Alphinity Concentrated Australian Share Fund

QUARTERLY REPORT – SEPTEMBER 2023

Staying High…

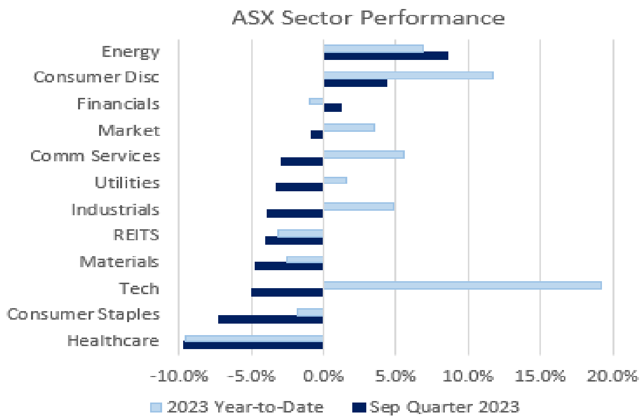
Market comment

…but not in any euphoric sense. In fact, quite the opposite with markets falling as interest rates, undoubtedly the most important variable in financial markets, look like staying "higher for longer". At least, that was the vibe in September, with both the US Federal Reserve and Australia's own Reserve Bank (RBA) signalling that further hikes may still be needed, despite their latest move to keep rates on hold. It was the move in bond yields however that spooked markets, with both US and Aussie 10 year bond yields rising nearly 0.5% last month to hit a level not seen in more than a decade.

Our market (ASX300 including dividends) started the quarter well but as the global macro picture deteriorated, equities struggled to hold value and the market ended up falling by 0.8% over the quarter. It wasn't a great quarter for offshore markets either and, while a weaker $A softened the blow, it wasn't enough. The MSCI World Index fell 0.4% over the quarter in $A terms, flattered by the $A depreciating by 4%. European stocks fell 2.2%, while China was a modest relative outperformer with the Shanghai Composite gaining 0.3%.

But it was the sharp move higher in bond yields that led to the realisation that without a recessionary shock, we'll need to live with higher rates. The irony isn't lost on us that while the very thing Central Banks were trying to do – that is, trying to engineer a soft landing – appears to be playing out, equity markets have been heading in the opposite direction. A healthy jobs market here and in the US means homeowners can pay their mortgages and consumers can still spend, and this has so far trumped weaker manufacturing activity and high energy prices, although these usually converge over time.

The new RBA Governor Bullock began her stint by keeping rates on hold, although a strong labour market and rising energy and property prices continue to be lingering concerns. August CPI came in at 5.2% for the year, up from 4.9% the prior month, which is still enough to cause headaches for the RBA, along with homeowners and renters.



At a sector level, as shown in the chart above, the biggest disparity between year-to-date performance and the last quarter was the reversal in Technology, a sector leveraged to rising rates. Unsurprisingly, Energy stocks held up well over both timeframes given the upward move in oil prices. More surprising was the resilience in the Consumer Discretionary space, the only sector other than Energy to outperform the market over both periods. Healthcare stocks had the dubious honour of being the worst performers over the shorter and longer term, while the normally defensive Consumer Staples also underperformed over both periods, although by smaller amounts. The Materials sector underperformed in aggregate although, within the sector, iron ore miners held up better than lithium stocks.

Portfolio comment

The Fund outperformed the market a little in the September quarter. The clear winner was online advertising group carsales.com although gaming machine company Aristocrat Leisure and major bank NAB also did very well. Other positives were from not owning toll road operator Transurban or global medical device maker Resmed Inc. Notable detractors were mineral sands producer Iluka Resources, gas producer Woodside Energy and not owning major bank ANZ or retail-heavy conglomerate Wesfarmers.

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)	-2.9	-0.7	12.1	10.5	6.1	8.4	9.4
S&P/ASX 200 Acc. Index	-2.8	-0.8	13.5	11.0	6.7	7.4	8.2

* 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 September 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

Slowing yet resilient economic growth, falling yet still above-target inflation and, as a consequence, central banks keeping rates on hold for longer have been recurring themes in our reports this year. This "stronger for longer" environment has left the Australian equity market trading largely sideways for most of the 2023 to date, with only dividend payments pushing the total return from shares into positive territory.

What might change this? To us, it still comes down to the earnings cycle which, of course, is intrinsically linked to the economic cycle. While some parts of the market, especially expensive long-duration stocks, would continue to find high bond yields a headwind, a broad-based cyclical recovery in earnings would likely be needed in order to overcome the impact of interest rates staying high.

The key question, then, is: are we late or early in the economic cycle? While difficult to know for sure, we lean towards being late cycle. We think it would be risky to interpret from the resilience of the economy to date that a trough is within sight. Large savings buffers, full employment and strong corporate balance sheets have all so far effectively absorbed the shock of sharply-higher rates, but that doesn't mean people are ready to further increase consumption meaningfully, or that corporates are looking to step up their capital expenditure intentions any time soon.

