Monthly Report – August 2022
Alphinity Australian Share Fund

I Fought the Fed and the Fed Won

Market comment

One of the more reliable market axioms is "Don't fight the Fed", the idea being that the US Federal Reserve Bank holds pretty much all of the cards when it comes to setting the underlying framework within which the equity markets operate. Despite repeated Fed statements of its concern about inflation, equity markets had rebounded substantially since the major sell-off between mid-April and mid-June as signs emerged that this concern might be dissipating. The optimists in the market intuited that the future course of short-term interest rates might therefore moderate from their swift march upwards.

Fed Governor Jerome Powell put paid to that idea in an address at the central bankers retreat at Jackson Hole in Wyoming USA this month, essentially saying he will do whatever it takes to stamp out inflation. This suggests no respite on rates, regardless of whether many of the root causes of the inflation we are currently experiencing can be addressed well by rates. Bottom line is that the nascent bull market since June was knocked on the head and US equities in $A went from intra-month gains of as much as 5% to a loss of more than 2% by the end.

In that context Australian shares did quite well, the ASX300 including dividends finishing 1.2% higher although that was all due to the hefty dividends that were paid here. There were no other major markets in the black in $A terms this month: European markets were down between 3% (Spain) and 8% (Sweden) as winter crept ever closer and the Russian gas crisis rolled on. The UK was off 4%, China and Japan were each down 1-2% and Korea was essentially flat.

August is results season in Australia, presenting us with the usual deluge of information about how companies we own – and those we don't own – are doing. It is a great opportunity to review the investment theses of holdings, assess companies we don't own to see if opportunities are arising, and most importantly meet with many sets of company management across every sector to build a view of what the future might hold.

We were generally pleased with the way most companies owned by the Fund performed this reporting season. In most cases we saw earnings upgrades – as our process aims for – and that generally flowed through into the performance of the shares themselves. Not always: in some cases share prices were overtaken by wider events, such as rising bond yields or concerns about the state of Australia's major trading partner, China. But the reason one has a portfolio of companies is that, if on average you get most things right, the portfolio overall does well. This was the case in August.

At a sector level, gains in Energy (+7%) and Materials (+4%) were the biggest contributors to Aussie market returns, while Property (-4%), Consumer Staples (-2.5%) and Utilities (-2%) performed less well.

Concern about energy continued to weigh on Europe as it heads into winter, and the Euro fell below parity with the $US for the first time in 20 years, having depreciated by 12% in 2022. The Nordstream gas pipeline, which runs some 1,200 km under the Baltic Sea between Russia and Germany and provides almost half of Europe's total gas supply, was closed by Russia for "maintenance" in August, adding further to anxiety there. With European gas prices having more than quadrupled so far this year, many industries have been forced to shift production offshore. Energy prices undoubtedly remain the biggest cause of an increasingly likely recession in Europe, as affordability declines to households and industry.

Portfolio comment

The Fund outperformed the market strongly in August. Positions in lithium exposure IGO, health insurer Medibank Private, airline Qantas and auto advertiser Carsales.com all added alpha; not owning the stock exchange, ASX also helped. The only things of note that detracted from returns was not owning shares in Oz Minerals, which was bid for, or lithium miner Pilbara Minerals, although both impacts were quite small.

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)	2.0	-2.5	-3.2	6.5	8.7	9.9	9.0
S&P/ASX 300 Acc. Index	1.2	-2.4	-3.7	5.6	8.2	9.3	8.3

*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 August 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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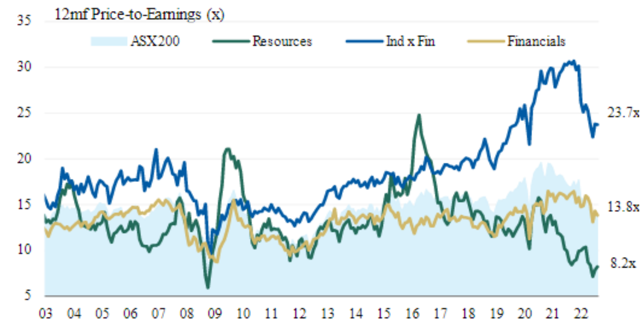
Market outlook

The August reporting season contained few surprises in either a positive or negative direction. Earnings for the financial year just finished were, in aggregate, largely in line with expectations and consensus earnings estimates for the current financial year, FY23, were revised down by 1-2% overall, which is fairly typical for a reporting season. Negligible earnings growth is now forecast for FY23, although this is more the result of falling earnings forecasts for Resource companies as a result of lower commodity prices than particularly low expectations in other sectors of the market.

As we suspected, many companies declined to give earnings guidance, blaming ongoing uncertainty brought about by Covid or referring to heightened geopolitical risk factors which made forecasting difficult. While we sympathise with their predicament, not providing guidance – whatever the reason – is starting to sound a bit too convenient and adds to uncertainty for investors.

