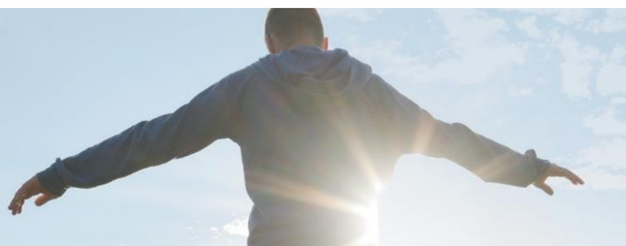
Alphinity Concentrated Australian Share Fund



MONTHLY REPORT – JULY 2023

Speed

Market comment

In iconic 1994 action movie *Speed*, Sandra Bullock saved the day by taking over the controls of a bus and keeping it above 50mph long enough for a bomb, which would have been triggered by slowing down, to be defused. Of course, anyone who has driven in Los Angeles knows how difficult that would have been so full marks to Sandra for pulling it off. In an eerie parallel, possible distant relative Michele Bullock has been appointed to take over the controls of a faltering economy and has the task of trying to defuse its inflationary tendencies without blowing it up. We wish her as much success as her namesake thirty years ago – at least first time around. It's too soon to be thinking about her reappointment in 2030 but we would advise caution: apparently, *Speed*'s sequel – *Speed 2: Cruise Control* – is considered by some critics as the worst movie ever made.

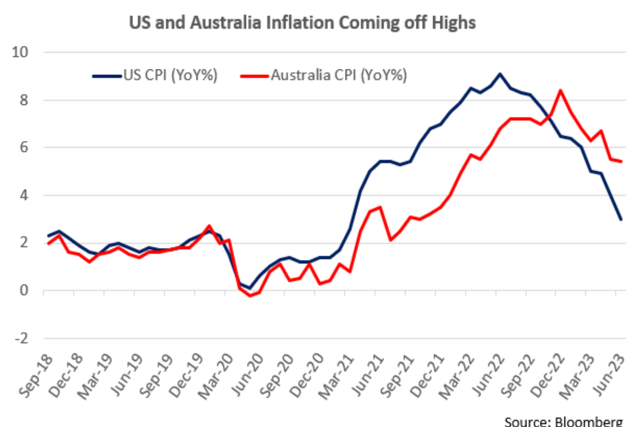
We do feel some sympathy for her predecessor. He was the public face of an organisation doing the job assigned to it by government with the one tool available to it, interest rates, Perhaps he was a convenient scapegoat for unpopular but necessary decisions to lift rates after too many years of loose monetary policy and huge amounts of fiscal stimulus had finally awakened the inflationary beast, but his comments during Covid that rates wouldn't rise until 2024 were a key part in his downfall, and we expect comments from the Bank will be less definitive in the future. But timing counts for a lot and, in the end, he was probably just unlucky to be the one in the hot seat when the long period of rate cuts needed to be reversed.

The markets didn't seem too fussed about who's running the Reserve Bank of Australia (RBA) though, and our share market continued along merrily as the US reporting season kicked off and ours came closer. Our market meandered almost 3% higher, a fraction better in $A terms than the US, much better than Japan's zero return but a touch below China's ~4%. Europe ranged from +3 to +6%.

At a sector level, Energy stocks were outperformers (+8%) while Financials and Tech (both +5%) also did better than the broader market. Defensives generally underperformed: healthcare (-1.5%) and consumer staples (-1%) were the weakest. The price of Oil rose by 13% in $A terms in July. Most base metals were firm, up by between 5% and 7%, while the bulk commodities, Coal and Iron Ore, lifted by smaller amounts. The price of Lithium, which is becoming quite an important commodity for Australia, softened by about 10% in $A terms over the month.

The market had to digest a number of quarterly production reports from mining companies in July, and some common factors included solid production numbers, higher capital costs and softening in some commodity prices, all of which contributed to fairly cautious guidance. Iron Ore prices have held up quite well despite the slowing China economy and a property market there that has thus far failed to rebound. Brazil's Vale, one of the world's biggest Ore producers, often plagued by production issues, is now actually increasing supply, which could put further downward pressure on the price of Iron Ore.

Lower inflation in the June quarter took some pressure off the RBA, and was enough of a signal for it to leave rates on hold for another month, only the second pause since the hiking cycle began. Annual CPI for the year to June came in at 6%, below forecasts and comfortably below the 7% of the prior quarter. While not quite as drastic a reduction as seen in the US, any moderation is welcome.



Portfolio comment

The Fund underperformed somewhat in July. The best contributors were energy company AGL, packaging company Orora and not owning Macquarie Group; worst were lithium play IGO, pallet pooler Brambles, mineral sands/rare earth miner Iluka, and supermarket Woolworths; not owning ANZ Bank also hurt.

