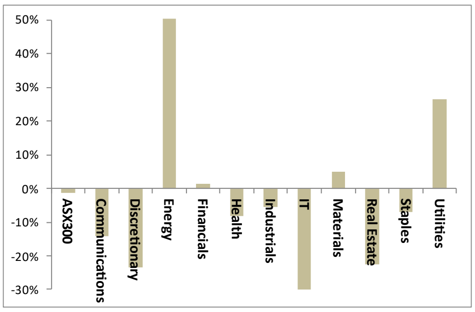
Quarterly Report – December 2022
Alphinity Concentrated Australian Share Fund

Limping home

Market comment

2021 was a good year for the share market (+18%) yet, considering all that went on, one we were very happy to see the end of. 2022 was a better year to live through but while Covid placed fewer and fewer restrictions on our business and social activities as the year progressed, big changes in the macro environment meant that share markets, in fact pretty much all investment markets, did poorly. Our equity market (ASX300 including dividends) rose 9% in the September quarter but fell just short at the finish line with a -1.8% return for the year. This was not a bad outcome given what else went on around the world this year, credit for which can largely be given to our exposure to energy and resource companies. The rest of the market was less exciting, and anyone wishing to maintain a degree of balance in their portfolio would have struggled to outperform. In fact, most other equity markets and pretty much all bond markets produced negative returns. In that context, -1.8% looks OK.

Performance in our market was very focused on a small number of sectors. Regular readers of these pages will be familiar with our complaints about how performance has been concentrated in a small number of companies this year; as it turned out around 70% of ASX300 companies underperformed the market this year. The chart below shows total sector returns in 2022: if you didn't own Energy or Utilities stocks you would have struggled.



Strength in Energy can be credited to the war in Ukraine and consequent energy crisis in Europe. This pushed up the prices of oil, gas, coal and lithium; BHP selling its assets to Woodside was just icing on Energy's cake. However, unless energy prices were to double again, returns from that sector are likely to be less frothy in 2023, and any sign of a resolution to the Ukraine war – as unlikely as that presently appears – could result in steep energy price declines. The strong return from the Utilities sector was primarily due to a takeover offer for Origin Energy.

The Materials sector covers most resource companies in addition to building materials. The difference between those two subsectors was stark: most resource companies did very well including the behemoths, Rio Tinto and BHP, which were up 20% and 30% respectively. Stresses in US housing however sent the shares of building material companies sharply south, the best being -15% and the worst -50%. Even the Staples sector, which is supposed to be fairly defensive in times such as these, did poorly. Financials performed quite well though, with solid double digit returns achieved by many of the Banks and Insurers, but Real Estate stocks reacted badly to the sharp rise in bond yields. It was a difficult market in which to produce overall outperformance: you would have needed to have a portfolio consisting almost entirely of coal and lithium miners and oil/gas producers, and/or been lucky enough to pick the takeover bid for Origin, as on fundamentals it didn't look like it was going anywhere. Origin was in the midst of a sharp earnings downgrade cycle; clearly the buyers see some appeal other than its earnings potential.

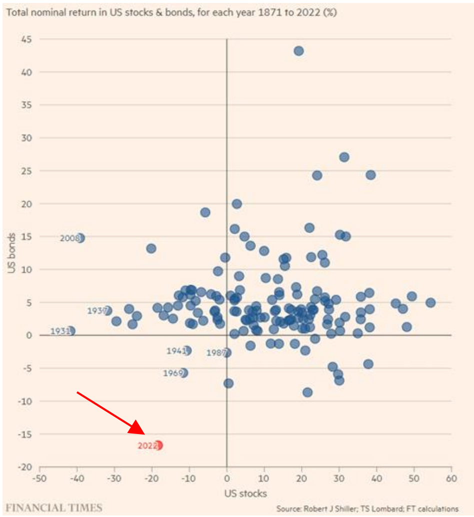
Looking across equity markets more broadly, in $A terms the worst market for 2022 was Russia's -33% although US tech index NASDAQ came close, falling 28%; the broader US market S&P500 did better, falling only 12%. Most European markets were sharply lower and the closer you were to Ukraine, the worse the return.

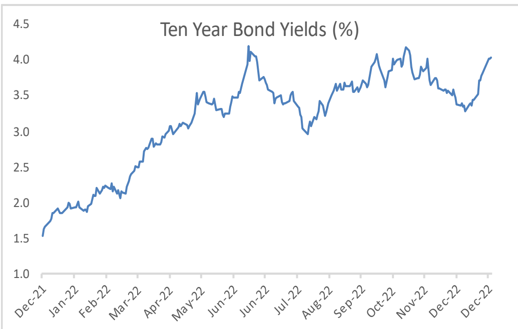
Performance*	1 Month %	Quarter %	1 Year %	3 Years % p.a.	5 Years % p.a.	10 Years % p.a.	Since Inception^ % p.a.
Fund return (net)	-3.4	8.2	-2.0	5.5	7.5	9.9	9.7
S&P/ASX 200 Acc. Index	-3.2	9.4	-1.1	5.6	7.1	8.7	8.4

*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 December 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.

