alphinity INVESTMENT MANAGEMENT

Monthly Report – April 2022
Alphinity Australian Share Fund

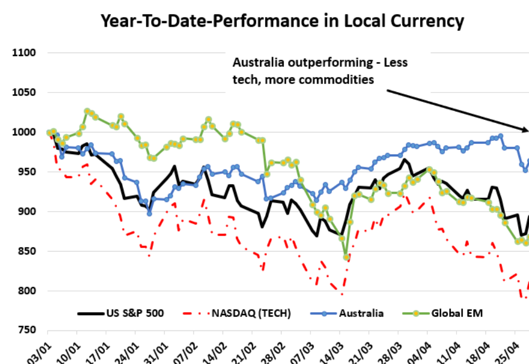
Election fever

Market comment

As Australia geared up for a May federal election, our shares absorbed a number of headwinds, including volatile offshore market moves, Covid on the rise in China, escalating bond yields here and offshore, and the prospect of imminently higher local cash rates. It fell a little less than 1% for the month of April, placing Australia quite well in the panoply of global market returns in $A terms, well ahead of the US and most of Europe. US and European firms began reporting Q1 22 earnings, creating huge price volatility around the announcements with any company missing or guiding weaker heavily sold. The broader US S&P 500 index fell 8.8% in $US terms, with the tech-heavy Nasdaq slumping 13.2% for its worst year-to-date performance on record. A 4.7% gain the $US softened the blow when translating these returns into $A.

Running on a similar theme to what we saw last quarter, Australia's composition of banks/resources and minimal tech exposure, in addition to being viewed as a relative 'safe haven' market away from Asian and European risk, again saw inflows into the country with offshore investors increasing exposure to banks and defensive stocks. Utilities (+9%) gained the most on the back of rising electricity prices while defensives also held up well with Consumer Staples (+3.4%) and Healthcare (+2.3%) outperforming. Large upward moves in the price of natural gas helped Energy stocks (+2.3%), while Tech (-9.9%) was the worst performer as investors shunned stocks trading on lofty valuations ahead of expectations of multiple interest rate hikes.

Commodities were mixed, with oil prices up 4.3% and natural gas prices closing 27% higher as Russia shut off gas supplies to Poland and Bulgaria. Iron ore was weaker, down 8% on the back of China lockdowns and softer property markets, although the Chinese government has since vowed to meet economic growth targets which would mean greater stimulus in the second half, again de-coupling from the rest of the world entering tightening mode.



With the election date set for 21 May, Australians will need to look beyond the slogans 'not easy with Albanese' and repeated loops of Scomo's bushfire handshakes, and focus on issues that matter, including cost of living pressures and an assessment of how we navigated the Pandemic. Looking at history, there have only been 8 out 28 periods where post-election three-month market returns were negative. In fact, on average the broader market has gained 4.4% in the 3-month period after election day, with stimulatory promises presumably bolstering consumer and business confidence. However, we are currently in a tricky environment where any further economic stimulation might just magnify the challenges resulting from an already over-stimulated economy. Oh, and trigger more of those pesky rate hikes.

Portfolio comment

The Fund underperformed the market a little in April. The largest positive attribution came from petrol refiner and retailer Viva Energy, global insurer QBE, insurance broker Steadfast, and not owning Block Inc. Against those were our positions in mining company Lynas Rare Earths and safety app Life 360 which all cost a small amount. Not owning hospital operator Ramsay Healthcare, which was subject to a takeover bid, or toll collector Transurban also 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)	-1.2	6.8	10.0	10.2	9.6	10.6	9.8
S&P/ASX 300 Acc. Index	-0.8	8.2	10.2	9.7	9.0	9.9	9.1

*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 April 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

With most central banks now having achieved rate lift-off and expressed a strong determination to control inflation, all eyes are on how much economies around the world will need to slow in order to achieve this.

The late start for raising rates has clearly increased the risk of a more significant slowdown, even an outright recession. At the same time, there are tentative signs that the peak in the rate of inflation has already passed in the US, where it has been most rampant. That is of course not the same as inflation getting back to target levels, which is around 2% for the US and 2-3% for Australia. This compares with the current 7-8% and 5% respectively. Rates still need to go up but perhaps not by as much as financial markets have been pricing recently.

The situation is complicated by the fact that inflationary pressure is still being at least partly driven by lingering supply chain constraints due to Covid and, more recently, Russia's invasion of Ukraine, rather than being all about strong demand. Should these constraints ease, inflation could be coming down faster and remove some of the need for central banks to move aggressively.

