Alphinity Australian Share Fund

QUARTERLY REPORT – DECEMBER 2023

Finishing Up

Market comment

Markets rallied nicely over the December quarter. Despite having a tough start in October, falling ~4%, November and December more than compensated. Our market (ASX300 including dividends) rose more than 11% over those two months for a December quarter return of 8%. Those two months transformed 2023 from what was looking like a meagre year into a quite pleasing return of 12%, a little better than the long-term average. The $A appreciating 6% against the $US helped to make our market look better than most in the December quarter. While in $A it underperformed Sweden's stonking 14%, our 8% was much better than China's various markets, which were down between 8 and 11%, and much of Europe (+1 to 6%). The US market returned 5% for the quarter, while the tech-focused Nasdaq did 7%.

Despite considerable volatility during the year the $A ended flat against the $US and our market's 12% for the year was mid-pack. We did better than most Emerging Markets but trailed behind many of the Developed Markets, such as the broad US S&P500's +25% and Nasdaq's +43%. It was not smooth sailing though: one broker noted that global shares went up 9% in January, down 8% in February and March, rose 15% to July, and fell 11% to October before rallying 15% into the year end. As we detailed last month, performance in the US was focused in a small number of very high-returning companies: excluding those "Magnificent Seven", the US market was up just 10.8%. The surprise winner for the year was Greece: its market rose by 48% in 2023, a far cry from its basket-case status in 2012.

In fact, some other Southern European markets in similar positions back then also did very well in 2023. Respected journal *The Economist* named Greece its economy of the year. The economic reforms instituted there a decade ago have rejuvenated its economy and its government was even re-elected this year, quite a feat in these populist times. "Greece shows that from the verge of collapse it is possible to enact tough, sensible economic reforms, rebuild the social contract, exhibit restrained patriotism—and still win elections. With half the world due to vote in 2024, democrats everywhere should pay heed."

Oil was a big loser on commodity markets in the December quarter, falling more than 20% in $A terms despite sharp production cutbacks in OPEC. Bulk commodities were mixed, with the price of Thermal Coal falling 14% but Iron Ore holding up nicely, up 11% in $US and 5% in $A. Base metals were generally softer, especially the battery metals, Nickel and Cobalt, each of which fell more than 15% in the quarter. The price of Lithium almost halved over the period, explaining much of the pain in that sector of the share market.

In all, despite things looking a bit dire at various points in the interim, the equity market closing at an all-time high says 2023 was not a bad year.

Portfolio comment

The Fund lagged the market a little in the December quarter. The best performers were building materials company James Hardie Industries, specialist retailer Super Retail Group, and industrial property specialist Goodman Group; not owning lithium producers IGO or Liontown also helped. Countering those were insurer QBE, pallet pooler Brambles and energy producer AGL; not owning iron ore miner Fortescue Metals also hurt returns.

Across 2023, the Fund made the most from global advertising platform Car Group (formerly known as Carsales.com), Goodman Group, Super Retail, petrol refiner/retailer Viva Energy, and gaming machine maker Aristocrat; while holdings in lithium play Pilbara Minerals, gas producer Woodside Energy, and not owning Fortescue or gold miner Newcrest/ Newmont all 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)	6.7	7.2	11.4	9.2	10.6	7.9	9.1
S&P/ASX300 Acc. Index	7.2	8.4	12.1	9.0	10.3	7.9	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 December 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

Equity market movements in December were again dominated by bond yields, which continued November's declining trend as market hopes for an economic soft landing in the US increased. These were enhanced by further evidence of US inflation easing more quickly than previously expected and a change in tone from the US Federal Reserve Bank (Fed) about the possibility of rate cuts in 2024 as US economic growth eases, but does not go negative. The market, as is often the case, has run ahead and is now pricing in a significant number of US interest rate cuts in 2024, with a high likelihood the first will be as soon as March. Expectations for cuts are not as imminent here, as our inflation seems to be stuck at elevated levels, but the prospect of meaningful relief at some point next year is nevertheless also gradually seeping into our market's consciousness.

