Quarterly Report – March 2021
Alphinity Concentrated Australian Share Fund

Cycling the Panic

Market comment

In the March quarter, the market rose by a pleasing but unexceptional 4% (ASX300 including dividends). Thinking back to this time last year however, in March 2020, the market was in the process of having a full-blown panic attack about what a pandemic might do to the global economy, particularly to corporate earnings which are the key drivers of share prices. The ASX300 tumbled 37% in the four weeks from its late February 2020 high to a low in the last week of March, the shortest, sharpest bear market we have ever seen. 12 months on from that we are now starting to cycle those panicked times, resulting in some very large numbers showing up.

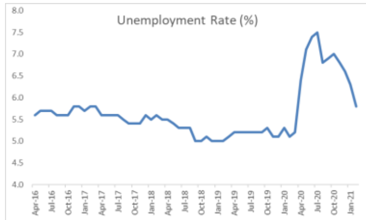
Things quickly started getting better after April 2020, at least for economies and equity markets; the human toll kept getting worse in many places and is only now really showing signs of improvement in some. Contrast the time of panic with the situation today, in which many global equity markets are at or close to all-time highs despite the ongoing economic impact Covid has had on many countries and companies. Australia’s economy seems to have escaped relatively unscathed, with the exception of a few sectors, thanks to the enormous amounts of government largesse thrown at it.

Australian shares were in the middle of the pack in terms of global returns: the US and UK did a bit better than our 4% with about 7% for the quarter in $A terms and the major European bourses in Germany and France were around 6% but some markets in Asia did a little worse: Japan rose only 1% for the quarter, China fell slightly and both NZ and Brazil were more than 5% lower for the quarter. Within the Australian market, the IT sector was the worst-performing, falling 11%, and Health Care was off 3% but Telecoms, Consumer Discretionary and Financials were the stars with returns between +7% and +11%.

The $A was reasonably steady over the quarter, slightly softer against the $US but slightly stronger against the Euro and Yen. Bond yields however rose sharply during the quarter, local ten years moving from 0.9% to 1.8%, in line with US bond movements.

The prices of some commodities also moved substantially in the March quarter: Oil was up 25% in $A terms, Thermal Coal rose 21% even though Metallurgical Coal fell 20%. Iron Ore was up only 2% for the quarter but remains at very high levels compared to historical trends, around $US150. Base Metals were mixed, with Tin up 35% over the quarter, Copper +15% and Aluminium +13% although Lead was unchanged and Nickel fell 2%.

Economic news closing out the quarter was pretty good, with unemployment falling substantially from 6.5% to 5.8% in February, much more quickly than had been expected. Most of the jobs gained were full-time suggesting a degree of resilience in the economy. This provides some hope that the end of the JobKeeper income support program might not be as disruptive as previously feared. Strong job advertisement numbers point towards further improvement in coming months. Banks are reporting very high demand for housing loans with owner-occupied loan applications up 11% and for investor loan applications up 9%. This is also being reflected in concerning house price growth in both major cities and regional areas. Notwithstanding all of this the Reserve Bank remains firm in its guidance of a zero cash rate for the foreseeable future.



Portfolio comment

The Fund outperformed the market substantially across the March quarter. It benefitted from holdings in National Australia Bank, resource exposures Oz Minerals and BHP and Super Retail Group while not owning consumer finance company Afterpay, gold producer Northern Star, supermarket Coles Group, tech company Xero or infant formula maker A2 Milk also helped. The largest detractors from performance were vaccine manufacturer CSL and not owning major bank Westpac or telecoms company Telstra.

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)	3.1	5.3	36.7	9.7	11.2	9.4	10.3
S&P/ASX 200 Accumulation Index	2.4	4.3	37.5	9.6	10.3	8.0	8.7

*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 March 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.

Market outlook

The strength of the economic recovery and its flow-on effect on bond yields are likely to continue to dominate the investment debate for the next several months. On the economic front data continues to come in ahead of expectations and this has positive implications for corporate earnings. With the vaccine rollout well underway in many countries and few signs of fiscal stimulus being meaningfully reined in, the economic outlook in much of the world remains positive. Australia's own vaccination program has been progressing more slowly. While disappointing for those looking forward to an overseas holiday, the success we've had in keeping the virus at bay should significantly limit any economic fallout from this delay.

