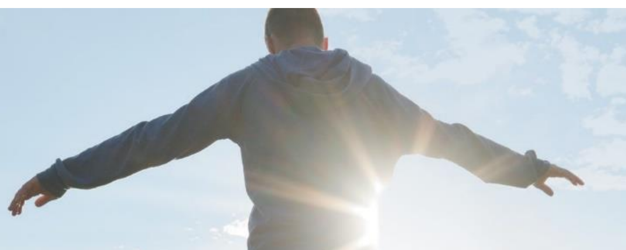
Alphinity Concentrated Australian Share Fund



QUARTERLY REPORT – JUNE 2023

The Big Chill

Market comment

The Australian market appreciated modestly as we gradually slipped into winter over the quarter. Only 1% though, and while this was better than some markets, like the -6% of China and Hong Kong, it fell short of +9% delivered by the US and Japanese markets and +4-8% from the various European bourses. The political situation in Russia all of a sudden became a bit harder to forecast with an attempted coup late in June, not that it seemed to bother the markets too much. Admittedly it all happened over a weekend, so markets didn't really have a chance to panic but, considering the potential implications, little concern was shown after the event as measured by bond yield movements and stock market volatility. The stand-out market was the "tech-heavy" Nasdaq in the US, where the hype around Artificial Intelligence (AI) names drove that index 13% higher over the June quarter, and is it now up 30% in a year, double the return of the Australian market.

The drivers in the June quarter were similar to those which have played out for most of this year, with Tech and Consumer stocks doing much of the heavy lifting as investors attempt to put a value on AI and assess any productivity gains this technology might produce. Consumer confidence in the US rebounded sharply, helped by signs that inflation is cooling and peoples' willingness to continue spending. The spending shift from goods to services in the US continued with the travel industry still reaping the benefits of pent-up demand for holidays post Covid, although Australian consumer outlook painted a less rosy picture, with cost of living pressures and higher mortgage rates hurting the domestic retail sector. Not having access to 30 year fixed rate mortgages like in the US has meant that the mortgage cliff is being felt much sooner, as homeowners increasingly come off low fixed rates and face higher variable mortgage costs.

There were large moves in US mega-cap tech stocks over the June quarter, like Apple (+18%), Microsoft (+19%) and Nvidia (+53%), and a small number of companies accounted for much of that market's strong overall move. Apple finished the quarter with a market value of $US3 trillion. For context, Australia's entire equity market is capped at ~$US1.7 trillion, and it was only in 2018 that the world was marvelling over Apple becoming the first company to achieve a "lofty" $US1 trillion market value. China's disappointing economic performance continued to weigh on emerging markets and contributed to relative weakness in here given the exposure of our mining sector to China's tepid growth. It feels as though the market is resting its hopes on more stimulus in China as the only way out, yet so far this has only been coming in a small way. A 10bp rate cut here and an electric vehicle (EV) subsidy there is not enough to restore growth in the minds of the international investors who have taken money out of China.

Sector performance in Australia over the quarter was driven by Tech stocks (+18%), although that sector is only a small part of the Australian indices. Energy (+4%) and Industrials (+3.5%) also outperformed, while Healthcare and Materials (-3%) were the greatest laggards. Consumer Discretionary (-2%) also under-performed.

The $A moved in a 4c range against the $US over the quarter, from 65c to 69c but finished in the middle, at pretty much the same level as it started. There was little joy for the miners, as commodity prices were generally lower over the period. Oil was down 6%, Coal -27%, Iron Ore -11%, Zinc -19%, Nickel -14%, Aluminium -11%. Just about the only thing we could find that was up in the quarter was base metal Tin, which rose a little more than 6%.

Bond yields traded in a wide range over the quarter but, like the currency, the net move from the start to the finish was relatively small. But at 4%, the ten year bond yield is now the highest in almost a decade: December 2013 was the last time it was here. Three year bonds also finished at 4%, the highest since 2011. With a cash rate of 4.1%, the yield curve is now about as flat as it gets.

