alphinity
INVESTMENT MANAGEMENT

Quarterly Report – March 2023
Alphinity Australian Equity Fund

Seismic Vibrations Bite

Market comment

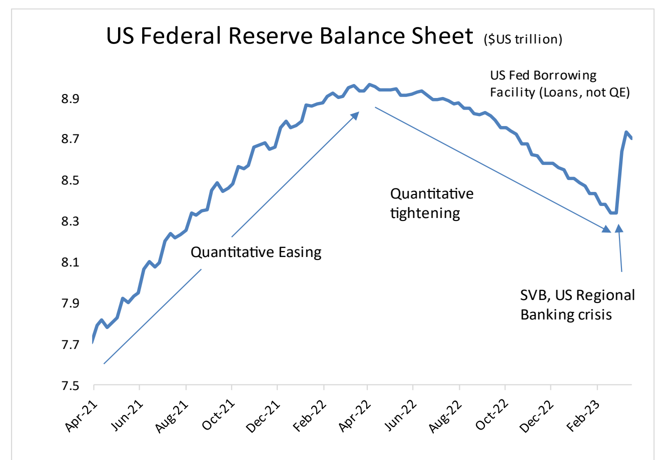
March was dominated by an event that took place close to the San Andreas fault that sent shockwaves around the world. No, not an earthquake, it was the sudden implosion of Silicon Valley Bank (SVB): more about this on p4. Our market (ASX300 including dividends) fell slightly in the month, taking the March quarter's total return to 3.3%. After a brief respite in February, macro concerns returned to dominate stock performance as fears of a banking crisis spread around the world and some financially-challenged banks developed the wobbles. It's always dangerous to say, "it's different here", but Australia's banking system is quite different to that of the US, and our big banks are extremely well-capitalised, so we think implications for Australia's financial system is limited. In any case, US monetary authorities acted quickly to contain the damage and depositors' capital was guaranteed. This should have ended the matter but it could return.

Markets were quite mixed in the March quarter overall. Our own gave away much of the very strong returns in January with weak February and March performances, but still closed 3.3% higher. Australia underperformed most markets over the quarter, with weaker commodities and financials combined with a stronger tech sector broadly the reason for relative weakness. The US Nasdaq gained 19%, its best quarter for years, as investors flocked to large cap quality tech stocks on the fall in bond yields. Emerging markets gained 5.4% in AUD terms, with a rebound in China and Hong Kong as investors warmed to the split up of Ali Baba and the hopes of more corporate-friendly behaviour ahead.

Despite the shock of the bank failures, most of the volatility was largely contained to the shorter end of the yield curve, where there was frantic re-pricing of interest rate risk as the path for rate hikes became less certain. Other markets like equities and corporate bonds didn't get caught up in the panic, outside of specific weakness in the case of some banks and insurers. While its easy (and often correct) to point the finger of blame at regulators and central banks for these types of corporate failures, the speed with which the US Federal Deposit Insurance Corporation and the Federal Reserve acted to protect deposit-holders and calm markets was impressive.

Indeed the rally into the end of the quarter suggested that investors were comfortable – for now – that the crisis will not blow out to a systemic catastrophe.

The chart below shows the extent to which the US Fed was reducing its balance sheet as the economy recovered (known as quantitative tightening) but also the sharp move higher as a response to the US regional bank stress. It should be noted however that that sharp move higher shouldn't be viewed as an "easing policy", rather a short term loan that needs to be re-paid within a year. It's difficult to see on the chart below, but the recent peak has already started to reduce as banks paid back these loans.



Commodities were mixed: iron ore, copper and gold were all stronger but oil and lithium prices declined. With Australia's ever-growing exposure to lithium mining stocks, the decline in lithium spot prices on fears of battery over-capacity in China drove lithium miners lower, only to be saved late in the month by a bid for Liontown Resources by Albemarle.

In the absence of any unforeseen shocks, the market should turn its focus back to inflation to guide its thinking on rates. If the Central Banks hold their nerves and continue the fight to bring inflation lower, it may set the stage for a large rotation out of tech and back into those deeper value cyclicals like Energy and Banks.

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)	-0.6	3.7	-0.7	16.5	9.0	8.5	9.8
S&P/ASX 300 Acc. Index	-0.2	3.3	-0.6	16.6	8.6	8.1	9.0

*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 March 2023.
^The Fund changed investment manager and investment methodology on 12 August 2011, 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 2011. 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.

alphinity
INVESTMENT MANAGEMENT

Quarterly Report – March 2023

Alphinity Australian Equity Fund

Portfolio comment

The Fund performed a little better than the market over the March Quarter. The material contributors over the period were quite diverse: gaming company Aristocrat Leisure, health insurer Medibank Private, petrol distributor Viva Energy, packaging company Orora and pallet pool operator Brambles, although these were partially offset by our position in National Australia Bank and not owning gold miner Newcrest.

