

Long live the King!

Market comment

Cash has been King so far in 2022. Our market withstood the global equity downdraught pluckily until mid-year but, as at the end of September, it was 10% lower (ASX300 including dividends) than where it started the year. Shares haven't been a great asset class to be in this year but the alternatives haven't been great either. Even bonds have been remarkably poor considering their traditional reputation of being boring but safe (see BTW on p3). Gold has been poor and we all know what property prices are doing. Bitcoin was the worst of the lot, falling more than 50%. Experience tells us that cash isn't a great place to be over the long term but it has been a pretty good place to hide so far this year.

This is despite cash giving you a negative real return. When you think about the rate of inflation, around 6%, a cash rate of 2.35% is significantly negative, and it will take a lot more tightening and/or a lot of moderation in the rate of inflation in order for the real return of cash to go back above zero. So Cash is not an appealing prospect over the long term, although it has certainly been a safe-haven in recent months.

Ours has been one of the better major markets in the September quarter, despite our crumbling currency. The \$A fell ~7% from US69c at the end of June to US64c in September. Australian shares ended about flat for the quarter despite falling 6% in September alone. We lagged the \$A returns of US shares (+2%) although all the credit for that went to the lower \$A: US shares were down 5% in \$US. Euro markets were all lower by between 2% and 9%. Asia was not immune with China and Hong Kong falling by 8% and 14% respectively. Japanese shares performed similarly to ours, roughly unchanged over the quarter. Shares in the UK fell 4.5% in \$A as its economic woes deepened and specific issues related to its economic recovery plan

caused concern. It turned out that commodity powerhouse Brazil was best, its market finishing the quarter 15% higher in \$A.

Major global events seemed to be occurring on a daily basis during the quarter, and they generally weren't good. Escalating war in Ukraine, stubbornly-high inflation leading to further monetary tightening in many countries of a scale not anticipated by most, and the death of a much-admired Queen all added to the bitter mood in the markets. Most commodity prices fell modestly over the quarter, as generally happens when the \$US is on the rise, although again the soft \$A cushioned the blow somewhat. The price of Oil fell about 20% in \$A but gas remained expensive as Europe's winter approaches and Russian gas becomes increasingly scarce.

Bond yields shot up in most markets, particularly the US whose ten year bonds rose from 3% to 4% over the quarter. The UK was the most extreme, rising from 2% to 4% since the end of June as a PM and Chancellor on training wheels caused its bonds and currency to spin out of control. Our own bonds also rose over the quarter although by a smaller amount, from 3.5% to 4%.

Portfolio comment

The Fund underperformed the market a little in the September quarter. Positions in lithium producer IGO, health insurer Medibank Private, safety app 360; not owning gold producer Newcrest or gas pipeline APA also helped. The main detractors from returns were Goodman Group, Orora, and not owning lithium play Pilbara Resources, coal miner Whitehaven Coal, and diversified resource companies South 32 and Mineral Resources.

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)	-6.3	-0.6	-8.0	3.6	7.3	9.0	8.4
S&P/ASX 300 Acc. Index	-6.3	0.5	-8.0	2.7	6.8	8.4	7.7

*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, 30 Sep 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

Market sentiment is still being dominated by the influence of short-term inflation data on Central Banks' future policy settings. The US third quarter reporting season will get underway in the next few weeks which should provide some insights into current the state of the US economy. Some of the recent company trading updates there, primarily in the Consumer Discretionary space, have suggested excess inventory and the need to de-stock following weaker than expected sales. This could be the first signs of the US economy slowing but considering the lag in the impact of higher interest rates on the economy, it will almost certainly be a few more months before we can draw definitive conclusions about this, especially while the US employment situation remains so robust.

The financial market turmoil and subsequent intervention by the Bank of England following announced, but later withdrawn, tax cuts by the new UK Prime Minister shows that Central Banks will act when faced with potential systemic risks. However, while it may have given Central Bankers around the world cause for reflection, it is unlikely to make the US Federal Reserve Bank move away from its determination to get inflation under control by raising interest rates further in the short term.

