Monthly Report – November 2022
Alphinity Sustainable Share Fund

The V word

Market comment

2022 has been a veritable volley of volatility, and November was no different. The market (ASX300 including dividends) finished comfortably higher this month, rising another 6.5%. Despite having looked decidedly unwell at various points in the year, the local share market has effectively traded in a series of Vs all year but at least our shares are back above the level at which they started – not by much but still far better than it could have been and a surprisingly strong performance considering the macro environment we have endured.

Even if Australian equities do finish the year in positive territory, it won't have been a great year for super fund returns. Offshore equities have been less resilient, and the other traditionally-large asset class, bonds, has had its toughest year for decades as rising yields have hit capital values. Bloomberg's global treasury bond index has declined 18% this year in $A terms. The return from unlisted assets will be the biggest question mark, and the willingness of the asset owners to mark valuations to liquid market movements is uncertain.

Markets were largely left to the forces of global macro, giving investors more time to scrutinise language from our central bank leaders. US Federal Reserve Bank Chair Powell delivered soothing comments like "*I don't want to over-tighten… it makes sense to slow down*" which gave offshore markets a nice boost right on month-end, and bond yields fell. Such softening language follows on from inflation data printing below expectations, leading many to speculate inflation might have peaked.

Sector-wise in Australia, despite all industries closing higher, only Utilities (+21%) and Materials (+16%) outperformed the broader index this month, while Financials (+1%) and Tech (+2.5%) were among the weaker groups. Performance in the Utilities group was solely driven by Origin Energy's 40% rise after receiving a takeover bid. Stronger commodity prices lifted Materials stocks, with iron ore +26% and gold +8%, although a pull back in the oil price weighed on the Energy sector.

Taking out the volatility of monthly moves, it's an interesting exercise to see how investors' positioning has changed over a longer timeframe. According to JP Morgan, over the two years from the depth of the pandemic to now, there has clearly been a rotation into defensives, while the materials (primarily resource) sector is a large underweight, which also partly explains large moves to the upside recently.

Politics was dominated by the US mid-term elections, in which the much anticipated "red wave" did not occur. It had been widely expected that the red team – the Republicans – would easily take control of both the US Congress and Senate, both of which have been in wafer-thin control by the blue team – the Democratic Party – since the election in 2020. While there was a swing against the sitting President, as usually happens, it was quite modest and the Democrats retained control of the Senate. What this means for the balance of Biden's presidency is yet to be revealed but it was a much better outcome for him than most pundits had expected. Of greater significance is what it will mean for the 2024 Trump Presidential run, although it appears his involvement only weakened the Republicans he supported.

Portfolio comment

The Fund kept pace with the market a little this month, delivering significantly positive returns. In November it was as much about what we didn't own rather than what we did. Our biggest contributors were holdings in iron ore miner BHP and advertising platform Carsales.com; not owning building products maker James Hardie Industries, big bank ANZ or gas producer Santos also helped. Conversely, our positions in big bank NAB and infant formula producer Bubs cost a little, although not owning iron ore exposures Fortescue Metals and Rio Tinto or takeover target Origin Energy cost more.

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	4.4	-2.2	6.7	10.3	10.5	9.8
S&P/ASX 300 Acc. Index	6.5	5.7	4.3	6.0	8.2	9.3	8.6

*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 November 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

With peak inflation in sight – and possibly even in the rear-view mirror – a major headwind to positive equity market returns has been removed. Having said that, the extent of impact on company earnings from the aggressive tightening of monetary policy that we've seen this year to rein in inflation carries with it a high degree of uncertainty, and central banks – while indicating a slower pace of rate hikes from here – appear still some way from considering any actual easing of monetary conditions. Ironically, in order for lower rates to be countenanced, the economic downturn would likely need to deteriorate by much more than is currently expected.

Equity markets are always forward-looking, but the 13% rally in the Australian share market over the past two months, and positive returns now over the last 12 months, seems to be factoring in a lot of future good news, in our view. A fairly short economic downturn is certainly a possibility; after all, excesses which have built up in the general economy appear limited with, for example, aggregate corporate debt levels looking quite moderate. In addition, the price correction taking place in the housing market is being caused by higher interest rates rather than a significant overbuild. The extraordinary speed of rate-hikes so far, however, would make any such prediction unreliable at this stage. In the meantime most leading economic indicators are still declining, particularly for US manufacturing.

The Australian share market could stand to benefit disproportionally from any improvement in Chinese economic growth following a difficult year due to Covid restrictions and the severe downturn in the Chinese property construction market. Bulk commodities and metal prices have recently rebounded sharply following further financial aid to the ailing property sector and some signs of easing covid restrictions. However, just as with global equity prices, commodities have risen on expectations of an improvement, rather any actual recovery in activity which is unlikely to occur until well into 2023.