Portfolio comment

The Fund performed in line with the market in June, and lagged slightly over the June quarter. The best contributors were global insurer QBE, pallet hirer Brambles, lithium play IGO, advertising platform carsales.com; not owning resource giants South32 or Rio Tinto also helped. Offsetting these however were holdings in resource giant BHP and medical device maker Fisher & Paykel Health; being underweight ANZ Bank and not owning high tech companies Xero and Wisetech also detracted from returns.

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)	1.5	0.2	12.6	10.9	6.6	9.6	9.7
S&P/ASX 200 Acc. Index	1.8	1.0	14.8	11.1	7.2	8.6	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, 30 June 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 1300 721 637 during Sydney business hours.

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Market outlook

Despite a fairly flat June Quarter, equity market returns in the first half of this calendar year continued to surprise positively, taking returns for the FY23 financial year to well above long term averages. A likely peak in the rate of inflation in several regions, including Australia, together with slower, but still resilient, economic and corporate profit growth have been the main drivers of the solid returns.

Does this mean central banks are closer to achieving what Reserve Bank Governor Lowe has described as the "narrow path" to getting inflation under control without tipping the economy into recession? At the margin the answer is probably yes, but there is a significant risk that the leads and lags between implementing higher interest rates and those rates impacting on the economy are longer than anyone anticipates. This is especially true since the RBA, as well as monetary policy makers in the US and Europe, don't appear yet to be finished with the current tightening cycle. Employment and wages growth in particular remain stronger than has typically been associated with achieving targeted inflation rates.

Historically, cuts in interest rates have not been too far behind the last hike, the reason being that central banks usually struggle to finesse the much-desired soft landing scenario. They have often kept lifting rates until the economy grinds to a halt, prompting a quick policy reversal. How many more hikes will be required to achieve the desired level of inflation? That remains to be seen, but the end result will likely be a more meaningful earnings slowdown than is currently factored into aggregate corporate profit forecasts.

From a sector perspective, there are few clear winners in the current environment. Consumer-exposed sectors, other than perhaps supermarkets, are finally seeing broad-based weakening. Banks are facing higher funding costs, slower credit growth and potentially higher credit losses while, for Resources to perform, China would likely need to meaningfully step up its stimulus measures – something its government to date has been unwilling or unable to do.

The Property sector has attracted a degree of renewed interest after sharp underperformance and apparently attractive share prices relative to reported net asset values. However, in our view it would not take too much in the way of higher investment yields being required by direct property investors for those discounts to narrow meaningfully. following a potentially destabilising management change last year Meanwhile, a combination of high vacancy rates resulting in constrained net rental income growth (with industrial/logistics still the positive exception) and higher funding costs is making it challenging for the sector in aggregate to grow distributions, which has been the main historical appeal of this sector.

With few obvious broader sector opportunities, bottom-up stock selection looks like the best opportunity for differentiated investment returns in the financial year ahead.

Portfolio outlook

The upcoming August reporting season should provide further insights into the extent of the economic slowdown the RBA has tried to orchestrate since the current interest rate tightening cycle started in May last year. The portfolio remains well exposed to companies that have seen better-than-average positive earnings revisions over the last several months. While there is always a risk, especially late in the cycle, that investors look beyond the current earnings environment and focus on a potential future earnings recovery, in our view it is unlikely that we have arrived at that point yet. A more decisive change in monetary policy, a pivot to a more expansive fiscal policy or a more significant fall in earnings that resulted in a "this is as bad as it gets" argument would typically precede such a change in investor sentiment.

For now, however, strong current operational performance should continue to be well rewarded. We see this as being achieved by a mix of portfolio holdings that also reported well in February – companies like Brambles, QBE, Steadfast, Medibank, Orora and Woolworths – as well as some newer positions in companies that have managed through a challenging industry environment and have come through at the other end in a good position to benefit as headwinds ease.

Last month we wrote about building materials manufacturer James Hardie being one of those companies. Despite going through a potentially destabilising management change last year, and even though US mortgage rates have ticked up again, the company appears to have stabilised and be back to delivering above-market volume growth.