The Reserve Bank of Australia received global headlines when it slowed the rate of interest rate increments to 0.25% (from 0.5%) at its latest meeting. Some commentators saw this as a signal that other Central Banks might soon follow suit and that the tightening cycle is close to its peak. While it is inevitable that the US Fed will also be contemplating slowing its pace of rate hikes in the next few months, Australia doing so first is probably more a reflection of the faster transmission mechanism of higher interest rates to the economy here given the predominance of variable mortgage rates, and the slower rate of wage growth here to date.

While the market volatility caused by the focus on short-term macro data is likely to continue, where bad economic news is interpreted as good news for financial markets as it could temper further rate hikes, bad macro-economic news will still be bad news for corporate earnings. An improvement in the outlook for those earnings will ultimately be required for a more sustainable improvement in equity market returns, in our view.

Portfolio Outlook

We expect our focus on earnings leadership will steer us through the current difficult macro environment. This sees us positioned relatively defensively at the moment but still well diversified.

While overall earnings risk into 2023 still seems biased to the downside, and this is reflected in the current portfolio positioning, it is in our view important to not get too caught up in the macro and to remain focused on individual company opportunities as well as sectors where the earnings outlook is more positive than a cursory top-down approach might suggest.

As such, the Fund has, following the August reporting season, increased its exposure a little to Qantas and to the Bank sector. It has also maintained, albeit at a slightly reduced level, the overweight to companies in the Energy sector. Qantas is currently benefitting from a very strong demand recovery which, in combination with limited seat capacity and a disciplined domestic market competitor in Virgin, has the potential to deliver a much stronger earnings recovery than is currently reflected in consensus earnings expectations. In the Bank sector, we see the market underestimating the companies' earnings benefit from widening net interest margins while in the Energy sector, gas prices are likely to be supported by the situation in Europe for the medium term.

These stocks and sectors clearly are not without risk should a deeper recessionary scenario play out than we currently envisage, but we see that risk as well worth taking and manageable in the broader context of what remains a relatively cautiously-positioned portfolio.

Top five active overweight positions as at 30 Sep 2022	Index weight%	Active weight %
Medibank Pvt Ltd	0.5	2.2
QBE Insurance Group Limited	0.9	1.9
National Australia Bank Limited	4.6	1.9
BHP Group Limited	9.9	1.8
Independence Group NL	0.5	1.5
Asset allocation	30 Sep 2022 %	Range %
Securities	98.5	90-100
Cash	1.5	0-10

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BTW

Equities is clearly our favourite asset class, that's all we do. Our experience, over many years, is that the returns available to equity investors are superior to anything else even if you do need to tolerate a bit of a volatility during times such as now.

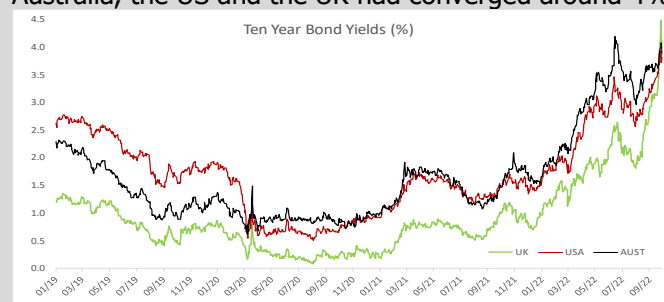
Equity investors tend to look down their noses a bit at those involved in bonds. Bonds tend to be a bit boring most of the time as yields generally move in a slow and incremental way. When they are exciting, like during the GFC and over the past few months, it is in a bad way. But bonds are important to equities as their yields – which are a proxy for the risk-free rate – set the baseline for many valuation methodologies.

A bond investor pays out a lump of capital and gets it back at a defined point in time. The bond investor will also get a fixed amount of income periodically along the way. If you hold a bond to maturity, that's what you get: no more, no less. If the bond is issued by a government you have a high degree of certainty, providing that government remains solvent of course; if it is issued by a company then you need to trust that the company will still be around when the time comes to collect your capital. The hierarchy of reliable return of capital for government-issued bonds generally starts with the USA, then Switzerland or Germany or, until recently, the UK. Australia is right up there, never having defaulted on Commonwealth-issued paper. Some countries have a more patchy reputation. Argentina, for instance, has had several defaults in recent memory and is currently only avoiding another by the grace of the International Monetary Fund.

