Quarterly Report – March 2021
Alphinity Sustainable Share Fund

Cycling the Panic

Market comment

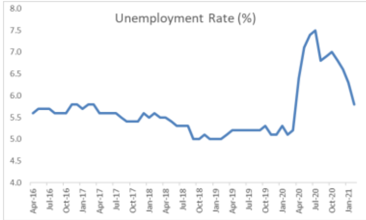
In the March quarter, the market rose by a pleasing but unexceptional 4% (ASX300 including dividends). Thinking back to this time last year however, in March 2020, the market was in the process of having a full-blown panic attack about what a pandemic might do to the global economy, particularly to corporate 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: unemployment fell substantially from 6.5% to 5.8% in February, much more quickly than had been expected, and 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 underperformed the market only fractionally during the March quarter. It did well from holdings in resource company Oz Minerals, waste company Bingo Industries and retailer Super Retail Group; not owning Afterpay, gold producer Northern Star, supermarket Coles Group, infant formula maker A2 Milk or tech play Xero, which all underperformed, also added to returns. Major detractors were tech exposures Megaport and Nuix, iron ore plays Fortescue Metals and Deterra, and lightweight auto parts maker Carbon Revolution. Not owning BHP also detracted from returns.

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)	2.6	3.8	40.4	13.4	12.7	9.7	10.4
S&P/ASX 300 Accumulation Index	2.3	4.2	38.3	9.7	10.3	7.9	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 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).

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 %
Fortescue Metals Group Ltd	1.7	2.4
Lifestyle Communities Ltd	0.1	2.1
Macquarie Group Ltd	2.6	2.1
Iluka Resources Limited	0.2	2.1
Goodman Group	1.5	2.0

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.

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 these patterns will normalise over time, the latest setbacks in Australia's vaccination programs are likely to reinforce and further extend domestic consumption trends. As such, we remain well invested in quality retailers such as Super Retail Group and Wesfarmers.

Asset allocation	31 Dec 2020 %	Range %
Securities	97.9	90-100
Cash	2.1	0-10

Source: Fidante Partners Limited, 31 March 2021.

Emissions

The estimated carbon intensity of the portfolio, using emissions data supplied by MSCI, is shown in the table below. It is well below that of the ASX300 benchmark. Almost any economic activity involves the emissions of CO_2 and the fact that our negative screens exclude eight of the ten largest emitters in the benchmark (which between them make up around half of the benchmark's total emissions) makes us confident that the fund is achieving its aim of minimising carbon emissions while still supporting companies which promote Sustainable Development.

Carbon Exposure Metrics

Scope 1 & 2	SSF	ASX300
Carbon Intensity*	**136.9**	**227.0**

* Weighted average tonnes of CO_2 equivalent emissions per $USm revenue
Source: Alphinity, MSCI. Data as at 31 March 2021.

SDGs

The chart below shows a summary of the Sustainable Development Goals positively and negatively addressed by companies in the portfolio as at 31 March in a format that was originally developed by Citi Research to show the proportion of revenues of each company that addressed Sustainable Development. It has since been evolved by Alphinity to also include an assessment of the companies' operational alignment to the SDGs.

Governance Spot

Rio Tinto put the Juukan Caves in Western Australia on the map in May last year, just after it removed the caves from the map for all time. On 24 May 2020 Rio set off explosives around the caves so it could recover iron ore that would be shipped off and sold to China for about $US100 a tonne. These caves had evidence of human habitation more than 46,000 years ago. It is an event many of us will not forget, a day Australia – indeed the world – lost a significant piece of indigenous heritage. It also shone a light on the cultural and systemic breakdown that had taken place over a number of years between the traditional owners and one of Australia's largest mining companies, one that had previously been perceived as a leader in ESG.

It still makes us extremely sad to think how easily this could have been avoided. If only the Traditional Owners had been adequately consulted in order to obtain their prior and informed consent, which would not have been given. If only cultural heritage was managed like safety is, in an integrated and holistic way. If only the CEO and Board, including the sub-committees, recognised the critical importance of governance and oversight in heritage matters. And if only the team on the ground was empowered to speak up. These are all things Rio is now trying to resolve. The event also triggered a series of shareholder actions that would end up costing three executives and at least two Board members their jobs.

A few days after the blast, in the midst of all the Covid travel restrictions, we had a call with the London-based Chairman of Rio to try and work out what went wrong. He promised a Board report and full cooperation with the many other enquiries around the matter. To his credit the Chairman followed this call up with several more calls over succeeding months with us and with others, and he made the CEO endure quarantine to go to the Pilbara himself in an attempt to make personal amends.

