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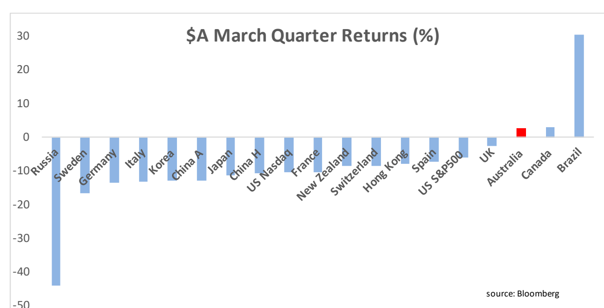
Alphinity Sustainable Share Fund

War is hell

Market comment

General Sherman supposedly said "War is hell" during the US civil war and what was true 200 years ago still applies today as the tragic scenes in Ukraine demonstrate. Despite everything going on in the world our market (ASX300 including dividends) still managed to make positive returns for the first quarter of 2022 of around 2%. March was not a great quarter for most other share markets, and the chart below puts our returns into some context. It could have been a lot worse: it was only Australia and other resource-heavy markets like Brazil and Canada that were able to show gains. It was a good time to be a miner.



Russia's share market was closed for a month after the incursion. It re-opened with a small bounce at the end of March, albeit with significant restrictions on the ability of foreign investors to sell, but finished well down for the quarter overall, a sharp devaluation of the Rouble adding to collapsing share prices.

Global equity markets had a lot to contend with during the March quarter, including whether Central Banks had lost control of inflation, the invasion of Ukraine, China re-entering lockdowns trying to eliminate Covid (remember Covid?), slowing company earnings growth, labour and commodity shortages, and some disastrous flooding on the east coast of Australia. Without a great deal of positive catalysts to offset, global markets suffered their worst quarter since the start of Covid two years ago. And not just equities, bond markets suffered a sharp rise in yields which translates into capital losses for bond holders. Despite all these headwinds, perhaps a degree of fatigue was a contributing factor that led to our equity market fighting back in March.

It was an unusual occurrence where higher growth US stocks, especially tech, started to rebound sharply at the same time as yields were rising. The normal relationship between higher yields and underperforming high-growth stocks, which held true in January and February, appeared to break down in March, and the 'buy the dip' mentality came back into force. We even saw a return (rather alarmingly) of the Reddit Day Trader Army: bored unemployed youth sitting in their bedrooms punting 'meme stocks', those companies often with little to no investment merit that gain cult-like followings through social media platforms. It was widely believed that the recent market correction had flushed out many of these players, but it appears that the army marches on.

Back home it felt like a classic Aussie rally, with Bank and Resource stocks doing the heavy lifting, and this time our market benefitted from its relatively modest exposure to Technology. Banks, Materials and Energy stocks make up the bulk of the market and it was this composition, supplemented by surging commodity prices and a strong $A, that led to our market outperforming.

A 45% increase in oil prices over the quarter led energy stocks higher, although bowser pain increased the risk of further drops in consumer confidence. That pain ended up being partially addressed in the Federal Budget and a temporary halving of the fuel excise will put a few more dollars into consumers' pockets. As for the rest of the budget, clearly an election is imminent.

Portfolio comment

The Fund underperformed the market across the March quarter, during which a number of large companies the Fund is unable to invest in performed very well, most notably resource companies South 32 and BHP and gas producers Woodside Petroleum and Santos. The largest positive contributors to returns were its holdings in diversified resource company Rio Tinto, metal recycler Sims Group and not owning tech company Xero or gaming machine maker Aristocrat Leisure. US building exposures James Hardie and Reliance Worldwide, local affordable housing group Lifestyle Communities and pathologists Sonic Healthcare all 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)	5.7	-1.8	14.1	12.8	12.4	11.9	10.7
S&P/ASX 300 Acc. Index	6.9	2.1	15.2	10.8	9.4	10.1	9.2

*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 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

Our market's world beating performance in the March Quarter, and particularly in the month of March, is largely explained by our heavy skew to Energy and Resources, and Banks which stand to benefit from higher interest rates, at least until the market starts to worry about higher bad debts. However, that these factors can combine with a rally in longer-duration growth stocks, as happened in March, for an extended period of time seems unlikely.

After some uncertainty around whether the US Federal Reserve and other central banks would moderate the pace of interest rate hikes due to the potential economic outfall from the war in the Ukraine, they are now doubling down in their efforts to contain the high inflation they are seeing today, and appear willing to risk a potentially greater slowdown down the track. Of course they can always change their mind but for now it looks pretty clear that interest rates are going up and liquidity stimulus is being reined in.