Another company now firmly in an earnings upgrade cycle is energy producer AGL. The company has been through the perfect storm of weak wholesale electricity prices, an ill-thought-through attempted demerger and subsequent management and board changes. While the broader energy transition from fossil fuels to renewables remains a formidable challenge for AGL from an energy generation perspective, wholesale electricity prices have recovered strongly and now appear to be underwritten in the medium term by higher gas prices. This should not just see a strong recovery in AGL's earnings. it will improve its balance sheet strength which will be an important factor in funding the capital expenditure required for the company to transition to a more renewables-based energy generation portfolio.

Top five active overweight positions as at June 2023	Index weight (%)	Active weight (%)
Brambles Limited	0.9	3.4
Aristocrat Leisure Limited	1.2	3.2
Woolworths Group Ltd	2.3	3.1
Medibank Pvt Ltd	0.5	3.1
QBE Insurance Group Limited	1.1	3.1
Asset allocation	**30 June 2023 (%)**	**Range (%)**
Securities	98.1	90-100
Cash	1.9	0-10

BTW

We've written about Elon Musk numerous times over the years, and concluded that he will probably be remembered as a very significant person in our era of history, and not because of his occasional status as richest person in the world. Since first becoming seriously wealthy in the early 2000s as a result of something as banal as a new payment system, Musk has used his wealth to build other companies that have already disrupted, or will likely one day disrupt, whole industries. It has happened in aerospace, for instance: this used to be the preserve of governments with deep pockets, but those pockets are now empty and his company SpaceX is relied on by those governments. It now launches more rockets each year than all the governments in the world combined.

The car industry too: electric vehicles (EVs) had been around since the 1800s but Musk's vision, his team's efforts and his investment since he acquired a controlling interest in the company in the mid-2000s drove EVs to new levels of performance, acceptability, and desire. Having made only token efforts before Tesla came along, pretty much every automaker now accepts that the future is electric and is spending billions trying to play catch up to what has become the incumbent.

He has started other businesses which could also one day become game-changers, including brain researcher Neuralink and tunnelling venture The Boring Company. And solar energy company SolarCity, and low-earth orbit satellite internet provider Starlink, which has been extensively used in Ukraine's defence effort as well as Australia's outback. He also co-founded the creator of ChatGPT, OpenAI.

Musk is a conundrum. He is extremely impressive in many ways but also notoriously mercurial and difficult to work for. He's had public fights with the US corporate regulator, the Securities and Exchange Commission, and often displays an adolescent sense of humour. He doesn't like criticism and can hit out viciously and inaccurately, as he did during the Thai cave rescue in 2018. Perhaps this is just an outcome of the sense of entitlement that must come with being the richest person in the world. Hubris too: last year he bought loss-making Twitter for an enormous price, almost on a whim, then proceeded to make it even less financially viable.

But his most visible venture has been Tesla and it has become an enormous success. It now manufactures on three continents and will sell around 2 million cars this year, all electric. It has a market value of around $US900 billion and the market expects it to make a pre-tax profit of about $US12 billion in 2023.

Tesla has also quietly become a top-10 car brand in Australia. More than 25,000 Teslas were bought in the six months to June, almost 5% of the total market with just two models on sale. It accounts for more than half of our total sales of EVs. Te Model 3 is the highest-selling sedan this year, pushing into second place the taxi drivers' perennial favourite, the Toyota Camry. Admittedly sedans are not the most popular body type and there have been supply constraints on the Camry but really, who wants to drive around in a taxi? Tesla's slightly larger Model Y has been an even bigger success and the streets of our capital cities are now teeming with Teslas. Helping its success has been good levels of stock and a series of price cuts to both models, thanks to scale efficiencies and shifting the sourcing of our cars from California to China. This has also made it possible for some buyers to access hefty state government subsidies. We're not convinced about the economic wisdom of offering subsidies on a product for which there is much demand and limited supply, but that's a discussion for another day.

The car market has been in a strange place in recent years. Since Covid struck in 2020, supply chain issues meant availability of new cars has been a huge challenge, with long waiting times emerging for delivery, years in some cases. Limited availability also meant less need for car makers to offer generous discounts in order to entice buyers, which the brands have grown to quite like. Even though supply chains have substantially recovered from the dysfunctional situation they reached in 2021, new car stocks are still not back to normal.

