Monthly Report – August 2021
Alphinity Concentrated Australian Share Fund

Bringing it Home

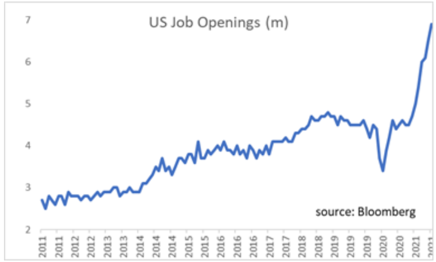
Market comment

The market continued to edge upwards in August (ASX300 including dividends), the 11th consecutive month of increases, buoyed by some generally solid results during reporting season and enhanced by a soupçon of corporate activity. Australian shares were up 2.6% for the month despite substantial falls in some of the largest companies on the Australian market, the iron ore miners. While the results reported were to the end of June, and therefore largely missing the widespread lockdowns that have subsequently taken place, corporate earnings were generally well-received.

It was a big month for large-scale corporate activity, starting with the proposed acquisition of loss-making local fintech company Afterpay by barely-profitable US fintech company Square Inc, a deal that if completed will go down as the biggest in Australian corporate history. A development with greater long-term implications was the proposal of BHP Group to collapse its dual-listed structure and also hand its substantial Oil and Gas assets over to local gas major Woodside Petroleum.

Earnings season gave investors a chance to respond to company-specifics rather than the macro, and overall large earnings beats drove similar gains in Europe (+2% in $A terms) and the US (+3.4%). Japan (+3.4%) and China (+4.8%) did a little better as they both recovered from weak performances in July. Capital markets however were somewhat unnerved by China's pledge for 'common prosperity' as policy makers seek to divide the cake more fairly rather than increase its size. A combination of increased regulatory scrutiny of technology and gaming firms, capping steel production and rhetoric against luxury consumption all negatively impacted related sectors, although some of the most levered stocks are already rebounding, suggesting the sell-off may have run its course.

In the US, a sharp drop in consumer sentiment and weaker jobs numbers pushed out rate hike expectations, although wages growth is something to monitor with labour demand remaining firm and average hourly earnings up 1.3% on the month. With the number of job vacancies at record levels, it is hard to see how wages there won't continue to go up. While Australia is behind the US in its re-opening, similar trends could occur here when that finally happens.



At a sector level, across reporting season there was a clear distinction between the outperformance of growth and defensives over the cheaper cyclicals. Tech (+16%, although that was boosted by the Afterpay bid), Healthcare (+6.6%) and Consumer Staples (+6.5%) were the best performers while falling commodity prices drove weakness in Energy (-4.9%) and Materials (-7.5%).

Commodities generally weakened in August, with a 30% decline in iron ore over the last two months weighing on our miners as China put the brakes on steel output. Oil fell 7.4% in August on demand concern given the rise in Delta cases and what this means for mobility. Conversely, Aluminium (+5%) and coal prices (coking coal +17%) surged as smelter closures in China led to rising spot prices.

Portfolio Comment

The Fund performed below the market in August. Afterpay was a big detractor, hopefully for the last time, but BHP was bigger after it was hit by the sharp fall in Iron Ore prices. Other detractors of note were from positions in auto spare parts distributor Bapcor and another iron ore name, Rio Tinto. On the positive side, not owning iron ore miner Fortescue Metals offset much of the drag from BHP, while positions in building materials company James Hardie, fast food provider Domino's Pizza, and insurance exposures Steadfast and QBE all made solid contributions to return.

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)	1.7	5.5	26.5	8.8	11.9	12.0	11.0
S&P/ASX 300 Accumulation Index	2.5	6.0	28.1	9.9	10.9	10.3	9.5

*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 August 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 Australian equity market has been supported over the last 12 months by three pillars: reasonable valuations, a strong cyclical earnings recovery and an extraordinary high level of liquidity in the global financial system. These supporting factors are one by one being removed, or at least becoming more fragile.

The first to go has been the valuation support. A Price to Earnings multiple of around 17 times, compared to long term averages of ~15, doesn't appear too alarming at first glance when you consider the extremely low level of interest rates. However, the overall market valuation is significantly flattered by the Resource sector which has been enjoying record high commodity prices but is trading on single digit earnings multiples. Excluding Resources the market is on a more sobering 22 times with the Industrials (excluding Resources and Banks) in the high 20s, the highest for several decades.