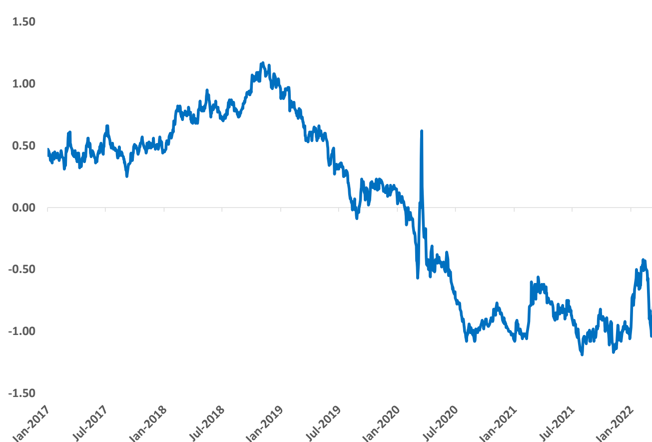
While gradual and pre-emptive lifts in interest rates have in the past been manageable for equity markets, the late starting point this time and the rather aggressive pace being articulated, at least in the US, might end up being more problematic. Higher rates initially will likely have a bigger negative impact on higher-valued growth stocks than on those companies driving and benefitting from high inflation, namely Resource and Energy stocks. However, the effect of those higher interest rates on economic growth will need to be monitored closely, especially as the developing Covid situation in China will make it more difficult for its government to implement its economic stimulus plans.

While inflation and wage pressures in Australia aren't as alarming as overseas this might be more a matter of time rather than a structural difference that makes us less vulnerable. Having said that we do still have a very high savings ratio and an enterprise bargaining system to keep wage increases under control, and this may make the inflationary pressure more manageable. However, some hangover from the last two years of excess liquidity and spending party appears unavoidable – certainly for the economy but maybe also for the equity market.

Top five active overweight positions as at 31 Mar 2022	Index weight%	Active weight %
Rio Tinto Limited	1.9	4.7
Macquarie Group Ltd	3.2	3.8
National Australia Bank Limited	4.6	2.5
Lifestyle Communities Ltd	0.1	2.4
Medibank Pvt Ltd	0.4	2.4

Portfolio Outlook

The quarter was a difficult one for the Fund. Not only did we have no exposure to Energy and limited exposure to Resources, we also didn't get the rebound in some of the more expensively-valued long duration stocks. As discussed in the previous section, we expect that the headwind from higher rates is not over for the latter group of companies. The chart below shows just how meaningful the increase in real US rates has been in recent months, and it may have further to go before it has run its course.



Of course, the performance of individual companies is not just about inflation and interest rates, even though it has felt a bit like that in recent times. This is especially the case as several companies with strong earnings momentum and recent earnings upgrades have been impacted more than usual by investors pondering the impact of interest rates across industries and sectors, in Australia and overseas. These are valuable debates to have, and monitoring changes in earnings leadership between companies and sectors is a key part of the Alphinity investment process.

However, current trading conditions and the assessment of company managements' ability to navigate external challenges are, in our experience, at least as important as broader macro assumptions. Overall, the fund remains well exposed to companyies with both short term and medium term earnings upgrade potential, in our view, including some which have not yet been rewarded for their positive leverage to higher interest rates.

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

alphinity INVESTMENT MANAGEMENT

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Emissions

The table below shows the estimated carbon intensity of the portfolio, calculated with emissions and revenue data supplied by MSCI and weighted by position size. Portfolio intensity is well below that of the ASX300 benchmark. Almost any economic activity generates greenhouse gasses but, as our negative screens exclude many of the largest emitters in the benchmark, we are confident that the fund is responsible for relatively modest amounts of CO2 equivalent emissions while still supporting companies which promote Sustainable Development.

Carbon Exposure Metrics

Scopes 1 & 2	SSF	ASX300
Carbon Intensity*	**90.5**	**227.5**

* Weighted average tonnes of CO_2 equivalent emissions per $USm revenue
Source: Alphinity, MSCI. Data as at 31 March 2022.

BHP

BHP has been a dilemma for much of our market in the quarter, and in fact for most of the last year. It is our largest resource company by quite a margin, one of the biggest in the world, and it has made a couple of structural changes that have had a great impact on its shares as well as our overall market.

BHP long had a dual listed capital structure, whereby it had shares listed on both Australian and UK exchanges. They were effectively different companies, with the shares of BHP Ltd and BHP Plc not being fungible with each other. This brought about a number of anomalies which were the subject of lobbying by some activist shareholders. In July last year, BHP announced that it would collapse the structure, effectively bringing the whole company back to the Australian market. This took place in January. Rather than it being a large company, accounting for around 6% of the ASX300, BHP became enormous, around 11% as at the end of March.

