Monthly Report – February 2023
Alphinity Australian Share Fund

Reporting in

Market comment

February brought the FY23 interim reporting season, a firehose of information from which we had to sip and assess the investment cases of many of our positions. The market (ASX300 including dividends) fell by 2.5% in February, giving back a little of January's strong performance. Pleasingly, the portfolio held up better than the market. Reporting season is often a period when the direction of the market overall is less significant than the movements in the share prices of the individual companies, which can vary greatly, and this was the case in February.

Global markets were generally better than ours, thanks at least partially to the $A which fell by ~5% against the $US, although less against other major currencies. The Trade Weighted Index was down just 1%. The macro scene was dominated by China, particularly its reopening. After pivoting late last year from "Covid-zero" to what seemed to be "let it rip", a large proportion of the population was exposed to Covid. Most recovered fairly quickly and, by the end of February, things appeared to be back on track, with officials now forecasting economic growth of 5% for 2023. Chinese shares were only flat in their own currency in February though, and those listed in Hong Kong were down almost 8%. European markets were generally 3-6% higher for the month; US shares rose by 2-3%.

Metallurgical coal, which is used to make steel, was well-bid during the month rising 6% in $US terms and 11% in $A, and iron ore was flat (up 5% in $A). The price of thermal coal, however, which is used for electricity generation, fell by almost 20%, and has now halved since the end of December. Unsurprisingly, the shares of the two main thermal coal-producers have fallen this year as well, although not by as much. Notwithstanding these large moves, the thermal coal price is still around double its average price of the past four years, which suggests there could be further falls ahead if/when the global energy picture improves. Global gas prices kept falling but Oil rose, the China re-opening contributing to positive sentiment around demand.

Broader commodity prices were mixed, with some of January's other gains partially reversed in February. Cobalt, Nickel, Aluminium and Zinc fared the worst. Copper and Lead eked out small rises, largely thanks to the currency, but the resource and materials sectors were the biggest underperformers. Conversely, the Utilities sector did the best, although the ongoing bid for Origin Energy can take credit for that rather than any operational excellence. Banks performed poorly too: Commonwealth's result revealed what could be interpreted as a peak in interest margins, and those concerns flowed through to the share prices of the other major banks.

Bond yields resumed their upward path in February, ten years rising from 3.5% to 3.85% as the market came to the view, after some prompting from Central Bank officials here and offshore, that expectations of short-term rates coming down this year – as markets had started to factor in – might be a tad optimistic. This impacted rate-sensitive companies, including Real Estate, which wasn't helped by events in the US where a number of debt defaults and floods of redemptions from open-ended Real Estate funds caused a number of those funds to be suspended. The mismatch between offering daily liquidity on assets which aren't quickly realisable is clearly not sustainable. While those types of property investment funds are not common in Australia, there was still a degree of impact on some of ours.

Portfolio comment

The Fund outperformed the market nicely in February, helped by strong returns from some of our key positions. The best contributors to overall performance came from health insurer Medibank Private, global insurer QBE, packaging company Orora, pallet mover Brambles Industries, gaming machine maker Aristocrat Leisure and insurance broker Steadfast. The only detractor of note was our position in BHP.

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)	-1.6	0.8	5.8	8.4	8.2	8.4	9.2
S&P/ASX 300 Acc. Index	-2.5	0.2	6.5	7.9	7.9	7.9	8.5

*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, 28 February 2023.

^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

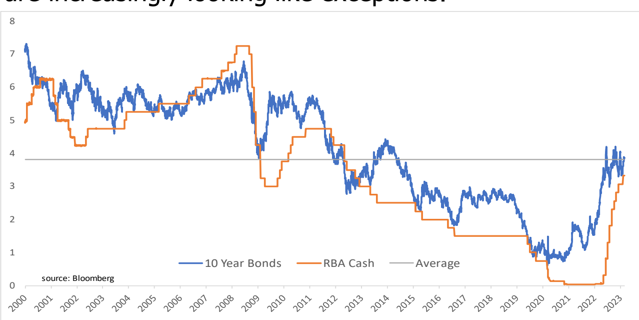
Earnings expectations have continued to moderate, both globally and in Australia, following fourth quarter/first half company earnings releases. While mostly negative, earnings revisions have been modest, especially when considering the degree to which interest rates have increased in some countries, including Australia. A combination of factors, including easing supply bottlenecks, reasonably resilient consumer spending and, more recently, stronger commodity prices following China's reopening have all contributed to earnings holding up better than many feared.

For FY23, Australian consensus earnings growth forecasts for the whole market are still positive at 2-3%, even though this has come down from around 4% over reporting season. With fewer than four months left of the financial year, this looks like a reasonable estimate. A similar growth rate is forecast for FY24; this might prove optimistic however, as the impact of higher interest rates over the last year is compounding, not easing.