The market's dividend yield, which has over time offered valuable market support, tells a similar story. The overall market at 4% is not too far off longer-term averages but remove the dividend bonanza in the Resource sector and the market yield falls to 3%. This represents a significant premium to cash rates or bond yields but is still low in absolute terms.

The period of exceptionally strong earnings growth, thanks to an economy boosted by low rates and Government support, as we recovered from last year's Covid-induced recession is also likely to be largely behind us. While aggregate domestic earnings for the financial year just finished came in slightly ahead of estimates, the market's overall earnings growth expectations for the new were lowered slightly to a fairly modest 5-6%.

The current round of state lockdowns has of course had a meaningful impact on the short term outlook for domestic earnings and should to some extent be looked through, and at least some pent up demand should help things rebound as the lockdowns hopefully end in coming months. Even so, mid-single digit earnings growth is likely to be a good outcome for the year as first half earnings still appear too optimistic given the economic fallout.

So we find that we may again be relying on liquidity and low interest rates to keep the equity market buoyant. Record low interest rates combined with a surge in bank deposits would certainly suggest that investors will remain attracted to the higher potential return in equities, and the spread of the Delta variant has probably delayed any meaningful reduction of central banks' tapering plans by several months months. However, even so the drivers of the strong market rally are looking increasingly exhausted.

Portfolio Outlook

The Fund's holdings as a whole achieved better positive earnings revisions than the benchmark during the August reporting season. While takeover activity and the unification of the BHP corporate structure in particular saw overall performance less aligned with earnings revisions than has been our historical experience, we are confident that the strong correlation between earnings upgrades and share price performance will manifest itself again in coming months.

Importantly, earnings upgrades were achieved across a number of sectors including for QBE (General Insurance), James Hardie (Building Materials), Amcor (Paper & Packaging), Medibank Private (Health Insurance), Reliance Worldwide (Industrials), Sonic Healthcare and Resmed (Healthcare), CBA and NAB (Banks), and Domino's Pizza Enterprises and Super Retail Group (Consumer Discretionary) being some of the highlights.

The short term earnings outlook remains strong for many companies in the Resource space and some of the portfolio holdings saw strong upgrades of consensus earnings forecasts, including Bluescope Steel and Iluka. However, the economic cycle shows increasing signs of maturing and we believe it will become increasingly important to not just to rely on that sector for earnings growth and superior returns. The broad range of well-perfoming companies already in the portfolio, in addition to some new candidates identified during August, puts the portfolio in a strong position in what potentially could become a more challenging period for the Australian equity market, in our view.

Top five active overweight positions as at 31 Aug 2021	Index weight %	Active weight %
BHP Group Limited	6.4	4.0
Commonwealth Bank Of Australia	8.4	2.9
QBE Insurance Group Limited	0.8	2.5
Macquarie Group Ltd	2.7	2.5
Medibank Pvt Ltd	0.5	2.4

Asset allocation	30 Jun 2021 %	Range %
Securities	97.2	90-100
Cash	2.8	0-10

BTW

Alphinity's investment process seeks reasonably-valued companies in, or entering, an earnings upgrade cycle. The team has learned, from many years operating in various share markets around the globe, that the trend in company earnings revisions are generally serially correlated – i.e. they tend to move in the same direction for a period of time. And because share prices are largely driven by peoples' expectations of future earnings, identifying that trend early can give you a performance tailwind.

Of course, trends don't usually go on forever. Human behaviour is such that once a trend is widely recognised, it tends to be extrapolated to the point that earnings expectations become stretched and unachievable, setting the scene for disappointment and a new trend of earnings downgrades. Understanding this – and looking out for signs that expectations have become unachievable – is a key part of our investment process. We developed this process almost 20 years ago and it has consistently generated above-market returns despite the incredibly varied market environments that have applied since then. These have included the multi-year bull-run from 2004 in the lead-up to the Global Financial Crisis in 2008; the Crisis itself; the strong recovery in 2009-11; the various Euro crises in 2011-2014 and the recovery after that; the Fed tightening and Trump election in 2016, and of course the massive dislocation caused by Covid over the last 18 months or so. We actively manage the portfolio to exploit changes in investors' expectations of earnings trends, so companies tend to move in and out of the portfolio over time. On average we would hold onto a position for three or four years. Some positions are more enduring, and some are cut short if they either don't work out as planned or reach their potential more quickly.

