Alphinity Concentrated Australian Share Fund

MONTHLY REPORT – AUGUST 2023

Ups and Downs

Market comment

It was a tale of two halves in August: markets were under pressure in the first half as bond yields spiked, but rebounded in the second as yields fell again. A late recovery wasn't quite enough to claw equities back into positive territory, the ASX300 (including dividends) falling by than 1%. Suffering a bit of a hangover after the optimism around central banks having probably avoided recession, markets had to come to terms with the reality that, despite inflation showing definite signs of cooling, interest rates are likely to stay high for longer.

The US market delivered the best absolute return in $A, but this was solely due to our currency falling by 3.5% against the $US. Most other markets fell slightly, the worst being Hong Kong, China and New Zealand, all down between 3 and 5%. But it has paid off this year for Aussies to invest in global markets with global stocks having risen by 20% in $A terms, recording positive returns every month so far.

China is especially important to our share market as growth in its economy tends to drive commodity prices, which in turn drives revenues for our large mining and energy sectors. The fairly tepid post-Covid recovery rally in China has left many investors disappointed, with the longer-term structural issues around its property market and population decline, that were becoming evident even before Covid, showing no sign of dissipating. President Xi has thus far been unwilling to unleash his big bazooka of stimulus, preferring more subtle and targeted measures. The problem is that investors appear unwilling to step in unless game-changing stimulus arrives. There appears to be no silver bullet for China, and no silver bazooka.

August was also our FY23 reporting season, and it can probably be summed up as "could have been worse". Things were generally not booming in absolute terms but, in many cases, companies' earnings turned out to be just a little better than expected. This resulted in a higher-than-normal degree of share price volatility at the time of release, with double digit percent moves on the day not unusual – and sometimes both up and down the same day. Although the earnings reported were mostly OK, stock price reactions were generally driven by guidance for the next year. Larger-than-expected cost increases was a common theme, whether it be capital expenditure in the miners and industrials or increases in interest expense for companies which carry high levels of debt.

We had a slew of economic data to digest towards the end of the month, both here and offshore, and most of the prints were on the weaker side. The US had what one might consider Goldilocks data prints: still good but weaker than forecast, and just right to support the soft landing narrative. The US economy grew at 2.1% in the June quarter (2.4% had been expected), and there were softer job openings (+8.8m vs +9.5m expected) which combined to send bond yields falling and equity markets rallying. Australia also had a better CPI with prices over the year to July rising by 4.9% versus 5.2% expected, and markets are now expecting fewer further rate hikes. This, along with increases in immigration levels this year, looks to have put a floor under property prices.

It was another eventful month in world affairs. One of the less surprising pieces of news was that Russian President Vladimir Putin had to send condolences to the family of upstart Wagner Group warlord Yevgeny Prigozhin after his jet exploded mid-flight. It didn't move markets at all, but then again nor did Prigozhin's failed coup attempt back in May. Meanwhile, the war in Ukraine grinds on, approaching its second full winter, and there is little sign of it finishing any time soon. The market seems more immune to geopolitical risk than ever before, which in itself is a bit of a concern. Interest rates remain the main game in town, particularly those pesky bond yields.

Portfolio comment

The Fund outperformed nicely in August with a number of decent winners and almost no losers. The best contributors to returns were from a variety of sectors and, pleasingly, from some of our larger active weights: industrial property (Goodman Group), online advertising (carsales.com), pallet pooling (Brambles Industries), medical devices (Cochlear), gaming (Aristocrat), health insurance (Medibank), and building materials (James Hardie). Not owning medical device company (Resmed), tech company WiseTech or supermarket operator Coles also added to returns. The only noticeable detractors were mineral sands producer Iluka Resources and financial services company Perpetual.

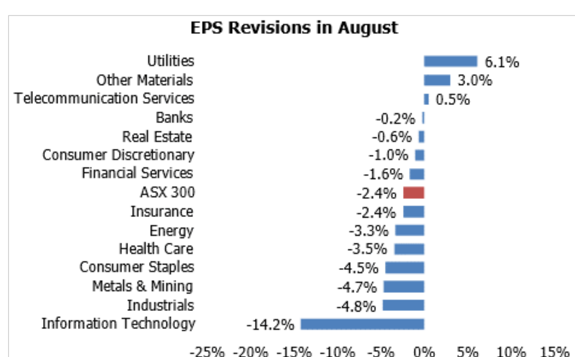
Performance*	1 Month %	Quarter %	1 Year %	3 Years % p.a.	5 Years % p.a.	10 Years % p.a.	Since Inception^ % p.a.
Fund return (net)	0.5	3.7	8.4	10.1	6.3	9.1	9.7
S&P/ASX 200 Acc. Index	-0.7	3.9	9.6	10.7	7.0	8.0	8.5

