Quarterly Report – September 2021
Alphinity Concentrated Australian Share Fund

Nevergrande

Market comment

It had to happen eventually. After eleven straight months of a rising market, 17 months in the last 18 in fact, the market retreated in September. While we limped across the line with a modest +1.8% return for the quarter (ASX300 including dividends), in September itself it fell by almost 2%. Much of this was due to soft resource prices, although not helping were events in China where prominent property developer China Evergrande teetered on the brink of collapse. A major apartment builder, it was the world's most valuable real estate company in 2018 although its shares are down 90% from that level. More on this on p3.

Global shares generally did better than ours in the September quarter with a 3.5% fall in the $A proving a strong headwind. New Zealand, Japan and the US were the stars, rising between 6 and 7% in $A terms; most European markets appreciated between 2 and 4%. Hong Kong was a challenged market though, with its own shares falling more than 10% and Chinese shares listed there down by 14%. The only worse market was Brazil, losing 16.5% in $A terms.

The main reason for the Brazil market's woes was Iron Ore. Resource prices usually move around a bit but they were particularly volatile this time. Iron Ore was the weakest of all, falling by more than 40% over the quarter after China told its industry to cut steel production. This worked against local returns too, with three of our large companies highly exposed to Iron Ore. Most other commodities were well supported and some were incredibly strong. Coking Coal rose almost 70% in the period. It seems anomalous to have the two key inputs into steel making move so much in opposite directions.

Thermal Coal, used to generate electricity, was up more than 90% in $A terms in the quarter and the price of Gas was also up substantially. Energy is becoming a serious issue around the world, exacerbated by the approach of the northern winter. China, which uses coal for much of its electricity production, started to suffer from wide-spread power shortages after some electricity generators cut production rather than produce at a loss due to the high coal price. It appears that victory in China's trade war against Australia is so far largely Pyrrhic as the ban on our coal is mostly negatively impacting its own people and industry while at the same time providing windfall returns for Australian coal producers selling it into other markets at these high prices.

Energy is an issue in Europe and the UK as well, for different reasons. In the UK it was merely a shortage of truck drivers post-Brexit resulting in petrol stations running out. The Army was brought in to resolve this but not before there was panic buying of petrol and some empty supermarket shelves. In Europe however it is more serious. Gas has become the energy of choice for dealing with the cold northern European winter as Coal has such high carbon emissions, Nuclear has emotional challenges in some markets, and Solar has issues with access to sunshine at that time of year. But with Russia understandably prioritising its own needs over Europe's, flows of gas through the pipeline from Russia have become limited and more expensive.

So lots going on in markets, aside from dealing with the sporadic outbreaks of Covid and its mutations which is still causing some concerns even in highly-vaccinated countries. Tired though we are of the whole pandemic thing, we can't help feeling that, as with the Delta variant, there may still be a few twists and turns to come before the book is closed on this dreaded plague.

Portfolio comment

The Fund outperformed the market in the September quarter. The best contributors were global investment banks and asset manager Macquarie Group, health insurer Medibank Private, security app Life 360 and auto advertiser Carsales.com. Not owning iron ore miner Fortescue Metals Group helped too, although this was more than offset by our position in diversified miner BHP Group. Not owning takeover target Sydney Airport or gas producer Woodside Petroleum both 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)	-1.8	1.9	29.2	8.9	11.3	12.6	10.8
S&P/ASX 300 Accumulation Index	-1.9	1.7	30.6	9.6	10.4	10.8	9.3

*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, 30 September 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

Simultaneous concerns about rising inflation at the same time global economic growth is fading weighed on equity markets in September. While somewhat unusual, this is of course not an impossible combination: there's even a term for it, stagflation. First identified in the 1970s, it didn't turn out to be a great environment for the share market. However, while many equity markets still look somewhat stretched, talk about stagflation is overly pessimistic at this point, in our view.

Global growth is clearly slowing following a strong recovery from the initial Covid-induced slump over the last year or so. Some of that slowdown is simply the economic cycle maturing; some is due to the resurgence of Covid thanks to the Delta variant, not least here in Australia; and some is ongoing and even worsening bottlenecks in the global supply chain. Overall though, there are few signs of growth stalling altogether. With the vaccines looking to be winning and supply chain constraints likely to gradually ease, in our view growth should just moderate, not disappear.

Inflation looks to us to be the higher risk. And while some of the pressure we're presently seeing around the world is linked to the unexpectedly strong demand recovery and resulting bottlenecks, inflation appears to have become more entrenched and affecting more long-lasting factors such as housing rents and wages. Tellingly, the US Federal Reserve Bank has become less vocal in its argument that it is all transient.

