Alphinity Concentrated Australian Share Fund

MONTHLY REPORT – January 2024

Priced For Perfection

Market comment

As with 2023, much of the performance in US markets was dominated by tech stocks, with the so-called Magnificent 7 continuing to outperform the rest of the US market appreciably. "Priced for Perfection" is a term often used when a company's share price has risen so much that it risks a sharp decline if it delivers anything less than a perfect earnings release or guidance, and it's hard to argue that it's not the case here. They have mostly been delivering though. At one stage it looked like becoming the 'Mag 2' with Microsoft toppling Apple position as the world's largest company, its market cap reaching $US3 trillion during the month. We recall a time not too far in the past – August 2018 in fact –when the world was marvelling at Apple breaching the $1 trillion mark for the first time and wondering if it could possibly go higher: turns out it could. Nvidia, maker of the graphics processing chips which enable Artificial Intelligence, holds the #3 position with a market cap of $US1.5 trillion. To put these numbers into context, the market cap of the entire Australian ASX300 is about $US1.8 trillion, meaning that both Apple and Microsoft are materially bigger than the sum of all Australian listed companies. We're not sure that this is justified considering the sum of our companies' profits massively exceeds the paltry $US100 billion made by Apple in a year, or the $US80 billion made by Microsoft.

2024 began much like 2023 ended, with many equity markets close to, or even breaking through, all-time highs. Our own market (ASX300 including dividends) generated a modest 1% positive return for the month but some moves were extreme: Japan and the US both being up more than 7% in January alone, although inflated by the $A which depreciated by about 4%. The joy was not universal though, as Korea and the various Chinese markets slumped by between 4 and 7%.

US markets did well but wobbled at the very end of the month after the US Federal Reserve chief hosed down the market's certainty that rate cuts would happen there as soon as March. Those expectations are to some extent replicated in Australia although more like the second half of the year for any cuts. Our inflation moderated further in the December quarter, with the headline rate down to 0.6% and 4.1% for the year. So while the trend is better, inflation remains well above the RBA's target band of 2-3%.

Politics featured even during the dog days of January. In the US, party primaries brought focus to the likely opponents in November's Presidential election, with a reprise of 2020's Biden/Trump extravaganza appearing increasingly likely. With 330 million people to choose from, the idea that an octogenarian fighting a soon-to-be-octogenarian to be the purported "leader of the free world" does make you wonder why there are so few credible alternatives being offered to the American people. A rather sobering thought is that Bill Clinton, who was inaugurated as President 30 years ago, is still younger than both candidates.

Politics here also came to the fore with the decision of our Federal Government to go back on its commitment to deliver previously-legislated tax cuts by proposing to re-distribute the cuts so that high income earners receive less but many more lower-paid people receive more. With around a million people losing out but some 11 million benefitting, our political leaders seem to have well observed the old maxim that "the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing". Mission accomplished!

Geopolitics didn't take a Christmas break either, with stresses building even further in the Middle East. Of particular concern is the threat to supply chains returning thanks to Houthi rebels in Yemen who are increasingly targeting ships passing through the Red Sea and forcing some going from China to Europe to take the long way around Africa, adding many days and much cost to their journeys. This has meant some manufacturing in Europe has been disrupted. Meanwhile the Israel/Gaza war goes on despite increasing calls for a ceasefire, and the Russia/Ukraine war refusing to end.

With those tensions building, the price of Oil ticked up a little, although not as much as one might expect, largely thanks to high oil production in the US and softness in demand from China. Other commodities prices were generally lower, although falls were cushioned by $A moves. Thermal Coal, used for electricity generation, fell by 17%, although Coking Coal, used in the process of converting iron ore into steel, actually rose 3%. The price of Iron Ore however was flat for the month after sobering economic news out of China ahead of its Lunar New Year celebrations. Base metals were largely unchanged with only Lead and Tin showing any signs of life.

Portfolio comment

The Fund outperformed the market nicely in January. The best performers were health insurer Medibank Private, global insurer QBE, major bank NAB, gaming machine maker Aristocrat Leisure, and pallet pooler Brambles. The only notable detractors were energy services company Worley and diversified miner BHP.

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)	1.6	12.5	6.0	9.5	9.7	9.2	9.8
S&P/ASX 200 Acc. Index	1.2	14.0	7.1	9.5	9.7	8.4	8.7

* 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 January 2024.

