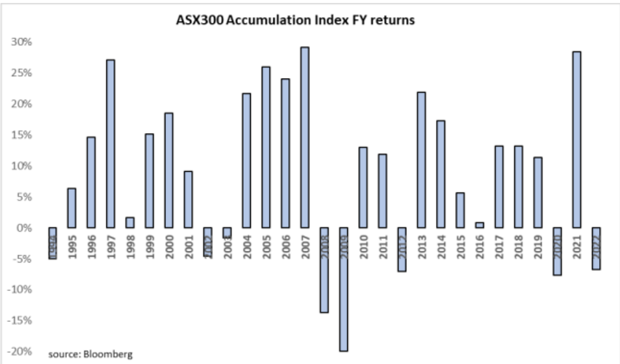
Quarterly Report – June 2022
Alphinity Sustainable Share Fund

Inflating expectations

Market comment

Australia had, until June at least, demonstrated a plucky resistance to the strong negative forces impacting share markets around the world thus far in 2022. This resistance was tested in June and failed. The local share market (ASX300 including dividends) was finally caught up in the global downdraught, falling by 9%, losing -12% for the June quarter and almost 7% for the year to June. The $A also fell, from $US0.75 at the start to end around $0.69. The primary concern has been the resurgence of inflation, which is driving sharp increases in interest rates in many parts of the world.

While we're not sure if stamping on domestic demand here will change global commodity prices, which seem to be the primary causes of the inflation we've seen so far, it is pretty much the only instrument the RBA has at its disposal: it put a further 50bp onto the local cash rate in June. The risk is that it keeps going to the point that any remaining life is hammered out of our economy.



We've had a poor start to the year but offshore markets have struggled even more. The broader US market has fallen 20% year to date, its worst start to the year in decades. Bond markets too have had a horror start to the year, with one global bank calculating that the return on US bonds was the worst since 1788! The price of bonds are inversely correlated with yields, so as yields have risen sharply, US bond portfolios have devalued by about 15% this year. There has been nowhere to hide in US markets. Australia's market composition (more resource exposure and fewer 'growthy' tech companies) has cushioned our fall relative to the US.

Meanwhile, in Europe, the inexorably-rising rate phenomenon was putting fresh pressure on the countries troubled by debt after the GFC, with Greece and Italy increasingly looking like it's 2011 again. Italian bond yields briefly surged past 4% in June, and while still well below the 7% of 2011, they are uncomfortably higher than the 1% levels at the start of the year. At the rate we're going, we might even see Swiss deposit rates go above 0%. Imagine no longer needing to pay the bank to keep money there!

One of the largest swing factors in markets currently is the outlook for China, trying to navigate out of Covid lockdowns while at the same time addressing a weak housing market. Its desire to stimulate and increase money supply has put it out of sync with most other global markets entering a tightening cycle. Appearing somewhat more immune to the rate hiking seen in most other places, flows appear to be gravitating to that region. The Shanghai Composite index was up 11% in June in $A terms, although it remains -6% year to date.

Commodities were broadly weaker as inflationary effects softened demand, with both Copper and Aluminium falling over 12% in June. Oil fell 7% to $US109, breaking 6 straight months of gains as inventories built up in the US. Iron Ore closed the month down 13% to $US115.

Portfolio comment

The Fund underperformed the market in the June quarter. Our strongest contributors were health insurer Medibank Private, global insurer QBE and insurance broker Steadfast, while not owning financial services company Block Inc (Afterpay) continues to be a boon. On the negative side however was not owning BHP for much of the period, and not owning Woodside Energy at all.

For the financial year, the biggest contributor was Block, followed by QBE, Lynas Rare Earths, health exposure Virtus and Macquarie Group. The main negatives were BHP and Woodside, although building materials maker James Hardie Industries and CPAP maker Resmed also hurt.

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)	-9.3	-13.5	-9.7	4.4	9.4	10.7	9.1
S&P/ASX 300 Acc. Index	-9.0	-12.2	-6.8	3.4	6.9	9.2	7.8

*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 June 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.

Market outlook

Following the June sell-off, the Australian equity market is now trading at a relatively low 13x 12 month forward aggregate earnings estimates, and about a 5% dividend yield. This compares to a historical average around 14x and a dividend yield in the 4-4.5% range. At a high level this would suggest that downside from here is limited, but while there appears to now be some buffer from a valuation perspective, our enthusiasm is tempered by how the market multiple is composed. Resource companies are still trading at single digit multiples but the rest of the market, while down considerably from peak levels, is still a little above historical averages. And there remains earnings risk across both.