Investors rarely hold bonds to maturity though, they are generally traded in the same way shares are. The market (i.e. willing buyers and sellers) sets the price at which a bond might trade, expressed as a yield to maturity. If a bond was originally bought for a yield of say 3% and the market moves down to 2%, the owner can sell it on the market for a hefty capital profit. Should it move to 4%, that profit becomes a hefty loss.

What's happened this year is that yields in bond markets around the world have been rising, and by a lot. This was inevitable at some point considering yields had fallen so low, largely as a result of the zero interest rate policies of many countries in recent years, but picking the timing and extent of the rise was problematic. Rising yields mean falling prices, which is counter to the typical role of bonds in an investment portfolio as something that is going to maintain its value in troubled economic times.

Bonds became exciting, in a bad way, in September. The UK, usually so solid that its bonds are known as Gilts (i.e. good as gold), briefly became an economic pariah. The last things Queen Elizabeth II did, after 70 years on the throne, was accept the resignation of Boris Johnston as PM and install Liz Truss, after a convoluted and protracted party election process. The first thing Ms Truss did, after the period of mourning was over, was to announce an economic package that sent Gilt yields rocketing and their values plummeting [we generally try to avoid hyperbole like "rocketing" or "plummeting" on these pages but yields tend to move in basis points at a time. Going from 2.8% to 4.5% in a few weeks makes "rocketing" quite apt]. UK's central bank, the Bank of England, had to resort to emergency measures in order to stop a meltdown, which brought yields back to 4%, but it still had flow-on effects to many other equity and currency markets and the quarter ended on a sour note. By the end of September, the ten year bonds of Australia, the US and the UK had converged around 4%.



Sharply higher yields means lower values for bond investors. At the start of 2022 a 10 Year Gilt traded at 1%, already significantly higher than the 0.1% nadir during the worst of the UK's Covid crisis in 2020. An investor holding long-duration Gilts since January would have copped a hit to their capital of about 37%, far worse than shares. This caused great consternation to UK pension funds. Defined benefit pensions are still quite common there, which leave companies on the hook for any shortfall in pension balances.

So the BoE has some issues to deal with. One thing it has to fall back on, however, is a rich history. It wasn't the world's first Central Bank, that honour goes to Sweden's Riksbank (1668), but the BoE was only 26 years behind and it's had to deal with a lot more than poorly-founded tax packages since then. Its first big test was in 1720 with the bursting of the South Sea Bubble; that was followed by wars with France, Spain, two world wars, the end of the gold standard, several financial crises, the dissolution of Empire and much more. We hope the BoE is up to the current challenge.

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ESG Sport

Jess went to Indonesia in September to carry out some research into the Palm Oil industry. Her primary purpose was to better understand the Palm Oil supply chain, the various uses of Palm Oil and its by-products, and any risks for companies we hold in our domestic and global funds. She also wanted to get a better sense of the labour and human rights risks that are more generally present for workers and companies with operations in emerging economies.

Palm Oil is used in many consumer products but the industry has been accused of desecrating substantial amounts of native habitat in south-east Asia so it is important to have a good understanding of its management practices. Jess' tour was hosted by Indonesian company Golden Agri (GA), one of that country's largest producers of palm oil, and kicked off in Jakarta where she visited a refinery and packing plant. From there she headed to Pekanbaru, in central Indonesia, to visit a nearby plantation, processing mill, and biogas plant. In addition to Golden Agri's tour, Jess also met with other experts in Palm Oil, local labour standards, and government regulation around biodiversity and plantations.