^ 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

Despite initially reversing the euphoria that had dominated markets in the final months of 2023, the focus in January remained squarely on when and by how much interest rates will be cut, rather than whether they will be. The desire to get in front of the next positive economic cycle seems to be trumping cautious central bank rhetoric and mixed economic signals. The extreme correlation of equity markets with bond yields appears set to continue for the time being. While most western economies have clearly held up better than expected for longer in this cycle, economic data overall for 2024 thus far has been quite mixed, making monthly data releases an ongoing source of market volatility. The market appears to be firmly placed in the "soft-landing" camp for now. Clearly the odds of a soft landing has increased in recent months, with contained inflation and possible interest rate cuts, but multiple economic and rate outcomes remain plausible, including a more pronounced economic slowdown or, on the other hand, stickier inflation fuelled by a resilient employment market; and commodity price pressures induced by geopolitics. The path for rate cuts still therefore appears far from certain.

With clear positive economic and rate outcomes already being priced into the market, the risk is that this scenario does not play out. Recent market moves have tilted market valuations to being on the expensive side. Relative to market earnings, stocks are getting more expensive as earnings in Australia remain in slight downgrade mode, with only iron ore price-related upgrades keeping us in the game in Australia for now. It seems therefore that earnings revisions will play a greater role in the market's direction, as further material multiple expansion would likely require a doubling down on the existing view that not only is the economy robust, but that there will be large interest rate cuts as well, supporting valuations. However, large interest rate cuts would typically be associated with much weaker economic and earnings outcomes, which is not typically good for markets.

That's not to say there won't be rate cuts this year, particularly in the US which will probably start to normalise rates to match its fall in inflation. The start of that process will likely be taken well by markets. The questions are more about is what is the 'normal' level of rates and at what pace will we get there? We suspect that central banks will be reluctant to give away too much of their dry powder quickly if they don't have to, at the risk of sparking further bouts of inflation. In in any case, falling US long bond yields are potentially doing much of their job for them already, with 30 year mortgage rates have fallen from over 8% to below 7% in the last quarter even without rate cuts.

February is reporting season month in Australia, when most of the market reports full-year or half-year results to end of December 2023. This will give us further insights into how overall earnings are holding up. The lead into reporting season in January is typically highlighted by some companies 'pre-reporting', where they are required to tell the market if results are going to be materially different to expectations. While there were a number of the usual pre-announcements, this year was relatively scarce compared to the past. Whether this indicates how overall results will play out remains to be seen, however with the economy here and offshore holding up, one might assume that companies are also holding up well. However, it is future earnings the market cares about and, while past earnings may be a good guide, outlook comments and guidance generally play a bigger role in market perceptions. We expect management teams will display a degree of caution when issuing guidance, as we have not yet seen enough time go by to be definitive about how the full impact on the economy of the rapid interest rate increases of the past two years. Notably, after being resilient for so long, the Australian consumer has shown some caution with a material slowdown in spending since November. A soft top line does not bode well for earnings when costs are still increasing.

So unless earnings or macro-economic indicators materially change course – or central bankers significantly change their tunes – equity markets will likely maintain their current positive disposition. We do caution however that a lot of good news is already factored into share prices and the risk is now a bit more to the downside should the current "goldilocks" scenario experience any hiccups. The market really needs more time and information in order to be definitive.

Portfolio outlook

While reporting season inevitably brings about a number of changes as new information comes to light, we have continued to evolve the Fund's portfolio as companies' earnings outlooks evolve. The market bounce does bring about a little more risk to earnings reactions as companies report through February as expectations are now that little bit higher.

Much as many economies – our own included – have continued to hold up better than expected, the portfolio skew has become a little less defensive over the last few months by taking some profits in a number of more defensive companies which have performed well, adding a little more exposure to cyclical factors (adding to iron ore for example) and topping up growth where we can see the earnings upside along with reasonable valuation. However, we do not yet see enough change in actual earnings leadership (as opposed to speculation) to justify wholesale change to the portfolio – it has been much more stock specific. We have taken some exposures down where companies have run ahead of valuation in the recent market bounce, for example in the consumer discretionary space. A more robust economy, plus speculation of rate cuts increasing, has seen the Bank sector continue to outperform into 2024. However, valuations appear even more stretched post the run and operational earnings risks remain at both the revenue lines and cost lines. Credit quality continues to hold up and may well provide an earnings boost, but this is unlikely enough to end up with earnings growing for the sector. Taking the exposure down here seems prudent for the time being.

The net outcome is still a slightly defensively-tilted portfolio, but with a more balanced positioning than a few months ago. We expect that individual company earnings outcomes will come to the fore during reporting season, which will be a welcome reprieve for the market from reacting to daily interest rate movements or speculation.