This lack of guidance by management might have contributed to the absence of larger earnings downgrades outside of Resource companies but it is also clear that the Australian consumer is yet to make more significant cutbacks in the face of higher interest rates. This is likely due to still-strong employment growth and the delay in higher interest rates hitting mortgage-holders repayments in earnest. This probably means that earnings growth in the first half will still be reasonable, especially as large parts of Australia were in lock down for much of the same period last year, while second half earnings expectations are more at risk.

While the paucity of large earnings downgrades to date might also suggest Australia is experiencing a controlled slowdown in economic growth despite the rapid rise in interest rates, admittedly from very low levels, investors will likely need to wait a few more months to see whether this really is the case, or if a larger downturn awaits in the new year. Despite some moderation from the peak, earnings multiples for non-Resource companies are still high (see chart below) which suggests higher interest rates are not yet properly reflected in most company valuations, or that a more meaningful slowdown might still be ahead.



Source: Morgan Stanley

Portfolio Outlook

The Fund achieved solid outperformance in August. A partial reversal of the equity market optimism that the US Fed was potentially losing its resolve to raise interest rates, which hurt relative performance in July, assisted in August but, more importantly, the portfolio achieved a strong score card in the August reporting season, with the number of companies delivering earnings ahead of what the market was expecting, both in terms of FY22 earnings and outlook, comfortably exceeding the number that delivered more mixed results. Some of the highlights this time were QBE Insurance, Medibank Private, Steadfast Group, Brambles, Iluka Resources, Woodside Energy, Viva Energy and Carsales.com. We believe the portfolio is well positioned for the current market environment in which overall earnings risk is skewed to the downside, in our view.

Following the conclusion of reporting season we have added to our positions in several of the above names. The Fund's overall exposure has become a little more defensively biased, especially as we have also continued to trim our exposure to Resources. Commodity prices have been softening considerably and China's stimulus efforts appear to be having limited effect, and appear unlikely to provide a meaningful boost to activity during the upcoming peak construction season.

We were also encouraged by positive updates and consequent earnings upgrades for our two major bank holdings, Commonwealth and National Australia Bank. We retain a largely neutral weighting to the sector but expect solid results in November, driven by improved net interest margins and still-benign credit losses, when NAB reports its full year result and CBA provides its first quarter trading update.

While the macro environment remains uncertain, we believe the portfolio remains well exposed to companies with the potential to deliver earnings ahead of market expectations, the key driver of our long-term relative outperformance.

Top five active overweight positions as at 31 Aug 2022	Index weight%	Active weight %
Medibank Pvt Ltd	0.5	2.3
National Australia Bank Limited	4.6	1.9
QBE Insurance Group Limited	0.8	1.8
BHP Group Limited	9.7	1.8
carsales.com Ltd	0.4	1.5

Asset allocation	31 Aug 2022 %	Range %
Securities	97.5	90-100
Cash	2.5	0-10

BTW

Most of our readers are familiar with listed stocks that trade daily on stock exchanges, but other equity-based structures like Private Equity (PE) and Venture Capital (VC), often thrown into the Alternatives bucket, may be less well known. VC typically focusses on start-ups; PE on established businesses that need a bit of work to fully realise their potential. The common theme however is that they are not listed on the market, and therefore not scrutinised as closely or valued on a daily basis the way shares are. Unlisted vehicles have come under scrutiny recently as markets have retreated, and questions are being asked about the validity of their valuations.

Anything whose value is only assessed occasionally can be subject to large revaluation moves, most often triggered when raising capital in a new round of financing. For the existing investors, there's an incentive for each new round of financing to reflect successively higher valuations but recently, along with the volatility in listed stocks, some valuations have plummeted. This matters because some large organisations have significant exposure to unlisted assets, and if those valuations are substantially overstated, people who need to transact can be unfairly advantaged/disadvantaged at the cost/benefit of remaining investors.

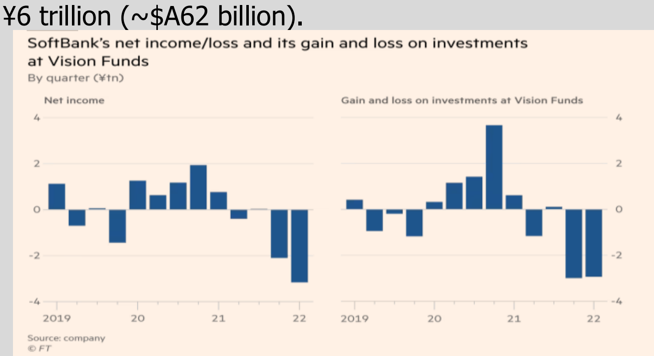
We are all accustomed to daily moves in the market, as painful as they can sometimes be, but imagine holding an unlisted investment where you have to book a huge valuation drop in one hit. For example, Swedish based buy-now pay-later (BNPL) firm Klarna had a valuation of $US46 bn as recently as 2021. At its most recent round of financing it raised capital that valued the firm at just $US6.7 bn. This is an 85% fall from its value a year earlier. Affirm, a listed BNPL firm in the USA, also saw its shares fall 85% over three quarters but its investors had opportunities to sell on any day throughout that period, thereby avoiding the totality of that huge de-valuation. Local tech hero Canva is undergoing the same debate: its most recent capital raise a year ago implied a $A54 billion total value; the most recent mark-to-market was ~$20 billion lower.