The UK's FTSE100 fell only a fraction thanks to its large number of multinational companies listed there; the more domestically-focused FTSE250 fell by 20%, possibly a more accurate reflection of the political and economic situation prevailing there this year. Positive markets were scarce. Brazil and Singapore were both modestly higher in their own currencies but inflated by the $A which fell by 6% against the $US. The $A itself however was flat on a trade-weighted basis, being unchanged versus the Euro and higher by 2% against the Chinese Yuan, 5% against the UK Pound and 7% against the Japanese Yen.

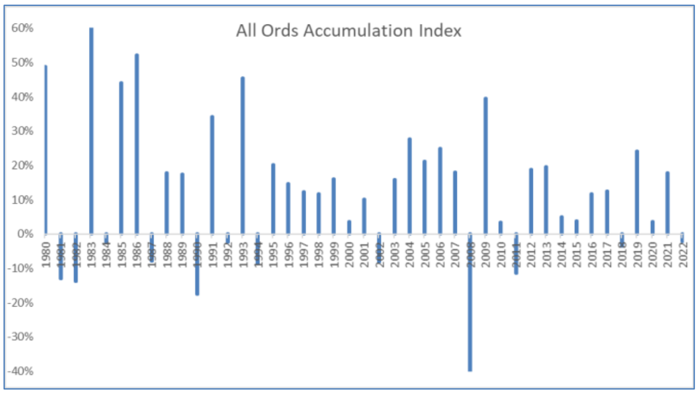
Relative to other asset classes, our shares weren't that bad. According to this chart from the Financial Times, US bonds produced their worst return in 150 years, and US stocks and bonds combined performed a rare double act. Australian bond yields also finished the year substantially higher than where they started. The yield on Australian ten year bonds rose from 1.5% to 4% in 2022; this equates to around a 20% decline in capital values.





Gold is often said to be a hedge against inflation but was essentially unchanged over the year in $US terms despite inflation in the high single digit range. So-called digital gold, i.e. Bitcoin, did not have a great year, finishing some 60% below 2021's closing price; the less said about that the better.

So, while 2022 was not a particularly enjoyable year in most markets, having money in Australian shares provided a better outcome than most of the alternatives, as bonds and property both provided negative returns. The chart below looks at the All Ordinaries Accumulation Index, which has more history than the ASX300. It includes dividends – a vital component of equity returns, especially in a high-yield market like Australia. It shows that 2022 was only the 12th year in the past 42 during which the total return from shares was negative. Recession years (early 80s, 1990) and 2008 (GFC) were clearly the worst; the market however withstood the self-induced "Covid-recession" of 2020. Even including the negative years, the compound annual return since 1980 has been a bit better than 10%. Encouragingly, only once during that period was there two consecutive negative years. While the economic outlook from here is not especially clear, hopefully 2022 will resume the typical pattern.



Portfolio comment

The Fund lagged the market this quarter, but performed in line with the market for the whole year. For the quarter, the best returns came from iron ore miner BHP, insurer QBE, analytics company ALS and not owning either James Hardie or Pilbara Minerals. On the other side, however, owning hacking victim Medibank Private and gaming machine maker Aristocrat Leisure both cost some performance, as did not owning big bank Westpac, iron ore exposures Rio Tinto and Fortescue Metals or takeover target Origin Energy.

For the year, the best returns were from BHP, gas producer Santos, QBE and not owning retailer Wesfarmers or tech exposures Square (Afterpay) or Xero, but these were largely offset by positions in industrial property player Goodman Group, Aristocrat, owning building materials firms Reliance Worldwide and James Hardie for part of the year, and not owning Rio Tinto or Fortescue Metals.

Click here for our 2022 ESG summary

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Market outlook

A new year generally comes with promises of new opportunities, and 2023 is likely to be no different. At this early stage, though, the key topics of debate have not changed from where we ended 2022.

There are some encouraging signs that global inflation is moderating, and some aspects could even be close to normalising. Other inputs to inflation however – including the very important wage component – remain robust, which means it is too early for central banks to declare victory. Nonetheless, further rate increases are likely to be less of a focus this year than the impact on economic growth and corporate earnings of the hikes that have already been made. Globally, earnings revisions have been firmly negative for some months and, even though expectations are now lower, they continue to look too optimistic in our view.

The Australian equity market fared relatively well in 2022 on the back of solid growth in overall earnings driven by the heavyweight Resources, Energy and Bank sectors. Earnings revisions fluctuated throughout the year as commodity prices first strengthened across the board with the onset of the war in Ukraine, then weakened in several sectors as global growth started to slow, before strengthening again towards the end of the year on growing optimism about China reopening.

