Alphinity Australian Share Fund

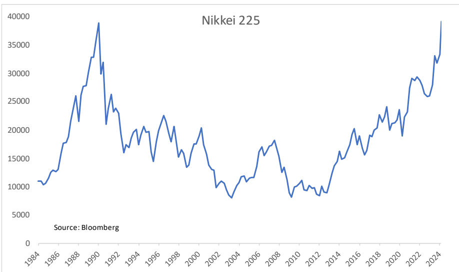
MONTHLY REPORT – FEBRUARY 2024

Shaking it off

Market comment

She was everywhere in February: performing in Tokyo, returning to the US for the NFL Superbowl and then holding seven concerts in Melbourne and Sydney. The idea of a cost of living crisis was called into question by the willingness of hundreds of thousands of young people (or their parents) being willing to spend many thousands of dollars on tickets, food, flights, accommodation and – most importantly – outfits to see the musical, cultural, financial and social phenomenon named Taylor Swift (p4). Back on our bourse, the market (ASX300 including dividends) performed modestly but positively, rising 1%.

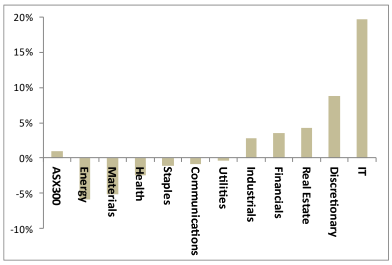
As we know all too well, reporting season is a time during which investment theses of our holdings are tested and either proven or disproven. There is a deluge of information, but reporting season provides a great opportunity to catch up with the management of our companies. February marked the end of that cruel summer, but the market largely shook off all those results. Is it over now? Pretty much, there are a few stragglers with odd balance dates yet to report but most of the news is out there. Overall, it was a love story for the market: things on aggregate turned out a little better than usual. There was a fair bit of karma: not as much bad blood as we often see, with 46% of companies exceeding the market's wildest dreams while 34% did something bad. But it was trouble however for the disappointers which traded on average 3% lower. For some of those, we might never get back together. Haters will hate, after all.



Taylor is too humble to take credit for one momentous event that coincided with her visit to Tokyo: the Japanese share market index, the Nikkei, finally surpassed its previous peak almost 35 years ago. The last time it was at this level was 1989 – coincidentally the year Taylor was born and the title of one of her albums – but the bursting of Japan's property bubble and the need to deal with deflation and adverse demographics kept it at a fraction of that level for a long time. Her first concert here also coincided with an all-time high for our market, but ours was only building on the highs of the previous month.

Commodity prices were all over the place in February, cushioned somewhat by the $A falling half a US cent. Oil was ~3% higher but the price of gas and uranium fell slightly. In the bulk commodities Thermal Coal rose 11% in $A terms but Iron Ore softened by 7% and is now trading close to 20% below its price at the start of the year. Base metals were mostly 1-5% lower with the exception of Nickel, which rose by 8%.

Not surprisingly then, Energy and Materials were our biggest sectoral laggards over the month of February with -6% and -5% returns respectively. The best sectors to be in were Tech (+20%), Consumer Discretionary (+9%), Real Estate (+4%) and Financials (+3.5%). Real Estate's overall lift was largely because of one company, the rest of the sector didn't do much.



Global shares in $A terms did quite well in most cases, even those where Swift wasn't. Her next destination, Singapore, was only up 0.8%, but shares in China and Hong Kong had a very strong month, rising 8-9%. US markets were also very strong with the techy NASDAQ up 8% and the broader S&P500 almost 7% higher. European markets were between +0.3% (Spain) and +7% (Italy). Japan was +6% and South Korea +7%. The biggest loser was Argentina which fell by 20% in February, although that just represented a partial reversal of January's crazy 38% rise. Seems like the Argentinian stock market is still adapting to its new regime.

Portfolio comment

The Fund outperformed the market in February. Logistics and data centre developer Goodman Group was the top contributor to returns, along with medical device company Cochlear, global ad platform CAR Group and global insurer QBE; not owning iron ore miner Fortescue Metals also helped. The detractors of note during the month were diversified miners Rio Tinto and BHP, health insurer Medibank Private, and supermarket operator Woolworths; not owning logistics tech company WiseTech also hurt somewhat.