In summary, the current improvement in market sentiment should not be ignored. After all, consumer and investor psychology are important drivers of actual outcomes. However to arrive at a more positive equity market outlook some improvement in, or at least a better understanding of, the depth of the current economic slowdown is also required, in our view.

Asset allocation	30 Nov 2022 %	Range %
Securities	98.7	90-100
Cash	1.3	0-10

Portfolio Outlook

We maintain a relatively defensively focused portfolio. Our main exposure is to companies where we can see evidence of earnings being resilient in a worsening economic environment; Treasury Wine Estates, Carsales.com, Brambles, Orora and Telstra are some of the holdings we believe fit this description.

We also own companies which are currently enjoying solid upgrades but will be more at risk in a severe downturn. Commonwealth and NAB in the banking sector fall into this category, as do Industrials like Qantas and Qube. A deep recession would be more problematic for these companies but, at this stage, we still see more earnings upside than the market currently expects.

We have taken some profits recently in the Resources sector by trimming lithium and nickel producer Independence Group. Our underweight to base metals, gold, and iron ore has been a detractor from performance in the last few weeks, whereas one of the key features of our performance historically has been consistent positive attribution from this sector.

We accept that the sharp pick up in commodity prices following the easing of Covid restrictions in China would, if maintained, result in meaningful earnings upgrades to the sector. At this point, however, we have seen little to no evidence of improvement in underlying activity there and see meaningful risk of disappointment for investors expecting an improvement in the short term, especially in construction. In fact, it is reasonable to assume that the relaxation of Covid rules in China will instead see an acceleration in infections, which, even without renewed restrictions, is likely to disrupt supply chains, and economic growth in general, for a number of months.

Structural growth stocks have largely struggled during 2022, due to the impact of higher interest rates on the value of their typically longer-duration cashflows. Many have also failed to deliver on earnings compared to high expectations. With interest rates approaching peak levels for this cycle, those that can regain earnings leadership, which arguably should be easier to do as more economically sensitive companies come under pressure, will likely be worth revisiting. We expect to have more to say on this in the new year.

Top five active overweight positions as at 30 Nov 2022	Index weight%	Active weight %
Lifestyle Communities Ltd	0.1	3.0
National Australia Bank Limited	4.5	2.9
BHP Group Limited	10.4	2.7
QBE Insurance Group Limited	0.9	2.7
carsales.com Ltd	0.4	2.6

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ESG Spot

The Conference of Parties (COP) is a convocation of world leaders that has been meeting almost annually over the last 30 years to discuss matters around climate change. COPs started in Brazil back in 1992 but the most famous was COP3 in Kyoto in 1997, from whence came the famous Kyoto Protocol. It really set the scene for people and governments to think seriously about climate change and how we can deal with emissions. At COP21, in 2016, the Paris Agreement entered into force, aiming to limit global warming to below 2^{O}C, and preferably no more than 1.5^{O}.

COP26 took place in Glasgow a year ago. It was meant to have been held in 2020 but was interrupted (like most things) by Covid. Nonetheless, COP26 finished on a high note, with much optimism and many new government commitments to secure net zero by 2050 or 2060. This optimism was quickly dispelled in the new year by the Ukraine war and consequent energy crisis.

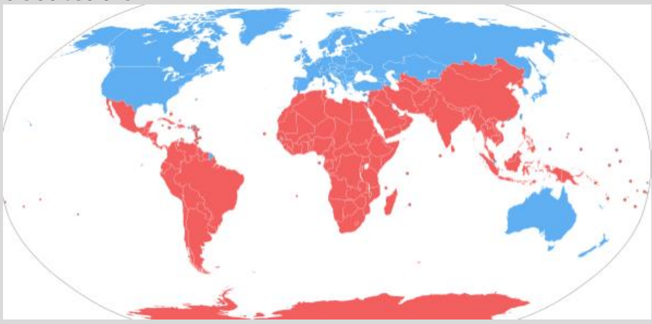
COP27 took place in November in Sharm El Sheikh, a resort town (above) on the Sinai peninsula in Egypt. The tone of the meetings was quite different to COP26. Accelerating the energy transition is key to addressing the climate crisis, yet the transition also needs to be just, orderly and equitable, and the energy crisis this year has appeared to put that transition back a few steps. It meant oil, gas and coal prices jumped sharply, creating many losers and a few winners around the world. During 2022, even some of the more "progressive" European governments re-started coal-fired power stations and were looking at rejuvenating some of their old nuclear plants. On a temporary basis we hope, but who really knows how long the Ukraine situation might go on?