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)	1.7	0.4	10.0	10.7	6.6	9.2	9.7
S&P/ASX 200 Acc. Index	2.9	2.0	11.7	12.0	7.5	8.3	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, 31 July 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 2011. The inception date for the returns for the Fund is 1 September 2011. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 1300 721 637 during Sydney business hours.

Market outlook

Softly, softly. The Australian equity market strengthened again in July, boosted by the RBA keeping rates on hold for a second consecutive month. While not yet declaring victory, the RBA appears slightly more confident that it can get inflation back in to its targeted 2-3% range, without further hikes and without pushing the economy into recession, although it expects it could take another couple of years to achieve. Other central banks, including the US Federal Reserve, are also sounding more assured they have the treasured "soft landing" path in sight. This would be a major achievement that few central banks have managed in the past. Of course, it would also mean they would have little incentive to cut rates any time soon. Consumers and corporates will likely have to learn to live for longer with higher interest rates than consensus has so far predicted.

The imminent August reporting season will provide important insights into just how much the economy has already slowed. The US reporting season, which is now largely complete, has seen small positive changes to earnings expectations, i.e. smaller declines for this year and slightly more growth for next year – albeit still modest – than previously predicted.

While continuous disclosure rules mean any company with significant negative or positive news since last reporting would have had to inform the market by now, outlook statements will give us insights into earnings trends since the end of June. Consensus earnings revisions leading into August have continued to be net slightly negative despite the upward-trending equity market. Share prices have strengthened considerably on expectations that corporate earnings will continue to prove resilient, or at least are close to the trough. Any earnings disappointment is likely to be severely dealt with. Earnings risk appears greatest in Consumer Discretionary (with the exception of travel) and Media stocks with Supermarkets, Insurers and some Tech stocks providing some offset. Tech, of course, is most leveraged to any disappointment given its premium ratings.

The index-heavy Energy and Resource sectors continue to be dominated by global influences on commodity prices, although companies' production reports so far have largely been disappointing from both volume and cost perspectives. The much-anticipated Politburo meeting in Beijing came and went without large stimulus measures being announced. While its language suggests more support will ultimately be forthcoming, Chinese authorities still appear more focused on not risking further deterioration in the economy than returning to the debt-fuelled initiatives of the past, which were so positive for demand for Australian commodities.

A bright spot has been the price of Oil, which has lifted due to solid demand, disciplined OPEC production and ongoing geopolitical tension. For the first time in a while, the price of Oil is now above the level analysts are assuming for both the year ahead and longer term. While inherently volatile, if the price is sustained at these levels it should provide support for the Energy sector.

In summary, economic news continues to point to a fairly orderly slowdown in corporate operational profits, even though a more severe fall in economic activity later in the year still presents a meaningful risk. Interest rates look to stay stubbornly high driven by the resilient economy and a growing realisation that US Government funding needs might also require higher rates than in the past to attract demand. High investor expectations suggests little room for disappointment in the months ahead.

Portfolio outlook

The Fund remains skewed to stocks which are going into reporting season with positive earnings momentum: i.e. the Fund's holdings on average have had more positive changes to earnings expectations than the market over the last several months. This is typically a good lead indicator that there will be further earnings changes in the same direction. Our quantitative insights back up our fundamental research which also suggests the portfolio has solid prospects for ongoing positive earnings surprises. Of course, given the prevailing economic environment, this could actually mean they have less risk of disappointing earnings than the overall market.

We have taken the opportunity to further increase our underweight to Resource companies as many of their share prices – temporarily in our view – strengthened on the back of sentiment in China that so far looks to us to be overly optimistic. This sector could present us with some interesting opportunities later in the year as medium-term price expectations, especially for iron ore-producing companies, currently look undemanding. The near-term outlook, however, is more uncertain. Increased supply, combined with the likely reintroduction of steel production caps by the Chinese Government in order to support steel prices and reduce the risk of over-supply, risks further iron ore price weakness in coming months.

As always, the August reporting season will bring new insights and possibly new investment opportunities. We look forward to reporting on them next month.

Top five active overweight positions as at 31 July 2023	Index weight (%)	Active weight (%)
Brambles Limited	0.9	3.3
Aristocrat Leisure Limited	1.2	3.3
QBE Insurance Group Limited	1.1	3.0
Medibank Pvt Ltd	0.4	3.0
Woolworths Group Ltd	2.1	3.0
Asset allocation	**31 July 2023 (%)**	**Range (%)**
Securities	97.6	90-100
Cash	2.4	0-10

BTW

July was not a great month for Australian billionaire couples. First came the news that iron ore magnate Andrew Forrest and wife Nicola would be getting a divorce after 30 or so years of marriage. A week or so after that, at the other end of the technology spectrum, it was announced that Atlassian co-founder Mike Cannon-Brookes (MCB) would be splitting from wife Annie. Any marriage break-up is a sad event but when you are mega-rich there can be wider implications, especially for investors. The Forrests and the Cannon-Brookes both account for substantial proportions of their respective companies' ownership: ~40% of Fortescue and ~20% of US-listed Atlassian. The Forrests have said there will be no change to the way Fortescue Metals operates, but only time will really tell.

