Monthly Report – May 2022
Alphinity Sustainable Share Fund

Scott-free

Market comment

Australia gained a new PM in May, but it wasn't Craig Kelly as we'd been promised. We swapped Scomo for Albo but, with the relatively thin policy platform Albo had run with, we are yet to discover what real difference it will make. More hose-holding and fewer unwanted hand-shakes perhaps? The local equity market has thus far been untroubled by the political change, retaining instead its focus on moves in overseas markets and rising speculation of recession in the US as a result of that country's well-entrenched program of monetary tightening. The local equity market (ASX300 including dividends) fell by about 3% in May, and is now about 2% lower for the calendar year. This is a much better outcome than most offshore markets have been able to achieve, credit for which can largely be given to preponderance of banks and resource-exposed companies in our market.

The broad US market was flat in local currency but down 2.5% once a slightly stronger $A was factored in, but its tech stocks, as measured by Nasdaq, were lower by more than 5.5%, and are now down 21% for 2022 to date. European markets bounced back in May, with Italy and Germany among the better performers in $A terms, although it felt more like a relief rally off the lows as war in neighbouring Russia/Ukraine and energy security issues sadly become normalised.

Back to home, there wasn't much to cheer about when looking at sector returns, with Utilities the best performer but still down 0.2%. Materials and Energy were relative outperformers, while REITS (-9%) and Tech (-8%) were the laggards. Interestingly, both Consumer Staples and Consumer Discretionary sectors fell around 6%, not helped by big falls in US companies Walmart and Target after both companies cut their profit forecasts as costs began to squeeze margins. Commodities were generally firmer, led by a 12% gain in oil prices. China began to ease mobility restrictions and the EU agreed to ban Russian oil imports. The Iron Ore price was flat over the month at $US133 with supply disruption and China stimulus supporting the price, although demand for steel itself was weak with inventories remaining high.

A rise in mortgage rates in the US has led to a softening in US housing data and we are also seeing the early signs of heat coming out of our own property market as higher borrowing costs begin to hit demand. New Zealand went hard early in increasing rates last year and continues to do so, with its central bank estimating that total mortgage payments could soon account for as much as 70% of a new buyer's household disposable income. Australian borrowers aren't yet under the same stress, given variable rates have only just started to rise, but the direction is clear.

Indicative mortgage payments for a new buyer

Source: RBNZ estimates.

Note: Calculated as the share of median household disposable income required to service a new 30-year mortgage on a median-priced house with a loan-to-value ratio of 80 percent at the average two-year mortgage rate.

Official interest rates were lifted for the first time in more than a decade in May, from 0.1% to 0.35%. It marked a change in tune from the Reserve Bank of Australia which had previously said rates would stay down until 2024, but was required considering the strength of the economy and building inflationary pressures. That was just the first, there will be more increases to come.

Portfolio comment

The Fund lagged the market somewhat in May. Our positions in major miner Rio Tinto, rare earth producer Lynas and health insurer Medibank Private all added value. On the negative side however were a number of positions that cost including property developer and owner Goodman Group, building materials producer CSR and supermarket operator Woolworths.

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)	-4.1	0.9	1.8	9.5	11.6	12.0	10.1
S&P/ASX 300 Acc. Index	-2.8	3.1	4.7	8.0	9.0	10.3	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, 31 May 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

After a soft start, suggestions that US inflation might already have peaked gave global bond and equity markets a much needed boost in the second half of the month. While some relief is understandable, following the fairly savage sell-off of previous months, we think it is premature to suggest that inflation risks have subsided materially. Long bond yields may have made most of their move in reaction to the inflation break-out but we are, in all likelihood, still quite early in the global economic slowdown and yet to see its full impact on corporate earnings. Equity valuations have started to reflect higher interest rates but arguably less so the risk to earnings.

But has inflation actually peaked? Oil prices are always difficult to predict but if they stay around current prices it is probably too early to say that it has. China remains the wild card in the outlook, especially for the Energy- and Resource-heavy Australian equity market.

It is somewhat encouraging that the Chinese government's attempts to stimulate the economy through both fiscal (i.e. spending) and monetary (i.e. lower interest rates) initiatives are increasingly clear. However, ongoing Covid restrictions in some of the provinces most important to Chinese economic activity means that authorities there might not have enough time to get construction activity going sufficiently to capture the peak of construction season. The starting point for most commodity prices is also relatively elevated compared to previous stimulus episodes. All up, the risks and opportunities around China look fairly evenly balanced, in our view.