Glasgow had pointed to the importance of finance as a catalyst to drive progress on all aspects of the global climate agenda. Many parties demonstrated the political will to deliver on those finance commitments. But to support 2050 net zero goals (or 2060 or 2070 for China and India), achieving interim targets is becoming a vital challenge to achieving the aim.

Nonetheless, over the past year 29 countries have come forward with more stringent emissions reduction plans, including Australia which is now aiming for a 43% cut from 2005 levels by 2030, up from 28% previously. Progress in Asia was especially strong, with Indonesia and Thailand both announcing tighter emissions plans, and India calling for the phase down of all fossil fuels, not just thermal coal. All eyes however remain on the world's largest emitters, China and the US.

The Prime Minister of the Bahamas, Philip Davis, provided a stark example of how climate change is affecting vulnerable communities. He reckoned as much as 40% of his country's debt is directly linked to the impacts of climate change. This was largely incurred in the aftermath of Hurricane Dorian – the extremely powerful and catastrophic Category 5 Atlantic hurricane, the strongest ever known to hit the Bahamas – which caused billions of dollars of damage in 2019.

One of the major outcomes was agreement to look at creating a 'Loss & Damages' mechanism, essentially reparation payments to vulnerable island states and less-developed countries in order to fund the mitigation of climate impacts. There was broad acknowledgement by most COP27 participants that the highly industrialised world, known as the Global North, which built its wealth largely using fossil fuels over the past couple of centuries, should be held responsible for the financial impacts of climate change. Australia is an honorary member of the Global North, the blue countries shown below, sort of like Eurovision. Excluding the economic powerhouse and huge emitter China from the North is debateable.



Of course the idea of reparations was not whole-heartedly embraced by the countries that would be required to fund them, but there aren't as many of those. Yet to be determined is whether it is historical emitters who will be responsible, or if it is the largest current heavy emitters and users of fossil fuels who should be held to account. Detail is still scarce, and the recommendations of those working on the mechanism will be put to COP28 in Dubai this time next year.

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BTW

Crypto came racing back into the public consciousness this month with the sudden collapse of what was the world's second-largest crypto exchange FTX. "FTW" was probably what a lot of people were thinking as they watched FTX go from the future of finance to a footnote in history. Everyone is now lawyering up but one thing is for sure, Sam Bankman-Fried (widely known as SBF), the 30 year old curly-haired dude usually pictured wearing shorts, is done for now. He was supposedly "worth" more than $US30 billion earlier this year (although this yet again demonstrates that a person's worth should not be measured by the amount of assets they are supposed to have!). Many have been repelled by some of the attitudes and behaviours seen in the crypto space – the corporate machinations, the casino-like nature of returns, the opaque markets, the jargon which excludes so many people, the macho derision directed at those who "just don't get it" – but SBF was different, and seen by many as the acceptable face of crypto. No longer.

Until last month there were three large crypto exchanges: Coinbase, Binance and FTX. FTX portrayed itself as the cleanskin in an industry replete with dodgy characters: a trustworthy partner whom many used as a custodian of their own crypto assets. Nassau-based SBF, however, is alleged to have taken billion-dollar personal loans from the company and cashed in hundreds of millions more during the most recent capital raisings. As recently as September he was still being described as one of the richest people in the world, and he and his associates made tens of millions of dollars of donations to both sides of politics in the recent US elections. He sponsored sports teams, stadiums, politicians and celebrities, and appeared on stage (in shorts) with luminaries in Davos. He had a superbowl ad. He had a string of famous endorsers, chief among them being NFL star Tom Brady who was not just a public face of the company, but also put a large proportion of his net worth into the FTX platform. There were many warning signs for those who wanted to see them: SBF himself explained the mirage of crypto value creation here, but FOMO is a strong force.

FTX was at one stage said to be worth $US32.5 billion, but was it really ever worth that much? Certainly not. That might have been the value implied by the $US500m paid by various investors – including some household tech investors like Tiger and Softbank – to acquire a sliver of FTX in January this year, but that just demonstrates the potential fiction of unlisted valuations. It is true that, in the listed space, we impute the most recent share price to a company's share base to arrive at its market cap, but shares are being trading constantly and transparently, and imbalances between a share price and reality are usually fairly quickly ironed out. When unlisted transactions like that take place only occasionally and well out of plain sight, it is dangerous to impute that valuation to the entire entity. If nothing else, it creates a perverse incentive for existing investors to invest more at ever-higher prices in order to support their own positions, but unless that valuation can be actually realised at some point, it is just a mirage. Some big local super funds might like to think about that.