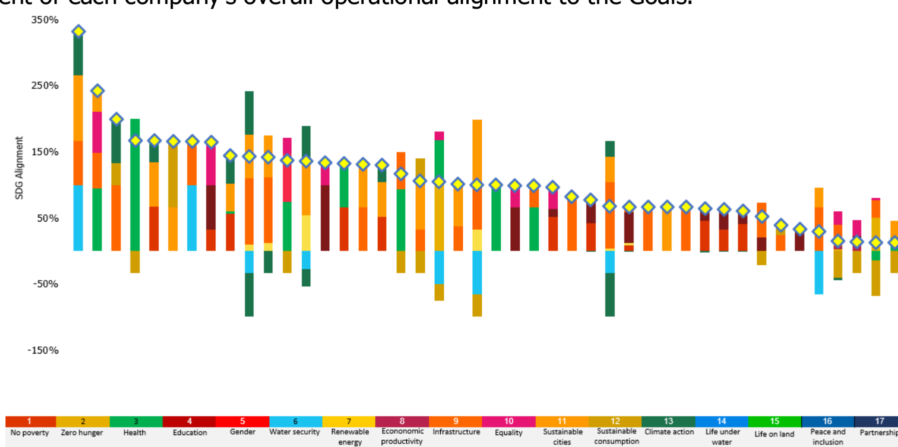
Having 11% of the market in one company is a portfolio management challenge when you are not able to invest in it, and this has resulted in some quite large swings in the Fund's daily and monthly performance relative to the benchmark. While we like most of what BHP does, its oil assets presently rule it out of this Fund, which has a remit to exclude companies with a material exposure to the production of fossil fuels.

Aside from its oil assets, BHP has an appealing mix of commodities that can help to achieve Sustainable Development, including iron ore, copper, potash and metallurgical (or met) coal. Thermal coal producers are excluded from the Fund as electricity can be made by a number of other means with much lower impact on the environment. Conversely, met coal is an essential input in the steel-making process and there is presently no viable technology to replace it. While it is possible to use hydrogen to make steel, the technology is yet to be proven at a commercial scale. When there is a good alternative met coal producers above the materiality threshold will be disallowed for this Fund.

Change is coming, however. BHP has announced that in coming months it will sell its petroleum assets to Woodside Petroleum which potentially makes BHP an allowable investment for the Fund. Whether or not we include it will depend on the view of the Sustainable Share Fund Compliance Committee and whether there is a suitable investment case at the time.

Sustainable Development Goals

The chart below illustrates our assessment of the degree to which SDGs are being positively and negatively addressed by companies in the portfolio as at 31 March 2022. It measures the percentage of revenues of each company that help to support each Goal and an assessment of each company's overall operational alignment to the Goals.



BTW

Nickel is an amazing metal. Not as sexy as gold but so much more useful. Nickel has been described as tough, corrosion resistant, hygienic and 100% recyclable. It is used in things like coins, to make alloys used in aerospace, and as an input to convert rust-prone iron into nice, shiny stainless steel. More recently it has become a key component in making batteries. It has become a critical metal for the future of our society. Nickel is mined in many countries, the largest being Indonesia, the Philippines, Russia, Australia, Canada, and China.

It also seems able to attract almost as many characters as gold does. Going back a few years, the first major venture of current-day iron ore billionaire philanthropist Andrew Forrest was Anaconda Nickel. It collapsed in 2001, burning a lot of shareholders and poisoning many with long memories against Forrest in his (ultimately) massively successful Fortescue Metals iron ore operations. The Anaconda nickel assets themselves turned out well in the end, with subsequent owner Minara Resources successfully developing and operating the mine before being taken over in 2011 by Swiss-based global metals group Glencore.

More recently we saw Singaporean Ng Yu Zhi, whose company Envy Group operated what was purported to be a nickel investment fund but was revealed in 2020 to be just a Ponzi scheme with almost no Nickel actually involved. That was after he'd taken a billion dollars of investors' money and frittered it away on an exorbitant lifestyle which included mansions, luxury cars and a big yacht. Ng was arrested last year and his upcoming trial promises to be just as extravagant.