Bond markets appear to have interpreted the more resilient corporate earnings and still elevated inflation data as meaning that Central Banks still have more work to do to cool the economy – and the labour market in particular – in order to rein in inflation. While equity markets were down in February, many have not yet given up on the narrative of peak inflation having already been seen and peak interest rates being within sight, perhaps encouraged by the mild earnings impact to date.

A definitive conclusion to this debate is unlikely to become apparent in the next few months. The answer will most likely be somewhere in the middle, and we continue to see the risk of further negative earnings revisions as the most significant obstacle to strong equity market returns in 2023. This appears to be, to some extent at least, reflected in current market multiples with the Australian equity market trading at a Price/Earnings ratio slightly below long-term averages. Having said that, sector skews continue to be meaningful, with elevated commodity prices supporting short term resource company valuation metrics and the longer duration sectors continuing to look expensive relative to history.

In this context it is worth noting that, despite the sharp rise in interest rates over the last year, both the local cash rate and longer term bond yields are only back to their 20 year averages, as the chart below suggests. The ultra-low rates and yields investors had been accustomed to in recent years are increasingly looking like exceptions.



Portfolio Outlook

The February reporting season was a welcome break from the many macro factors that had been dominating individual share price performances. The Fund had a good month with most portfolio holdings which reported delivering strong results, positive outlook statements and, as a consequence, strong share price performance. Some of the highlights were pallets pool company Brambles, global insurer QBE, retailer Super Retail Group, packaging/distribution company Orora, logistics specialist Qube, airline Qantas and asset manager Macquarie Group, in addition to The Lottery Corporation, Medibank Private and Woolworths. While the earnings drivers naturally varied amongst this very diverse group of companies, common features were strong operational performance, the ability to manage cost pressure from higher input costs through a combination of operational efficiency and pricing power. We added to our positions in both Woolworths and Medibank Private after their 1H results with increased confidence in their renewed operational momentum with diminishing challenges from Covid disruptions and November's cyberattack respectively.

In the banking sector, only CBA reported first half earnings while the others released 1st quarter updates. CBA delivered a strong set of numbers but also indicated that increased competition and a gradual rise in funding costs will start to impact margins in the second half. We continue to like the banks for their positive margin leverage from higher interest rates and strong balance sheets. However, we have trimmed the sector to a more neutral sector weight while monitoring for further evidence of their earnings resilience.

One of the main topics of debate has been the speed and likely endurance of the economic recovery in China following its remarkably fast reopening. Leading economic indicators have mostly turned positive, while the actual increase in activity has so far been mainly observed in consumer spending rather than manufacturing and construction, which are the most important sectors for commodity consumption. Our Resource analyst will be traveling to China later this month to once again gather on-the-ground information, the first trip possible since the Covid outbreak more than three years ago. For the moment, however, we remain moderately overweight bulk commodity producers but underweight the base metals which are more exposed to the global economy.

Top five active overweight positions as at 28 Feb 2023	Index weight%	Active weight %
BHP Group Limited	10.4	2.5
QBE Insurance Group Limited	1.0	2.1
carsales.com Ltd	0.4	1.7
Medibank Pvt Ltd	0.4	1.7
National Australia Bank Limited	4.3	1.7

Asset allocation	28 Feb 2023 %	Range %
Securities	97.9	90-100
Cash	2.1	0-10

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BTW

Scandals have been going on in the Nickel market for thousands of years. The first recorded one took place in Babylon around 1750BC, Reuters tells us. The British Museum has a clay tablet on which is inscribed the complaints of a merchant named Nanni, who had been delivered a load of nickel rather than the more valuable copper he had bought. In the middle ages it became known as Devil's Copper as the two were apparently quite difficult to tell apart, and Nickel was so inferior.

In Nickel's defence, it would be many centuries later before anyone knew of its superior qualities for use in alloys such as stainless steel and, more recently, as a key component in batteries. It seems like only yesterday, but is actually almost a year ago, that we wrote a piece relating some mischief that had taken place in the Nickel market. In March 2022 we related a story about the Singaporean company Envy Group which had a billion-dollar (alleged) Ponzi scheme based around nickel, involving a colourful Chinese man known as "Big Shot" which culminated in trading on the London Metals Exchange being suspended for a period. That one is currently running through the Singapore courts after the (alleged) perpetrator was charged with 105 offences.

The latest scandal rocking the nickel world involves Prateek Gupta, who is accused of defrauding global commodities trading firm Trafigura. It involved buy-back transactions, a common trade financing practice whereby the trading house buys the metal from the producer, owns it while in transit then sells it back for delivery to the end client. It appears that what was sold to Trafigura in the first leg of the transaction was not legitimate, and it has resulted in the trading house having to take a provision of more than half a billion $US. Trafigura won a court order in London freezing $US625m worth of assets of Gupta and his various firms. Gupta is of course challenging the freeze.