Australia's inflation has been lagging the US and Europe but the April Consumer Price Index (CPI) print of 5.1% showed that Australia is not immune from global trends. The RBA had to make a humbling retraction of its previous no-rate-increases-until-2024 stance. With most domestic home loan borrowers on variable rates, unlike the US where borrowers up until December last year were able to lock in a 30-year fixed mortgage rate at just over 3%, the impact from higher rates will be felt here more immediately. This is another reason for why rates might not have to go up as much in Australia in order to achieve the desired slowdown. A high savings ratio should buffer some of the additional mortgage payments.

On the earnings front global earnings revisions, outside of Energy and Resources, have now turned firmly negative. The trends are similar in Australia but with a higher level of support to aggregate earnings from Energy and Resources while the rest of the market's earnings expectations are so far only moderating slightly.

Discussions with companies clearly highlight inflation and the potential margin impact as being front of mind, a stark contrast to only a few months ago. The inflation pressure is now coming not only from input prices but also from higher wage costs, especially for the year ahead.

Top five active overweight positions as at 30 April 2022	Index weight%	Active weight %
South32 Ltd	1.0	2.1
Macquarie Group Ltd	3.3	2.0
National Australia Bank Limited	4.6	2.0
Medibank Pvt Ltd	0.4	1.9
QBE Insurance Group Limited	0.8	1.8

Companies' plans or ability to respond with significant efficiency drives appear to be limited at this stage, although so far revenue growth is largely holding up.

All up, it appears to us that pessimism about the size and pace of rate increases is a bit overdone, while earnings expectations are likely to have only started to reflect a weaker economic growth outlook and higher funding costs. A cautious approach to overall equity market performance and stock selection remains appropriate in this environment.

Portfolio Outlook

The portfolio continues to exhibit positive earnings revisions ahead of the overall market. Although the current macro uncertainty has created an unusually large amount of share price volatility, we believe earnings will ultimately drive share price performance.

We still see the risk of further compression of the premium the market is willing to pay for high growth stocks and remain underweight these companies in aggregate, although we have selectively added to some names where we expect upside to earnings expectations in the short to medium term and whose valuations now look more reasonable. We recently added to our position in CSL. There may still be some risk to earnings over the next 12 months due to last year's plasma collection challenges, but with collection volumes now similar to pre Covid levels and poised to surpass historical levels in the year ahead, we perceive CSL to be well positioned to deliver better earnings growth over time.

On the more cyclical side we remain overweight in Energy where price expectations continue to look too low, especially for LNG. The opportunity in Resources has been complicated by the Covid situation in China as well as a reduced gap between consensus price expectations and spot prices. However, with covid cases in Shanghai now falling, the opportunity for the Chinese Government to deliver on its stimulus plans should support prices and potentially offset some of the negative demand impacts from slower global growth.

Outside of Energy and Resources, the potential for positive earnings surprises is increasingly found in more defensive companies with stable demand and the ability to pass on higher supply costs. Supermarkets fit this description and we have added to our position in Woolworths following a positive sales update.

Finally, we believe the positive impact on running yields for insurance companies with large bond portfolios is still underappreciated. This, in combination with still strong premium growth, positions several companies in the sector for earnings outcomes ahead of market expectations.

Asset allocation	30 April 2022 %	Range %
Securities	97.8	90-100
Cash	2.2	0-10

BTW

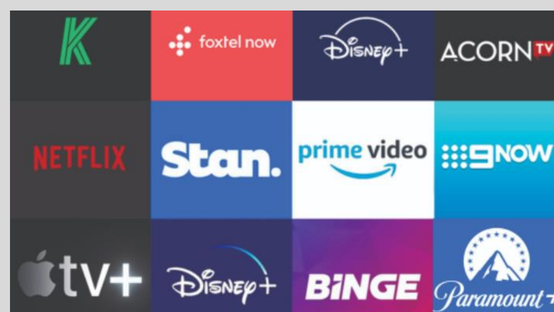
Many of our readers would have been around long enough to remember driving to video stores to rent movies (remember those clunky VHS boxes?), often paying $6 a film and then much more in late fees if you forgot to return them on time. In addition to the cost and inconvenience, there was pressure on the movie chooser as you often had one shot, with limited access to research tools like movie review websites, to make an informed decision. You would risk the wrath of your family or flatmates should you choose poorly.

Fast forward to 1998 and the birth of Netflix. It started renting out DVDs by mail but a year later changed from pay-per-use to a subscription model. While considered somewhat revolutionary at the time, it wasn't until a decade later that Netflix changed its model again into a full streaming service. This would have a profound effect on the way millions of people choose to spend their free time. Having a first mover advantage in the streaming space, Netflix quickly grew subscribers and became so popular that it even spawned the phrase "Netfix 'n Chill", a term more popular with the younger cohort who probably weren't born during that troublesome era of VHS movie rentals.