Bond yields still appear too low in this context but may, having increased significantly over a short period of time, consolidate around current levels until more data on the progress of inflation and the durability of the economic outlook becomes available. While earnings growth remains solid and there are multiple sources of further upside from things like lower bad debt charges for the Banks, commodity prices staying high for Resource companies and the ongoing general reopening of the economy, this now appears largely reflected in share prices, with the Australian equity market now having more than recovered all of its Covid-induced decline.

Further upside in the short term is thus likely to require a sustained fall in bond yields driven by reduced inflation concerns, or even stronger earnings growth. While neither is an impossible outcome, they are also not things we would be willing to rely on.

Top five active overweight positions as at 31 March 2021	Index weight %	Active weight %
BHP Group Limited	7.0	3.6
National Australia Bank Limited	4.5	2.5
Woolworths Group Ltd	2.7	2.5
Commonwealth Bank Of Australia	8.0	2.5
Macquarie Group Ltd	2.7	2.1

Asset allocation	31 Mar 2021 %	Range %
Securities	96.7	90-100
Cash	3.3	0-10

Source: Fidante Partners Limited, 31 March 2021.

Portfolio Outlook

With few changes in terms of our overall view of the world and following the solid earnings upgrades we experienced across the portfolio during the February reporting season, we don't see any reasons to make significant changes to our overall portfolio positioning, which worked well in February and March.

We have continued to be disciplined and take profits in the Resource sector as the share prices and short term earnings expecations of many resource companies have risen in tandem. There remains signficant earnings upside for many of these companies from FY22 onwards if the prices of many commodities, especially iron ore and copper, hold at anywhere near current prices. However, FY21 earnings are now increasingly factoring in prices around spot and we have limited confidence in prices remaining at current levels for the next 12-15 months.

Following the sharp selloff earlier in the quarter in some of the more yield-sensitive sectors, like Technology and many high multiple stocks, the rebound over the last few weeks as bond yields stabilised has been equally swift. We continue to see many of these stocks as being vulnerable to further interest rate increases over the course of the year but the selloff did create some opportunities which we took advantage of.

One such company is Domino's Pizza Enterprises. We have long been admirers of the company's growth ambitions, its execution and the potential earnings upside from it growing its operations in Japan and its expansion in Europe. Following some years of investing and bedding down the strategy in these markets, Domino's February interim result provided some clear indications that earnings momentum is now building as they get to scale in several markets. This, in combination with a macro-led correction in the share price, provided an attractive opportunity, in our view.

We have for some time argued that the market has been too quick to discount the changes in consumer spending patterns due to Covid. While we do recognise that they will normalise over time, the latest setbacks in Australia's vaccination programs are likely to reinforce and further extend these consumption trends. As such, we remain well invested in quality retailers such as Super Retail Group and Wesfarmers.

BTW

Stephane caught up with Andrew Forrest, of Fortescue Metals fame, in March. Fortescue has become one of the largest iron ore miners in the world which has placed Forrest's family among Australia's wealthiest. Great wealth brings with it great opportunity and, to their great credit, the Forrests have not just piled up gold coins in their basement to roll about in, Scrooge McDuck style. Rather, they appear to be genuinely putting that wealth to work in ways that have the potential to make the world a better place.

The Forrests' charitable foundation has so far engaged in various activities with the aim of addressing some of the world's more invidious problems like stopping slavery, improving the living conditions of indigenous Australians, curing cancer and dealing with the vast amounts of plastic waste our society generates. Forrest's latest project seeks to drive the country's transition to green energy, through Fortescue Future Industries (FFI), which sits within the listed company Fortescue Metals. It is not intended as a philanthropic activity though; the plan is to make money.

Fortescue has been a key beneficiary of high iron ore prices over the past few years and the Alphinity funds have done very well from owning it since we bought into it at less than a quarter of the current share price in early 2019. The Forrests themselves and their foundation are receiving enormous dividends and Fortescue's minority shareholders have also done very well. So have the people of Australia: iron ore royalties have been one of the few financial bright spots in the country's income statement.

