

# Reality Bites

## Market comment

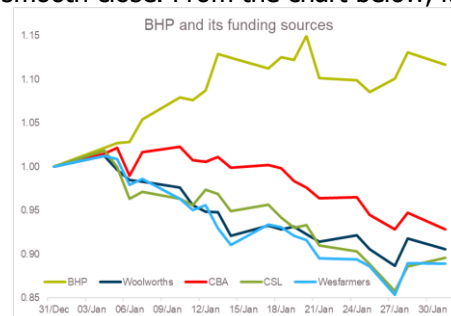
It's as if "last drinks" was called and the party music stopped with the New Year celebrations as the penny finally dropped that the world's most well-anticipated rate cycle might be bad for companies trading on lofty valuations. Throw into this mix rising supply and labour shortages in many markets and energy prices soaring on Russia/Ukraine tensions and the menu was set for the first meaningful market correction since the onset of Covid two years ago, particularly in the high growth part of the market.

The first stocks to get hit were the frothiest, those inflated by hype and hysteria and for which valuation either doesn't make sense or doesn't even exist. These include the various meme stocks, cryptocurrencies and unprofitable technology companies. With them went the \$A which fell 2.5c to close the month at \$US0.70. As we approached full capitulation mode, broader parts of the market became caught up in the sell-off, including profit-making tech, consumer and healthcare stocks, some of which might prove to be great buying opportunities as their valuations normalise.

For the month, our market (ASX300 including dividends) fell 6.5%, a soft performance compared to many other markets in \$A. In \$A terms the US S&P 500 index fell 2.3% and the tech-heavy Nasdaq closed 6.2% lower: better than Russia, Korea and New Zealand at almost -10% but most other global markets were less negative than ours. On a sector level, the thematic was very clear with Energy the only strong performer (+7.5%) while the more expensive Technology (-17%), Healthcare (-12%) and Consumer Staples (-9%) sectors bore the brunt of the selling.

It wasn't all doom and gloom however, with some of the cheaper cyclical companies in the materials and energy spaces, often thought of as "value", benefitting with some investors rotating into this part of the market. Arguably, Australia's performance should have been better given the predominance of materials and financials stocks, and less tech exposure than some other regions, but there were also index rebalance considerations which muddled the waters somewhat.

If the market volatility around rate hike concerns wasn't enough to contend with in January, the main index compilers also threw in a large index re-weighting. For more than 20 years mining company BHP's share register was split between the UK and Australia but shareholders voted last year to collapse the structure, bringing the whole company back to Australia. This saw BHP's weight in the ASX300 rise from 6.7% to 11% on 30<sup>th</sup> January. A staggering 390 million BHP shares – \$18 billion worth – traded that day as index funds became forced buyers. The share price was surprisingly stable however as enough arbitrageurs had bought in the lead-up at lower prices to ensure a smooth close. From the chart below, it is clear that there was a degree of pressure placed on some of the other large capitalisation companies which saw their index weightings reduce.



Commodities were generally stronger as both US and Australian bond yields continued to march higher. Iron ore gained 24% to \$US144/tonne, with re-stocking support ahead of Chinese New Year, and oil prices lifted 17% to \$US91/barrel; the gold price weakened however, unable to outperform in both inflationary and non-inflationary environments.

## Portfolio comment

The Fund outperformed the soft market nicely in January. Its holding in BHP was the biggest contributor to performance, followed by gas producer Santos and mineral sands company Iluka; not owning tech exposure Afterpay/ Square Inc/ Block Inc also helped. Counting against were holdings in medical tester Sonic Healthcare, building exposures Reliance Worldwide and James Hardie. Being underweight iron ore miners Rio Tinto and Fortescue and gas producer Woodside also detracted.

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)	-5.4	-2.8	12.8	10.9	9.4	11.4	10.2
S&P/ASX 200 Acc. Index	-6.4	-4.3	9.4	9.8	8.5	9.5	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, 31 January 2022.

^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.

## Monthly Report – January 2022

Alphinity Concentrated Australian Share Fund

### Market outlook

The inevitability of less-easy monetary conditions and higher interest rates hit home more fully amongst equity investors in January. Although most central bankers around the world have yet to act and actually raise rates, the majority have now shifted to a tightening bias. Even our own RBA Governor has acknowledged that rates could go up in 2022, rather than 2024 as he had previously stated. While the debate is now more firmly about when and how much, rather than if, the key issue for overall equity market returns remains the extent to which higher interest rates will impact economic growth. With monetary authorities having left it unusually late in the economic cycle before taking action, risks around more aggressive measures than are currently expected being required, and a more significant slowdown as a result, have clearly risen.