Fast forward again to the Pandemic and one of the biggest problems to solve, aside from the obvious health and safety issues, was how would we entertain ourselves with all this free time sitting in our homes during lockdowns. According to MIDiA Research, time spent consuming content went up by 12% during the lockdown. All forms of home entertainment rose sharply, as did online gambling and gaming. We saw new entrants start to flood the space. What was once an easy menu to navigate through, is now a smorgasbord of streaming options, including Disney, Amazon Prime, Kayo Sports, Stan, Binge, Paramount, Britbox and so on, and the list of options seem to grow by the week. What was once a $15-a-month subscription to one service has potentially ballooned to Foxtel levels of spending if you've connected to four or five.

MIDiA used the term 'attention recession', suggesting that Netflix is just one part of the attention economy that peaked in 2019, before Covid, with the pandemic only serving to 'delay the inevitable effects of companies that are competing in a now saturated attention economy'. As we moved into the post-Covid recovery phase, the impact was unevenly felt between sectors with audiobooks, podcasts and video all losing share of peoples' attention while social video (TikTok/Youtube) continued to keep growing.

Total hours of attention are falling while social is still growing, and the streaming companies are competing for even smaller pieces of leftover time. Content has always been the differentiating factor, and companies like Netflix spend up big time to produce original content. For example former James Bond Daniel Craig is being paid an eye-watering $US100 million to be in the Knives Out sequels. Disney spent $US22 billion on content in 2021, and is planning to spend a further $US33 billion this year. Netflix spent $US17 billion in 2021. It could only wish for a repeat of Squid Game, a series that cost only $US21 million to make, but netted them nearly $US1 billion in profits on just one series.



All of the risks discussed above culminated in consecutive poorly received earnings reports from Netflix, with the stock falling 35% in one day after the company reported a decline in net adds. The company reported 261.44 million paid memberships, down 200k from the previous quarter, but importantly also guided for paid net adds (additional subscribers) to be -2 million, well below consensus estimates of +2.3 million. The stock has now fallen 70% from the highs reached last November. It's not just 'peak-Netflix' though, more likely 'peak Streaming'. Disney has also fallen 35% over the last six months.

While these companies will no doubt try to find solutions like raising prices, smarter bundling and clamping down on free-loaders (multiple users signing into one account), it feels like the subscriber model is broken and the investment case for most of the whole space is challenged according to our investment process. Earnings quality is a key factor in our investment process, and with such an unclear path for subscription growth in what is a saturated market, it's difficult to make an investment case.

Indeed, some of the streamers might wish we were back in the 1980s, with its high barriers to entry and ability to charge customers $6 a pop and $12 in late fees… Remember: Be kind, rewind!

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Travellers' Tales

Opportunities to travel have been somewhat lacking recently so when the prospect arose of going to a hardware store, our consumer analyst Jacob jumped at it. In order to check out Total Tools, a trade-oriented tool shop supplied by listed company Metcash, he needed to go to Brookvale, on Sydney's northern beaches. But how to get there? The ferry wouldn't take him all the way and a taxi isn't very environmentally friendly. Someone suggested the bus, at which point he said, to the amazement of the whole office, that he hadn't done that before.

We wouldn't want to paint Jake as elitist, though. We know that for many people a bus ride is a daily occurrence but Jake grew up in a regional town where, apart from the odd school bus, there wasn't the need or even opportunity to take public transport. Where he now lives in Sydney, trains are the go-to mode of transport, so catching a bus was a novelty. And what a bus it was! Not a normal blue one, it was one of those fancy yellow double-decker B-Line bus that serves the northern beaches of Sydney. Taking a prime seat on the top deck he was able to get a great scenic experience of Sydney Harbour while going across the bridge, down Military Road and over Spit Bridge to the slightly grungy semi-industrial suburb of Brookvale.

There he saw a wide variety of cordless power tools such as drills, impact drivers, circular saws but was most impressed to see a hammer with a shelf price of $389.

This was no ordinary hammer, it was made from titanium and had a replaceable strike plate. But still, $389? Inflation is everywhere, and probably at least partly explains the cost of hiring a tradie in Sydney.

The tools are sold in large packs comprising several 'skins' which are the tools without the battery. Batteries are purchased separately but there are only two batteries common across all skins. One of the more interesting categories which seems to be growing rapidly is the battery powered gardening tool category. This has traditionally been the domain of petrol engines (and still is predominantly) but cordless tools like lawn mowers, trimmers, blowers etc are growing pretty rapidly, even in a professional context. Even the humble lawnmower is now built with chips these days. No wonder there is a global shortage.

After having a good look around and talking with various customers and management he hopped on the B-Line back to the city to indulge in another experience of that wonderful transport mechanism. The best thing of all however, was that due to some State Government largesse which had temporarily removed fares from public transport, both legs of the trip were free!

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