A range-trading market seems a reasonable outcome in these circumstances, with either a significant downward reset of aggregate consensus earnings estimates in the upcoming reporting season, or a clear change in the Reserve Bank's policy signalling. Even a return to neutral rhetoric, rather than full reversal to easing, would probably be sufficient for a more sustained improvement in the equity market outlook.

From a sector or style perspective the picture has become more mixed. As mentioned, some commodity price expectations in the market are now looking quite stretched. While the effect of China's stimulus efforts are starting to become more tangible, a slowdown in the rest of the world has put pressure on base metals such as copper and aluminium in particular, increasing the risk of reduced earnings estimates in parts of the Resource sector. Energy prices, while hard to predict at the best of times, continue to trade ahead of consensus estimates. With at least some elements from the situation in Europe behind those high prices, earnings risk in Energy remains to the upside, in our view.

"Growth" companies might get some support from increased earnings risk in some of the more cyclical parts of the market, but valuations and ongoing interest rate rises might still cap the upside to that part of the market. The upcoming August reporting season will, as always, provide valuable insights into company performance and current trading but the relatively recent change in economic growth expectations might mean companies will give less helpful guidance about future earnings than is usually the case.

All up, notwithstanding the recent falls we are only a little more comfortable with the Australian equity market now than we were earlier in the year. We do see some opportunities, but risks remain from pressures building in the domestic economy as a result of higher inflation, rising interest rates and tighter monetary conditions.

Portfolio Outlook

The Fund seeks to obtain higher-than-consensus positive earnings revisions, although this has been hampered this year as most of the positive revisions have been occurring in Energy and Resource companies. While we have been exposed to the resources that can help to address Sustainable Development, not investing in oil or gas-producing companies has been an impediment to positive earnings revisions for the portfolio as a whole, and the highly uncertain macro environment is also providing ongoing challenges.

As we head into yet another full-year reporting season in August, a reasonably defensive overall positioning appears to be appropriate as the Australian economy continues to slow in the second half of 2022. Having said that, with so many factors at play and a fairly significant de-rating of the market having already occurred, we would caution against becoming too pessimistic at this point. While macro forces are hard to resist, individual company circumstances can often be powerful enough to provide a strong reversionary force once the macro has subsided. We remain confident in the ability of our investment process to keep identifying companies that can deliver ahead of expectations even in the current environment, just as it has in others. They are the companies we expect will outperform.

Top five active overweight positions as at 30 June 2022	Index weight%	Active weight %
Medibank Pvt Ltd	0.4	3.3
BHP Group Limited	10.5	2.9
Woolworths Group Ltd	2.2	2.9
QBE Insurance Group Limited	0.9	2.8
Lifestyle Communities Ltd	0.1	2.3

Asset allocation	30 June 2022 %	Range %
Securities	98.2	90-100
Cash	1.8	0-10

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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 CO_2 equivalent emissions while still supporting companies which promote Sustainable Development.

Carbon Exposure Metrics

Scopes 1 & 2	SSF	ASX300
Carbon Intensity*	101.1	244.6

* Weighted average tonnes of CO_2 equivalent emissions per $USm revenue
Source: Alphinity, MSCI. Data as at 30 June 2022.

Fossil Fuels

Not being able to own oil and gas producers has held back the performance of the Fund somewhat this calendar year. Geopolitical developments in Eastern Europe have resulted in energy shortages in some parts of the world – most extremely in Germany – and the price of oil, gas and coal has exploded upwards, as have the share prices of many of the companies which produce them. When shares we don't own are performing, the question we always ask ourselves "Why don't we? Should we?" The answer is "No."