Andrew Forrest presented this vision to the market. While quite long and slightly clunky in delivery (he could learn some presentation skills from the slick Silicon Valley tech sector!), his plan is for FFI to generate green electricity on a huge scale, more than Australia's present total electricity output, using renewable sources. [Interestingly, last year a fellow-billionaire, one of the founders of tech giant Atlassian, proposed another massive renewable energy investment with the aim of becoming a significant energy exporter, although in that case it would essentially be a very long extension cord reaching to Singapore.] FFI's proposed project however would use the electricity to make green hydrogen and green ammonia which can be used to power mines, ships, trucks, trains and whatever else, and even exported. It also aims to make steel in Western Australia without using coal, so with zero emissions. So far there have only been trial plants elsewhere in the world making green steel; FFI plans to do this at scale. If it is able to achieve this, it could not only have a global impact but also diversify the market for its existing iron ore mines away from China.

One of the challenges around green energy is that while pretty much everyone thinks it's a good idea and is certain that it's the way of the future, until recently the cost of the technology was prohibitive. This changed with economies of scale and it now appears to be much cheaper to build wind or solar per unit of production than anything else, even if you ignore the cost of pollution. Renewables are also much quicker to build and the plants are generally of smaller scale and geographically dispersed, meaning that the grid should be more resilient. Reliability of supply would still be a concern but can ultimately be controlled with storage.

Andrew Forrest is a polarising figure. We've had many dealings with him and the company since the early days of Fortescue and have found him to be quite visionary, even inspiring at times. The delivery of his iron ore projects has been impressive. Some people in the markets however can't forgive his first mining venture, Anaconda Nickel, which blew up spectacularly 20 years ago. Many were convinced that Fortescue would head in the same direction, especially a decade ago when the company had very large debts and very little revenue. Fast-forward to today and Fortescue is now essentially free of debt and generating train-loads of cash which its stakeholders – not just shareholders – are sharing in. FFI has the potential to be similar but it is certainly not free of risk.

Our only criticism is that this is a venture that would probably be better done by the Forrests' foundation rather than the listed company. Most Fortescue Metals shareholders would own shares in the company for exposure to its iron ore assets, and some might resent being co-opted into the vision of green energy, which is likely to be relatively slow to come to fruition and even slower to generate returns. This is something the listed market often struggles to deal well with. Yes, you need to take a long-term viewpoint and the 10% of earnings being allocated to FFI is hardly betting the farm, but any visionary start-up like this requires a degree of patience the listed market often struggles to provide.

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Non-traveller's Tales

The world became transfixed by the situation in the Suez Canal in March when the 400 metre-long, heavily-laden container ship Ever Given, operated by Taiwanese transport company Evergreen, became wedged across the canal, blocking it for almost a week. The cause of the incident has yet to be fully explained: initially it was thought to be strong winds pushing against its high load of containers like a sail but there have subsequently been suggestions that a degree of human error was also involved. Usually when this sort of thing happens it is due to a combination of factors but the end result was the same – a blockage of the Canal for a number of days and the reminder of how vulnerable world trade is to a small and totally foreseeable event like this.

The Suez was one of the engineering miracles of the late 1800s, opening up a shipping route between the Indian Ocean and the Mediterranean which obviated a lengthy and dangerous trip around the bottom of Africa for trade between Asia and Europe. Around an eighth of the world's trade traverses the Canal, and this could be observed by the build-up of more than 400 ships while the Canal was blocked. Some ships opted to head south around Africa, adding more than a week in time and a lot of cost for fuel onto their journeys, but the backlog was cleared within a week of re-opening. The main impact for Australia will probably be a shortage of European cars for a little while. The toll for a ship to go through the Suez can be as high as $US300,000 and the Canal has become a significant income generator for Egypt, contributing as much as 2% of its GDP according to some estimates. Egypt has since claimed damages of $US1 billion for the blockage although considering most of the ships eventually went through it would appear that the actual damages would be much less than this.

It was then with some bemusement that we saw the same scene played out on a smaller scale. A truck operated by the same transport company, with the same writing emblazoned on its side, ended up in the same position on the Changchun-Shenzhen highway in southern China only a few days after the ship ran aground. While able to be rectified much more quickly than the ship, the pathos of the situation was lost on no one. Some even thought it was a set-up but myth-busting website Snopes investigated and confirmed it as being true. They say that bad luck runs in threes so we expect that the executives at Evergreen will be on high alert for something else to go wrong!

For further information, please contact:
Fidante Partners Investor Services | **p:** 13 51 53 | **e:** info@fidante.com.au | **w:** www.fidante.com.au
Fidante Partners Adviser Services | **p:** 1800 195 853 | **e:** bdm@fidante.com.au | **w:** www.fidante.com.au
Alphinity Investment Management | **w:** www.alphinity.com.au