Market outlook

Following a brief period of individual company earnings focus, macro factors are again dominating the headlines. And following an even briefer period of market nervousness investors appear to have decided, for now at least, that the main upshot from the US regional banking calamity is further arguments for the US Federal Reserve and other central banks to end the current rate hiking cycle. The rationale behind this view is that reduced credit availability will now do some of the work higher interest rates would otherwise have had to do. Our own central bank's decision to not raise interest rates further in April is likely to have been at least partly influenced by this thinking.

As rising interest rates have been the main headwind for global equity markets a peak in interest rates is, everything else being equal, clearly positive. However, things are seldom equal. As we have argued for some months now the focus for equity investors should move from whether rates have peaked, or are close to peaking, to how long they will stay around current levels and how significant the impact on the economy, and in consequence, corporate earnings, will be from the sharp hikes we have already had.

While central bankers have shown they can change policy direction swiftly if the economic data surprises them, positively or negatively, they have also shown that they are concerned about repeating past mistakes of taking the foot off the brake too early. In Australia, this concern is likely to have been reinforced by the support from Federal and some State governments for CPI-equivalent minimum wage increases, which will likely flow on to substantially higher awards wages as well.

Domestic earnings have to date been surprisingly resilient to the tighter monetary conditions. However, while the combination of a lower $A, China's economic recovery and company specific earnings drivers could provide some meaningful offsets, our sense from recent discussions with companies is that slowing demand and still-increasing costs have started to have a more meaningful negative impact on the domestic economy. This is especially true for sectors exposed to the sharply-slowing housing construction market, but is likely to spread to consumer spending more broadly in the next few months as the current backlog of construction work gets completed.

In summary, we don't expect interest rate cuts in Australia in the near term. If there are, it probably means the economy is in some trouble which will mean corporate earnings are at risk.

Asset allocation	31 Mar 2023 %	Range %
Securities	98.6	90-100
Cash	1.4	0-10

Portfolio Outlook

Notwithstanding the volatile macro environment, the Fund remains well exposed to companies in which we see the potential for earnings to surprise positively – both relative to market expectations and to other companies. The February reporting season and our subsequent company meetings have only strengthened our conviction in most of our key holdings.

Earnings leadership will, as always, continue to evolve at the company level as well as more broadly from a sector and style perspective. Major economic turning points however typically result in the need to make more significant portfolio adjustments. While we continue to look for signs of a turning point, we don't see that we have arrived there yet. A period of clear direction for the broader economy and other macro settings, whether negative or positive, has typically been associated with meaningful opportunities for above-market returns for the Alphinity process.

Last month we went to China for the first time since the Covid outbreak in 2020, and our meetings confirmed that economic recovery is underway. However, it is at this stage not as strong or as convincing as during previous efforts at large economic stimulus so more might be required to meet China's GDP objectives this year. This is particularly true in its important residential construction sector, where the restarting of stalled development projects is masking an improving – but still weak – trend for new projects. While risks are presently higher than normal, demand for Iron Ore should nonetheless still prove resilient. This, combined with stable rather than significantly increasing global supply, should be supportive of stronger earnings for the Australian bulk producers than current market estimates suggest.

Our visit also highlighted a challenging environment for short-term lithium demand following an excessive ramp-up in China of battery production for electric vehicles in 2022. While we view this as largely an excess inventory issue which will ultimately be worked through, it nonetheless presents meaningful earnings risk for the sector. As a result we have further reduced our exposure this area.

Top five active overweight positions as at 31 Mar 2023	Index weight%	Active weight %
BHP Group Limited	10.9	2.9
Brambles Limited	0.9	2.1
Medibank Pvt Ltd	0.4	2.1
QBE Insurance Group Ltd	0.1	1.9
National Australia Bank Limited	4.0	1.5

alphinity
INVESTMENT MANAGEMENT

Quarterly Report – March 2023

Alphinity Australian Equity Fund

Traveller's Tale

After being tied to the desk in February for reporting season, March brought with it the opportunity to get out there, see the world, see companies, check on investment theses and generate new insights and investing ideas. Members of the domestic equity and ESG teams ended up in North America, South America, Europe and Asia in March – every continent except Africa and Antarctica in the space of a few weeks. In addition, we went to pretty much each state of Australia. We will eke some of these stories out over coming months

Moana had the most exotic trip, to Bangladesh and Vietnam where she mostly saw apparel-making companies who work for large Australian and global companies, including Kmart, Big W, Premier Group, H&M and Uniqlo. It has been quite some time since China was the main country from which to source clothing, as its peoples' technical skills have increasingly increased and the price of labour has escalated. Apparel moved to other countries in Asia but the working conditions in some has been called into question.

