Monthly Report – February 2022
Alphinity Sustainable Share Fund

Russian for the door

Market comment

At first the market (ASX300 including dividends) bounced back from January's slump, rising more than 5% by mid-month before being hit by Vladimir Putin's attempt to reunite Russia with an "inalienable part of [its] history, culture and spiritual space" (i.e. Ukraine). While of little surprise to anyone watching the troop build-up, the reality of soldiers on Ukrainian soil late in the month was enough for investors to initially race for the exit and the market gave up much of the gains it had made, finishing just 2% higher for the month, which largely represented the dividends that had been declared during reporting season. We expand on the geopolitics of Ukraine a little more on p3.

Putin made our reporting season somewhat moot, with pleasing results in many cases being overtaken by events and causing the share prices of some companies, which probably should have risen, to fall. From time to time big-picture developments (which one might consider the possible start of World War III to be) can overwhelm individual company fundamentals but it tends to be fairly short-lived: unless the macro is significant enough to change those fundamentals, the micro tends to reassert itself eventually, although that can take a bit of time. For companies with little valuation support however, particularly highly-priced companies with minimal or no earnings, there is no backstop of tangible valuation so the moves can be (and were) very sharp indeed.

It wasn't all doom and gloom for Australia though, large parts of our market still did fairly well in February. Tech and Consumer Discretionary companies mostly fell but Banks, which make up about a fifth of our total share market cap, were higher over the month. Most banks issued positive trading updates, but signs that interest rates may start going up this year – much sooner than our central bank had previously promised – was probably of greater support. Resource-exposed companies, which make up another fifth, were also generally well bid; Energy companies did well, thanks to the rocketing oil price, as did Utilities and Consumer Staples. These helped Australia's market hold up a lot better than most others around the world.

Our dollar also did OK, firming by almost 3% against the $US and Euro. In $A terms, the broad US market fell by almost 5% in February, and the tech-focused Nasdaq by almost 6%. Euro markets were lower by between 2% (Belgium) and 11% (Sweden), and the UK fell just under 2%. Less developed markets seemed to do worse the closer they were to Russia, however, with Poland -14%, Austria -15% and Hungary -28%. None was worse than Russia itself: its market fell by 49% in $A terms as the world imposed swathes of sanctions and its currency crumbled. Ukraine's market was down a more modest 9% although it was closed for most of the month – they clearly had bigger things to concentrate on.

War can sometimes be good for markets though, as we discuss on p4. Much as we dislike the idea of profiting from a dismal situation such as this, some companies will inevitably benefit, if not from the war itself then from second and third order effects. Some commodities, for instance, will see heightened demand to support the war effort; and for others, particularly those of which both Russia and Ukraine are significant producers, supply will be disrupted by sanctions. Oil and gas are the most obvious of these but a number of mineral and agricultural commodities will also show the effects. The price of Wheat, for instance, which Russia and Ukraine combined account for more than a quarter of world exports, rose by 25% in February and was still rising strongly in the early part of March.

Portfolio comment

The Fund underperformed the market in February. Its fossil-free charter prevented it from owning mining company BHP or gas producer Woodside. The best contributors were its holdings in diversified resource company Rio Tinto, metal recycler Sims and major bank NAB, rare earth miner Lynas, and not owning either tech exposure Xero or gaming machine maker Aristocrat Leisure. Counting against were holdings in tech company Life 360, plumbing products maker Reliance Worldwide, building materials maker James Hardie, being underweight major bank Westpac and not owning South 32 or gold producer Newcrest.

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)	0.5	-4.4	10.8	11.2	11.7	11.4	10.3
S&P/ASX 300 Acc. Index	2.1	-2.0	10.2	8.7	8.6	9.5	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, 28 February 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.

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Market outlook

The Australian reporting season was slightly positive overall with aggregate earnings expectations revised a bit higher. This was largely driven by continued strength in commodity prices. Banks and Supermarkets also surprised positively, partly due low expectations after some lacklustre bank earnings releases in November and Woolworths warning of elevated covid costs before Christmas. The impact of Covid on many other sectors make interpretation of overall trends more difficult but higher inventories held by companies was a recurring theme. Whether this will prove to have been prudent management of uncertain supply chains ahead of solid sell through in the second half, as omicron disruptions ease, or signs of slower-than-anticipated sales for the year remains to be seen. We suspect it is a bit of both.

With geopolitical risks having decidedly taken a turn for the worse with the tragic situation in the Ukraine, commodity prices, especially energy-related ones, have lifted further. This is understandable given the very real supply risks posed by Russian sanctions and an occupied Ukraine. However, a drawn out conflict could also impact demand and overall economic growth.

While this may cause some pause for thought, we suspect the ongoing commodity strength will add to central banks' impetus to raise interest rates, rather than causing them a major rethink. The Bank of England has already moved and the US Federal Reserve has all but confirmed that it will begin a series of rates hikes in the next few weeks. Such well-flagged intentions should arguably already be 'priced in' by market participants and may even be welcomed by investors in the short term. However, a more sustained stabilisation in longer dated bond yields will likely require some further signs of economic growth and/or inflation slowing, in our view.

