollars in Bitcoin. Tesla had $US19 billion of cash in December and the board must have thought that keeping it all in the bank for a zero return was a poor outcome so they put some of it into Bitcoin. We don't know exactly when Tesla bought it but Musk started giving hints in January that something was afoot when Bitcoin was trading at about $US30,000. The endorsement by this visionary, who was until recently the world's wealthiest person, was enough to send Bitcoin rocketing to $55,000, before finishing the month at $US45,000. This led to some observers to wryly note that Tesla made more from Bitcoin in a month than it had from making cars for 13 years (Tesla became profitable for the first time in 2020, earning $US690 million in profit after tax after sustaining years of losses).

We've written before about some of the shortcomings of cryptocurrencies, including that forgetting one's password inevitably leads to a loss of those coins for all time – not just to you but to the whole system. It has been estimated that up to a third of the total Bitcoin that will ever be available has been lost in this way. The bulls will tell you that this inherently makes the remaining coins more valuable and this is possibly true. And to be fair, physical gold can also be lost or stolen in the same manner, although it's harder to just forget it. But it certainly adds an extra frisson of excitement to "investing" in cryptocurrencies.

In the current era of Modern Monetary Theory (MMT) in many countries, which entails massive monetary expansion being undertaken by central banks, the spectre of currency debasement has made cryptocurrencies like Bitcoin popular in some circles. People look back to hyperinflation in Germany in the 1930s, or in Zimbabwe in more recent times, and see potential for MMT to one day trigger something similar. They reason that as there will only ever be 21 million Bitcoin in existence (18m have already been mined) but the supply of money is increasing exponentially, each Bitcoin must inevitably become more valuable. There is some intellectual appeal to this, although being rare does not in and of itself make something intrinsically valuable – there also needs to be some substance behind it, in our view. Supply and demand, however, are undeniably powerful forces. The demand currently being seen for Bitcoin and some of its ilk might turn out to be as ephemeral as the coin itself. Of course it might turn out to be the new dominant global currency and even >$US40,000 per coin might be a bargain. You will only be able to tell with the benefit of hindsight.

While Bitcoin itself might have a finite supply, the same can't be said for cryptocurrencies as a group. Coinmarketcap.com keeps track of more than 8000 different cryptocurrencies, but Bitcoin is by far the biggest and most well-known. It presently accounts for more than 60% of the total value of all coins out there. Its total value exceeded $US1 trillion at its most recent peak. The total for all coins is $US1.4 trillion. You could say the rest are bit players.

Tesla's move not only notionally links its share price to the price of Bitcoin, it also works against the company's environmental credentials. Tesla has made a lot of noise as being part of the solution to climate change on the basis that electric vehicles (EVs) don't produce as many emissions as conventional vehicles. There are lots of puts and takes involved in working out whether making and driving an EV is really clean but we know for sure that Bitcoin is not.

One "mines" for coins by processing complex mathematical equations requiring immense computing power consuming immense amounts of electricity. Like mining for resources, the closer you get to the end of the resource, the harder it is to find what's left. University of Cambridge has built an estimator of the energy expended mining for Bitcoin which calculated that around 120 terawatt hours of electricity is being used annually just on mining Bitcoin – and there are plenty of other coins being mined at the same time. 120 terawatt hours is as much as the whole of Australia consumes in six months. Whether this represents a good use of the world's remaining carbon emissions budget is debateable.

The other intersection of Tesla and Bitcoin was Musk's statement that Tesla would start to accept Bitcoin in payment for its cars. This poses some challenges, as Bitcoin's price can (and does) move by 10% or more in a day. Details are as yet scant but we presume Tesla won't put out a price list denominated in Bitcoin, that would still be in $A or $US and then the buyer would pay use Bitcoin to pay the equivalent at whatever the prevailing exchange rate might be. There is huge scope for remorse if you settled on your new Model 3 in Bitcoin which was worth twice as much a few weeks later! Just inserting a Bitcoin payment facility into the purchase process at whatever the exchange rate was at the time of settlement doesn't sound that novel or demanding. Equally, unless you were in a country without an effectively functioning banking system, paying with Bitcoin wouldn't seem to offer a tangible advantage either.

As we discussed last month, there is a difference between investing and speculating. When using ephemeral entities like cryptocurrencies, which exist only in the virtual world, are easily lost, pay no income and whose success is solely from buying it at a lower price than you end up selling it for, the current action in Bitcoin looks to us like speculation.

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BTW2

There's been a bit of buzz about SPACs lately, including whether we'll end up having any in Australia. What is a SPAC you might ask? In typical financial markets fashion, it's a new acronym for an age-old concept. SPAC stands for Special Purpose Acquisition Company, a company whose assets are essentially cash and not much else.

There are hundreds of SPACs listed in the US with hundreds of billions of dollars of cash available to invest. Last time we saw them in our market they were known as cashboxes. The ASX outlawed cashboxes in the 1980s due to the risk they pose to minority shareholders, who are likely to end up with something completely different to what they originally signed up for. The last surviving cashbox from that era of which we are aware is Premier Investments, the listed vehicle set up by Melbourne billionaire Solomon Lew in 1987. For many years Premier just had a truck load of cash and a couple of stakes in listed companies it particularly favoured. 30+ years later it still has $450m of cash on its balance sheet.

SPACs are commonly used in the US to skirt the very demanding process of taking a company from private ownership to the listed space. SPACs can raise funds well before any deal is done and then buy a business without the need to issue a prospectus, which would need to have forecasts the market could hold it to. While we can see the obvious benefit for those avoiding scrutiny, investors appear to be foregoing a large amount of protection.

Macquarie's Asia-based equity strategist Viktor Shvets reminded us of the famous book by Charles Mackay, Extraordinary Delusions and the Madness of Crowds. It was first published almost 200 years ago but still speaks to the situation today. Mackay relates the story of a man who said he would be starting "a company for carrying on an undertaking of great advantage but nobody knows what it is", which sounds a bit like many of the SPACs going around. The next morning, the promoter was inundated with money from eager investors. Having suddenly won the lottery, he fled town. Mackay described it thus: 'He was a philosopher enough to be contended and set off the same evening for the Continent. He was never heard of again'.

It would not surprise us if something similar happened to a SPAC at some point. In frothy times like this, with its low interest rates and the amount of money that has been thrown about by governments and central banks in many parts of the world, risk appetite is immense and some investors are not as discerning as they should be. As one commentator said: "There have been bubbles before, but I don't think there's ever been a bubble where investors got excited to buy into an asset class with a proven track record of failure that combined buying assets for absolute top dollar with management teams incentivized to get a deal done at any price".

Caveat Emptor – let the buyer beware – applies in most situations, but particularly to SPACs.

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