In 2013, a fire in a factory complex in Dhaka resulted in the deaths of more than 1100 workers – an astounding human toll that was a catalyst for significant change in Bangladesh. In addition, there were accusations of exploitation of the mainly female workers who were being forced to work very long hours with unpaid overtime in order to meet customer orders. It wasn't just labour conditions that was problematic: a great deal of pollution was being created through the garment-making processes, like the dying of fabric.

In the succeeding decade, a lot has changed a lot but some things not so much. The working conditions of the factories she visited were still confronting, but even so far better than existed in 2013. Industry standard hours have been brought down to 48, with workers being paid an hourly rate, with access to sick leave. Child labour was nowhere to be seen: there were signs in the factories prohibiting the practice: having said that, the fact the sign was also in English suggests its intended target was not only aspiring child workers! Moana was told child labour was no longer an issue, at least in tier-1 factories. The labour issues are now more about working hours, conditions, unpaid overtime and gender inequality.

Of course Moana was only being shown a curated selection of factories, and those she saw were quite acceptable, but there is a seemingly irresolvable tension between the factories and their customers, the apparel brands. The brands want the cheapest possible product, but the factories also need to charge enough to pay their workers a living wage but also live up to ever-increasing compliance demands of their customers. Those customers are often not willing to pay up however, in fact she was told that the unit prices of clothing has actually fallen each year for the past five. And customers are generally unwilling to give factories long-term contracts so they often need to make capital investments without any guarantee of getting any payback. While there was probably a message they wanted to be conveyed back to the brands from investors, it does appear that small increments in the cost of a garment, or for that matter one of these Paddington Bears from Vietnam destined for UK chain Marks & Spencer, wouldn't make much of an impact on its retail price.

Moana was also given a glimpse into the life of a typical garment worker, being invited to the into home of one in Dhaka. It was quite confronting from a western viewpoint, but the worker was very proud of her one-bedroom flat with electricity but no running water and shared facilities; these living conditions however were superior to many of her peers. The typical wage is around $US110 a month – about $A160 – for their 48 hour working week; any overtime. In fact, garment workers in Bangladesh actually get paid more than teachers and nurses.

Vietnam was significantly more developed than Bangladesh. Factories were more spacious, more automated and generally air conditioned. A typical garment industry worker in Vietnam earns close to double those in Bangladesh, but even that still falls well short of a living wage according to most human rights organisations. It appears that the higher labour cost in Vietnam has driven more automation which enables more complex manufacturing processes and higher-value products. This is the cycle Bangladesh needs to get onto, but in doing so they face the risk that a meaningful wage break-out could result in manufacturing shifting to yet another low-wage jurisdiction.

alphinity
INVESTMENT MANAGEMENT

Quarterly Report – March 2023

Alphinity Australian Equity Fund

BTW

March a relatively obscure US bank, Silicon Valley Bank, experienced financial difficulties and had to be bailed out by monetary authorities, and the aftershocks reverberated around the world. While SVB wasn't a big bank, it wasn't small either: with approaching $US200 billion in deposits it was the 16th-largest in the US. A prominent banker to the tech industry, SVB's collapse was quickly followed by two other banks, Silvergate and Signature, both of which had strong ties to tech and/or crypto. Our Global team has published on this topic too. [On the other side of the world, Swiss bank Credit Suisse also had issues, although for different reasons and with a different solution.] There are several thousand banks in the USA and failures do happen from time to time: why this one cause so many ructions?

Initial rumours of trouble spread quickly through the Silicon Valley grapevine which ultimately led to a run by depositors, with massive transfers being made online to the "too big to fail" banks. People even lined up outside branches with withdrawal slips (or whatever the modern equivalent is). No one wants to risk losing their money so they remove it, just in case, in doing so adding more stress to the situation. The end happened in a matter of days, with people lining up outside SVB branches wanting their money…now! Once confidence in a bank has been lost, it is hard to get it back.