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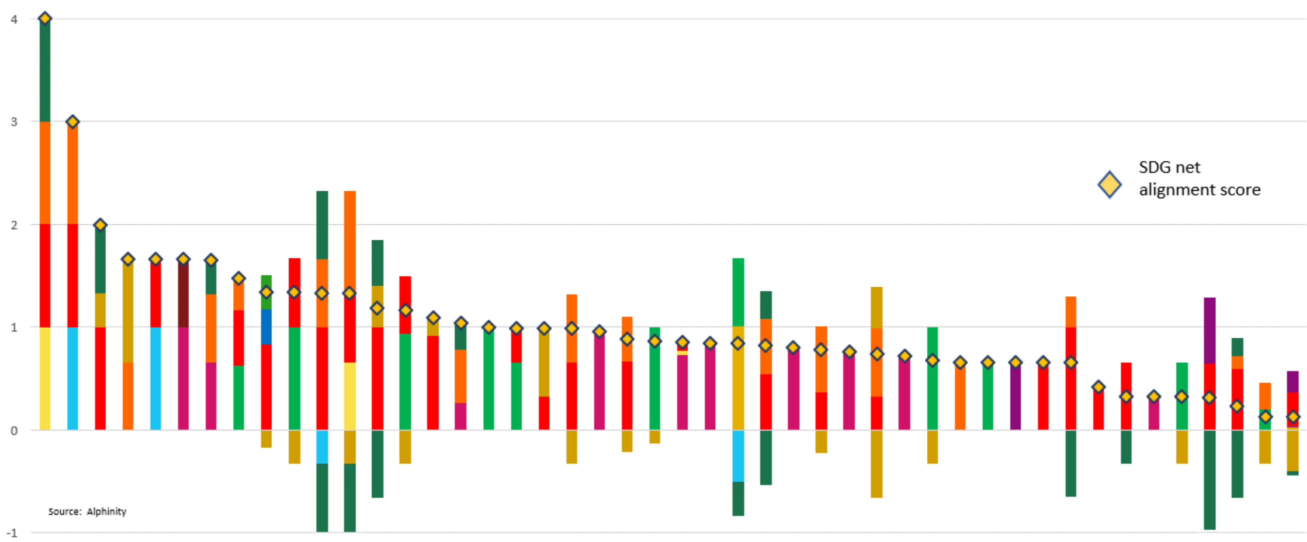

BTW

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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Governance Spot (cont from p3)

But when the Board report was delivered a few months after the blast, not only was it far from adequate, in our view, it failed to find anyone really accountable for the incident; apparently all the blame lay with people who had already left the company. Many shareholders, including ourselves, expressed surprise and concern about this and eventually the CEO and two senior executives announced their resignations.

Rio massively underestimated the implications of what it had done and the strength of the views of shareholders. Almost all decisions related to accountability it made after that – especially the decision to award the ex-CEO and executives to their full bonuses – has shown how out of touch it is with its shareholders' expectations. The director who produced the report into the incident resigned soon after. Another director resigned because of other business commitments. The Chairman has promised to resign this time next year and a few others are (or should be) considering their positions.

Rio is holding its annual shareholders meeting in May. Considering all the changes that have so far taken place, the Chair not seeking re-election next year, the changes to the Executive Committee and structure, and fundamental changes to the way they engage with traditional owners and heritage issues on site, we believe Rio is on the right path to start to repair its reputation and mitigate the risk of this type of event reoccurring. We are however highly concerned about the payouts received by the departed executives, who have left with bulging wallets. We are also highly concerned about the poor judgement demonstrated time and time again by members of the Board, including the Chair of the Remuneration Committee.

Otherwise we are supportive of the changes Rio is making to its heritage management approach, the revised organisational structure, and the introduction of a new Social Performance Team. We will continue to monitor the implementation of these changes, as well as the company's response to any further recommendations from the ongoing Federal Government enquiry when it is released.

Since the day of the blast, Rio Tinto shares have risen 17%, a bit less than the overall market's +22%. This compares with iron ore peers BHP +30% and Fortescue +44%. It would be reasonable to blame at least some of that underperformance on the events in the Pilbara – but at the end of the day the high iron ore price continues to support Rio shares.

Ultimately, when considering how to manage significant controversies and ESG related issues, we try to be forward-looking. Considering the changes it has made, we feel that the Rio of the future will be a very different company to the Rio of the past. The new CEO appears to be a cleanskin and has surely learned from the firestorm of public opprobrium the company was subjected to in 2020. For now, we are prepared to be shareholders, thereby keeping a seat at the table, but we will be keeping a close eye on its policies and conduct to make sure the changes are real and enduring.

[picture: archaeology.wiki]

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