alphinity
INVESTMENT MANAGEMENT

Monthly Report – April 2023

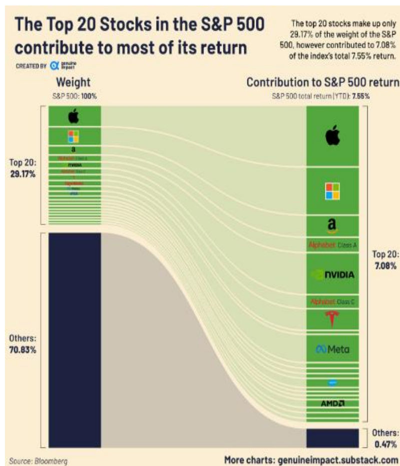
Alphinity Concentrated Australian Share Fund

April Fool

Market comment

The world's financial system is imploding? Just kidding, April Fool! Markets in April continued to bounce back from the banking system panic in early March, returning ~2% (ASX300 including dividends) for the month, meaning our shares are now comfortably 5% higher for the first four months of the year, despite the little dummy spit in the early part of March. Fears of a meltdown in the global banking system seem to have dissipated – for the time being at least – although ructions are still being felt by US regional banks which have suffered big deposit outflows despite substantial support from regulators. The woes of First Republic Bank is evidence of this, its shares falling from $US140 as recently as January to just $3.50 at end of April. Authorities scrambled to devise a plan for its survival and it was subsequently subsumed by the too-big-to-fail JP Morgan. Problem solved, for now anyway.

April also saw most US and European companies deliver quarterly earnings reports, with a surprisingly large number beating estimates despite the consensus expecting earnings downgrades. An alarming characteristic in the US has been the extremely small number of stocks providing most of the index's performance. Eight US mega-cap tech companies have been responsible for more than 90% of S&P500 returns in the year-to-date, and only 32% of companies in the S&P 500 index have outperformed the index this year.



Whilst not as extreme as the US, our market is not immune to concentration of performance, but this is largely in resource exposures rather than tech stocks. With an index weight of more than 10%, weakness in mining giant BHP was the largest factor holding back returns here. BHP fell 5.8%, capping off a month to forget in Materials, the sector falling 2.6% and the only group to lose value in April.

Iron ore prices came off lofty levels, falling 12% to $US106 per tonne as China demand softened and inventory levels rose at steel mills there. China's weaker-than-expected peak construction period and the intention of Chinese authorities to crack down on speculative pricing contributed to the spot iron ore price being soft. A number of quarterly production reports, including those from Rio Tinto and Mineral Resources, also underwhelmed.

The price of lithium fell sharply in April, hurting Australia's many lithium plays. Losses in the broader Materials sector however were offset by gains in every other sector in the ASX 300 index, chiefly Property (+5%), Tech (+4.5%) and Industrials (+4.3%). Healthcare and Financials also outperformed the broader index. Bond yields were fairly stable, both in Australia and in the US, and by the end of the month all eyes were on the Reserve Bank to see whether it would continue to pause its rate hikes. It didn't.

Globally, most regions continued to deliver good returns with Europe +4.7% in $A terms in April and +16.5% this year. Recession fears have curbed spending in parts of the market with companies focussing on cutting costs. The luxury end of the consumer market however is yet to show signs of a slowdown, with the French luxury brands company LVMH becoming Europe's largest company with a market cap of €430bn. This performance has also handed its Chair and CEO Bernard Arnault the title of the world's richest person, overtaking Elon Musk, whose wealth has been heading in the same direction as his rockets recently. Arnault now has an estimated net worth of $US236bn: that's a lot of Louis Vuitton handbags and Moet champagne, but more importantly represents the power of its brands. Emerging markets underperformed, with weakness in Hong Kong/China. Chinese tech mega-cap Ali Baba fell 16% in April after it was revealed that Softbank was further reducing its stake in the company.

Portfolio comment

The Fund performed essentially in line with the market in April, and there were few companies of note on either side of the ledger. The only meaningful positive contributor was not owning diversified miner Rio Tinto; the only meaningful detractors were owning resource giant BHP and not owning big bank ANZ.

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	-0.4	3.0	13.9	8.1	8.9	9.9
S&P/ASX 200 Acc. Index	1.8	-0.8	2.8	14.0	8.3	7.9	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 April 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

Global equity markets remain torn. On one hand there are encouraging signs that inflation is moderating which suggests interest rates should therefore be close to peaking. On the other hand the impact on corporate earnings from the global economic slowdown is likely to have further to run.

The Australian reporting season in February suggested that earnings growth is slowing but not at an alarming rate. House prices stabilised in most capital cities after our Reserve Bank took a one-month pause in its regime of rate hikes. The surprising May hike could make this a short-term event and, while the economy is not deteriorating in a precipitous way, consumer trends do appear to be weakening, which suggests that higher interest rates and other cost of living pressures are starting to have a meaningful impact. We expect the interim results of three of the major banks this month will reinforce the trend of slowing growth but few signs of distress in the way of a noticeable rise in impaired loans.