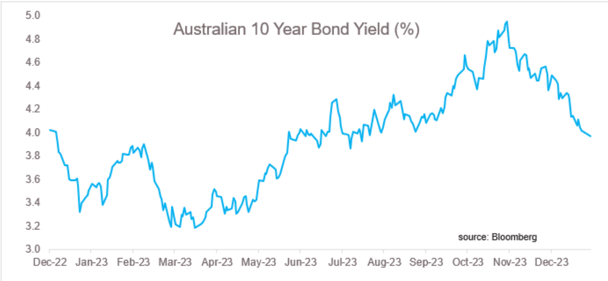
While the market is currently choosing to look over the valley of softer company earnings, focusing on this expected monetary easing instead and rotating towards cyclical exposures, we are not yet convinced that, when lower earnings are announced, they will be ignored by the market. Steep Fed cuts are only likely to take place if the economy were to slow substantially more than the market is expecting. In order for earnings leadership to rotate towards cyclical sectors on a sustained basis, we believe a synchronised upturn in earnings would be required. Historically, earnings leadership after a peak in bond yields has actually tended to favour defensive names, especially when the conclusion of the tightening cycle is happening in the run up to a Presidential election – as is the case in 2024. We do therefore caution against blindly following the 'soft landing' narrative and embracing this cyclical rotation without considering earnings. Our focus on earnings surprise remains a critical anchor to stock selection, as it is the only driver that will eventuate in sustained share price outperformance over time. Stocks surprising positively can be found in any type of markets and any type of company.

While Alphinity's approach is always bottom-up, we are still conscious of the macro. From a top-down sector perspective, as we exit 2023 we observe that, should the spot price of Iron Ore hold at current levels, Iron Ore producers are likely to experience meaningful positive earnings revisions in 2024. Supportive growth measures in China, combined with minimal global supply growth, bodes well for this commodity. The rest of the Resource sector is not benefiting from the same positive spot prices revisions.

US housing-exposed stocks are likely to gain from a revival in activity as mortgage rates decline, as long as its economy does not fall into a severe recession, which we see as unlikely. We suspect that, despite very strong share price performances recently, the market may still be underappreciating this tailwind for companies like James Hardie.

Similarly, Consumer Discretionary names could also keep surprising positively. Earnings expectations in this sector has been subdued for quite some time as the market has been waiting for the impact of the last 13 interest hikes to flow through to lower spending. Valuations are in many cases stretched however, which requires discerning stock selection.

We are conscious that we must be nearing the end of the positive earnings revision cycle for personal and commercial insurers, yet earnings in this sector should still benefit from ongoing moderate premium price growth and margin expansion as claim escalation costs slows.



Portfolio outlook

While we can't ignore the broader macro backdrop, which after all has been having outsized impacts over the last couple of years, we've found that focussing on individual company outcomes and earnings drivers is the key to generating performance over time. While the portfolio remains fairly defensively biased, considering that earnings leadership has tended to reside in companies with resilient earnings and strong pricing power, we have made a few adjustments of late that has made the Fund a little more cyclical, following upgrades of certain companies' earnings.

Over the past month, we continued to add to Iron Ore miners, namely BHP and Rio Tinto, producing a sizeable overweight to that commodity. While we remain underweight Health Care, we have built an overweight position in CSL as we believe robust immunoglobulin demand, price increases and cost-out measures will support earnings. Phase 3 clinical results of CSL112, a drug designed to reduce the risk of recurrent cardiac events, is expected to be released early next year and has the potential to be another 'blockbuster' for the company. We increased further our holding of US housing-exposed James Hardie Industries, and also accounting software company Xero, noting the increasing evidence that the company is pulling both price and cost levers to lift future earnings.

These changes have been largely funded by taking some profit in prior strong performers such as Aristocrat, Car Group, Cochlear, and Woolworths; and by further reducing our bank exposure by going more underweight ANZ. As always, we will continue to closely monitor any changes in earnings leadership that might emerge in the new year, but for now we believe the portfolio is positioned well to perform as we enter 2024.

