Monthly Report – October 2022
Alphinity Australian Share Fund

Hack attack

Market comment

Hacking went mainstream this month and everyone re-learned just how important – and fragile – cyber security is. It started with telecoms major Optus in the dying days of September but a number of other companies since jumped on board (see BTW on p4). It didn't hold the market overall back though, with a welcome ~6% bounce-back from September's drubbing. So far this year there have been six months during which the market (ASX300 including dividends) has moved up or down by more than 3%. While it is still a little below where it started the year, it is up 10% from its nadir in June. With this degree of volatility, it feels like anything could happen the final two months of 2022.

Global markets also did pretty well for the most part. Most were solidly positive, led by Italy and Germany with heroic 11% gains as fears of a gas-less winter dissipated. Most other Euro markets were up by 4% or more, and the UK managed to appreciate 6% despite losing another PM. The US also performed very well with its broad market benchmark S&P500 rising almost 9%. The $A was virtually unchanged over the month.

October also saw the re-appointment of Chinese president Xi Jinping for a third five-year term. While the re-appointment was quite unsurprising, the way in which it was done – his supposedly unsupportive predecessor Hu Jintao being forcibly escorted off stage immediately after Xi's confirmation – was a slightly shocking demonstration of absolute power. Regardless, what the share markets had really been hoping for was a moderation in China's highly-disruptive Covid Zero policy. No easing of restrictions was announced, so for now China remains subject to snap regional lockdowns and isolated from rest of the world. Chinese shares suffered accordingly, falling more than 6% over the month. Hong Kong shares were worse, 14% lower.

Our Reserve Bank, the RBA, somewhat reduced the aggression of its monetary tightening program, the cash rate this time increasing a more modest 0.25%, and bond yields moderated a little. This supported a number of sectors of the share market: Financials rose 12% and, within that, Banks alone were +15%, an extraordinary performance for such a big sector. Property, Consumer Discretionary and Energy stocks each were up by about 9%. The Healthcare and Consumer Staples sectors lagged somewhat, both recording sub-1% falls.

The price of oil continued to rise (Brent +9%) but other commodities showed mixed performances. China woes helped the price of Iron Ore to fall by 12%, resulting in poor returns from some of our major miners, although Metallurgical Coal rose 6%. Base metals were generally firm. The price of Lithium keeps rising as the trends towards electrification and decarbonisation build; it rose 7.5% in October alone, has more than doubled this year and now sells for almost 10 times the price it was just two years ago. This has been very good for the share prices of lithium-producing companies.

Portfolio comment

The Fund outperformed the market in October. Positions in big bank National Australia Bank, airline Qantas, lithium producer IGO, gaming machine maker Aristocrat Leisure and security app Life 360 all contributed positively, as did being underweight Rio Tinto and not owning Fortescue Metals. On the other side of the ledger, our holing in hacking victim, health insurer Medibank Private, cost considerably; miner BHP and being underweight ANZ Bank also detracted a little.

Top five active overweight positions as at 31 Oct 2022	Index weight%	Active weight %
National Australia Bank Limited	4.9	2.0
QBE Insurance Group Limited	0.9	1.9
Medibank Pvt Ltd	0.4	1.7
Aristocrat Leisure Limited	1.2	1.7
BHP Group Limited	9.0	1.6

Asset allocation	31 Oct 2022 %	Range %
Securities	98.4	90-100
Cash	1.6	0-10

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	1.6	-2.4	5.6	7.8	9.3	8.9
S&P/ASX 300 Acc. Index	6.0	0.5	-2.6	4.9	7.2	8.7	8.1

*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, 31 October 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.

Monthly Report – October 2022
Alphinity Australian Share Fund

Market outlook

With the Australian equity market having de-rated quite significantly thus far in 2022, even though some sectors with structural growth drivers still look expensive to us, most of any further downside will be determined by how much the economy will slow following the fairly dramatic tightening of monetary conditions and a (likely) absence of meaningful fiscal stimulus.