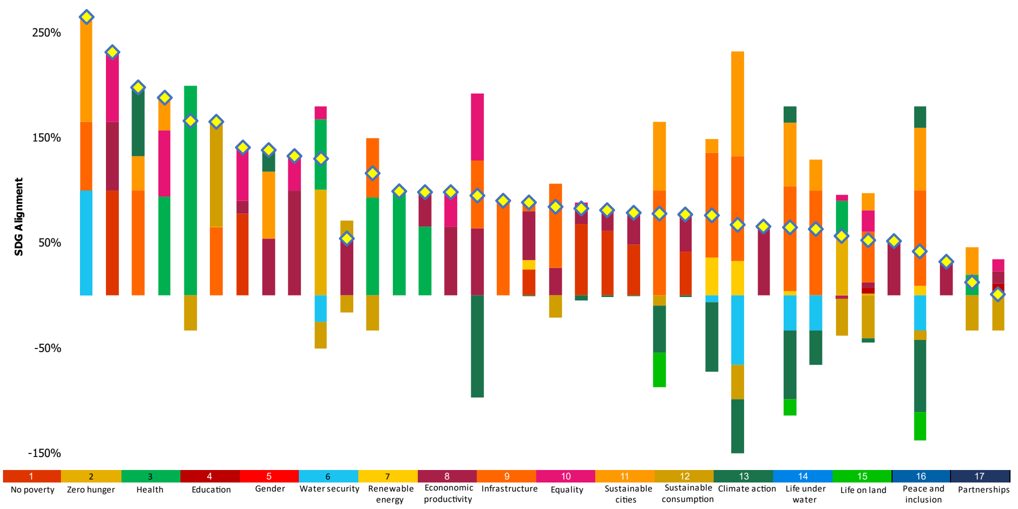
The Sustainable committee took a principled stand some years ago that companies producing fossil fuels were not consistent with achieving the Sustainable Development Goals. It was not a naïve decision; it was made in the full knowledge that at some point there would be a cost to performance. Our many years in markets has taught us that no trend lasts forever, markets are cyclical and any trend ultimately runs out before reversing, wholly or partly.

That's what we're seeing at the moment. Energy prices were low during Covid but the current situation has reversed that. But this episode of very high energy prices won't last forever. A high price generally elicits a response which will tend to bring them eventually back to some equilibrium. It might be more fossil fuel exploration, preferably with carbon capture. It might accelerating the deployment of lower-emitting sources like renewables. It might also be demand falling away as a result of slowing economies demanding less energy. Most likely it will be a combination of them all.

Energy prices could go even higher for a period, especially as the European winter approaches and Russian gas supplies become less acceptable. But we can be sure that at some point some of the pressure that is currently being felt around the world will be relieved, and some of our lost performance will be recaptured. But we are <u>not</u> considering unwinding the fossil-free status of the Fund.

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 30 June 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.



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BTW

Understanding the difference between price and value is one of the most fundamental concepts in investing. The price of something is usually clearly evident, for example the $100 price tag on that pair of jeans, but its value is more conceptual: what are they really worth? How much would you be willing to pay? Would you pay $150 if that pair of jeans were scarce, or if some celebrity endorsed it? It becomes more complex when attempting to arrive at an assessment of a company's future worth: it requires many assumptions and, in the case of the last couple of years, a degree of artistic license in certain industries. It's worth exploring some of the things that drove equity prices higher during the Pandemic, and some of the factors that have ultimately led to the downfall of some companies which were trading on unsustainable valuations.

Lockdowns during the Pandemic resulted in a large number of people in many countries being stuck at home, some without jobs but being fed stimulus cheques. What do bored people do when stuck at home with excess cash? It turns out that a lot of them punted the stock market, or crypto, or both, and this helped to fuel the greatest speculative bubble since the dot com crash more than 20 years ago. There are of course many unique circumstances this time round when comparing to the tech wreck, one of which is that sky-high valuations were not just confined to tech. In the dot com era, companies with 'crazy' valuations had market caps of $4 or $5bn; this time we saw valuations of $20bn, $40bn, even $80bn. And it wasn't just confined to technology: as hedge fund guru Jim Chanos recently said, "this is the dot com era on steroids".

He pointed to the US gig economy darlings of 2020: Uber, Lyft, Peleton and Doordash to name a few. The unit economics on these businesses were terrible during a time when it should have been nirvana. If food delivery companies couldn't make money during the height of the Pandemic, when would they EVER be profitable? The answer is probably never. A recent article in US magazine The Atlantic, *The End of the Millennial Lifestyle Subsidy* posited that these companies subsidised the lifestyles of younger people which helped to suppress inflation, and the culprits were the companies themselves who continued to saturate markets with unsustainably cheap pricing and only cared about metrics such as the TAM (total addressable market), ignoring the more important metric of profitability. There is a problem when companies were being rewarded to be unprofitable.