We expect Central Banks will continue to take steps towards reducing monetary stimulus. Economic growth should be strong enough to allow this, and inflation should be strong enough to require it. While removing this impetus will likely cause some challenges for equity markets, the alternative – i.e. more growth and inflation now but sharper rate rises in 12-24 months – doesn't seem like a better alternative.

Top five active overweight positions as at 30 Sep 2021	Index weight %	Active weight %
BHP Group Limited	5.3	3.9
Commonwealth Bank Of Australia	8.9	3.6
Macquarie Group Limited	3.0	3.5
National Australia Bank Limited	4.4	3.2
Medibank Pvt Ltd	0.5	2.9

Asset allocation	30 Sep 2021 %	Range %
Securities	97.1	90-100
Cash	2.9	0-10

Portfolio outlook

Portfolio positioning is complicated in the current environment. On the one hand, despite still having attractive valuations many cyclical companies have lost some of their appeal thanks to the slowdown in global and domestic economic growth. On the other hand, companies supported by more structural growth drivers are vulnerable to higher bond yields due to their historically high valuation premiums.

As always, we continue to be led by where we see earnings leadership combined with attractive valuations. In the Resource sector, this has seen us follow our exit of Fortescue and Oz Minerals a few months ago with an exit of our position in Rio Tinto. As a result the Fund is now underweight iron ore. While our exposure to BHP has also reduced, we see greater earnings offsets for it as a result of the Group's product mix and it remains one of the core resource exposures for the Fund.

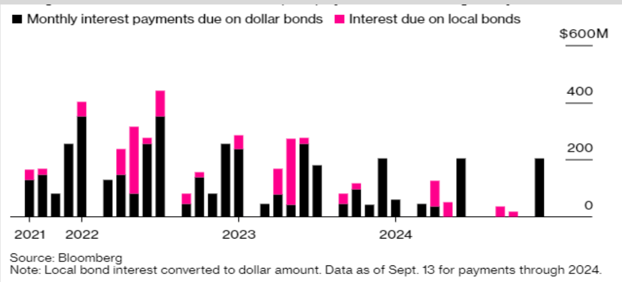
We also added another diversified miner, South 32, to the portfolio. Following the divestment of its troublesome South African thermal coal business the company's earnings leverage to alumina, and especially aluminium, has increased substantially and we see further significant earnings upgrade potential for the company. Santos remains our preferred oil and gas exposure. We also added to fuel refiner and retailer Viva Energy Group following its solid first half result, as it still has upside from recovering fuel volumes, not the least in aviation fuel. Outside of the Resource and Energy sectors, our portfolio adjustments have been more gradual.

In the Insurance sector we complemented our holding in global insurer QBE with the more domestically-focused Suncorp. Suncorp still has some work to do but we are encouraged by early signs of improving insurance margins. Qube delivered a strong result in August and is at last in a position where cash is being released from its multi-year investment in the Moorebank Logistics precinct; this can be now used for capital management in addition to supporting stronger growth in its core logistics network.

We have also added to our holdings in global asset manager Macquarie Group, health insurer Medibank Private and building materials producer James Hardie following strong trading updates. These additions and increases have been partly funded by trimming positions in conglomerate Wesfarmers and industrial property developer Goodman Group after both exhibited strong performance.

BTW

There's an old saying in finance circles that if you owe a bank a thousand dollars and can't pay it back you have a problem; if you owe a billion dollars and can't pay it back, the bank has a problem. It's probably fair to say, therefore, that if you owe $130 billion, as Evergrande apparently does, China – maybe even the world – has a problem. As the chart below shows, most of the debt is denominated in $US and likely owed to holders outside China. And $130 billion is just its debt, at least that much again is believed to be owed to suppliers and the roughly half a million people who have placed deposits on apartments.



Source: Bloomberg
Note: Local bond interest converted to dollar amount. Data as of Sept. 13 for payments through 2024.

Taking a step back, given the company's history, a bond default was increasingly probable. Evergrande's share price had fallen more than 90% since its peak in mid-2020 and its bonds, currently trading at ~20% of face value, didn't get there overnight, or even over a few weeks. It is not just a company that sells apartments either: it has large interests in music, food, finance, media, health and tourism. It also owns 75% of an electric car company, Evergrande New Energy Vehicle Group, which hasn't yet sold a car and has incidentally also stopped paying its employees and suppliers. The EV shares are down by even more – from $HK60 in July to around $3 at the end of September.