The complexity of the challenge facing Central Banks and governments have been observable for most of 2022 but on obvious display in recent weeks. Central bankers fully appreciate the need to get inflation back under control but, at the same time, they also want to avoid causing a deep economic slump. And while governments would like to ease the cost of living pressure for its citizens they realise (possibly with the exceptions of the now-former Prime Minister and Chancellor of the United Kingdom) that doing so risks adding further to inflation. Some Central Banks, including our own, are now adopting a slower pace of rate hikes in recognition of the lags in impacting the economy, but they are still lifting rates as strong inflation and employment data keeps them concerned about pausing too soon.

It is, at this still early stage, difficult to assess just how much the economy will slow in Australia. A recession looks pretty certain in Europe and most lead indicators point to recessionary conditions also in the US in the next six to 12 months. Australia has so far, despite the highest inflation in decades, escaped the degree of wage pressure that has been seen in the US. The speed with which higher interest rates are feeding into mortgage payments and contributing to falling house prices might allow the RBA to stop raising rates earlier than the US Federal Reserve (Fed) is able to. However, the RBA will, like the Fed, probably err on the conservative side. In the meantime, we should remember that the lags noted by the RBA will likely also apply to corporate earnings.

The US reporting season has mostly finished, with areas of weakness becoming more evident in consumer goods, consumer-exposed tech and capital goods manufacturing. This has been partly offset by strength in the Energy sector and some services sectors such as Airlines, leading to only small earnings downgrades across the whole market for 2022, and low single digit % for 2023. Employment and wage growth remains solid, although it is no longer one way with hiring freezes and job cuts becoming more common. This suggests that higher interest rates are starting to have an impact, but that it is still relatively early in the downturn.

In Australia, the Annual General Meeting season is well underway and year to date commentary so far points to a still relatively robust earnings environment. The banks that have reported have largely confirmed a benign credit loss environment and a positive impact on interest margins from higher interest rates.

In summary, inflation is most likely close to peaking in developed markets, including Australia, which should be welcome news to both investors and Central Banks. However, while stocks are cheaper today than they were at the start of the year, the earnings impact of the slower economy is likely still ahead of us and, at this stage, it could be quite challenging for investors to 'look across the valley' to the next earnings upcycle.

Portfolio Outlook

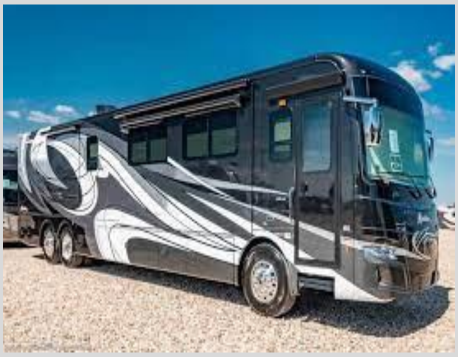
Company earnings updates to date have so far confirmed that the portfolio is well exposed to companies and sectors exhibiting more positive earnings upgrades than the overall market. Our overweight to banks appears to have positioned us well for further upgrades from higher loan margins as does the general insurance sector, notwithstanding sizeable claims from the east coast floods. Consumer spending has so far held up well in aggregate but is at risk of disappointing in 2023 but Qantas continues to look well positioned to capture a decent amount of pent-up demand. Of course, the degree to which the banks and airlines can maintain their earnings leadership will depend on the severity of any economic slowdown in the domestic economy.

The portfolio is currently well underweight the Resource sector after having been overweight earlier in the year when commodity prices were still being supported by a tight supply/demand balance. The earnings cycle has been firmly negative for most Resource companies since May, with lithium the notable exception, through a combination of disappointing growth in China and the general global slowdown. The key property sector in China continues to be very weak and is unlikely to provide much support for steel producers. Risk for the iron price is at best equally balanced, in our view.