Looking further afield the US economy has so far also been surprisingly resilient, despite the US Federal Reserve Bank's tightening efforts. More recently, it has even shown signs of growth rebounding in some areas with, for example, retail sales growing and job openings increasing again. At the same time, many leading indicators continue to suggest this reprieve will prove temporary with a further slowdown likely in 2024.

This leaves us with China as a potential source of better days ahead. Two Alphinity team members visited China in September and they concluded that while a meaningful rebound in property construction activity there looks unlikely, some other parts of the economy – such as manufacturing and services, and even to some extent infrastructure – are likely to enable an acceptable GDP outcome for 2023. This could be enough for the market's current relatively low Iron Ore and Metallurgical Coal consensus price expectations for 2024 to be exceeded. However, we will first need to get through the seasonally slow winter months before factoring too much of this upside into our projections.

In summary then, we are leaning towards stronger-than-expected growth for the rest of 2023 but also increased risks of a sharper economic slowdown in 2024 as rates stay high for longer. Those high rates will both constrain economic growth and provide a real alternative to equities, property and infrastructure until the rate cycle moves lower again.

Portfolio outlook

In a year during which the macro environment continued to be challenging to navigate it's been encouraging to see stock selection contribute solidly to overall returns. Stock picking has been the key pillar of our long-term track record and, while macro factors will of course always influence individual companies' earnings, identifying companies which are in an earnings upgrade cycle will in our view will keep being rewarded. The Fund has maintained its greater-than-benchmark exposure to companies seeing positive earnings revisions. Until we see a meaningful shift in broader macro factors, we expect that those companies which have recently been delivering ahead of consensus expectations will be the most likely to do so in the next 3-6 months as well.

The August reporting season aligned well with this thesis, with a solid earnings upgrade score card for the portfolio in aggregate. As always, a few company results indicated deteriorating trends and we have taken action accordingly. We had already been taking profits in The Lottery Corporation and in this quarter we exited the position altogether. We also exited fund manager Perpetual which, after a promising start, has been disappointing as the inflection point for costs and improved funds flow continued to be pushed further into the future. We also sold out of mineral sands producer Iluka Resources as the price outlook for its key commodities deteriorated at the same time as the company is entering a heightened capex phase.

Finally, we switched our position in Fortescue Metals into Rio Tinto. Both companies remain intrinsically linked to the iron ore price in the short term but the numerous management changes at Fortescue as well as increased uncertainty about the capital allocation framework for the company's investment decisions in renewable energy projects has increased its company-specific risks. While its ambitions in renewables are admirable, the share price consequences of unrealistic project assumptions have been on stark display in Europe this year.

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

Top five active overweight positions as at 30 Sept 2023	Index weight %	Active weight %
Aristocrat Leisure Limited	1.3	3.5
Brambles Limited	1.0	3.4
National Australia Bank Limited	4.4	3.3
Medibank Pvt Ltd	0.5	3.2
QBE Insurance Group Limited	1.1	3.1

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BTW

We've written a bit about Tesla over the years which, after a rough start, has been a profitable carmaker since turning earnings positive in 2021. Success breeds imitation and there are now a number of pure Electric Vehicle (EV) makers listed on the US market hoping to replicate Tesla's success – Fisker, Lucid and Rivian being three. Vinfast was recently added to the list, one most people have heard never of and which originates from an unexpected part of the world.

Vinfast listed on the US NASDAQ recently, choosing that deep, liquid market over its native Vietnam, and is in the process of delivering its first batch of EVs into the US market. After initially toying with a traditional IPO, Vinfast chose to list through a SPAC, a Special Purpose Acquisition Company. SPACs are set up with the sole purpose of acquiring stuff and were at one stage quite popular in the US. Until it buys something though, the entire assets of the company consist of the cash that was raised at its IPO. So essentially cashboxes, which are not allowed on the ASX. SPACs can be risky, as people who buy the shares at IPO have no idea what the cash will end up being used for, so a degree of trust in the skill and competence of the people in charge of the cash is required. There are however some investor protections in place, such as the ability to redeem most of your investment if you don't like the deal that's been done.

The SPAC Vinfast chose, Black Spade, IPO'd in 2021. It traded in a desultory fashion around $US10 a share until the proposal to acquire Vinfast was announced in May this year. The value attributed to Vinfast at that point was $US23 billion – not a small amount but well below market leader Tesla's (at the time) $800 billion plus. One might think this fair enough considering Tesla makes millions of cars and billions of dollars in profit, whereas Vinfast was yet to deliver its first cars, and makes billions of dollars of losses. But equity markets are often willing to pay for the opportunity, and so it was with Vinfast, if only briefly.