Top five active overweight positions as at 31 Dec 2023	Index weight %	Active weight %
Rio Tinto Limited	2.2	3.0
BHP Group Limited	11.0	2.6
Medibank Pvt Ltd	0.4	2.5
Goodman Group	1.9	2.3
QBE Insurance Group Limited	1.0	2.1

Asset allocation	31 Dec 2023 %	Range %
Securities	98.3	90-100
Cash	1.7	0-10

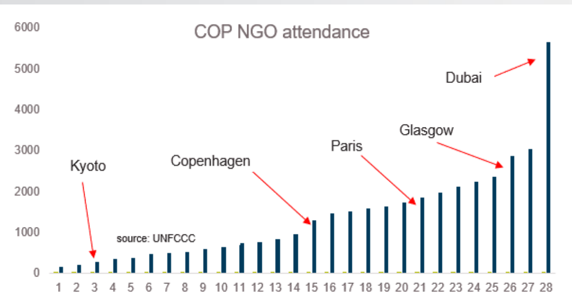
BTW

COP28 took place in the United Arab Emirates (UAE) in December. COP stands for Conference Of the Parties. This used to be UN-speak for a meeting of minds to discuss any topic, but seems now to be exclusively associated with the UN Climate Change Conference. We're not sure if anyone thought it through to this extent beforehand but the idea of tens of thousands of people – hundreds of thousands by some accounts when unofficial hangers on are included – flying vast distances to an oil-producing desert country, where you can ski indoors even when it's 50° outside and where air conditioning is required all year round, to talk about the urgent need to reduce carbon emissions does risk a minor brain explosion.

That the person in charge, Dr. Sultan Al Jaber, also heads up UAE's national oil company was also difficult for many to accept, although he argued that his deep inside knowledge of that industry positioned him well to know what the real issues were and how achievable the potential solutions were. That turned out to be a valid argument, with a surprisingly strong call coming out of the COP for the world to transition away from fossil fuels. 'Transitioning away' is softer than what some were calling for, like phasing out' or 'ceasing to use', but the distinction is subtle and inserting that language can only be interpreted as a step forward. In addition, the phrase 'fossil fuels' had never even appeared in a COP communique previously, so COP28 at least called out that particular elephant in the room.

There have been lots of COPs, 28 in fact. The most notable COPs were #3 in Kyoto in 1997, from which the Kyoto Protocol was issued; #15 in Copenhagen in 2009, at which then-PM Kevin Rudd accused China of very poor behaviour involving rodents; #21 in Paris in 2015, attended by then-PM Malcolm Turnbull, from which the Paris Agreement was issued which aimed to limit warming to 1.5°C; and of course COP26 in Glasgow in 2021 at which ScoMo made Australia's first formal, albeit reluctant, commitment to net zero. The UAE event seems to have been far better organised than COP27 in Egypt last year, despite its vastly higher attendance. It did not have the same issues around catering, potable water or essential plumbing that had 27ers walking through sewage at one point. COP28, by comparison, ran very smoothly.

More than 100 world leaders attended, including Syrian bad boy Bashir Al Assad whose issues would appear to be more imminent than 2050. The big guns – Joe Biden, Xi Jinping, Vlad Putin and Anthony Albanese – all stayed away but sent emissaries. Some 100,000 people attended COP28, double the number at COP27, and a staggering 400,000 more registered for the public area, the Green Zone. Some likened the crowds to being in Disneyland. There was huge inflation in NGOs – non-government organisations – which accounted for around half the attendees. The chart below shows the trend in the number of NGOs involved. Each one would likely have a few dozen delegates.



The variety of NGOs attending was also intriguing. COP categorised them into BINGOs (business and industry NGOs); ENGOs (environmental NGOs); RINGOs (research and independent NGOs); TUNGOs (trade union NGOs); YOUNGOs (youth NGOs); IPOs (indigenous peoples organizations); Farmers; and LGMAs (local government and municipal authorities). There was also a multitude of industry lobbyists who didn't qualify as NGOs, which are not-for-profit, including 2453 lobbyists for the fossil fuel industry according to one report.

The delegations of some countries were huge. China sent more than 1,000 people and Brazil more than 3,000. The UAE itself had 4,000 but at least they didn't need to travel. We had difficulty finding out how big the official Australian contingent was but we were well represented by our Climate Change Minister, his assistant minister and a multitude of bureaucrats. There were a few Opposition MPs there too, whose agenda seemed to be pushing nuclear energy as the solution to our energy challenge – a solution which hadn't occurred to them when in government not that long ago. It is clearly much easier to push nukes when you can't do anything about it. The Climate Change Minister surprised many by actively advocating the end of fossil fuel use, despite Australia's status as a large exporter of gas and coal.