Mr Gupta had sold more than a thousand shipping containers of nickel ingots to Trafigura. All was not as it seemed though, and when the buyer checked the contents of the first hundred or so containers that had arrived in Rotterdam, none of them contained nickel. They instead were full of carbon steel, which is worth much less than the shiny silvery stuff. How much less? A lot. Carbon steel sells for about $US800 per tonne, compared to about $US25,000 per tonne for Nickel currently. The Babylonians of 1750BC would be rolling in their tombs if they knew that Nickel was again at the centre of a fraud case but that it was the valuable metal, rather than the one being used to dupe the buyer.

The size of the fraud and the tactics employed by Gupta read a bit like a crime thriller. As the inspection date of the fake Nickel cargoes approached, Gupta claimed to be having medical issues. Two days prior to inspection date, in November 2022, he messaged his contact at Trafigura to say he had suffered a heart attack. We're not sure how genuine this was, although knowing you've just shipped more than 1000 containers of relatively worthless material that was about to be uncovered would probably give anyone palpitations; in this case one might reasonably suspect it was a stalling tactic. It bought him some time though and, given that many of the dodgy containers are still at sea, it could be many more months – even years – before it is totally unravelled.

The more concerning part of this tale is how Trafigura got itself into this mess. It was actually Citi, its bank, that first noticed red flags, at which point it cancelled the $US850m credit line Trafigura was using to finance the nickel shipments. The bankers have detailed in court documents that Trafigura missed basic things like of certification checks and incorrect customs codes.

What is still unclear is whether some people inside Trafigura were aware of Gupta's fraud. Authorities have secured copies of messages between him and the main trader on the Gupta account, the now-unemployed Harsheep Bhatia, and the two seem to have been quite personally close. Although there was no direct evidence Bhatia was implicated, the authorities also said "we have been unable to plug what we see as certain gaps in the WhatsApp exchanges" between Gupta and Bhatia.

One of the causes of the various and frequent scandals in commodities trading – which are by no means limited to Nickel – is the antediluvian nature of the market itself. Unlike the highly-electronic financial markets, metals tend to be traded person-to-person and often have paper-based data trails. What needs to happen is a co-ordinated effort within the industry to create greater transparency around the origin, authenticity and title of the commodities, and to develop transferrable electronic records of cargoes and logs of cargo movements which might help limit the scope for things like document fraud and multiple pledging of cargoes. This seems to be – finally – an application for which blockchain could be well suited.

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Traveller's Tale

Australian reporting season meant that the domestic team was tied to its desks in February, but the global team was out there. Chris went to the US to attend a conference, also meeting with companies in Miami and Houston. US corporates have largely finished reported earnings by late February and then, the annual pilgrimage to Miami begins for conference season. For many Americans, visiting Miami in February is highly appealing. Long days, temperatures in the 20s and a nice sea breeze is just the change most New Yorkers needed after several months of winter snow. Swapping 28° in Sydney for 28° in Florida didn't have quite the same appeal for Chris but, nonetheless, he spent a week there meeting with many and various industrial companies from across the globe.

Companies he saw varied from large machinery makers to equipment rental companies to rail and trucking operators. The message (for the most part) was one of cautious optimism. Part of it might be that there is such a lag between interest rate hikes and the impact of those rates being felt in the industrial economy, but it does appear as though some tailwinds are beginning to gather momentum. These include benefits now flowing from the numerous stimulus programs that have been enacted in the US in recent years (including the Infrastructure Act, the Chips Act, the Inflation Reduction Act and so on), from the continued drive to decarbonise, and even to some extent from a move to "nearshore" supply chains closer to home.

On the way back Chris also spent a day in Houston seeing Oil & Gas companies, and also some servicing that industry. On the drive from the airport to downtown Houston you can see evidence of the stimulus companies in Florida were calling out, and it is clear how much Texas is benefitting. Everywhere you look there is new construction. Highways are at least four lanes wide both directions and traffic is still often at a standstill. The number of people living there grew by more than any other state in the US and its net migration from other states was second only to Florida. In fact, in 2022 Texas became the second State in the US to boast a population of more than 30 million. Interestingly, at the other end of the spectrum was California and New York, both of which saw net outflows of more than 300,000 people.

Spending all that time meeting the management teams of companies we own, their competitors and also companies we might own in the future is invaluable but on the way home, Chris sadly found out once again that airlines are still adjusting post Covid. Delayed and cancelled flights, a 35-hour trip home with an unplanned stop in Brisbane, not to mention the broken customs system he encountered when he finally landed in Sydney, did test his patience at the end of a long trip. It's just lucky that the view out the window at 10,000 metres never gets old.

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