Asset allocation	31 Jan 2024 %	Range %
Securities	99.2	90-100
Cash	0.8	0-10

Top five active overweight positions as at 31 Jan 2024	Index weight %	Active weight %
Rio Tinto Limited	2.2	3.8
Medibank Pvt Ltd	0.5	3.2
National Australia Bank Limited	4.5	3.1
Goodman Group	1.9	3.0
BHP Group Limited	10.5	2.5

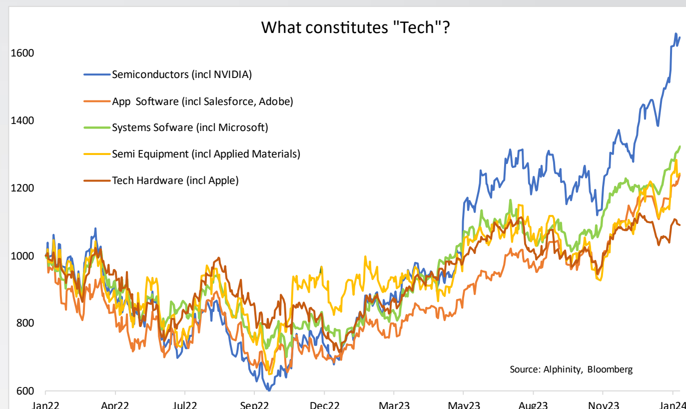
BTW

It can be dangerous to look at broad groups of securities and make individual stock decisions based on overall sector moves. Sectors like Technology and Commodities have become so large and diverse that aggregate overall moves can often mask wild swings 'under the hood'. We've found that undertaking bottom-up fundamental analysis is critical, as it allows us to identify great stocks in challenged sectors and avoid companies which might have enjoyed the ride on the back of a hot sector, but whose ability to deliver earnings is questionable.

The recent trend of highly specific Exchange Traded Funds (ETFs) in the US such as the LIT ETF, which only tracks lithium stocks; or SOXX that tracks US semi-conductor stocks, has allowed investors/speculators greater choice than traditional ETFs which just invest in broad indices. It's worth remembering that just like the individual stocks, ETFs can also become dangerously crowded or shorted. The danger arises when the liquidity of the underlying stocks dries up or, even worse, when ETF managers join the buyers/sellers of the underlying stocks at the same time: stock price moves will be magnified in both directions. In addition, there is often a degree of leverage used in ETFs, and the ETFs themselves are used widely by hedge funds that also frequently use leverage to further enhance returns. All that trading and gearing has the tendency to make for volatile stock prices.

Tech stocks in the US rallied 53% in $US terms in 2023, well above the S&P500 benchmark return of 24%. However within tech, if you just owned semi-conductor stocks, then you could have achieved a return of 108%. And within semis, if you just owned Nvidia you would have returned 340%. US returns weren't just about tech, however. Auto Manufacturers also did pretty well, closing the year up 81%, and Homebuilders were +73%. It was a tougher year for Healthcare and drug retailers, which fell 10% and 30% respectively. Personal Care took the wooden spoon, falling 43% as a group, although with just two stocks (Estee Lauder and Kenvue) it's more a 'niche' than a 'group'. There were many winners and losers within the S&P500, and great dispersion within industry groups. We like dispersion: the more stock returns differ, the better is the chance to deliver alpha when a stock-picker's market returns. One relatively new factor in US, and these days even global indices, is that size has become impossible to ignore. The mega-cap stocks, Apple and Microsoft are now very large components of the S&P500 – around 7% each – becoming the US equivalents of our own behemoths, Commonwealth Bank and BHP. Nvidia and Amazon are both about 4%. It has reached the point that in order to generate outperformance, US managers really need to get those big ones right. We feel their pain.

The chart below breaks down US Technology into its major industry groups. In brackets are the biggest stocks in each group. Semiconductor stocks were the clear stand-out, although there was wide dispersion between the best performers (semiconductors and systems software) and relative underperformers (hardware, of which Apple is the largest constituent). Despite the importance placed on company-specific earnings, there is still useful information to be gleaned from broad macro moves. For example, Tech and some of the higher growth sectors like Healthcare might come under pressure should bond yields again spike higher. It's important to always consider the broader macro indicators in context when thinking about portfolio construction.



Other than Tech, there is probably no sector as diverse as Commodities. The Commodities Research Bureau in the US publishes daily the widely-followed "CRB All Commodities Index". This index fell 8% last year, while a similar index, the Dow Jones Commodity Index, fell 4%. It's quite hard to get much insight from that however as there are so many different types of unrelated commodities out there: metals, oil, grains, FCOJ (frozen concentrated orange juice) and pork bellies, just to name a few. There is little to no correlation between most of those.