* 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, 31 August 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

Market outlook

The Australian equity reporting season finished with a reasonably even spread of earnings beats and misses, although the magnitude of the misses was a little greater. Small overall downgrades to reported FY23 earnings saw total earnings end slightly lower than the prior year. A lot of attention is paid to companies' outlook statements in any reporting period, but it seemed even more pronounced this year. Outlook statements were generally framed negatively, a continuation of the trend since the current interest rate hiking cycle began 15 months ago, although the types of downgrades have remained quite consistent. In aggregate, expected earnings for FY24 were lowered slightly, and the market now expects FY24 earnings to be less than those delivered last financial year.



We expect the trend of earnings expectations drifting lower, but not collapsing, will continue over the next quarter or two. This view is supported by the composition of the earnings revisions in August, with higher interest costs than the market expected featuring heavily. With interest rates likely to now be close to peak levels and consensus finance cost expectations most likely reset to more realistic levels, this driver of many downgrades over the last 12 months should have less of an impact going forward.

There were some interesting observations at a sector level. Discretionary Retailers continued to deliver better outcomes – i.e. a lower degree of earnings decline than that feared by consensus – and Insurers reported generally strong underlying results. Healthcare stocks mostly disappointed, although company-specific factors were largely to blame rather than anything endemic to the sector itself. Other non-sector specific factors were also noticeable: companies with high debt burdens were often marked down, as were those for whom wages constitute a large part of the cost base. This will be something to keep a close eye on in the year ahead as wages costs are still accelerating in Australia, despite sales being likely to keep slowing.

Regardless of the small fall in August, the return from the Australian equity market over the last year was a pleasing 9%. Earnings per share however were flat or even down over the same period, meaning the earnings multiple of the market overall has risen, and is now back above long term averages. This is especially the case for Industrial companies (i.e. the market excluding Banks and Resources).

With cash and bonds now yielding much more than at any time in several years, presenting viable alternatives for investors, the current equity risk premium is uncomfortably low, in our view.

Asset allocation	31 Aug 2023 %	Range %
Securities	98.0	90-100
Cash	2.0	0-10

Portfolio outlook

The portfolio's skew towards companies with positive earnings momentum was well rewarded in August. So was also our reluctance to pay overly large premiums even for companies with positive earnings sentiment given the outsized risk from any disappointing earnings news for highly valued companies. Relative performance was also helped by the emergence of more cautious investor sentiment during the month. This came about largely due to stubborn inflation and stronger-than-expected economic growth, particularly in the US, which saw market participants hit the pause button on the goldilocks scenario of soft landing and quickly normalising inflation.

Frequent and rapid shifts in macro sentiment has been a challenge for all active managers to deal with over the last year or two, ourselves included, and while we are fully expect that this volatility will happen again at some point, it was pleasing to see bottom-up stock picking being rewarded during the August reporting season. Solid earnings announcements, and importantly generally positive outlook statements, were provided by a mix of companies that have been in the Fund for quite some time and also by some of our more recently added positions. Some of the highlights in the former category were Goodman Group, Medibank Private, carsales.com, QBE Insurance and Steadfast Group. Some of the relatively new positions that contributed positively included Brambles, James Hardie Industries, Cochlear and Worley. We were pleased that our winners came from many different sectors, meaning it was stock selection, rather than sector allocation, that added the most value.

Commodities continues to be a sector in which positioning is tricky. Cost and capex overruns were recurring themes from Resource companies during reporting season, and economic reports out of China continued to be concerningly weak. As always this led to hopes of government stimulus, and in recent weeks, modest stimulus measures were actually announced by the Chinese authorities. While undoubtedly positive for commodity demand, this stimulus still appears to be more focused on stabilising and improving consumer confidence in the general Chinese economy, and in the hard-hit property sector specifically, than meaningfully boosting construction activity, and therefore demand for our commodities, in the way previous stimulus programs did. Although we remain underweight the Resource sector, at the same time we are staying alert to any concrete evidence of a pick-up in activity in China. Encouragingly, supply discipline from resource-producing companies remains solid at this point.

The Alphinity team is travelling far and wide in September and October. This will see us doing on the ground research in the US, Mexico, Latin America, Israel, China, Korea and Japan, covering a range of industries and sectors including Healthcare, Consumer, Technology, Building Materials, Resources and Energy. We look forward to relating some of our findings in coming reports.