Palm Oil currently accounts for 56% of the world's edible oil trade and 84% of it originates from Malaysia and Indonesia. Although many companies seem nervous of being associated with Palm Oil, it is very widely used. As much as Sunflower, Canola and Soybean Oil put together in fact. When thinking about Palm Oil plantations, you might assume the only thing there is palm trees. This is not the case; there is extensive ground cover, plenty of other plant species, and lots of bird and other wildlife. Gone are the days everything else was bulldozed. For GA at least, there is a focus on biodiversity and sustainable management if plantations. Most plantation operators allocate between 10-15% of their land towards conservation.

There is a high level of awareness in Indonesia around the concerns about Palm Oil. The Indonesian Government has significantly reduced the approval of palm oil plantations and also increased the minimum standards for labour management. This means that in order to remain viable plantation owners need to increase yield on existing land.



Jess was struck by the openness and transparency of the GA team. All questions were answered without hesitation, there was no control over taking photos, management was happy to share the challenges of the palm oil industry and discuss ways in which things have changed. They were extremely proud of the work they are doing in the technology, research, and science space.

Jess saw drones, precision agriculture, Amazon-style automated packing sheds, plantation mapping, and modelling for yield. There was also extensive testing to identify



desirable characteristics related to canopy size, water retention and pest resilience.

The minimum employment age is 18. In the Palm Oil industry, all workers are paid a base wage on top of which is added incentives. Apparently, the average palm fruit picker is paid the local minimum wage plus 40%. The labour environment is very competitive. Many workers leave their homes in order to work in other regions, mainly Malaysia, with the promise of a good deal. Unfortunately, these workers often encounter poor working conditions and significantly lower pay packets than they were promised during recruitment. Employers like GA are focussed on keeping Indonesian workers in Indonesia and ensuring that salaries and living conditions are at a high standard.



Worker accommodation at the GA plantation is high quality, as shown below. There are two homes per bungalow, either for a single family or for three individuals, each with a private room.



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One very special part of the trip was visiting a local school with 300 students, the children of the local community and plantation workers, which is funded in part by GA.



The trip emphasised the vast range of uses of Palm Oil. For example, waste materials are used to create biofuel, high fibre mill waste is used in animal feed, and oil shortening is used in baked goods worldwide. Nestle, one of GA's large customers, even uses a Palm Oil-derived cocoa butter substitute as an ingredient for chocolate sold in very hot regions as the chocolate doesn't melt as easily! Nestle, Unilever and McDonalds each have their own labour and quality certification system for the manufacturing plants.

The GA team was keen to emphasise the health profile and yield benefits of Palm Oil compared to other vegetable oils. For instance, producing a tonne of palm oil requires 0.3 ha of land, whereas a tonne of sunflower oil needs 1.3 ha. Palm Oil is also one of the few vegetable oils that does not require hydrogenation, and is therefore does not have trans fats.

Across their seven downstream locations (bulking stations, crushing plants, and refineries), GA needs to comply with 24 different management systems. Some of these are specific to a customer, like the Nestle example above, and some are universal standards like ISO 14001 and ISO 9001.

All GA sites are Roundtable on Sustainable Palm Oil certified; RSPO is the most-recognised global certification.

Overall, Jess' trip highlighted a number of important changes that have taken place in the Palm Oil industry in Indonesia. It also identified a range of benefits Palm Oil offers relative to other vegetable oils. The industry is clearly much more environmentally and socially focussed than it was previously, but it is hard to ignore the vastness of the plantations and the reality of what's been lost in the wake of the industry's growth over the past 20 years.

Palm Oil's dominance in the global oils market, and the limited number of locations where palms will grow well, means that there will be ongoing pressure to expand, which will likely lead to further deforestation. It's an industry that has a poor history and poor reputation. Clearly companies like GA are trying to change practices and improve the perception of the industry, but most companies are not where GA is. We are well aware that Golden Agri is probably the very best example of Palm Oil plantation management and recognise that illegal Palm Oil farms and mills still exist all over South East Asia. This reinforces the need for companies that procure and use Palm Oil in their products to have transparent supply chains, audits and oversight of their sources.

As a result of this trip, we feel we are better equipped to talk to companies that use Palm Oil in their manufacturing about the various risks, issues, and management practices. We also understand there are significant differences between Palm Oil that is produced in different regions. In this case especially, one size does not fit all.



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