Things are murkier at Atlassian. It has two classes of shares: 60% of the company's equity is in Class A shares which are listed on the US Nasdaq exchange; the balance is unlisted Class B super-voting shares which have ten times the voting power. Class Bs carry the same economic value as Class As but effectively give the two founders, MCB and Scott Farquhar, 87% of the votes. This structure would not be allowed if Atlassian were listed on the ASX, which was no doubt a factor in choosing the US to list. From a shareholder democracy point of view, differential voting rights are anathema: why should one group of shareholders have more say in the company than others? If you want to accept external capital, why shouldn't the providers of that capital have a proportionate say in the way the company is run?

Differential voting rights was a key reason for News Corporation shifting its domicile from Australia to the USA in the early 2000s. Rupert Murdoch wanted to issue non-voting shares so that he could issue shares without diluting his own control. He tried a few times in the 1990s to get the differential share structure accepted in Australia but the ASX kept saying no. His response was to shift the company's domicile to the US – which to be fair is where most of its operations are these days – where he could execute that nasty gerrymander. Now, even though his family vehicle only owns about 16% of the total equity of News Corp, it has more than 40% of the voting rights which allows him to control the whole company. There is effectively no chance of anyone making a hostile takeover, which might suit the Murdoch family's own interests but is diametrically opposed to those of the minority share-holders, who provide most of the capital they are using. Fans of the HBO blockbuster *Succession* will be familiar with the type of entitled behaviour that can come from having untrammelled family control of a public company: "Not the PJs!".

At least News investors have the choice between owning voting and non-voting shares; Atlassian is more insidious in that its super-voting shares are unlisted. No one else can buy them, and even if one of the Founders decided to sell some, the shares they sell would lose their super-voting capacity. So MCB and Farquhar will maintain control of Atlassian no matter what, even if there is a shareholding change forced in a divorce settlement.

One thing is for sure, none of them will be left homeless. The Forrests have multiple houses and farms and bourgeoning aqua/agribusiness, luxury goods and tourism exposures, including ownership of the Waldorf Astoria Hotel at Circular Quay in Sydney, which is currently under construction across the road from the Alphinity office. The Cannon-Brookes apparently have more than $300m worth of real estate in and around Sydney, including an estate in Point Piper for which they paid $100m in 2018. Interestingly, the absolute record price paid (so far) for a house in Australia was set by his mate Scott Farquhar, who spent $130m in 2022. Clearly the place Scott had bought for $70m in 2017 just didn't cut it anymore!

The Forrests and Cannon-Brookes both own islands off the coast of Queensland: Lizard (left) and Dunk (right) respectively. Lizard Island is a luxury resort reportedly in great shape; Dunk Island is more of a fixer-upper: Annie only bought it last year and it was not in great shape after being hit by a nasty cyclone a few years ago.

The two families are also joined by an ambition to save the world, and until early this year had a joint venture to export renewable energy to Asia which ended in acrimony. The plan was to build an enormous solar farm in the Northern Territory with a big extension cord to take the power to Singapore. A dispute arose over the second part of the plan and the company was put into administration.

It appears that Forrest was more keen to use the power locally to make hydrogen and steel but MCB favoured the export angle, despite the enormous complexity of building and maintaining a sub-sea power cable and the significant transmission loss that would be involved in sending the electricity 4000 kilometres. We tend to side with Forrest on that one but MCB ended up winning the fight and the plan is in the process of being revived. We'll see how it pans out but even Singapore seems to be a bit lukewarm on the idea. As far as we can tell, the solar farm is still only in the planning stage.

Australia's wealthiest people after Cannon-Brookes split, Jul 23, 2023 ($b)

1	Gina Rinehart	38.7
2	Harry Triguboff	24.5
3	Clive Palmer	23.7
4	Anthony Pratt & family	21.5
5	Scott Farquhar	19.3
6	M. Perkins & C. Obrecht	16.5
7	Nicola Forrest	14.5*
8	Andrew Forrest	14.1*
9	Ivan Glasenberg	14.1
10	Richard White	10.7
11	Mike Cannon-Brookes	10.1*
12	Annie Cannon-Brookes	10.1*
13	Frank Lowy	9.4
14	Cameron Adams	8.4
15	Kerry Stokes	7.8

The keepers of the AFR Rich List were quick to pounce. Within a day of it being announced they relegated Andrew Forrest from #2 to #9, and added Nicola in at #8. But the Forrests are on a one-way path by choice: they have pledged to give away the vast bulk of their wealth during their lifetimes and have already started to do that, recently paying about $5 billion in Fortescue stock into the family foundation. The Cannon-Brookes haven't yet made that pledge. Soft tech stock prices in the US last year had already given Mike a much-needed haircut, but the marriage split could take him out of the top ten altogether. We feel for him, how humiliating must it be down to just $10 billion?