At this point, however, most growth indicators remain solid. This should not come as a surprise as monetary policy, even in today's fast-paced world, works with a lagged effect. As long as economic growth, and as an extension corporate profit growth, remains solid, the main consequence of higher interest rates is likely to be on longer duration high-multiple stocks such as Information Technology and the more traditional bond proxies such as property companies. Despite the significant rotation by investors out of these sectors, into cheaper and primarily cyclical stocks so far in the new year, we would expect that this relative performance trend can continue for the next few months before broader economic growth concerns take centre stage.

Assessing at which point we currently stand in the economic cycle remains complicated both by Covid and the ongoing global supply chain issues. The upcoming February reporting season is also likely to be impacted by these factors and consensus earnings expectations appear somewhat at risk from elevated costs and some subdued trading conditions over the Christmas and New Year holiday periods. Investors need to tread carefully in this environment. Admittedly, after the market pull-back in January, valuations are lower now than they were at the start of the year but they remain elevated relative to long term metrics.

### Portfolio Outlook

The Fund's focus on companies exhibiting earnings leadership, by which we mean companies for which investors' earnings expectations are increasing but where we also see potential for further earnings upgrades, has proved its value over the long term, and importantly also more recently. This, and our relatively low exposure to companies most at risk from tighter monetary conditions, has also worked well since the start of 2022. Broader market conditions, so far at least, look quite different to those of the past two years and have the potential to be the inflection point following a decade of falling interest rates.

With individual company earnings back in focus over the course of the February reporting season, we expect there will be the usual mix of positive and negative results and outlook statements. This will no doubt cause us to review the investment cases of some positions as well as possibly identifying some new opportunities. Overall, however, we don't see that the economic environment has shifted materially, and expect recent earnings trends to persist. Given the Fund's overall skew to stocks with positive earnings momentum, we feel that the fund is well positioned for what may be a tougher year for the equity market as a whole.

Recyclable packaging company Orora was recently added to the fund. Its defensive earnings characteristics are attractive in the current environment but, more importantly, we see earnings upside for the company relative to what the market currently expects. After some difficult years in North America, a combination of questionable acquisitions and customer losses, and negative Australian glass volumes resulting from China trade issues, earnings have stabilised and have started growing again. Orora has several sources of potential earnings upside, including a margin improvement program in the US, a global resurgence in aluminium beverage can demand, and low risk capacity expansion opportunities in Australia where new glass container markets have been identified. These, coupled with a strong balance sheet and solid ongoing cash generation, will allow the company to add to its earnings growth profile through an ongoing share buyback program.

Top five active overweight positions as at 31 Jan 2022	Index weight%	Active weight %
National Australia Bank Limited	4.3	3.8
Macquarie Group Ltd	3.1	3.6
Goodman Group	1.9	2.6
Santos Limited	1.0	2.5
QBE Insurance Group Limited	0.8	2.5

Asset allocation	31 Jan 2022 %	Range %
Securities	97.9	90-100
Cash	2.1	0-10

## Monthly Report – January 2022

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### BTW1

The dictionary definition of the word 'frothy' is "light and entertaining but of little substance". Froth is also the foam bubbles which forms atop a nice beverage, although this is often skimmed off the top of beers when it is there in excess. Given the market moves in January, the term 'frothy' can also be applied to describe assets that have risen on a mix of hype, day trader mania and whose valuations either are unrealistic or don't exist: like cryptocurrency and loss-making technology companies. It's like the market somehow didn't hear the loud warning bells that have been tolling for months from the US Federal Reserve that rate hikes are coming. Or we just ignored the staff shortages causing our favourite cafés and restaurants to open on a part-time basis. Or we pretended stimulus cheques would keep rolling in forever. Or we just stuck our heads in the sand and pretended none of this was real while watching our crypto wallet balances every minute. It seems that January was the month where the market woke up and skimmed the froth off its drinks.



Another quote that seems quite appropriate in these markets is one from the legendary investor Warren Buffet himself who once said: "Only when the tide goes out do you discover who's been swimming naked". It seems like a lot of unprofitable companies have been swimming naked for a while, hoping the water level wouldn't recede. In fact, Goldman Sachs has an index of non-profitable tech (below) – a group of companies which have negative earnings but, somewhat disturbingly, have an aggregate market value of more than \$US650bn. Of course, "non-profitable" should not be confused with "not for profit": one is run by design, usually for charitable reasons, the other isn't.

No profits; no problem - until now  
Goldman Sachs' non-profitable technology index (points)



Another section of the market caught up in the froth was the IPO/SPAC market. Most of us are familiar with IPOs, but SPACs are vehicles which don't exist in Australia; we looked at them in our [February 2021](#) report.

Special Purpose Acquisition Companies (SPACs) are also referred to as blank cheque companies. They have been very popular in the US for some time, but many stock exchanges globally are falling over themselves to attract the business to them. There is little discussion of them coming to Australia. The sole purpose of a SPAC is to take a private company public without going through the rigour of an IPO: this doesn't seem like great investor protection to us. Regardless of whether you were listing via the traditional IPO route or through a SPAC, 2021 wasn't a good year.