In the meantime, bond proxies and highly-valued growth stocks continue to look the most vulnerable to us. The silver lining for our equity market is Australia's relatively high exposure to in-demand commodities in everything from energy and metals to a range of agricultural products. This has already manifested itself in earnings as well as better relative equity market performance than the rest of the world this year – so far at least.

Top five active overweight positions as at 28 Feb 2022	Index weight%	Active weight %
Rio Tinto Limited	2.0	4.6
Macquarie Group Ltd	3.0	3.4
National Australia Bank Limited	4.4	2.8
Medibank Pvt Ltd	0.4	2.6
Lifestyle Communities Ltd	0.1	2.5

Asset allocation	28 Feb 2022 %	Range %
Securities	97.7	90-100
Cash	2.3	0-10

Portfolio Outlook

Since the start of 2022, the Fund's performance has largely been driven by the restrictions placed on it by its Sustainable Charter which excludes gold companies and those producing and generating energy from fossil fuels: given all that is going on around the world, these have been strong performers. Our underweight to the expensive IT sector and strong stock selection in allowable Resource companies has contributed solidly, but rising bond yields and close to record-high commodity prices across the board (i.e. global macro factors) explain most of the underperformance. While the macro environment remains fluid we expect it to continue to be supportive of the portfolio in the near future. In the case of the IT sector, higher bond yields may have been the catalyst but the underperformance has also been a timely reminder that share prices are ultimately driven by share prices and the Australian IT sector, with some exceptions, either has no earnings or has struggled to deliver on the market's expectations.

At the end of the February reporting season the majority of stocks in the fund that reported saw upgrades to FY22 and FY23 earnings expectations, and aggregate earnings revisions were ahead of the overall market. In our view some of these earnings upgrades are yet to be reflected in share prices and perhaps have been lost in the current macro-dominated market environment. We remain confident in the outlook for global asset manager Macquarie Group, Industrial property developer Goodman Group, Medibank and James Hardie to mention a few of these names.

Last month we wrote about packaging group Orora as a recent addition to the fund, and the company received solid earnings upgrades for both the current financial year and for FY23 at its recent result. Since then we have also added electronics retailer JB Hi-Fi and online human resources company Seek. These two companies operate in very different industries but have some common attributes: they are both innovative industry leaders with strong management and, importantly, delivered numbers well ahead of consensus earnings expectations.

JB Hi-Fi has looked inexpensive for some time as investors anticipate a more difficult post-Covid retail trading environment. We agree that current earnings levels are probably unsustainable in the short term but expect a better margin outcome will continue to see the company deliver earnings ahead of consensus expectations. In the case of Seek, its valuation has kept us out of the stock for some time although a lower share price as a result of this year's market volatility, together with a strong earnings outlook and a cleaner company structure, aligned to provide what we believed was an attractive investment opportunity.

BTW

As was the case with Covid, it appears that being a long way from everywhere else does sometimes have its advantages. However, the war in Ukraine is still a highly unwelcome development which impacts Australia, notwithstanding how remote we are from the action. We thought we'd have a look at where Russia's key ally stands in this fight.

China is in an interesting position. President Xi recently called Russian President Vladimir Putin his "best friend", and the personal relationship appears to be one of the strongest among world leaders. There are obvious common strategic interests, such as matching China's voracious demand for oil and other commodities with Russia's ample supply and combining Chinese economic strength and Russian military strength to counterbalance the weakening, retreating, but still more powerful USA. China, however, appears to have little appetite either to join Russia in the global pariah club or to start a shooting war (unless it must do so in order to fulfil a key objective, such as reunification with Taiwan). China also has far more important trade, technological and financial interests in Europe and the USA.

China has also had strong trade ties with Ukraine, most importantly as a source of agricultural commodities. It appears likely that these exports will be protected under any scenario, whether from an independent Ukraine or from a Russian client state. Given the difference in economic power, China sees Russia as a junior partner. The potential Chinese threat to Russian Far Eastern territories was a long held fear for the USSR and is now for Russia – this means the relationship between China and Russia is less like the all-in bromance between their leaders, and more a strong strategic partnership with seeds of a potential alliance. China has to decide whether it wants to play peacekeeper, and use its influence to accelerate the peace, or set the stage to prepare itself to minimise foreign interference if and when it decides to assert sovereignty over Taiwan.

China's positioning is an important, but far from the only open question. A misinterpreted or conscious provocation or a border skirmish could also drag an unwilling third country into the war. These sorts of wild card risks are amplified by poorly-trained guerrilla forces fighting alongside regular military on both sides, and also populist governments whose foreign policy decisions are driven by voter polls rather than strategic calculus. The proposed scheme of transferring Polish fighter jets to Ukraine could be construed by President Putin as *casus belli* for direct military action against Poland, a NATO member.