Have we reached peak COP? Probably not, history suggests that boondoggles like this take on a life of their own, but there might be a degree of retreat after this one. COP29, is being held in oil/gas major Azerbaijan and the logistics suggests there might be fewer attendees, as Baku will struggle to match the easy access and accommodation Dubai offered. COP30 in 2025 will be back to another large oil producer, Brazil, and Australia is in the running to host COP31 in 2026. It is a little ironic that the fossil fuel superpowers appear to be in the COP ascendency!

In the near term (i.e. up to 2030) COP28 concluded that all countries need to ramp up renewables and be more energy-efficient but for the period after that the answer for emissions-free power seemed to be nuclear. The COP set a goal to triple global nuclear generation by 2050, the date by which net CO_2 emissions are hoped to be zero. Considering it can take more than a decade to just plan and build a large-scale nuclear power plant, the world will need to get a move on. Some place their hopes in "quick and cheap" SMRs – small modular reactors – although even they take some years and many billions of dollars to deploy. Australia will benefit from our Uranium reserves if this comes to pass, although there still remains ideological and locational aversion to propagating nuclear energy here.

It's easy to be cynical about big events like COPs but they do serve a purpose: just to have 200 countries arrive at broad agreement about the need to achieve something big is quite a feat, even if it might prove trickier to execute.

Traveller's Tales

Alphinity's year of travel kept up its momentum in December, with global portfolio manager Chris making his last international trip for the year, this time to Japan, going to Tokyo, Osaka and Kyoto. Plane delays, lost luggage and missed flights are par for the course for a global PM but he'd had a clean run all year until this final trip. His return flight being cancelled just three hours before departure threw a small spanner in the works, but he took the opportunity to squeeze in another round of sushi, so it was time not wasted!

While the food in Japan was outstanding, the reason for heading there was to meet with some of the world leading industrial companies, and companies that have a role in the automation of manufacturing processes were high on the list. Japan is the leader in Robots, Cobots (robots cooperating with humans) and sensors. It is one of the leaders in warehouse automation and semiconductor equipment. Chris had great meetings with companies like Keyence, Yaskawa, & SMC. He toured Minebea-Mitsumi's new showroom, where they have on display a transparent car (above) showing all the bearings and sensors that they make for the production process. He saw Komatsu's latest electric digger and Kubota's small agriculture machinery. A final highlight was meeting with Secom, a large security company, where he spent some time talking to their virtual security guard (right), although he was left unsure as to how it would chase after an offender.

Japan is a fascinating country with an interesting financial history and culture. In the 1980s it was considered to be a global leader in technology and innovation. By the end of 1989, eight of the 10 largest companies globally were Japanese, with US's IBM and Exxon rounding out the top 10. At one point, real estate values in Tokyo traded for nearly 350x those in Manhattan and the entire Japanese property market was estimated to be worth over four times that of the US. This proved to be unsustainable.

Just three years later not a single Japanese company made the top 10 list. The Nikkei 225 index peaked on the last day of 1989 and spent the next two decades falling before reaching its nadir in 2009, some 80% lower. Since then, the Japanese equity market has slowly recovered and in 2023 came to within ~10% of its 1989 level. In local currency terms, the Nikkei had a very strong 2023, up 28% and outperforming even the magnificent seven-inflated S&P500. The Yen, which depreciated by 10% against the $US, explains quite a bit of this, but there is also renewed optimism that change is finally afoot within corporate Japan.

To start with, the Tokyo Stock Exchange has been restructured. There have been new recommendations made by the Exchange whereby companies are required to trade on a price-to-book greater than 1x or explain how they plan to get there, and strong encouragement has been given for companies to engage more frequently with investors. Real reform of Japanese governance has been talked about for decades and the changes here are small, and in some cases qualitative, hence a healthy degree of scepticism, but they are a potential signal of intent.

And there is some evidence that companies are responding. For example the Toyota Group has begun unwinding some of its cross shareholdings, stock buybacks are picking up and there has recently even been a few attempts at hostile takeovers. Change does not seem to occur rapidly in Japanese markets, but our Global Equity Fund is watching closely for investment opportunities while remaining focused, above all else, on company fundamentals.

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