FTX came undone when, on 5th November, Binance announced that it was selling a large holding of FTX's token FTT, sending the price of FTT crashing. It then transpired that the FTT token also constituted the bulk of FTX's own balance sheet, and so the downwards spiral started. As the FTT price fell towards zero FTX quickly became unviable at which point, on the 8th, Binance offered to acquire FTX. Two days later, however, Binance rescinded its offer and the collapse of FTX happened very quickly thereafter. It seems that $US8 billion or so worth of users' assets on the FTX exchange had (allegedly) been used by SBF's crypto trading firm Alameda Research and both groups were put into bankruptcy protection. SBF blamed poor account labelling for mixing up his clients' funds with his own: that's a multi-billion dollar admin error!

SBF's replacement as CEO of FTX, John Ray, is a corporate restructuring legend, but even he seemed daunted by the task. After just a few days on the job he said "*I have over 40 years of legal and restructuring experience, I have been chief re-structuring officer or CEO in some of the largest corporate failures in history. Nearly every situation I've been involved in has been characterised by deficits of some sort, usually in internal controls. Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as what has occurred here at FTX.*" This was the guy who sorted out Enron!

There appears to have been a fair bit of corporate chicanery involved. FTX didn't have a company accountant or even a list of employees, and company funds had been used to buy hundreds of millions worth of Bahamian property in individual employees' names. Expenses were very informal, and approved on chat by emoji 👍. Alameda Research, the crypto trading firm also largely owned by SBF, shared office space and many of its personnel with FTX. The Alameda CEO was Caroline Ellison, SBF's occasional girlfriend. People have since been trawling through social media feeds of both SBF and Ellison and finding all sorts of incriminating things, such as Ellison's apparent drug use. Well-connected though, it turns out her father is a prominent Ivy League economics professor and a former boss of the current Chair of the main US market regulator, the Securities and Exchange Commission.

Speaking of regulators, where were they when all this was happening? Around the globe regulators have been highly reluctant to get involved in crypto. After all, even with fairly heavy equity market regulation, things like Enron and Madoff still took place from time to time; their chance of catching bad

(cont. p5)

BTW (cont.)

behaviour in the complex and opaque crypto market is even more limited. All those securities regulators are probably breathing sighs of relief now, as multitudes of fingers would now be pointing at them after this debacle, and no doubt looking to their governments for redress. Traditional regulators struggle to understand crypto as it is not a security. A coin issues no prospectus, has no corporate structure, no directors, no published accounts – if there are any accounts at all – nothing most regulators would recognise or be able to relate to or act on. This has meant that people wishing to engage with crypto have had to rely on the ethics, competence and goodwill of those promoting and benefitting from the coins, qualities that appear to have been in short supply.

There is some irony in that some in the crypto space, including SBF himself, had been crying out for regulation. The *raison d'être* of Bitcoin and most of its ilk was to build a monetary system independent of the evil clutches of government and central bank monetary profligacy; now they are trying to gain a jot of credibility by having oversight from different arms of those same governments. SBF's own support for regulation enhanced his reputation in the industry, but the SEC still seems to not want to have anything to do with crypto. The CFTC (Commodity & Futures Trading Commission) is a bit edgier and seems more willing to engage.

But we're not completely sure it's a good idea to legitimise crypto by giving it regulatory endorsement. To this point, crypto contagion hasn't spread into the real world, which is a good thing. Earlier in the year we wrote about the collapse of Luna, but the only damage done there was to the unfortunates directly exposed; there was no contagion to other markets. Maybe this one won't spread either. As Jefferies' New York-based market strategist David Zervos said "*the real reason that we have seen so little systemic risk and turmoil appear in this aggressive Fed rate-hiking cycle of 2022 is that all the Ponzi schemers were smart enough to go into the unregulated world of crypto. Why mess around with [the chance of] criminal prosecution in the traditional markets when a similar scheme can so easily be promulgated in the unregulated world of crypto? If you want to be a bad actor, the crypto world is a perfect playground. I'm not implying that all crypto actors are bad guys. Far from it. But if Madoff were around today, crypto would have surely been his preferred habitat. If you deceive folks out of billions in FTX, Luna, or BlockFi, there is no jail time. If you did the same thing in stock or bond markets it's a life in prison. Crypto is a Ponzi schemer's dream come true.*"