The Australian Federal election brought some significant changes to the Australian political landscape. And, despite what has been widely described as Labour's small-target election strategy, it appears that corporate Australia is cautiously optimistic about finally having a better-defined pathway to follow when it comes to energy policy and emissions reduction strategies. As those challenges remain intractable, a clearer picture of winners and losers in the share market should emerge over coming periods.

Top five active overweight positions as at 31 May 2022	Index weight%	Active weight %
Rio Tinto Limited	1.9	4.4
Medibank Pvt Ltd	0.4	2.6
National Australia Bank Limited	4.6	2.5
Macquarie Group Ltd	3.0	2.3
QBE Insurance Group Limited	0.8	2.2

Portfolio Outlook

Positive earnings revisions continue to be found largely in the Energy and Resource sectors, quite a headwind considering the Fund's restriction on Fossil Fuel-producers and high emitters. We have recently added a position in BHP following the sale of its Oil & Gas division, which brings its fossil fuel production to a negligible level, well below the Fund's 10% revenue threshold. Now that it is ex-energy, BHP produces some very appealing minerals that can help to positively address a number of Sustainable Development Goals, including copper and nickel (supporting electrification), the raw materials needed for steel-making (for infrastructure) and potash (for food production).

We have also recently trimmed our position in building materials maker James Hardie Industries. While the company delivered another strong result and remains well positioned for medium-term market share gains, the US housing market is showing clear signs of slowing which will inevitably make it more challenging for the company to beat current consensus earnings expectations.

May was a busy period for company results with three of the major banks reporting interim results in addition to Macquarie Group and several companies in the Chemicals and Building Materials sectors.

The results released by three of our big banks confirmed, in our view, that our preference for NAB and CBA over Westpac and ANZ is well-founded. Both reported solid updates demonstrating an impressive ability to keep costs well under control at the same time, importantly, as delivering solid loan growth.

A market correction such as that currently underway, as usual, provides us with both opportunities and threats. We have identified a number of additional investment opportunities which we will no doubt be discussing in coming updates. While diverse in industry exposure, they all have one thing in common, the potential to deliver earnings which we our research shows is ahead of current market expectations.

Asset allocation	31 May 2022 %	Range %
Securities	96.6	90-100
Cash	3.4	0-10

BTW

We've written a few pieces about Cryptocurrencies in these pages in recent years, recording some of the high points and low points, but Cryptos have managed to gain some resonance in society, particularly amongst younger members. We established that they are not much good as currencies (i.e. being a store of value and medium of exchange), leaving them only with possible financial appeal. So, are they good investments?

We distinguish between investing (what we do on your behalf) and speculation. Investing is looking at an asset – in our case shares in a company – and making a dispassionate assessment of its worth. Where that worth is well above the current price, we buy. Then we hold on, monitoring the position for indications that our valuation is on track to be realised or signs that our thesis is coming unstuck. Over time, if we're correct, the shares become worth what we think and, when we assess them to be trading at a price that fully reflects its potential, we would tend to sell. That's investing.

But there is no fundamental value of a cryptocurrency. Coins are mathematical entities that exist only in the minds of those who created them; their "value" – i.e. the price at which they trade – is wholly reliant on someone else being willing to pay that price. It is the very definition of ephemeral: a small change in market psyche, or the actions of a "whale", can cause the price of Bitcoin to plunge. Or double. Admittedly some real assets, such as Gold, are also highly dependent on sentiment: why does it trade for ~$US1800 an ounce? Because enough people are willing to pay that much. But at least Gold is a physical asset that has a use apart from trading: you use it in electronics, you make jewellery from it. It is useful. It is tangible. In our view Crypto-currencies might be good for speculation but should not be thought of as investments.

But that's just our view. Many Crypto proponents argue coins should indeed be part of investment portfolios as they are un-correlated with other assets, i.e. their value is likely to be maintained when proper asset classes, like equities or bonds, are falling. But this was just an untested theory. Both bonds and equities have been in bull markets ever since the first Crypto was invented, it is really only this year that there have been some sharp declines. We now have the first real test of this theory of non-correlation. Given the turbulent markets, how did those uncorrelated Cryptos do?