Looking back at the moves over 2023, we saw the price of Oil fall 4% to $US77/barrel, Iron Ore gain 18% to $US132/tonne, Lithium Hydroxide fall 81% to $US14,000/tonne and Gold rise 13% to $US2060/oz. Being overweight gold and iron ore would have added a lot of value, while exposure to lithium would have hurt a lot. Taking into consideration such a large divergence in performance between these different commodities, we expand below on the current thematics affecting them, as well as one that has been receiving a lot of attention lately: uranium.

The Oil price was weak in the final quarter of 2023, falling from $US90 to $US77/barrel, although it rebounded slightly this month as concerns with escalating tensions in the Middle East ramped up. However, it didn't move higher during the initial series of attacks in the Red Sea where the Houthis targeted western ships, which one would normally expect to create a 'knee-jerk' rise in the oil price. Thus far, Iran has largely stayed out of direct conflict, preferring attacks to be carried out by proxies such as the Houthis in Yemen and Hamas in Gaza. There could be a binary outcome in terms of the oil price, depending on whether Iran eventually becomes more directly involved.

The other reason why Oil hasn't been stronger lies in non-OPEC supply. US oil production is pumping, quite literally. In fact, US oil production is currently at record highs, and producers of shale oil are very profitable. The number of oil rigs operating in the US hasn't gone up much, it's been technology that is making the difference. Improved drilling practices have enabled much longer horizontal sections in wells, providing a much higher rate of extraction. Perhaps a more startling observation is that Iran, despite being heavily sanctioned, added about half a million barrels of oil per day into the market in 2023. The US isn't really enforcing sanctions any more, its priority is keeping energy prices under control. In this election year, the Biden Administration will likely be trying to strike a balance between environmental responsibility and keeping a lid on petrol prices. (....continued p4)

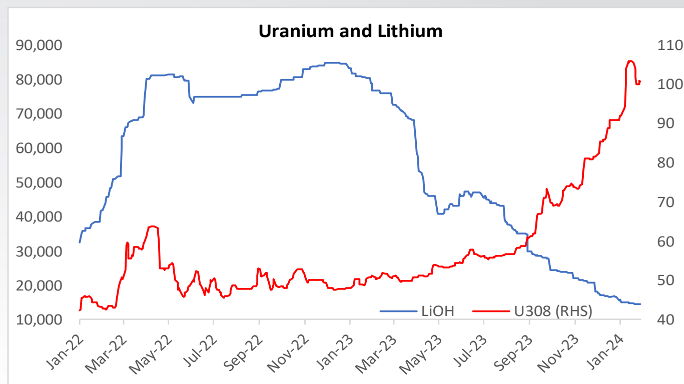
Alphinity Concentrated Australian Share Fund

MONTHLY REPORT – JANUARY 2024

The price of Iron Ore has held up remarkably well over the last year, in contrast to the impact a soft property market on the weak Chinese economy: this historical correlation has broken down. There are a few reasons that may explain its resilience. Steel production is being moved away from housing into other sectors like infrastructure, machinery, autos and defence, and exports out of China have also increased substantially.

One commodity that had the wind taken from its sales in 2023 was Lithium, the key ingredient in batteries that have been riding the EV wave. The price of Lithium Hydroxide rose 170% to $US85,000/ tonne in 2022 after a widespread shortage of the metal ignited a speculative buying frenzy. Despite popular belief that this transformative clean energy material would forever be in short supply, those prices brought a rapid supply response, at the same time EV demand came off a little. As they say, nothing fixes high prices like high prices and production increased by 40% in 2023 with China, Africa and Australia all ramping up activity. The lithium price collapsed by 80% during the year.

And we can't overlook, Uranium, which has assumed Lithium's spot as the latest hot commodity. Uranium has been used in various forms for more than 2000 years, with Romans using its ores in ceramic and glasses, its bright yellow colour providing a good source of colour. Little did they know back then of its radioactive qualities. Spot prices surged from $US30/pound to more than $US100/pound in 2023 on a mix of production issues in Kazakhstan, Russian supply being locked out of



Western usage, and a positive outlook for long-term demand. Let's hope Uranium doesn't live up to the name given to it by Czech miners: peche blende or "bad luck rock". It so called when they came across a deposit of what was then useless ore while mining for silver.

One of the main bottlenecks of Uranium supply has been a shortage of sulphuric acid, a key ingredient used to dissolve oxides in the ore to arrive at pure uranium. The irony is that around 80% of the world's sulphuric acid is produced as a by-product of refining fossil fuels. As the world de-carbonises and relies less on those, there will be less sulphuric acid produced, which could create issues for alternative energy sources like uranium.

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