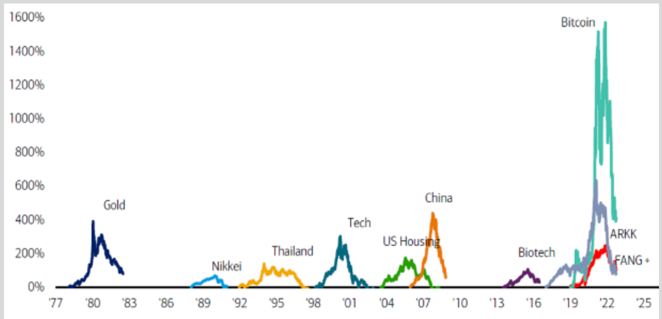
Compared to all the controls and protections we're accustomed to in equity markets, it's ludicrous to think an individual could control the exchange, the market-maker/trading firm operating on that exchange AND also have custody of its clients' assets. It was too easy for client funds to be transferred into Alameda, regardless of whether it through malice or incompetence. It seems obvious that there should be a very distinct separation between exchanges and market makers, but this was simply not the case for FTX.

Back to SBF, the realisation of his predicament was played out in real time on Twitter, with him first of all apologising for, then attempting to explain, what had happened. His public comments since have turned from defence to defiance, then to radio silence. To add insult to (its clients') injury, FTX was also hacked just as all this was happening and someone, suspected to be an insider, apparently made off with a further half billion or so worth of crypto. Whatever is left in FTX is stuck there until further notice, possibly forever.

Was FTX fraud, or just a case of massive incompetence? A lot of the detail is yet to be revealed but we do know that in the weeks prior, FTX had been trying to buy out some other struggling crypto players, BlockFi and Voyager. It said it was doing this for altruistic reasons but, from what has occurred at FTX, there might have been an ulterior motive. Both BlockFi and Voyager had also gone bust by the end of November.

Interestingly, this whole thing appears to be less a failure of crypto itself than the centralised exchange/custody model adopted by most players: that made it easier to appropriate their clients' funds. If you sell an asset on a legitimate exchange, getting the proceeds should never be an issue. If the exchange is offering some sort of return on those assets, however, investors should be questioning what it is doing to generate that return. Getting players away from exchanges and operating entirely on the blockchain seems a step too far for retail investors, at least for now. A frighteningly large number of people who hold crypto in exchanges don't even know how to redeem them into their own wallet.

The scale of crypto's fall since it peaked a year ago has been huge, even in the context of other bubbles of recent years. From a peak of more than $US3 trillion, the total value of all 21,974(!) types of crypto out there has fallen from a peak of more than $US3 trillion last year to a little over $US800 billion now; even that still seems to be quite a lot. Bank of America recently published the below chart which shows just how large the cryptocurrency bubble had become a year ago. While it probably won't go all the way to zero, it still could have a bit further to fall.



Source: BofA Global Investment Strategy, Bloomberg

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Traveller's Tale

Andrew went to London in November. His trip stood out from many of the recent Alphinity journeys in that his planes all ran on time and his luggage turned up in the right place and at the same time as him. However it was just the same in terms of the sky-high (pun intended) price of the ticket, and how packed the planes were. No wonder Qantas keeps coming out with earnings upgrades! As CFO in addition to being Portfolio Manager, he is now trying to cope with the emotional conflict of being both really upset at the high cost of travel, and really happy with those costs for Qantas earnings sake!

As for the actual trip, Andrew headed over there to meet with banks and insurers, although why in November is known only to himself; after all, aren't meetings with banks and insurers depressing enough? London can be bleak sometimes, and that week was no exception with little sign of the sun and the temperature rarely even making it into the teens. Equally, especially in the leadup to Christmas, it can be a magical place as all the lights → go up and the shops all fill with Christmas goods. All the right signs were there this year, although considering some of the political, economic and social turmoil the Brits have been hit with in 2022, one could have excused them if they'd been a bit more subdued than normal. Most meetings started with them apologising about the ineptitude of their government, and they couldn't even muster much hope for England in the Football World Cup.

While perhaps typically downbeat about the immediate past, the present and the looming future, the reality was that, despite all that has been thrown at them, London seemed to be buzzing, and busy as ever. Restaurants were full, there was plenty of construction going on and unemployment remains very low. Much like the rest of the western world, the UK is waiting for whatever impact high inflation and higher interest rates might have, but is not yet seeing it actually show up in things like loan losses or unemployment.

One comment made by execs he met with at a UK retail bank, however, suggested that cracks might be starting to appear. They have recently seen the lowest decile of transaction account holders increase their use of Buy-Now-Pay-Later by 700%. The saying that inflation eats a society from the bottom up has probably never been more stark than in that example.

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