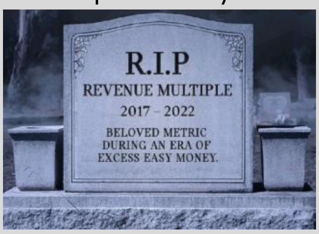
The main culprit was arguably the revenue multiple: people in markets would often look at how a company's top line is trending and ignore the bottom line, and this was facilitated by zero interest rates. But now, with rising rates and falling valuations, that topsy-turvy world is flipping back to normality: free money is finished and profits do actually matter. That $20 Uber ride now costs $50, and not just during peak-hour surge pricing. We also saw the explosion of Fin Tech, which was essentially sub-prime lending using an app. Small-value short-term loans abounded with little thought as to when or if they would be repaid. Not to mention Buy Now Pay Later, unsecured consumer finance which somehow escaped consumer finance regulation. Clearly there's no credit risk at all when you're letting teenagers buy clothes and/or electronics without needing to front up the cash. What could possibly go wrong with that?

Another factor that drove speculative buying was the ease with which people could trade shares. The enablers were the trading platforms like Robinhood in the US and others elsewhere offering zero commission on all trades. So the equation of bored people sitting at home + free money + free trading + free access to leveraged products just added kerosene to the fire. Trading platforms like Robinhood generally have a business model that relies on "Payment for Order Flow". They basically get paid by packaging up all their retail orders and selling this flow to market makers who could potentially front-run them. Robinhood portrays itself as a charitable venture for small traders out there, but in reality they're clipping the ticket on the way through.

Listed equity markets, while at times volatile and subject to speculative bubbles, are at least transparent. We can see prices every second of every day, and while sell-offs such as we have seen this year can be painful, more reasonable valuations can be reached quickly. Companies are required to report their earnings, and they are generally presented in a consistent and understandable way. At the less transparent end of the market, however, there was the rise and fall of SPACs (special purpose acquisition companies). Primarily in the US but also infiltrating other countries, these companies raised capital in an Initial Public Offering (IPO) with the purpose of acquiring another (at that point) unknown company without an IPO. For a period last year, new SPACs were raising on average USD3bn every day, equivalent to the entire US savings rate. That was mind boggling, and clearly unsustainable.

An issue yet to reveal itself is in the unlisted space, such as private equity (PE), whose valuations are not regularly marked to market. PE has had two massive tailwinds over the last decade: declining interest rates and rising equity values. With all that leverage, one would expect PE firms to be doing better than the S&P500 in recent years, but generally that hasn't been the case. We could see the potential for PE to suffer from the same reality check that hedge funds had after the financial crisis.

Painful as it is for those currently receiving the rough end of the pineapple, a correction such as we are seeing now can be quite healthy for the market as a whole. It can take out some of the more unhelpful behaviour (and players!) and focus us all back on more meaningful things, like earnings. And also reward those who didn't get caught up in the hype.



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Traveller's Tales

The Gini (Coefficient) is Out of the Bottle

The Alphinity Global team is back on the road! Collectively, in the first six months of 2022, the team has been on nine overseas trips and met with more than 100 companies across seven countries. Travelling again after two years of Zoom calls is an excellent opportunity to reconnect with corporates and gain valuable on-the-ground insights.

Mary attended a Sustainable Futures Conference in New York which highlighted a vast array of companies that are focussed on achieving concrete Sustainability and ESG outcomes. In rural areas, farmers are flush with cash from the prevailing high soft commodity prices and seasonal trends remain strong. And, like the Alphinity Global investment team, Americans and Europeans are out there travelling and experiencing life post-COVID with an enthusiasm that is almost unprecedented.

Sadly, not all of our on-the-ground insights were positive. Having lived in the US for many years and returning after a long COVID-induced hiatus, Mary observed that income inequality has clearly worsened and is becoming a major challenge for America as a society.

While this has been an ongoing issue since the 1980s, COVID has significantly exacerbated the problem. In 2020, tech-enabled white collar workers in large US cities packed up their laptops and moved almost seamlessly to working from home (WFH) and watched their assets – homes, stocks, etc – appreciate considerably on the back of extremely easy monetary policy around the world.

On the other hand, many lower income jobs became less and less secure during extended COVID lock downs. Stimulus cheques helped for a while but that stimulus is now being withdrawn and low-income wage growth is not keeping pace with rampant inflation.