China's remarkable policy U-turn on Covid is showing no signs of wavering at this point. Despite unofficial reports of overwhelmed hospitals as infection rates accelerate, the Government has instead announced a further range of easings, most noticeably at international border crossings. While we've learned that nothing is certain with Covid, it appears that Chinese authorities have decided to push through the current wave of infections. They are doing so regardless of the impact on its citizens health or further short-term weakening of an already-struggling economy, to get to the other side as quickly as possible so that the economic stimulus measures that have been building over the last 12 months can finally take effect.

There will be important implications for Australian corporate earnings should China be successful in bringing forward its economic recovery. The Resource sector, together with a still-resilient Bank sector, would provide a solid buffer to a probable global earnings downdraught. So while global equity markets, Australia's included, continue to face some meaningful challenges, especially from an earnings perspective, Australia's own prospects look a bit better, at least from a relative perspective.

Portfolio Outlook

In the current market environment in which there is lower-than-normal earnings certainty, Alphinity's focus on earnings leadership will potentially be even more important than normal. While the overall market valuation has improved meaningfully over the last 12 months, thanks to strong aggregate earnings growth (albeit concentrated in a small number of sectors) in a fairly flat market, relatively few companies are trading on such low multiples that they can afford to disappoint on either short- or long-term earnings. We expect this will be true for stocks across the whole spectrum of the market, be they typically classified as defensive, cyclical, growth or any other type of stock.

The re-opening of China that is currently taking place, and the Chinese government's new focus on economic growth even if it comes at the expense of public health, has improved the outlook for some commodities, and therefore further improved the earnings prospects for some of Australia's resource companies. However, in world that is slowing, with the probable exception of China, this will primarily have a positive impact on the bulk commodity producers (i.e. iron ore and metallurgical coal used in steel-making) in our view. BHP is already one of the largest active positions in the Fund and is well positioned to build further on last year's strong performance. Further evidence of the China reopening and/or greater momentum in Chinese economic activity might justify allocating even more of the portfolio to the producers of these commodities.

As we head into the February reporting season we have a portfolio of stocks that have experienced solid earnings upgrades relative to the overall market over the last quarter or two. We believe this positions the portfolio well for most of the likely market outcomes.

Top five active overweight positions as at 31 Dec 2022	Index weight%	Active weight %
Commonwealth Bank Of Australia	8.3	3.8
National Australia Bank Limited	4.5	3.7
QBE Insurance Group Limited	1.0	2.6
BHP Group Limited	11.1	2.4
Medibank Pvt Ltd	0.4	2.2

Asset allocation	31 Dec 2022 %	Range %
Securities	97.9	90-100
Cash	2.1	0-10

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BTW

There is no such thing as a quiet year in financial markets, but it feels like investors have never had to deal with so much volatility as has been dealt to them in the last three years. The global pandemic forcing the world into isolation; the unprecedented globally co-ordinated stimulus efforts to bring world out of it; the tech/crypto/meme stock bubble and its inevitable bursting; Russia invading Ukraine sending commodity supply shocks rippling across the globe; a bond market crash in the UK accompanying the shortest-serving British Prime Minister... yes, it's been a busy few years! Back home, our own Reserve Bank had credibility issues after saying interest rates would stay low until at least 2024 and then having to scramble in 2022 to catch up to what was going on in the real economy; China leaving us in the deep freeze until a change of government as Albo replaced Scomo; and a number of 'hack-attacks' on previously trusted institutions which put cyber security on top of most Board's agendas.

Despite all the various life-changing events above, we all re-learned that one of the things that matters most in financial markets is interest rates. This year, Central Banks in almost all developed markets finally put an end to a decade of cheap/free money, during which interest rates were around zero, and even went negative in Japan and Europe. There is nothing more friendly to equity markets than having a bank charge you to hold your cash, as frequently happened in Switzerland.

We got used to concepts like 'The Fed Put', referring to the US Federal Reserve's recent practice of putting a floor under stocks by cutting rates when things look a bit dicey. As long as the prices of goods and services remained low, rates could hover close to zero, and the only inflation we saw was in asset prices. Bonds, stocks, property and crypto all rocketed in value as money looked for a home that wasn't a bank. This backdrop of free money, combined with generous welfare cheques being given to people stuck at home during Covid isolation, inevitably led to any valuation discipline being thrown out the window. Over 2020-2022, we saw the rise of meme stocks, thousands of different coins in crypto land, NFTs, and SPACs to name just a few.

Facebook changed its name to Meta, the 'Metaverse' tried to take on another incarnation but its shares dropped 64% as both users and advertisers left in droves. Tesla's did about the same as its erratic CEO found something new and shiny to focus on: Twitter. The fact that other companies with longer heritage in making cars were starting to impinge on Tesla's battery-powered turf surely didn't help.