The most disappointing portfolio position this month was Medibank. The company's share price had been performing strongly and was firmly in earnings upgrade mode, right up to the cyberattack in October. While some questions remain about how the hackers gained access, the key question from an investment perspective, setting aside the human aspect for now, following the sharp share price decline, is the extent to which the impressive degree of membership growth the company had achieved over the last year or two will be impacted. Strong operational performance prior to the incident allowed management to defer this year's premium price increase into 2023; this should be a solid incentive for customers to stay with the company for now, and could be enough to see potential leavers delay any decision until the environment is more certain. We will continue to monitor the situation as it evolves and will adjust the position as necessary, relative of course to all the other investment opportunities. At this point, however, the share price is implying a worse outcome than we consider plausible.

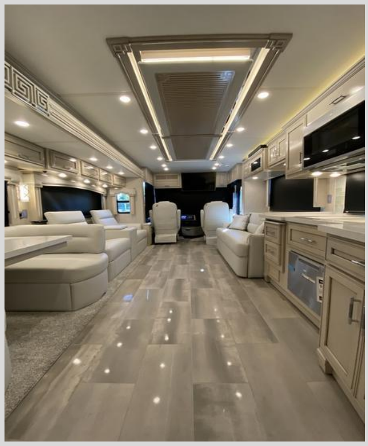
Traveller's Tale

Jacob went to the USA in October where, among other places, he trawled through Texas and Oklahoma looking at RVs. Recreational Vehicles. Vans kitted out to allow people to go "camping" with all the comforts of home, and then some. Satellite TV? Tick. A hot tub? Can be done. Expanding walls? No problem. Solar panels? Of course. Vehicles the size of a bus which can sell for $US1 million or more. Some people sell their house with a view to living in their RV full-time for years on end while travelling the country, and – being America – buyers will often take on a significant amount of debt to buy their vehicle.



Why Oklahoma? Portfolio holding carsales.com recently spent a billion dollars buying Trader Interactive, the parent company of *RV Trader* which is the largest online advertiser of RVs in the USA. And Oklahoma feels like the RV capital of the world. It's always insightful to hear what a company's paying customers think about its service, its effectiveness, and its pricing. Whether the service is compelling or if it would be the first thing cut if tougher economic conditions arise could make or break a company's investment case. A random sample of dealers won't give you the whole answer, but it can give you a decent idea. While there will invariably be complaints about price increases and such from the dealers, the broad consensus of the people he met was that *RV Trader* generated the largest number of leads of any source. This hints at some of the latent pricing power inherent in Trader Interactive, which is much earlier in its maturity than Carsales, where it is by far the Australian market leader and provides a crucial service for almost all car dealers.

RV Trader's importance within the RV market is only likely to increase. Demand conditions are expected to cool somewhat from Covid-induced excesses meets an improved supply dynamic as supply chains to the RV manufacturers begin to free up. During Covid, an unprecedented level of demand was met by severely limited vehicle supply, as dealers had difficulty securing vehicles from manufacturers who were themselves facing significant delays as the lack of critical components, such as microchips, rendered production lines lifeless. From an RV dealer's perspective, the environment was quite favourable, elevated demand and restricted supply meaning discounting of product was unnecessary. This supported margins, but it also meant that advertising for new leads was far less important given demand far exceeded supply. It had also allowed some dealers to cut back on the number of premium ads they placed on *RV Trader* and this added even further to dealers' margins.



While global supply chains are still under some pressure, bottlenecks are gradually freeing up and RV production is moving back towards more normal levels. In such an environment the flow of leads becomes even more crucial to dealers. While some might be tempted to cut costs, it seems unlikely they will use cutting advertising as a savings opportunity considering turnover is the lifeblood of RV dealerships; in fact, if anything it is more likely that dealers will need to increase the number of premium ads they buy to drive turnover in a more subdued demand environment.