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Traveller's Tale

Recent Travellers' Tales have focussed on Alphinity's globe-trotting global equities team and its adventures meeting companies around the word. Over the last few months, Alphinity's five global portfolio managers have collectively met with more than 130 companies in 14 different cities in eight different countries. Along with great insights from their trips, there has also been a lot of banter around which airline is best, or maybe more accurately, least worst. Maximum aircraft capacity utilisation is great for airline profits but does not necessarily make for a great experience for travellers. Despite many delays, re-routes and cancellations, they have managed to hold many worthwhile meetings.

The Aussie equities team is also constantly on the road, and Andrew recently crossed the ditch to visit our Kiwi cousins. When people think of New Zealand, they usually think of extreme sports, sheep, skiing, Central Otago Pinot, and more sheep. While he's a keen skier, Andrew wasn't there for sport. He is an actuary and therefore has a passion for banking and insurance. One of Alphinity's founders, he has been covering banks and insurers since inception in 2010, and was doing so for many years before that. His regular visits to NZ are opportunities to get some insight into the banks there – which are pretty much all owned by the banks here – and also a read on how well the NZ economy has been holding up in response to what has been one of the most aggressive rate hiking cycles in the world.

Having started tightening in 2021, NZ is often seen the canary in the coalmine when it comes to the impact of rapidly rising interest rates, but the little bird still seems to be alive and singing. The NZ economy has been incredibly resilient, although it is certainly slowing. Although in a technical recession (i.e. it has had two consecutive quarters of economic contraction), most people there seem to dismiss that as a blip from the recent floods and cyclone, and expect things will bounce back. Overall, the feeling was that while the economy was slowing, it is still doing OK.

Outside construction, especially residential which was particularly negative ("we have not been able to get a single pre-sale off the plan all year"), everything else was pitched as "we thought it would be a lot worse than it is", or "no disaster, no cliff". While things have slowed, or are still slowing, both households and companies are well prepared for it with balance sheets in good shape, unemployment remaining very low, and immigration coming back strongly. Even consumer spending is holding up, although there are some signs in recent weeks that it is slowing, much like in Australia. Forward-looking credit stress indicators for banks are deteriorating in most areas but, as they are coming off such a low base, no one is yet too concerned. The Reserve Bank of New Zealand has said it is likely to pause on rate rises given the extended lag effects in NZ, a result of so many mortgages being on fixed rates. The general consensus is that the RBNZ probably has another one or two more increases to go later in the year. Unemployment is a key measure for the central bank, and the Bank wants to see it at least in the mid-4% range from the current mid 3s. There has been quite a bit of 'labour hoarding' to date: companies are reluctant to cut back and want to see if the slow-down is more prolonged before letting people go.

So things aren't too bad and maybe NZ too will get the positive outcome some are predicting for the US. Let's hope the landing is soft, both on the economic front and the powdery slopes.

Important information: This material has been prepared by Alphinity Investment Management Limited (ABN 94 002 835 592, AFSL 234668) Alphinity, the investment manager of the Alphinity Australian Share Fund. Fidante Partners Limited ABN 94 002 835 592 AFSL 234668 (Fidante) is a member of the Challenger Limited group of companies (Challenger Group) and is the responsible entity of the Fund. Other than information which is identified as sourced from Fidante in relation to the Fund, Fidante is not responsible for the information in this material, including any statements of opinion. It is general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable to your circumstances. The Fund's Target Market Determination and Product Disclosure Statement (PDS) available at www.fidante.com should be considered before making a decision about whether to buy or hold units in the Fund. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. Past performance is not a reliable indicator of future performance. Alphinity and Fidante have entered into arrangements in connection with the distribution and administration of financial products to which this material relates. In connection with those arrangements, Alphinity and Fidante may receive remuneration or other benefits in respect of financial services provided by the parties. Fidante is not an authorised deposit-taking institution (ADI) for the purpose of the Banking Act 1959 (Cth), and its obligations do not represent deposits or liabilities of an ADI in the Challenger Group (Challenger ADI) and no Challenger ADI provides a guarantee or otherwise provides assurance in respect of the obligations of Fidante. Investments in the Fund are subject to investment risk, including possible delays in repayment and loss of income or principal invested. Accordingly, the performance, the repayment of capital or any particular rate of return on your investments are not guaranteed by any member of the Challenger Group.

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