A common theme in our BTWs last year was the mispricing of various asset classes, whether it was investors tolerating sky high valuations for way too long in listed stocks (like Afterpay) or private equity and venture capital not marking-to-market asset valuations, leading to frightening distortions and hefty mark-downs when it came to the next round of capital raising (like Canva). Speculative financial mania reached its purest form in the $US3 trillion crypto bubble culminating in the FTX downfall, which could go down as one of the greatest corporate frauds in history (allegedly).

Although we scratch our heads when bubbles pop, and think "surely we will all never be so naïve as to let this happen again", bubbles have been around for a long time and will continue to turn up in various different forms. From Dutch Tulips in the 1630s and the South Sea bubble in 1720 through to Japan's real estate and stock market bubble in the 80s and the Dotcom bubble in the 90s, the investing world should be no stranger to these events. The answer as to why history keeps repeating probably lies in one of the more basic fundamental characteristics in the human psyche: greed. The appeal of 'free money' is just too compelling.

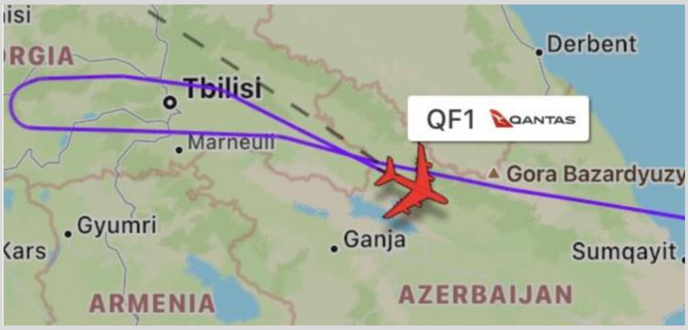
Perhaps the aptly-titled book *Money for Nothing* by Tom Levinson, about the South Sea Bubble, sums it up well. That bubble took place after Great Britain had issued huge amounts of debt to fund war with France in 1689. There ended up being many different debt instruments, all on different terms, and they were not tradable. The South Sea Corporation came up with the idea of creating a different form of money.

It would buy up various forms of British national debt, consolidate it all and then sell equal identical shares of it. It would then be tradeable and South Sea Corporation shareholders would get fabulously rich by enabling that liquidity, in the process skimming off a third of the value for its shareholders – the financers themselves and members of the British parliament – once the bill was passed. No conflict of interest there! What followed was an enormous bubble followed by a huge crash. It was what prompted the famous quote of Sir Isaac Newton "I can calculate the motions of heavenly bodies, but I cannot calculate the madness of crowds".

While it now seems the world is suffering from a hangover after a decade of free money, with interest rates taking off and with recession fears on the horizon, here's hoping that we're in for a more rational investing backdrop in 2023, one in which banks don't charge you to keep your money and where some of the more egregious bubbles have been flushed out, until the next one at least.

Traveller's Tale

Alphinity became embroiled in a well-publicised travel incident just before Christmas. Jonas was heading with his family to his native Sweden to spend Christmas when, a few hours out of Singapore on the way to London, his flight chucked a U-turn and landed in Baku, Azerbaijan, after a smoke alarm was triggered in the hold. He and a few hundred friends ended up spending a day or so there, meaning that he missed Christmas in Sweden. Why Baku? Apparently it is the only airport in the region with a runway long enough to handle a fully-laden A380.



Some passengers were a bit narky about the situation but, realistically, what else could Qantas have done? Ignore the warning light, hope for the best and push on to London? With around 400 passengers and crew at risk, surely caution was the most prudent course. Could they have handled it any better? Probably, airlines plan for many contingencies but not this one it seems, and it took quite a while to arrange a hotel on arrival. After some delay Jonas and his family ended up in the Baku Marriott, so it could have been worse.

Considering all the stresses that all airlines have had to deal with this year, including high fuel prices, match-unfit passengers and flight crews that kept catching Covid and causing flights to be cancelled, it might have been a tad optimistic to have left on a Friday and expected to be in Sweden on Sunday. As it turned out, Jonas and his family spent a day in Baku, which is apparently quite a nice city and a place they would probably otherwise never have gone. Meanwhile Qantas scrambled a spare A380 from Australia to collect them and take them to Heathrow, where they arrived on Boxing Day to encounter striking terminal workers. Their onward flight had long departed but they did all eventually all get to Sweden.

More importantly, we found this picture in an online news report about the incident which shows not only the back of Jonas' head, but also a glimpse of the first Alphinity backpack ever to enter Azerbaijan. While Christmas 2022 did not go quite as planned, it is no doubt one that will be long remembered in Jonas' household.

For further information, please contact:

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