The reason we mention this now is that August 2021 marks ten years since we first bought into one particular company. It has grown into a major portfolio holding although it didn't start out that way. But it has managed to achieve a consistent stream of earnings upgrades over the decade, and our understanding of its value has grown along with that. We keep watching for signs that the upgrade cycle might have become exhausted but it hasn't happened yet. We have from time to time taken our position higher and lower but it has been a strong and consistent contributor to Fund returns. In fact, its shares were trading at more than $23 at the end of August, many multiples of the $3 price when the initial position was taken in August 2011.

The company is Goodman Group, which develops and manages industrial property. It is a company with global relevance. It is now one of the largest and most competent companies in its field, controlling more than 18 million square metres of modern logistics facilities worth more than $50 billion. Goodman has properties in Australia and New Zealand, Japan, China, parts of Europe, the UK, Brazil and the US. It is not the world's biggest operator of logistics property – US company Prologis (which, incidentally, is a substantial position in Alphinity's Global Equity portfolios and has also been a strong performer) has about five times as much. But in our view Goodman is the best.

We should note that we didn't anticipate this amount of performance when we initially bought in, the investment case just kept evolving in an increasingly positively way over time. We established early on that the earnings trend was in its favour but our most useful insight was that the changes going on in retailing around the world, particularly the rise and rise of online, would result in significant demand for modern logistics facilities (below), which is Goodman's specialty.

The corollary of this is that the demand for retail property – shopping malls and such – was likely to diminish somewhat. Malls may not have gone out of business since then but many are struggling, and not just in Australia: this too is a global phenomenon. By avoiding the structural losers like local mall-owners Scentre Group, Vicinity Centres, and the old Westfield (now known as Unibail-Rodamco-Westfield), which have all under-performed, and owning the winner, Goodman, your Fund has generated significant amounts of alpha. We concede that warehouses are not as flashy as a big inner city shopping mall but they have proven to be better investments.

Even more impressive is that Goodman has done all this while paying its debt down to negligible levels, almost eliminating financial risk and providing the company with the ability to take advantage of any opportunities that might arise should there be a dislocation in its market. That's the sort of company we like.

Traveller's Tale

The Olympics could have been a disaster but ended as a triumph for Japan and a very nice outcome for Australia: sixth in the medal tally for both Gold and for total number of medals won. The evolving geopolitical landscape was clear to see with China rivalling the traditional winner of most Gold medals, the US. In fact China was in front until the final day when the US won the gold for Women's Golf, taking it to 39 Gold, 41 Silver and 33 Bronze: 113 overall. China won 88, of which 38 were Gold. China improved on its position in Rio in 2016, while the US went backwards.

China has not traditionally been a force in global sport despite its enormous population which should be fertile ground for sporting excellence. The country's focus until recently has been more on dragging hundreds of millions of its citizens out of poverty and, that task largely done, it has only been in the past decade or so that it has become more interested in world domination in other areas.

The surprise package was Japan, although often host countries lift when they are competing at home. Hosts get preferential access to finals which helps: if you're not in the race it's hard to win a medal. But it made a strong effort winning the third highest number of Gold, 27, and 59 medals overall (41 at Rio). This put it fifth in the medal table behind the US, China, Great Britain, and Russia.

Australia came home with the sixth most medals at 46, and also the sixth most golds at 17. We also won 7 silver and 22 Bronze medals. An impressive effort and our best Olympics ever. Swimming was the best contributor, with nine Gold. Emma McKeon by herself won more medals than more than 100 countries. We couldn't find one that exactly matched her 4 Gold and 3 Bronze but she certainly did better than 29th-ranked Belgium's 3 Gold, 1 Silver and 3 Bronze. One of Belgium's Golds came at the expense of our men's hockey team, the Kookaburras, ending cruelly in a penalty shootout.

Thinking about it on a per-capita basis, which we concede is often an indicator of an inferiority complex, if China had won the same proportion as Australia, it would have 926 Gold, 381 Silver and 1199 Bronze. Maybe one day it will; the IOC might just need to come up with a few more events…

Jamaica deserves special mention: winning 4 Gold, 1 Silver and 4 Bronze from a population of fewer than 3 million people is hugely impressive. But the winner is probably plucky little New Zealand. With only a fifth of the population of Australia, NZ won a third the number of medals, coming in at #13 in the table. It won 7 Gold, 6 Silver and 7 Bronze. This is almost the same outcome as Canada (7, 6, 11) which has almost eight times the population. Nice work bro!

Despite the potential for disaster, the Covid situation – for athletes at least – was well managed. There was very little infection within the village itself but the virus was raging outside its walls. It isn't over for the people of Japan, but at least they can be proud of the show they put on for the rest of the world.

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