The US March quarter reporting season currently under way is thus far painting a similar picture. The slightly downbeat earnings expectations generated by cautious outlook statements in January are proving too pessimistic and full-year earnings forecasts for some companies are actually being increased slightly at this point. Of course, in the current environment, too much evidence of economic resilience risks Central Banks retaining a tightening bias, so as to ensure that inflation continues to moderate and doesn't become entrenched at current high levels.

On balance, we continue to see a risk that both global equity markets and domestic investors are pricing in stabilising interest rates without taking into account the substantial lags in economic impact of the sharp increase in interest rates around the world in the last 12 months. China's influence on the global economy in general, and particularly on Australian resource exports, has also become more uncertain. While trends generally remain positive, the strong momentum observed earlier in the year has cooled somewhat, and residential construction has failed to pick up meaningfully. Whether this means the Chinese Government accepts a muted recovery or will rather choose to introduce additional stimulus measures should become more clear in the next few months.

Asset allocation	30 Apr 2023 %	Range %
Securities	98.5	90-100
Cash	1.5	0-10

Portfolio Outlook

Despite ongoing macro uncertainty, the portfolio has continued to exhibit better earnings revisions than its benchmark with March quarter updates from Brambles, Viva Energy, Medibank Private and Woolworths some of the highlights. Indications of stronger-than-anticipated increases in mobile pricing plans across the telecom sector has also benefitted Telstra.

The mixed news out of China, especially the suggestion that there might be a Government-mandated cap on steel production, has seen weakness across the commodity price complex. The portfolio remains underweight this sector and we trimmed our iron ore exposure somewhat as near term earnings upside has become more limited.

The Fund has for a long time been underweight gold mining stocks, preferring to invest in companies with more sustainable growth prospects. Despite sharply higher interest rates around the world, which has increased the opportunity cost of investing in assets such as gold with no income stream, the gold price has been strong thus far in FY23, and this has detracted from the Fund's relative performance. The strength has been largely due to gold's status as a "safe haven" in times of trouble, and this appeal has more than offset its lack of income. In addition, the weakness of the $US against major currencies has bolstered the price of gold, which is traded in $US. We will continue to monitor the situation but at this stage we are not convinced that the current strength in the gold price will be sustained.

We trimmed the Fund's exposure to the Bank sector earlier in the year to close to a neutral position as mortgage pricing competition intensified. This trend appears to have continued and we trimmed our exposure further, even though strong balance sheets and attractive dividend yields should cushion the fallout from a faster than expected normalisation of net interest margins.

We remain confident in our ability to identify companies with stronger earnings prospects than forecast by market participants. We believe this will ultimately be rewarded by investors, notwithstanding continued volatility in market sentiment.

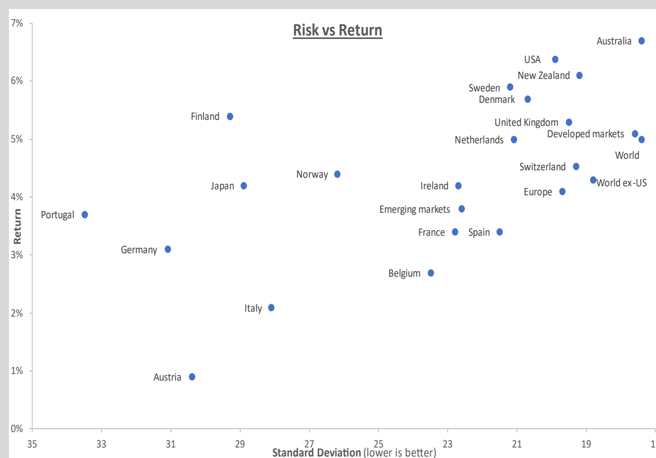
Top five active overweight positions as at 30 Apr 2023	Index weight%	Active weight %
Brambles Limited	0.9	3.0
BHP Group Limited	10.4	2.9
CSL Limited	6.7	2.7
QBE Insurance Group Limited	1.1	2.6
Medibank Pvt Ltd	0.5	2.6

BTW

As managers of Australian equities portfolios we are generally enthusiastic advocates of Australian equities. We are also enthusiastic advocates of global equities, but that's a story for another day. We have often pointed to the strong returns that have been achieved from our shares over the long term, notwithstanding the need to endure a few ups and downs from time to time. We noted in our December quarterly report that over the past thirty years the compound average return of a bit more than 10% p.a. achieved from Australian shares, which is pretty good. Even when you factor in the impact of inflation, which has averaged in the low single digits over that time, there have been some serious real gains made by those investing in Australian shares.