Top five active overweight positions as at 31 Aug 2023	Index weight %	Active weight %
Brambles Limited	1.0	3.5
Aristocrat Leisure Limited	1.2	3.3
Medibank Pvt Ltd	0.5	3.3
QBE Insurance Group Limited	1.0	2.8
Woolworths Group Ltd	2.2	2.8

BTW

Disruptors have been around since the beginning of time: the creative mind of humanity has always come up with better ways of doing things which displaces existing methods. You could say the humble fork was a disruptor. It converted people from eating with their hands and was in common use by the 4th century AD after becoming popular in Italy where its tines made it easier for people to gather up their pasta. Skipping a millennium or so and we hit the great inventions of printing, the compass, electricity, telephones, cars, and the internet to name just a few. These inventions brought great technological advances, but also disrupted the existing methods of doing the same thing. For example, cars replaced horses, electricity replaced wood and paraffin, internet searches replaced looking up the Encyclopaedia Britannica. The list is endless.

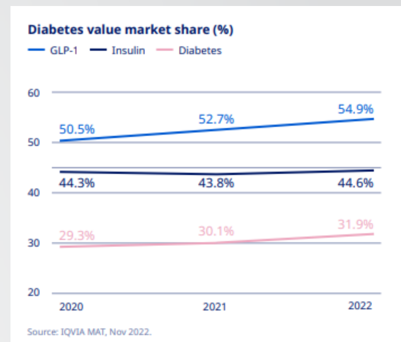
Recently, two disruptors have been quite prominent in the market's thinking: generative Artificial Intelligence (AI) and weight loss super-drugs. There is much hype when disruptive technologies like these first come to market. For example, according to Reuters, the term AI was mentioned 827 times on 76 out of 221 earnings calls in the most recent US reporting season. While we can understand why a company like Microsoft, in the forefront of the technology, talked a lot about AI on its Q4 earnings call, even the CEO of Kroger was doing it: eight mentions on its most recent earnings call, after never previously. Kroger is a US supermarket chain, not the type of company you usually associate with AI! And it wasn't just in the US: many Australian companies talked (or at least were asked) about the application of AI in their businesses during our reporting season.

For all the hype, there will be a few companies that can really benefit from AI, like Global portfolio holding Nvidia which produces the chips, and Microsoft, which can charge more for AI-enabled services. This technology has disrupted many jobs such as events managers ("CHAT GPT: tell me where I can book a function for 5,000 people that meets certain criteria"), and graphic artists. It even has the potential to put screen-writers out of work, protests against which has presently brought the Hollywood movie industry to its knees.

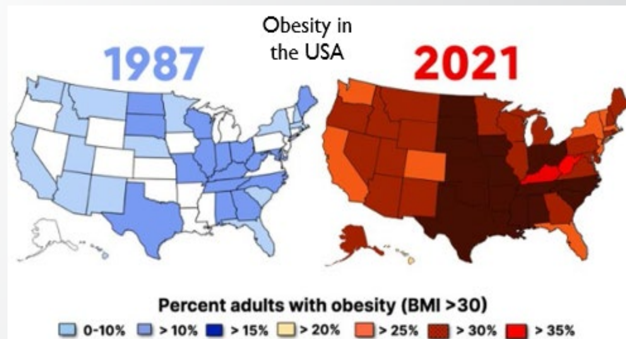
A more recent disruption is taking place in the healthcare sector with regard to weight loss drugs. The funny thing is that these drugs weren't actually designed to treat obesity; they were for type II diabetes. Of course, it's not the first time drug companies have made a drug to treat a certain condition only to find it actually addresses something else even better. Viagra was initially made by Pfizer to treat hypertension and cardiovascular disease, but its "side effect" of addressing erectile disfunction quickly became its primary use and led to the enormous success of the drug. With that success came competition and economies of scale, and the price of Viagra has fallen from the original $80 a pill to $2 now (so we're told).

Recently, drug companies like Eli Lilly and Novo Nordisk have been involved in numerous clinical trials to treat diabetes, which have had the side effect of suppressing appetite and has contributed to meaningful amounts of weight loss. Ely Lily makes Mounrjaro (yet to be approved for weight loss) and Novo has both Ozempic and Wegovy on the market. The generic term given to these weight loss drugs is GLP-1.

Performing a similar exercise, counting mentions during the most recent quarter's earnings calls in the US, GLP-I appeared about 1,000 times but only half those mentions were by pharma companies. This chart, taken from Novo Nordisk's 2022 annual report, shows the scale of its market share dominance, particularly GLP-1. While currently quite an expensive drug, costing users between $US800 and $1200 per month, when competition from Eli Lily and others emerges it would be reasonable to expect large, rapid price declines, similar to what happened with Viagra.