Not so well it turns out. Comparing Bloomberg's index, which tracks the major coins, to the worst US equity market this year, the "tech-heavy" Nasdaq, Crypto actually has done substantially worse: down 47% this year to the end of May against Nasdaq falling "only" 21%. It seems that many of the people who trade coins also trade tech stocks and when they were in the mood to sell, they seem to have sold everything. The message to take from this is probably that if you're looking for a stabiliser in your investment portfolio, a massively volatile "asset" like Bitcoin may not be very helpful.

There are also so-called stablecoins in the Crypto space, coins that are backed by stable assets designed to provide the decentralisation benefit of Crypto but with more stability than traditional coins, much as you'd expect from a proper currency. Are they a better alternative? Well, it seems that even stablecoins weren't that stable with one of the big ones, Terra USD, losing many billions of dollars of "value" and very quickly becoming worthless.

The problem with Terra was that its backing wasn't by real assets like $US or Treasury bonds, it was backed by a sister coin, LUNA. The idea was that holders of both Terra and LUNA could always swap their holdings in return for the other coin, creating a stabilising arbitrage. Problem was, LUNA didn't turn out to be stable either. In May, some Terra whales undertook a short attack against the stablecoin. Holders tried to redeem their Terra holdings for LUNA creating an over-supply of the coin, resulting in a death spiral where the value and credibility of both Terra and Luna crumbled to nothing in a few hours.

Some people have made a lot of money trading Crypto. Good luck to them. They should look at that in the same way you do when putting money on a horse at the races or feeding notes into a slot machine. Or day-trading shares. It is a windfall. It is good luck, nothing more. Sadly it is the least informed and the desperate who usually end up on the wrong side of the trade. Those "in the know" – generally the exchanges and the sellers of coins – have the best chance of doing well.

Once most of the speculative rubbish coins cease to exist, there might be an exciting future for blockchain, the infrastructure that backs crypto, with decentralised finance putting buyers and sellers into direct contact without the need for a middle man. Such opportunities could potentially include settling house transactions within minutes instead of weeks, or the ability to better organise the flow of payments for shared intellectual property within communities, such as artwork royalties being paid directly to indigenous communities. But those uses are still well into the future. For now, with Cryptos, as all things, the buyer needs to beware.

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Traveller's Tales

Stuart headed off to the US during the month, hitting Chicago, Minneapolis, Boston, Atlanta and Dallas then back to Sydney over the course of a week and seeing a range of companies in the building materials space. It included a long drive to the remote logging township of Hayward in far north Wisconsin and had a close encounter with local fauna that left him feeling decidedly bearish.

Economic activity is humming all over the US. Roads were congested with full semi-trailers, airports were heaving with people, there was even a queue to get into TGI Fridays, but most notable was the difficulties he had getting a rental car. Twice he experienced extended waits for cars despite having bookings, prompting flashbacks to the scene in 1990s sitcom Seinfeld ("You can take the reservation, but you can't hold the reservation, which is really the most important part of the reservation!").

Most hotels and restaurants were short staffed and advertising for people, as was the Qantas lounge in LAX, which indicates that the current inflationary environment could be around for a while yet. One pandemic-induced trend has been working from home, allowing employees to live a bit further from the CBD.

In a meeting with a home builder in Texas he heard about one unlucky customer, intent on utilising this trend, who was trying to make his New York salary go a bit further by buying a house and "working from home" in Dallas. He didn't anticipate that the builder would need to verify his employment and salary by calling his employer, who was equally surprised to receive the call. Shortly after that, the employee called back to cancel the contract as his plan to move that far away had come unstuck.

A broader trend has been the rise of "influencers" in helping deliver corporate strategy. Portfolio holding James Hardie Industries recently signed a deal with US home renovation gurus Chip & Joanna Gaines to help promote Hardie products on their home renovations channel.

While the campaign hasn't kicked off yet, it was interesting to hear of the shortage of window frames generally which was compounded recently by the Gaines decorating a house with black window frames. His contact saw several instances of the already stretched supply chain scrambling to source previously-unstocked black windows to meet the sudden demand. James Hardie is hoping their advocacy has a similar impact on the fibre cement siding market, once they have a bit more spare capacity.

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