While there are too many potential "known unknown" wild cards to list, the unknown unknowns is what really gets you. As 19th century Prussian military strategist Carl von Clausewitz once said, *"war is the realm of uncertainty; three quarters of the factors on which action in war is based are wrapped in a fog of greater or lesser uncertainty. A sensitive and discriminating judgment is called for; a skilled intelligence to scent out the truth"*. In other words, as with any human complex adaptive system, history and game theory can at best only provide us approximate odds about the future, not definitive answers.

The balance of probabilities suggests that military conflict will likely get worse before it gets better, and it will likely take weeks and months to resolve than days. The end state will probably not satisfy any of the parties, and both sides will get less than they are currently willing to accept. The isolation of Russia by international sanctions is unlikely to reverse for some time, and Ukraine is unlikely to regain full sovereignty for some time. It tells us both economies will emerge out of the war much weaker than they were going in.

What does this mean for global financial markets? The most obvious implications, other than for assets directly affected by war and sanctions, are for commodity prices and interest rates. Together Ukraine and Russia are important exporters of oil, gas, nickel, aluminium, wheat, fertilisers, and other key commodities including some more obscure ones, like neon gas which is used in chip manufacturing. If the military conflict and sanctions drag out, shortages and elevated prices are likely to continue for longer as well – potentially for years, as has been the case with Iran.

The need to be more dovish in the face of risk-off sentiment and real economic consequences of military conflict in Europe could hardly come at a worse time for Western central banks, which need to combat inflation. So far, their choice seems to have been to consider inflation as more important, and this looks rational given the limited direct economic consequences of the conflict outside Russia and Ukraine. But growth in the scope of the conflict could force them to reconsider this trade-off.

Second and third order consequences of sanctions will be felt well beyond Russia, the most obvious being further strain on already-stretched global supply chains, by European exporters and by tourist destinations which rely on Russian spending. Many less obvious ones will no doubt manifest over the coming weeks, given how complex and interconnected global supply chains are. For example, Ukraine is the motor industry's hub for manufacturing wire harnesses. A lesson of history, which humanity seems destined to repeat, is that while shifts in relative power can be secured by war, in absolute terms, every warring side loses.

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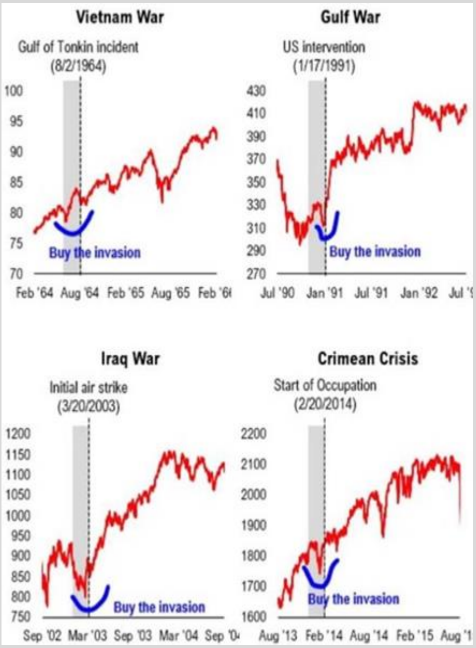
BTW2

Any hopes of calmer markets following the January carnage were dashed as fears over rate hikes were replaced with fears of war as Russia made good on its threat to invade Ukraine. Volatility and gold were clear winners in a flight to safety, although the extraordinary forward-looking nature of markets again reminded us of just how quickly geopolitical risk can get priced in.

For example, in the five days leading up to the invasion of Ukraine, the Nasdaq Composite Index, composed largely of highly-priced US tech stocks, fell by 8%, only to rally 3% on the day of the actual invasion, including a staggering 8% intra-day upward move. Looking at history, though, perhaps this move wasn't so extraordinary after all. These charts, courtesy of Barrenjoey, show a few incidences of what happened to markets (in this case the US market) after the outbreak of wars in (fairly) recent history.



Art Cashin, 81-year-old veteran of the New York trading floor, once related his experience during the Cuban Missile Crisis in October 1962. Everyone was on edge as the US and the Soviet Union approached the brink of Mutually Assured Destruction. One day, word began to spread that Russia had actually launched nukes towards the US, and they would arrive in 11 minutes. A trooper to the end, Cashin ran around the exchange floor trying to sell short but was unable to do so. The 11 minutes passed, but nuclear annihilation never came. Soon after, Cashin reported to his boss. He was told that, in the future, if the world is about to end, the proper trade would be to buy, not sell. "Why go long if the world is ending?" "It never does end," he was told, "and even if it did, who are you going to settle the trade with?"

Market forces however don't work in isolation so before we say, "war is a great buying opportunity", we must also acknowledge both the macro landscape and the inflation/ interest rate situation. Some of the current bounce is no doubt based on expectations that rate hikes could be smaller, or delayed by more than the market currently expects. This is a potentially dangerous notion: do we really want the US Federal Reserve to be even further behind the tightening curve? Especially when inflation now looks set to ramp up even further, particularly given some of the recent moves in food and energy prices? In these examples of previous conflict we certainly didn't have the current record low interest rates and inflation at 40-year highs. The backstop of monetary easing that the market has become accustomed to – relying on lower rates to solve periods of weak markets – is surely in the past.

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