For most of us a run on the bank usually conjures up visions from the olden days, as portrayed in classic movies like *It's a Wonderful Life*, in which bank manager George Bailey tried to calm all his panicked customers trying to withdraw their money from the local Savings & Loan. It almost seems outrageous to think the same thing could happen in current times, with banks under such heavy regulatory oversight, but you may be surprised how much the level of regulatory requirements differ between smaller regional banks like these, and those 'too big to fail' – known as systemically important banks. Credit Suisse was one. It was rescued.

In a classic case of closing the gate once the horse was already several paddocks away, one credit ratings agency cut SVB's rating by 13 notches the day after the receivership was announced, from A3 (which sounds pretty strong to us) to C (which sounds a bit marginal). Let's hope no one was relying on that rating to make important financial decisions! In the days after, it was a little amusing to see a number of tech entrepreneurs – so often the bastions of libertarianism, wanting governments to get out of their way – calling for protection for depositors from the same government. The fact they might have had large deposits in SVB was surely just a coincidence. But their calls were heard and depositors were quickly protected by various monetary authorities, to a much greater extent than the $US250,000 required by law.

SVB was an unusual bank, quite different to ours. It had around $US200 billion in deposits, largely sourced from cashed-up tech companies but made relatively few loans to them as most tech companies have been so cashed up in recent years. SVB had largely invested those deposits in US government-backed securities, bonds and mortgages. Interest rates started going up in 2022, effectively closing equity markets as a source of capital for loss-making companies so they needed to withdraw from SVB (and others) to fund their profligate lifestyles. SVB was therefore forced to sell assets, but it's hard to think of a less-"risky" investment than a US government-backed bond. So how could it go so wrong?

Bonds are thought of as having less risk because the government guarantees it will return the face value on maturity. The risk of losing your capital is very low, providing the government is still solvent at that time. There are many other facets of risk however, and SVB suffered from one of the most insidious: duration risk. SVB's liabilities (i.e. deposits) were mostly able to be withdrawn with little or no notice, whereas its assets – the mortgages and government-backed securities – tended to have maturities extending out to 30 years. In the years of zero interest rates, a 30-year bond at 1 or 2% might have looked pretty good. When that yield rose to 4% however, some pretty serious capital losses started lurking in SVB's – and pretty much every other US bank's – balance sheet.

BTW (cont.)

In a quirk of accounting, US banks aren't required to value securities intended to be held to maturity at market, they can keep them on their books at cost forever. This is a crucial difference between US banks and ours, which are required to use the lower of cost or market. It wouldn't matter too much unless there were a situation wherein the value of those bonds fell sharply. Bond yields going up a lot was just that situation. The value of a bond falls as its yield rises, and SVB was forced to sell down its bond portfolio to cover the outflows, at whatever price it could get in the market, requiring a multi-billion dollar haircut. It was hardly a triumph of regulation though, as one commentator noted: "There was nothing exotic here … no CLOs, credit-wrapped CDOs, etc … just a good old-fashioned mismatch for a bank susceptible to a withdrawal run on deposits."

This event has raised an interesting dilemma for the US Federal Reserve and its effort to fight inflation with rate hikes. Given that fight has not yet been won, will Central Banks pause or even cut rates to acknowledge these new risks, or will they hold their nerve and keep pushing rates higher? At its March meeting, the first post-SVB, the Fed still lifted rates but by only 0.25%. April's meeting will be interesting.

Although the mood of the market is changing wildly depending on the day, the rally since mid-March suggests the crisis has been contained, absent any other significant shocks. Equity markets have strengthened and stock market volatility (usually measured by the VIX index) is remaining calm at low levels. There are few signs of distress in credit markets and the most volatility has been seen at the short end of the yield curve where rate expectations have swung back towards future cuts. Maybe it's a case of investors comforting themselves with "the Fed has your back" way of thinking - which is what we thought the Fed had recently been trying to avoid.

It appears that central banks will continue to use the tools available to them, like using their balance sheet and opening up swap lines, to target specific areas of market stress. We saw this last year when the Bank of England effectively solved the UK Gilt crisis by opening up specific liquidity lines rather than resorting to the blunt tool of cutting rates, which would have only made the task of fighting inflation even harder.

It proved to be an effective response, and it was encouraging to see the European Central Bank this month not give in to the panic. It hiked rates by 50 basis points, signalling its intent to keep fighting inflation. While the recent events have been shocking, with failing US banks; and also sad, with 160-year old Credit Suisse being sold to its arch-rival UBS, unless the shocks become more systemic, it makes sense for central banks to continue using the other tools available to them to solve specific problems, rather than cutting rates at the wrong time, which would risk letting the inflation genie even further out of the bottle. That would make their lives, and our lives too, more difficult over the longer term.

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

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