Tesla's disruptive example has given some manufacturers the courage to consider different operating models. Since the dawn of time, car dealers have bought vehicles from the manufacturers and sold them to the end buyer, making a profit or loss (generally a profit) depending on the deal they do. Tesla has only ever sold direct to the consumer, selling at a fixed price via the website, cutting out the middle man and "owning" the customer relationship itself. It is controversial though. In 16 US states, including Texas, it is against the law to sell direct. So when Tesla sells Texas-made cars to Texans, it has to follow the absurd practice of physically taking the car across the state line, then taking it back to the customer into Texas. Tesla is pressuring the state to review that law.

Direct selling, where a brand has a direct relationship with the end buyer, is nirvana for any consumer goods company and it generally has the added benefit of removing price from the discussion. If you want our product, you pay the asking price, no haggling. New entrants at the premium end, such as Polestar, have also gone that way while new entrants in the mass market, like Chinese brands MG, Haval, Great Wall and so on, with no brand equity to speak of, have stuck with dealers. Some have mixed and matched.

Two well-established manufacturers, Mercedes and Honda, have gone part-way there by making their dealers into agents, whose role is now not to make deals but just to deliver the cars to their new owners for a fee. Mercedes dealers, who have invested a lot in showrooms and marketing over the years, were miffed about the change and took action in the Federal Court for compensation, the result of which is imminent.

Traveller's tale

Jonas, who covers healthcare stocks for our Global Equity team, visited the headquarters of Intuitive Surgical in Sunnyvale, California in June. Intuitive Surgical is held in Alphinity's Global Equity Fund, and it's a company that enjoys a near monopoly position in minimally-invasive robotic surgery. All of the top-ranked US hospitals for treating cancer, urology, gynaecology and gastro diseases use the company's Da Vinci surgical system, as do a number of hospitals in Australia.

The below photo is of Intuitive Surgical's Davi collection system, and Jonas was fortunate enough to test this system during his visit. Not so fortunate was the (thankfully pretend) patient he managed to completely butcher on the operating table! Thankfully for Alphinity's clients and any patients needing surgery, Jonas is sticking to investment decisions and not swapping to a scalpel any time soon.

Fortunately, there are real-life surgeons out there who are increasing their use of Davinci for low-invasive, safe and efficient surgery, which has been driving Intuitive Surgical's earnings and the stock has been performing strongly for the global portfolios.

Trent, who covers Technology stocks in the Global team, was also in the US, but in San Francisco at a tech conference. His main takeaway was: if in doubt, just yell "AI"! It was a fascinating week, with every company presenting apparently having a market-leading position in AI that they had been working on for years. Although talking about the infinite potential of AI was much easier than articulating a path through what appears to be a difficult macro environment.

The most interesting things from his trip were:

- so many beautiful offices for so few people. A day of meetings down in Silicon Valley was conducted in a procession of beautiful, cavernous buildings full of the latest tech and magnificent hanging gardens. The only thing missing was people occupying them
- monetisation paths and timing for software stocks (other than Microsoft) remain uncertain with most companies still grappling with what an AI-based offering looks like
- Autonomous vehicles are getting better: Trent found it fascinating to watch the complex dance when a driverless Amazon-owned Zoox taxi was trying to get past a drunk bicycle rider wobbling his way home on the streets of San Francisco. The patience and navigational complexity of the Zoox, in what was clearly an unstructured edge case, was very impressive

- The walk back to your hotel in San Francisco is eye-opening. The social issues in San Fran are pretty horrifying and the degree of homelessness and drug use is confronting and depressing. On a similar note, US department store Nordstrom is about to close its two stores in downtown San Francisco, one of which is in the large Westfield shopping mall, citing low foot traffic resulting from shoppers no longer feeling safe with all the crime in the area. The owners of the Westfield, Paris-listed company URW, will effectively hand the keys of the whole shopping centre to the lenders and walk away later this year. It is only 20 years old.
- On a happier note, one particularly impressive building was Nvidia Corp's headquarters in Santa Clara, a building the shape of a spaceship. Unlike everywhere else Trent went, the inside of this one was teeming with people, perhaps an allegory for the demand Nvidia's stock has experienced this year which made it into a trillion dollar company. Must feel nice to be so popular!

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