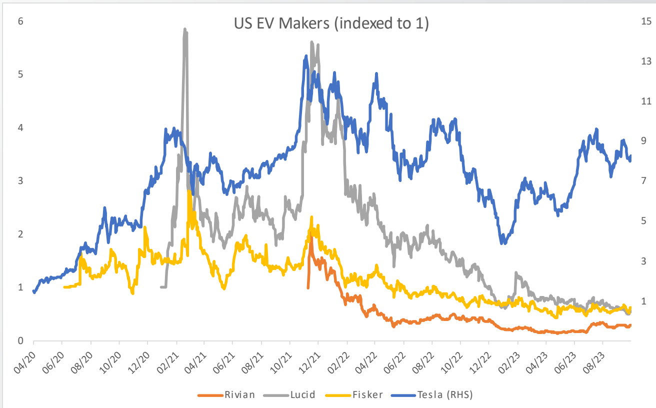
The Black Spade SPAC was set up in 2021 by Hong Kong-based gambling magnate Lawrence Ho, a person well known to Australian investors thanks to his past partnership with James Packer and Crown Casino. It raised $US150m in 2021, a long way short of the $23 billion offer for Vinfast. The vendor of Vinfast, Vietnam's richest man Pham Nhat Vuong, took 2.3 billion Black Spade shares in exchange for the company and now owns 98.6% of total outstanding shares; he hasn't traded any of his shares since the acquisition. The thing about companies in which one party controls the vast bulk of shares means there is a very limited free float: anyone who wants in needs to buy shares from one of the existing holders of the 1.4% balance. Unless there are willing sellers in that cohort, strange things can happen with the share price. With all the hype around the transaction in August, which coincided with the first delivery of cars in North America, strange things did happen to the share price.

Black Spade shares were renamed Vinfast on 15th August and went from $10 to $37 on the first day, before falling back to $15 by the end of the week.

From that point it gathered steam again, going to $17, $37, $49, $68 and finally $82 on August 28th. At that point the total value of the company was more than $US200 billion: five times as much as General Motors and four times as much as Ford. A shadow of Tesla's total value of course but for some reason Tesla seems to get a tech-like multiple of 78x earnings rather than Ford/GM's old-school heavy manufacturing multiple of 4 or 5x.

Vinfast, on the other hand, doesn't have a multiple at all as it is still solidly loss-making. Nor do loss-making Lucid or Rivian for that matter. Anyway, August 28 was as good as it got and Vinfast shares spent September heading back to where they started, about $10. The whole round trip seems a bit pointless really, unless you were one of the lucky sellers/unlucky buyers at those much higher levels.

It hasn't been a happy time for shareholders of the other US start-ups, cool truck maker Rivian, uber-luxury car company Lucid and the more mass market Fisker. They all had strong starts from their more traditional IPOs in 2021, 2020 and 2018 respectively. Rivian raised money at $78 per share although it had fallen to about a third of that by the end of September. The other two are trading around half their respective starting points.



Tesla remains king though. Its ~$800 billion market cap is arguably supported by profitable manufacturing and visible success, judging by the number you see on the roads of our major cities. Is it worth $250 per share? That's harder to say: the market sees its earnings climbing rapidly in coming years so 78x 2023 earnings becomes "only" 55x 2024 earnings, 43x 2025 earnings and 33x 2026 – providing market forecasts are correct of course: a big proviso given recent downward revisions.

Traveller's Tale

After the rush of the August reporting season, September generally provides an opportunity to get out and see the world, kick tyres, meet management teams, test the investment theses of existing positions, and explore the merits of potential new positions. This took consumer analyst Jacob to the US and Brazil, largely around Melbourne-based online company Carsales.com. It has been enormously successful here, becoming the dominant means of advertising cars in Australia, both for individuals and car dealers. But it hasn't been satisfied with that: Carsales has also taken its skills to disparate countries such as Korea, Mexico, Brazil and, most recently, the USA.

Brazil is a large and rapidly developing country with a population culturally predisposed to car ownership which presents a compelling opportunity for Carsales to bring its expertise to bear in a rapidly growing market. Public transport options are fairly limited in most major cities in Brazil, and much of the population considers car ownership to be an important status symbol. It was interesting to observe how few motorcycles were present on the streets of Sao Paulo despite their relative affordability and the significant traffic congestion; this was a notable difference to many other developing countries.

While pockets of great wealth are clearly evident in Sao Paulo, Brazil's biggest city, there are sadly also areas of acute economic disadvantage which are often associated with elevated crime rates. As a direct result of this, one of the fastest growing segments of the car market in Brazil is for 'Blindado', armoured passenger vehicles like the Porsche pictured here. Specialist manufacturers in Brazil take new vehicles and retrofit them with bulletproof glass and Kevlar lining in the door and roof panels to protect occupants from car jackings. Whereas a Porsche like this might cost around R$600,000 (~A$200,000) in its natural state, blindado would take it closer to R$800,000, a considerable investment in safety. Armour is also available on many more plebian vehicles too.

Jake's time in Brazil was without incident but safety concerns were top of mind, not just for him but the team at Carsales. Imagine if something happened to one of their most important shareholders! So, he took some comfort from the high level of security offered by the armoured van they provided for the various site visits.

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