At the helm of Evergrande is the billionaire Chairman, Professor Hui Ka Yan, who owns 70% of the company. He took out $HK23bn (around $A4 billion) in dividends in 2020 while the company was piling on debt. Evergrande also owns one of the most successful football clubs in China, Guangzhou FC. Buying a sporting team must be part of a billionaire's rite of passage: Softbank's CEO Masayoshi Son owns a baseball team. Son also has the unique distinctions of being both Japan's second richest person and the person to lose the most money in history, about $70bn during the 2001 dotcom crash.

Back to Evergrande. With the benefit of some hindsight, given its history and China's recent pivot to 'Common Prosperity', it's clear that the Chinese Communist Party is no longer going to accept bailing out such firms. Nor will the Government tolerate systemic risk, so it appears most likely that the mess will be cleaned up via a debt restructure with state owned enterprises stepping in. It's clear however that the hierarchy of official concern will be for (a) local property buyers; (b) local suppliers of labour or goods owed money by Evergrande; (c) local bond holders; then (d) foreign bond holders.

While these are no doubt worrying times for property buyers, suppliers and investors alike, it's worthwhile trying to assess the likelihood of contagion risk. Market commentators are quick to describe it as China's Lehman Brothers moment to sell a story, but while this thing still has a long way to play out, it's hard to equate a busted property developer with the trigger of a global credit crunch.

Perhaps a more important longer-term challenge for China is the way offshore investors will start to perceive different class structures of investments, and how willing they will be to accept lining up behind Chinese investors when the time comes to get paid. Evergrande said at the end of the month that it had "resolved" payment of a yuan-denominated domestic bond, but made no mention of what it would do about the much larger $US commitments it has quickly approaching.

For most large foreign investors, Evergrande's equity and bonds account for only a small proportion of their exposure to China assets. Looking at its share register, most of the holders are Chinese holding companies with the only obvious Westerners being a couple of index funds and a northern European sovereign wealth fund that is notorious for owning a bit of pretty much everything. But even if the Evergrande mess somehow does get sorted out there could be permanent damage to perceptions of global investors about the wisdom of being exposed to Chinese corporate debt or equity.

Having said that, the scale and wealth of China is such that the greed of the West might find a way to look through that risk. As Lenin is supposed to have said, "The Capitalists will sell us the rope with which we will hang them."

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Traveller's Tale

It's not just Evergrande that's making people nervous about China. Even aside from its expansionist practices in both the South China and East China Seas and its oppression of countries which can't realistically fight back – Australia included – there have been some fascinating things going on in corporate China over the 12 months. The disappearance of Alibaba's Jack Ma after he criticised financial regulators late last year followed by the pulling of the Ant Group IPO; the gutting of Uber-equivalent Didi just days after it listed in New York; the effective nationalisation of companies providing education services in China: it appears that there is a degree of sovereign risk involved for foreign investors there.

Then this month, confirmation that China had been engaging in hostage diplomacy will surely make people from countries China has issues with – which seems to be pretty much everyone apart from Afghanistan under the Taliban regime and North Korea – hesitant about travelling there.

It started in December 2018 when Canadian border officials detained Meng Wanzhou, an executive of telecoms equipment provider Huawei and the daughter of Huawei's founder. Canada did this on behalf of the US which alleged that the company had been dealing with Iran in breach of US sanctions. Meng was detained in her $20m mansion in Vancouver (pictured), with its eight bathrooms and indoor pool, while the three countries traded diplomatic blows. Days later, Chinese authorities arrested two Canadian executives working separately in China, both named Michael, and charged them with espionage. The Michaels spent the time in less salubrious accommodation than Meng, Chinese jails, were tried and convicted (as 99% of cases coming before Chinese courts are – after all, if you weren't guilty you wouldn't have been charged!). China denied that their detention was related to Meng but, within minutes of Meng being released this month, the two Michaels were on a plane back to Canada. That's some coincidence.

Hostage diplomacy has a long history. In the modern era it has mostly been practiced by less reputable regimes like North Korea and Iran but according to that universal source of insight, Wikipedia, it was widely used by some of the ancient Chinese dynasties to keep vassal states in line. Two Australians are currently being held in Chinese jails: academic Yang Hengjun, who was taken in January 2019, shortly after Australia criticised China for taking the Canadians; and news anchor Cheng Lei in August 2020 for supposedly "carrying out criminal activities endangering China's national security". Australia however lacks the diplomatic leverage of having a prominent person such as Meng in custody to trade for their release. Conventional diplomacy is clearly not working.

Unfortunately, the hostage situation did work. It took almost three years but eventually the US varied the most serious charges, Meng claimed vindication and fled back to China to be greeted as a hero. This sort of thing will make people think twice about going to China, and this will not be good for trade, mutual understanding or possibly even world peace.

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