But, one might ask, how do Australian shares compare with other countries? Pretty well, it turns out. Our friends at Credit Suisse, despite having to deal with some internal issues, recently published a report which calculated inflation-adjusted returns from the 35 share markets around the world that have been in continuous existence since 1900. It found that, adjusted for inflation and currency, Australian shares performed the best of any country. We generated a 6.7% per annum real return; the USA came in second with 6.4% p.a. That looks like only a fractional beat but when you compound it over 123 years that tiny margin really adds up: $1000 invested in 1900 in Australian shares would have been worth $2.912 million but "only" $2.013 million in the USA.

Even better, our market did it with the lowest risk of any market other than Canada: it was only a fraction better but had 1% p.a. lower returns. $1000 in Canada would have ended up as only $914,000. In financial markets, risk is generally thought of as volatility, or the standard deviation of returns. All shares move up and down but the amplitude of those ups and downs in our market have proven, over the long term, to be a bit smaller than most others. That's generally a good thing for one's blood pressure. When low



volatility is combined with high returns, investors should be particularly happy. Australia's low volatility seems a bit counter-intuitive considering the exposure we have to highly-cyclical resource companies. What makes the difference is the "automatic stabiliser" that is the $A, as it tends to move with commodity prices which offsets some of the share price volatility.

Interestingly, the standard deviation of our market has been the same as that of the MSCI World Index, which only managed 5% p.a. The real return from our market was 1.7% better per year over 123 years. Quantifying that, $1000 in "World" equities would now be worth $404,000 against our $2.9 million.

New Zealand shaped up pretty well with 6.1% p.a. or an ending value of $1.45 million but higher volatility than Oz. Austria is only two letters short of being Australia but there was a gulf in performance: its shares were the worst of the bunch with a paltry 0.9% per annum. $1000 invested in 1900 would now be worth only $3010. Back in 1899 Austrian shares (although, strictly speaking, they would have been Austro-Hungarian in those days) made up 5% of the world's total market cap; now it is just 0.06%.

In that context, why would you ever invest in global equities rather than just sticking with Australia? Well, there are plenty of reasons to have both. After all, a good global equity manager will be able to avoid the dud markets: they will cherry-pick the best options from the many countries and many thousands of companies out there in which to invest. Diversification can also help manage risk, especially in time periods shorter than 123 years, and that is worthwhile.

Credit Suisse also showed the best and the worst single-year returns of those markets. Our worst year in 123 was 15 years ago: -42% in 2008. We remember that year vividly and, while it was quite confronting at the time, the market didn't stay down for long and anyone panicking out at the bottom would have missed some seriously good returns soon after. In fact that event triggered the formation of Alphinity just two years later. Australia's best year was +52% in 1983, during the Bob Hawke renaissance, when the country was coming back from global recession and a terrible drought. The most extreme fall was Japan whose market fell by 85% in 1946, right after the end of World War II. Even going up 120% year soon after didn't make much difference, you would need to go up by seven times just to get back to where you started.

123 years is beyond the investment horizon of any individual. In fact it's beyond pretty much everyone's lifetime. They always say past performance is no guarantee of future returns, but it says something.

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Travellers' Tales

Andrey recently went to the USA and Peru to see companies across the tech and industrial space. It would be difficult to think of a bigger contrast than those two sectors but there was one common theme: the persistence of WFH. For instance both in high-tech Silicon Valley and lower-tech Houston, going to see company management at their offices revealed the lack of personnel on site – particularly just before or after a weekend.

In a land where the car is king, the sight of almost empty carparks like this→ one at the corporate head office of IT company Intuit – is something that would never have been seen just a few years ago. But since Covid, workers seem to like the idea of working from home, and the ultra-low unemployment rate there, and the risk of losing staff, has made it difficult for companies to make fairly reasonable demands. It will be interesting to see what difference a tick up in unemployment might make.

Some companies are talking about mandating a partial return to the office of three or four days a week, but others are embracing WFH as a new operating model. For the moment, however, few have managed anything close to a full return to the office. As a result, CBDs in both San Francisco and Houston are far from recovering to their pre-pandemic health.

Sometimes the travel we undertake can be challenging and rather unpleasant, at other times it's not so bad. Jacob went to Washington, Oregon and California, primarily to see wine companies and to attend an investor briefing from Treasury Wine Estates in the Napa Valley. He visited a vineyard to learn more about the company's efforts to minimise any adverse environmental impacts of making wine. Managing weeds and pests is an important aspect to any agricultural endeavour and, while the vignerons try to avoid using chemicals as much as possible, it is inevitable that some needs to be used from time to time.

Chemicals are expensive, and clearly the less used the better for the environment, so TWE has opportunities for not only sustainability gains but also financial gains in this area. He saw a number of different pieces of equipment they use, some manned and some autonomous, but by far the coolest was this tiny Yamaha R-Max unmanned helicopter which they use for highly-targeted application of pesticides in the vineyards. The R-Max is much more efficient than traditional crop dusting using fixed winged aircraft, or even manual application from the ground, especially in steep terrain. Just one example of technology helping to improve one of the oldest activities in human endeavour: winemaking.

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