In the US, nine of the 10 biggest IPOs lost value in 2021 despite the broader market producing great returns. For instance, Rivian Automotive Inc, a loss-making electric pickup truck start-up, was the biggest IPO in the US last year. It started with a bang in November, rising from \$US78 to \$170 a share in the first few days. It still has a substantial market cap of \$US54b despite having fallen to \$64 a share by the end of January. Australian IPOs were also generally poor, which we expand on in BTW2 on p4.

SPACs in the US were a disaster in 2021. Spare a thought for Chamath Palihapitiya (pictured), tech investor and former Facebook executive who was dubbed the SPAC King for the numerous SPAC deals



carried out by his venture capital fund, Social Capital. His four biggest SPAC deals – Clover Health, Opendoor, SoFi and Virgin Galactic – fell 32% on average in 2021. Actually, don't spare a thought for Chamath, who no doubt earned hefty management and transaction fees, think of his investors who have worn all the downside.

Of course, as this 'peak insanity' fades and the tide recedes, it might leave some great companies washed up on the shore along with the junk. We are looking for these high quality businesses which might have been caught up in the broader sell-off, those companies that produce earnings but perhaps have been sold as they trade on a high multiple. This will undoubtedly provide some great buying opportunities even the market no longer 'buys the dip' and realises that Central Banks are not there just to prop up stock markets.

Perhaps the penny is dropping that Central Banks might end up doing what they say. Perhaps the best outcome is a crunch in certain parts of the market, like meme stocks and unprofitable low quality companies trading on silly multiples. Then we don't have a broad market slump, just a much-needed dose of sobriety.

**BTW2**

IPOs: a handout of free money to investors by brokers. That's a common perception, fed by instances of some of the huge first-day "bumps" of the past. Think IDP Education in 2016, up 57% day 1. Netwealth in 2017, up 43%. Nuix in 2020, up 51% (although that turned out to be a good selling opportunity!). Such large windfall profits reflect a disparity between what the sellers are willing to accept and what the buyers, those allocated stock in the IPO, are willing to pay.

Clearly, if the price goes sharply higher when the company lists, the seller has left money on the table. Sellers have learned to price more efficiently through the use of various market mechanisms and keep more of that upside for themselves. Fair enough, but the pendulum may have swung too far the other way, as shown by the IPO experiences of 2021. Despite being claimed to be a great success by the ASX Listings team, as it was a record year for listings, we investors would rather look at performance, not dollars raised, as the metric of success. Of 85 IPOs greater than \$10m which raised \$12.45 billion, only 32 finished the year higher than its IPO price; 27 were 20% or more lower. The worst was Tissue Repair Ltd, which closed 62% below issue price. At year end the total value of the shares issued was \$12.53 billion: not a great outcome for IPO buyers.

It's reasonable for the seller of an asset to want to maximise its price but there needs to be some appeal for the buyer too. Why buy a fully-valued asset? There are plenty of those around. There needs to be some reward for taking the risk of locking money away at a fixed price between being allocated the stock and the date it trades, which can be many weeks. During volatile conditions – and markets are usually volatile – there is a meaningful risk that the market might be down sharply by that time and you can't do anything about it.

IPOs are not risk-free, as shown by one that took place in January. BeforePay was the latest in a long line of so-called fintech companies to launch. Before Pay and its ilk (Zip, Sezzle, Klarna, Postpay and so on) want to emulate the success of Afterpay, which generated good returns for its original investors. Each has its own nuance: while most have been variations on the BNPL (Buy Now Pay Later) theme, BeforePay is essentially a modern twist on payday lending, a practice frowned upon by many as exploiting people with financial difficulties, those who can least afford to borrow. You can imagine the trouble people could get into by combining payday lending and BNPL.

Anyway, BeforePay raised \$35m at \$3.41 per share in an IPO in November, valuing the entire company at more than \$150m. When it eventually hit the screens, on 17 January, market conditions were quite different: bond yields escalating globally and equity markets sliding. It was not a happy day for the new shareholders, BeforePay shares falling more than 40% to \$1.90. It had reached \$1.65 by the end of the month and was still falling at the start of February. It begs the question, why would someone take up shares just to dump them soon after at a fraction of the price?

We did well last year by avoiding all the IPOs except one, non-bank lender Judo Capital, which listed in November and finished the year a little higher than the issue price. Apart from that one we just didn't see a good enough risk/reward proposition for our investors from those being offered. That saved us a lot of stress and our unitholders a bit of money. It is in the interests of IPO promoters to "leave a bit of money on the table" for subsequent investors as an incentive to take the risk involved in primary equity raisings.