VC is typically used by start-ups and smaller businesses which are believed to have longer term growth potential. The biggest of these is Softbank's Vision Fund, a subsidiary of the Japanese Softbank Group led by legendary billionaire Masayoshi Son ('Masa'). Masa is an extraordinary fellow, one who defied the common perception of Japanese CEOs as conservative cash hoarders with little appetite for risk. He was the world's richest man briefly twenty years ago before losing 99% of his wealth in the dot com bust, only to rise again from those ashes to control the world's biggest tech-focused VC fund.

Some of the Vision Fund's better known investments include Uber, TikTok, Didi, Doordash, and Klarna but we can't forget when, in 2017, Masa wrote a $US4.4 billion cheque to buy a stake in WeWork, valuing it at $US47 billion, followed by more capital injections in succeeding years. All it took was a 20 minute meeting with its infamous CEO Adam Neuman, and Masa was swept up in Neuman's pitch, investing at the very top only to lose much of it as WeWork (and Neuman himself to some extent) imploded spectacularly. We wrote about all that back in 2019. WeWork eventually listed in 2020 with a $US7 billion total value but is now trading at less than half that. Softbank now owns 57% of the company, ~$US1.7 billion worth.

We shouldn't be too hard on Masa though. It's easy to point to the disasters, and subsequent media beat-ups have done that, but he has also had some great investment successes. For example, he put $20m into Ali Baba in 2000, and that company has gone on to become one of the world's largest e-commerce marketplaces. Softbank recently booked a staggering gain of $34bn by cutting its stake in Ali Baba to help shore-up cash and protect the fund against future downturns.

The Vision Fund however posted a $US21 billion revaluation loss for the quarter, and nearly $50bn in the first half of the year, as Tech companies sold off heavily as interest rates rose. Showing remarkable humility, Masa posted a video recording after its earnings release, with a key quote in the Q&A session: "*when we were turning out big profits, I became somewhat delirious and looking back at myself I am quite embarrassed and remorseful*." As David Sachs of the All-In podcast said, Masa didn't go as far as committing Seppuku, but it was more or less the verbal equivalent. The chart below shows the scale of the last two quarters' losses: close to ¥6 trillion (~$A62 billion).



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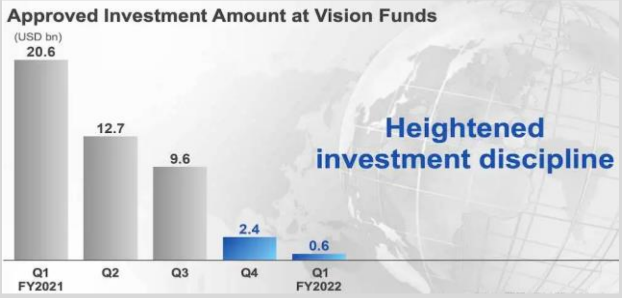
BTW (continued)

Sending chills through many potential start-ups, the chart below shows the huge drop in the amount of capital being deployed by Vision Funds. Masa, the risk-taker and aggressive deployer of capital, went from $US20.6bn of approved investments in Q1-2021 to just $US0.6bn in Q1 2022. And does the slide's title suggest a degree of ill-discipline in the past??



When we talk about the cause of bubbles, a common response is often 'market conditions', such as ultra-low interest rates and Central Banks pumping liquidity into the global monetary system. This certainly enabled the bubble, but the excessive amounts of capital being deployed by VC and PE firms helped create the market top.

The interesting question then becomes: how much money can VC firms invest in companies for future growth? One of the many problems with WeWork actually stemmed from the sheer amount of capital being thrown at it, more than its CEO knew what to do with it. If you put too much money in and the assets aren't available to sensibly invest it, the whole thing is at risk of collapse. WeWork initially started buying inexpensive buildings and charging rent as if they were top-tier office space. Once Masa put his money in, WeWork started buying Class A office space and then renting them at Class B prices, essentially flipping the business on its head. It just couldn't deploy that much capital, and Neuman became distracted and started to do other stuff like WeGrow (education), WeLive (apartments). Not to mention chauffeured jet skis to help him catch waves. "The way I surf, I don't have time for paddling", he once told a colleague.

The motivation of VC is to give more capital to firms so they can 'capture the market'; the problem with this model is that capital then becomes the primary asset, rather than just enabling the company to accelerate its growth. As with all cycles, at some point investment in VC and PE vehicles may return to their previously eye-watering levels but, if Softbank's actions are a guide, we might be in for a period of reduced VC investment. It now looks like Masa is behaving like the traditional conservative Japanese investor he ran so far away from.

For further information, please contact:

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