Aside from the obvious health benefits, it is worth thinking about how effective weight loss drugs could affect other industries, such as fast food, gyms, health and even dating sites. There might be less criticism of people visiting the likes of McDonald's or KFC. If you feel more confident as a result of losing weight, fitness and dating companies might experience a surge in growth. One Australian company citing GLP-1in its recent earnings call was Resmed, which makes breathing machines designed to treat sleep apnoea. If these drugs are so successful in reducing excess weight, one of the chief causes of sleep apnoea, it could result in less demand for Resmed's machines. Even robotic surgery company Intuitive Surgical talked about GLP-1.



To borrow a term used widely in the tech industry, the TAM (total addressable market) for these drugs could be half the US population. The issue facing these pharma companies is not demand, it is being able to supply the drug. For example, while there is enough of the compound chemical to meet demand for Novo, the issue comes down to supply chain and the company is not able to procure enough of the injectors. A McKinsey study estimated that even if there was a 30% penetration rate of these drugs in the obese population, the obesity rate in the US would be lower than it was in 1997, and this could happen within a couple of years.

Perhaps a good portfolio hedge might to go long both McDonalds and Novo Nordisk, and maybe the Happy Meal could come with a cute and fluffy injectable dose of Wegovy instead of a toy? All jokes aside, it's an incredibly interesting time for disruptive technology, especially in AI and healthcare.

Traveller's Tale

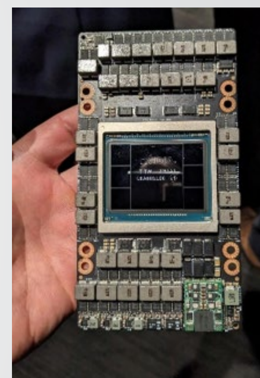
Alphinity's Global Equity Fund holds a position in accommodation booking online platform Airbnb. In addition, many Alphinity team members are regular Airbnb users so we get a constant stream of anecdotal feedback on the company and its services.

In August, Global Portfolio Manager Mary went to the UK to accompany her teenagers to a water-based sporting event in Dorset, in the very south of England. There were few hotels nearby so she ended up renting an Airbnb. It was great place to stay: lots of space, clean, lovely host and good value for money. Even better, it was close to a big hill which, despite some dreary weather, proved a great vantage point from which to watch the sporting event.

Or so it seemed. Mary soon learned from some locals that the hill was actually over a large underground prison. It had originally been built in the 1800s as a citadel to defend nearby Portland Harbour but was converted into a prison just after the end of the Second World War. It has been opened and closed a few times since then, and at one stage was going to be an immigration centre, but is now a prison again and houses felons with whom teenagers really should not be associating.

Her property's description had been framed on the Airbnb site along the usual lines of "character-filled historic charm", but proximity to a prison was not one of its selling points. One of the prison's selling points, however, was prisoners serving you coffee. They run the Jailhouse Café, of course under the watchful eye of the screws. The café's aim is to rehabilitate inmates and provide them with skills for life on the outside, and is open to anyone. Regardless of its neighbours, her Airbnb rental served its purpose well and, judging from Airbnb's most recent results, Mary was not the only traveller to use its service for summer travel. Airbnb's key metrics – gross booking value, revenues and EPS – all beat the market's expectations and its preferred measure of earnings, adjusted EBITDA, hit an all-time high. The appetite for post-Covid travel shows no sign of waning.

The lesson Mary learned? Airbnb has a great business model, but it is still advisable to use Google Maps (Google being another one of the Fund's holdings) to do a little more due diligence on the surrounding area before booking.



Moving from consumer to tech, Trent went to San Francisco for another technology conference and to visit some of the companies under his coverage. Tech is not a sector for the faint-hearted and, with the recent AI boom and ongoing tensions around US/China export restrictions, it turned out to be a well-timed trip from which he gathered some valuable insights. Here, Trent is holding Nvidia's new H100 Tensor Core GPU which is used in supercomputing and retails for $US20,000. As Nvidia itself puts it, the H100 has "unprecedented performance, scalability, and security for every workload... With the NVIDIA NVLink® Switch System, up to 256 H100 GPUs can be connected to accelerate exascale workloads. The GPU also includes a dedicated Transformer Engine to solve trillion-parameter language models. The H100's combined technology innovations can speed up large language models by an incredible 30X over the previous generation."

We think this means it's really good at AI. It would want to be: at 256 x $US20,000, that's a $US5m computer before you pay for the box, keyboard and mouse. Unfortunately, Trent's budget didn't stretch far enough to buy one and there were no souvenirs to bring home.

For further information, please contact:

Fidante Partners Investor Services
Phone: 13 51 53 Email: info@fidante.com.au Web: www.fidante.com.au

Fidante Partners Adviser Services
Phone: 1800 195 853 Email: bdm@fidante.com.au Web: www.fidante.com.au

Alphinity Investment Management Web:
www.alphinity.com.au

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