Oklahoma is home to a significant number of wind turbines, reflecting its location firmly within the US wind corridor. The wind resources there are so significant, in fact, that if it built enough turbines, Oklahoma could apparently generate about a third of the USA's entire electricity needs.

At first glance the link between RVs and wind turbines is not immediately obvious, but discussions with some dealers there revealed that many RV sales are being made to companies and contractors in the wind power industry. It seems engineers and contractors need to build and service turbines which are often located a vast distance from the nearest town. Further, the current overheated state of the US economy is being reflected in the high cost of lodging. This is changing the calculus for many companies, tipping the economics in favour of buying RVs over frequent extended hotel stays for their employees.

While this is a somewhat interesting anecdote in isolation, it is just one of many small examples of the often-unexpected impacts of high inflation levels on the economy. Rampant inflation in the US was evident throughout Jake's visit with his food, accommodation and transport expenses all substantially higher than on previous trips. It highlighted the scale of the task in front of the Fed to tame the prevailing inflationary pressures.

Monthly Report – October 2022
Alphinity Australian Share Fund

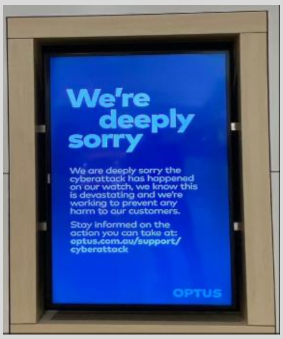
Monthly Report – October 2022
Alphinity Australian Share Fund

BTW

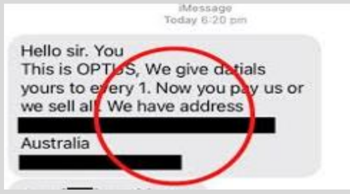
Cybercrime and hackers demanding ransoms: it sounds like stuff that should be reserved for blockbuster movies like Mission Impossible or The Matrix and, until recently, most Australians were happy to leave those types of storylines in Hollywood. In the real world, we usually think of national security threats being dealt with by serious people in the Federal Government. Recent high profile cyber-attack incidents have left some Australians feeling vulnerable about the security of their most confidential and personal information.

Think about the changes in the ways we typically connect in this post-Covid world. We used to be in the office on a PC physically connected to a local area network locked down with multiple layers of security. Now, to access those same work files, we are able to connect through a Wi-Fi hotspot running off "Frank's iPhone" in a local cafe on your personal MacBook – that is if you prefer being cool over functionality.

The potential sources of risk are exponentially higher. It could be Frank's Wi-Fi connection. It could be your MacBook. It could be your lack of attention on device security while you complain about the temperature of your almond latte (we assume all people who use MacBooks in cafes drink almond lattes). Then multiply these vulnerabilities by the thousands of employees in a reasonable size business and you have an attack surface that is wide and fragile. This is why cybersecurity has become so critical. The threat environment has increased materially as hackers increasingly target company systems and data for ransom (perhaps bitcoin has a purpose after all?) and the entry points for these attacks have exploded in size.



Back to the more recent developments closer to home were cyber security incidents at high profile businesses such as Optus and Medibank, where hackers were able to penetrate systems and gain access to confidential information. Optus exposed the personal data of around 10 million customers, 40% of Australia's total population, in a cyberattack. A Sydney-based tech reporter contacted the alleged hacker who contradicted the company's claims of it being a sophisticated attack, saying they had simply pulled the data from a freely-accessible software interface.



Whether the attack was sophisticated or not, the reputational damage is immense and almost impossible to quantify. This month, health insurer (and portfolio holding) Medibank Private was victim to another cyber-attack. This was much more sophisticated, starting with stealing the credentials of someone with high-level access in the company, which was then sold on a Russian-language cybercrime forum. Medibank announced that the hacker had accessed some of its customers' personal information and taken some health claims data, firstly thought just to be from its budget brand ahm (do you get what you pay for?) but the company eventually found the hack had gone much deeper into the Medibank database. Pathology company Australian Clinical Labs has also reluctantly admitted to a cyber-attack earlier this year. Telstra had a small-scale breach, although it was largely confined to staff. Online retail platform Ezibuy had some records of a fairly benign nature stolen too. These all raise a broader question: how well equipped is Australia to protect itself?