The most recent Nickel shenanigans emerged in March. It involved Chinese company Tsingshan Holding Group and its founder, Xiang Guangda→, known as 'Big Shot' in Chinese commodity circles. On the 7th of March the London Metals Exchange found that it needed to extend margin call deadlines as a result of a massive squeeze on Tsingshan's short nickel position. The price of nickel was $US25,000 a tonne at the start of March, already up 40% on a year before, but the squeeze sent it over $US100,000. All hell broke loose that day. Tsingshan's main broker, a Chinese bank, was caught by surprise and couldn't come up with the required multi-billion dollar margin call in time. The LME gave them more time to pay up but ended up having to suspend trading in Nickel for a number of days while it was sorted out.

The LME is one of those quaint institutions that started hundreds of years ago in a London coffee shop where buyers and sellers of metals would meet and do deals, and gradually formalised into an exchange. It has one of the world's last remaining "open outcry" trading floors: i.e. traders standing around a pit shouting bids and offers at each other. The LME was bought by the Hong Kong Exchange in 2009.

That the exchange bent over backwards to save Tsingshan from defaulting is itself interesting. It made people question: is one Chinese-owned organisation prioritising the interests of another Chinese-owned organisation at the expense of global financial market participants? Or did the LME just conclude that the threat of contagion was so great the least risky course of action was to try as hard as they could to avoid Tsingshan defaulting? One thing is for sure, the many market participants who were unable to trade for several days, unable to take profits on long positions and had billions of dollars' worth of profitable trades abruptly cancelled were not happy with the outcome. Some are now lawyering-up.

Tsingshan mines Nickel in Indonesia at a cost of less than $US10,000 a tonne; selling at more than double that on the LME was understandably appealing. The LME does allow physical delivery, so in theory Tsingshan could have just shipped the metal to whoever was on the other side of its short but the grade of nickel it makes doesn't meet LME standards so that option was not available. In the end, Tsingshan will need to make a financial settlement and then hope that what it sells its own Nickel for is enough to cover its liabilities to the LME. This is unlikely, there will inevitably be a shortfall. While all parties involved were tight-lipped about how it was being resolved, by the end of March things had settled down a bit. Nickel was trading at ~$US33,000, still elevated but less extreme. It all could end up being quite damaging for the LME though, with competing metals exchanges in Chicago and Shanghai eyeing the opportunity to take share.

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Travellers' Tales

After something of a hiatus, international business travel has returned to Alphinity. The month of March saw three of Alphinity's Global Equity team heading to the US: Jeff to Florida, Trent to San Francisco and Jonas ended up in Orlando.

Florida is a long way away and required Jeff to fly first to Los Angeles (no issues there, Qantas remains one of the better international airlines around) after which he was thrust onto a local carrier, a place where even the brave hesitate to tread. Domestic air travel in the US was a miserable experience even before Covid, consisting of lengthy queues before you get to the dehumanising experience of being searched, X-rayed, and made to wait like cattle at the gate before the Darwinian exercise of actually boarding the plane. No one wants to check luggage so people, loaded like camels, enter the eye of the needle, and you need to be one of the very first on board to grab what little space there is in the overhead lockers. Not being a member of a local airline loyalty program is a distinct disadvantage here, as the courtesies we enjoy as frequent travellers in Australia is largely absent, even from "partner" airlines.

Trent was luckier: he was able to fly directly to San Francisco for his tech conference so he didn't need to make any connections, it was simply a cab (not yet an autonomous one!) into a city where everyone seems to be either a software engineer or has options in a start-up. The conference came at an interesting time for tech companies as the twin forces of rising rates and pending withdrawal of liquidity brought a sharper focus on the previously unfashionable notions of profitability, cash flow and valuation. Some of the high growth/high valuation darlings were under significant pressure while on the podium, but the spending patterns in cloud, data analytics and cyber security remain firmly entrenched.

Meanwhile, Jonas went to meet with a wide range of companies. It was on his final internal leg, between Orlando and Los Angeles, that he had a dubious honour thrust upon him. During the flight there was an announcement from the cockpit that the plane in which he was sitting was one of the oldest in the American Airlines fleet, and that he should be proud to be one of the very last to ever be on that plane.

While we can appreciate that pilots have close and often affectionate connections with their aircraft, and that it might have been a significant time in his/her life, travelling on a plane that the airline has identified as being so far past its prime that it needs to be retired is not something most passengers want to hear. We want to know that we are on a modern, reliable and highly-maintained plane: not one so new that teething troubles haven't yet been ironed out, like the early days of Boeing's 737-Max, but one whose quality is able to maintain the industry's reputation as the safest form of mass transport. We are pleased to report that Jonas made it to Los Angeles and gratefully shuffled his way onto his next flight, a (relatively) new Qantas A380, for his return to civilisation.

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