At an extreme, this worsening in income inequality is noticeable in the incidence of homelessness in many major cities in the US. Mary also went to Seattle to meet with Microsoft and Amazon, and there the homelessness problem is confronting. An estimated 40,000 homeless people are living in the Seattle area, many only a stone's throw away from the headquarters of some of the largest and most profitable companies in the world.

Statistics support the visual impression. There has always been a great disparity between the rich and poor in the US. According to World Bank rankings, its Gini co-efficient, a measure of income inequality (where lower is better) sits at 41, on par with countries like Haiti, Qatar and Djibouti. For context, Australia is 34.4, materially better but not as equal as some of the Nordic countries which tend to be in the high 20s; the most equal is Slovenia with 24. At the other end of the scale are a number of African and South American countries with Ginis in the 50s and 60s. There is even greater income inequality among US states with New York and California ranked worst and third worst in the country.

Our current global portfolios have very little exposure to the low income consumer in the US, so this trend poses little earnings risk to our stocks specifically. The greater risk however is that this eventually translates into a higher prevalence of worker unrest and pressure for unionisation will build.

While in New York Mary accidentally stumbled across a Justice for Chipotle Workers demonstration, a protest of Chipotle Mexican Grill staff who are demanding wages of $US20 per hour, up from just under $17 presently. Unionisation movements are also gaining ground at high profile companies like Amazon and Starbucks. Given the ultra-low unemployment rate in the US, companies paying inadequate wages could quickly find themselves without a workforce.

We are happy to be on the road again. The world has changed in positive and negative ways since pre-COVID but we are committed to using on-the-ground meetings and travel insights to hone our understanding of the markets in which we invest on your behalf. Happy travels!

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ESG Spot

Moana spent June in Europe to gain a sense of some of the key emerging topics from some of the world leaders in ESG. Based in London for a month, those sunny days, long daylight hours, short flights to neighbouring countries and the vast size of the financial hub didn't fall short of her expectations. Flights were full and airports were teeming with travellers on the quest for a Euro summer. Crossing international borders was surprisingly smooth, albeit with long queues due to vaccine checks.

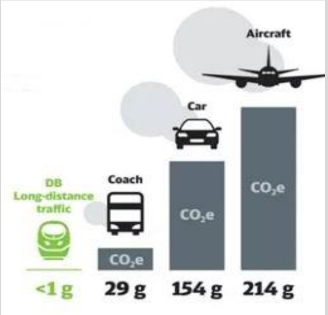
Attending the *Responsible Investor Europe* conference was a highlight of the trip. Given that it had been almost three years since it was last held in person, the ESG and investor communities were buzzing to connect again and celebrate the growth in ESG despite COVID-19. But deliberating on the challenges that come with this attention was a bigger part of the conversation. The message was clear: as much as the focus on ESG is growing, the core intent of responsible investors and sustainable companies alike should ultimately be to deliver positive impact in the real world. This will be especially pertinent in emerging markets in the future.

The *Responsible Business* conference emphasised the massive opportunity ESG data providers and sustainability consultants have to guide corporations in effective ESG strategy and disclosures. It was exciting to hear that the Scope 3 emissions targets of many large multinationals would be meaningful in reducing their supply chain emissions. Smaller companies are now feeling pressure to reduce their own emissions and innovate green products to maintain a competitive edge.

Unfortunately, with the focus on climate change, biodiversity, circular economy and EU regulation, the lack of discussion about modern slavery and human rights was noticeable. Given the focus in Australia, thanks largely to mandatory annual modern slavery statements, mature discussion and expectations around human rights reporting has not yet filtered across to Europe.

Moana also happened upon the world's first Shell EV-only charging station in London. EVs are quite common on the road, with taxis boasting their emissions-free status both on vehicle bodies and inside the car. Electric "Boris bikes" and e-scooters too, were common throughout the city. London suffers greatly from traffic-related pollution so electrifying the transport system will improve air quality over time, with the added benefit of reduced emissions. At least in London itself.

Questions still remain around the origins of the electricity that is being used for transportation. The UK's energy mix is still supplied largely by fossil fuels and, unless the charging stations are powered by renewable energy, any genuine impact on reducing emissions is still uncertain. Over time, as the energy grid decarbonises, the carbon intensity of London transport will also decrease so scaling infrastructure now is a step in the right direction. But for the moment, it seems that taking the fast, smooth, quiet long-distance trains across Europe could be a much better environmental option, at least according to this graph of per-kilometre emissions from the Deutsche Bahn network in Germany.→



For further information, please contact:

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