A recent survey conducted by US cybersecurity company Proofpoint, in conjunction with Massachusetts Institute of Technology, explored the perceptions of 600 directors around the world of cybersecurity. The firms they represented each had more than 5000 staff in different industries across 12 countries. Only 58% of Australian directors saw cybersecurity as a top priority, the lowest of all countries surveyed; the global average was 77%.

It also found that only about half the Australian directors were confident in their boards' understanding of systemic risks from cyber threats, the second lowest of countries surveyed (the global average is 75%), yet almost three quarters of them felt that they'd made adequate investments in cybersecurity. It's worth noting the survey was conducted before the recent wave of high profile incidents; we suspect directors' comfort levels are somewhat lower now!

We have long talked with our companies about cyber-security, and most directors worth their salt are willing to discuss how their board is addressing it. Financial companies, whose access to our finances is incredibly tempting, are particularly vigilant. Banks are at the pointy end of cyber-attacks and our banking guru, Andrew, has been through some of the major banks' security centres where they defend against millions of attack attempts a day. And while the idea of Cyber Insurance is quite appealing for instances like this, the reality is that cyber policies generally cost a lot but cover little. (cont…)

Monthly Report – October 2022
Alphinity Australian Share Fund

Cyber security is very important to Alphinity too. We don't have access to any individual's personal information, all that is maintained by the Responsible Entity (RE) of the Fund. The RE itself is a major listed financial services company with vast IT resources, and our IT service provider has access to the Australian Signals Directorate, the peak Federal government body tasked with protecting Australians against myriad cyber-attacks from offshore. This doesn't guarantee there will be no hacks; hackers are very clever and there could always be vulnerabilities no one has anticipated, but it does provide some comfort.

So is cyber-security all risk, or can it present opportunities too? It is overwhelmingly risk but not entirely. Some listed companies operate in that area although there aren't many Australian companies. The most prominent is probably Nuix, the less said about which is probably best. Our Global Equity Fund owns a position in Fortinet, a US-based network security solutions company. It started as a pure firewall business before migrating to a platform business, and is the second biggest player behind Palo Alto Networks. Fortinet has a genuine and significant advantage in price and cost for firewall appliances as it developed its own chipset. There is a gulf in management culture between the two companies, with Fortinet being more measured/less flashy in its approach. The Palo Alto Networks CEO is ex-Google, married to a Bollywood actress and went to Ashton Kutcher's wedding. Fortinet's CEO is more understated, although his daughter apparently does have her own Netflix show, Bling Empire, which is similar to the Kardashians (so we're told).

While the discussion above might appear to be a bit harsh on corporate Australia, it should be noted that levels of investment spending in cyber security has been increasing significantly in recent years, and will no doubt increase further after the latest incidents. And while we hear about the few times data is breached, companies are never rewarded for thwarting the millions of attempted attacks that try to penetrate systems daily. We humble non-coding folk can also do our part. Learn from those fake phishing emails sent by your IT department: the one from 'Micrasoft' requesting your card details; those seemingly aimed at your below-par attire in the office inviting you to click on a link to the company dress code; and the more inventive attempts like the apparently accidental email from the CEO with links to "bonus data for senior execs". Hackers are only getting more sophisticated, so we all need to remain vigilant.

For further information, please contact:
Fidante Partners Investor Services | **p:** 13 51 53 | **e:** info@fidante.com.au | **w:** www.fidante.com.au
Fidante Partners Adviser Services | **p:** 1800 195 853 | **e:** bdm@fidante.com.au | **w:** www.fidante.com.au
Alphinity Investment Management | w: www.alphinity.com.au