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)	1.1	9.5	9.6	9.3	8.9	8.0	9.2
S&P/ASX 300 Acc. Index	1.0	9.5	10.5	9.1	8.6	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, 29 February 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

Resilience is a word that well describes our economy right now. The surge of inflation in recent years, which triggered a series of rapid and steep interest rate increases in an environment full of tense geopolitical situations, hasn't so far plunged either the US or Australian economies into recession. In fact, recent data suggest that with inflation slowing and expectations of rate cuts in 2024, we might well be at the trough in economic activity. Indicators such as the OECD Leading Indicators and the Institute of Supply Management surveys even infer that the US economy might have started re-accelerating in late 2023. This change in sentiment has been reflected in both the US and Australian equity markets hitting fresh record highs in February. Accompanying that, however, is marginally stickier inflation so far this year than was expected which, while perhaps unsurprising, should unemployment and economic growth remain positive, does question the extent and timing of any rate cuts to come. While the range of likely outcomes in the macro backdrop is narrowing, it is still far from certain.

The important thing for us is underlying company earnings. The month of February provided hundreds of data points across the world as companies reported their full year or semi-annual results and gave forward-looking outlooks. While US earnings overall surprised positively – albeit driven primarily by the big tech stocks – after all the February company reports in Australia, overall market expectations for EPS growth this year and next barely changed (around -1% on Alphinity's numbers). While fairly flat might not seem all that impressive, it is actually better than the net downgrades of several per cent typically seen during results seasons, and was clearly enough to satisfy investors who are willing to overlook the minimal earnings growth this year and focus on the expected +4.7% earnings rebound in FY25.

This fairly flat outcome however masks quite a few divergences amongst sectors. The sectors in which results led to more positive earnings revisions versus expectations were IT, Utilities, Banks, Real Estate and Consumer Discretionary. Within these, the clear stand-out was Retail, as consumer demand remained robust relative to quite negative expectations and gross margins surprised to the upside. Banks benefited from small earnings upgrades, as deposit competition remains benign, while bad debts stayed remarkably low and costs were in line. Bank balance sheets are very robust with significant bad debt provisioning having taken place over previous years in anticipation of a more dire economic outcome. Utilities benefited from the pass-through of high electricity prices and good cost management, although the lift in their bad debts was meaningful.

On the other side of the ledger, the sectors in which earnings were down-graded the most were Telecommunications, Resources, Health Care (although primarily pathology companies) and Energy. Resources was the stand-out, whereby both commodity price pressures and cost inflation compressed margins more than expected, especially for lithium, base metals and gold producers. A lot of attention is focused on China's economy post the Lunar New Year celebrations to see whether the Dragon wakes up and if the series of policies announced to support its dire property market will flow into improved overall economic activity: the jury is still out on that. While the health care sector overall continues to face margin pressure, some companies have fared better than others, for example portfolio holdings Cochlear and Resmed, thanks to specific market dynamics and company initiatives.

It is apparent from our discussions with various management teams during the month that inflationary pressures have receded. The cost of raw materials is falling, freight rates are declining, supply chain disruptions are lessening with few pressures emanating from the Red Sea so far, and labour cost pressure slowly abating. Depending on the industry, price discipline remains solid but price growth is progressively being replaced with price preservation, which is harder to maintain. The focus on margin improvement through cost-outs and productivity measures is evident. The mood among companies appears a touch more positive than was the case in last August's reporting season. Dividends were slightly lower than expected, suggesting that companies are holding back cash to strengthen their balance sheet and/or in preparation of acquisitions. The acquisition cycle appears to be recovering, with a several deals announced in February, with bids coming in from various parties for CSR, Alumina, Altium and Boral.

Portfolio outlook

With the market's one year forward earnings multiple at 16.5x, a bit above its long-term average of 15.7x, the delivery of earnings is therefore paramount. Our focus on identifying quality, undervalued companies undergoing positive earnings revisions should play well in this environment.

This focus has been rewarded in the reporting season with some of our larger positions contributing the most. Disappointers were largely avoided yet, as happens in all reporting seasons, some companies we did not own stood turned reported better results than we had expected, and a few we owned disappointed. We have taken actions on both fronts. We also continued to adjust portfolio weightings based on our updated convictions.

We remain overweight insurers as the combination of premium growth and cost deflation is supportive of margins. We remain overweight Industrials although this is because of individual company stories. We have lifted slightly our overweight to Health Care through CSL, Cochlear and Resmed. We have further increased our bank underweight as we sector seems particularly expensive considering the 4-5% earnings decline expectations for FY24 and FY25. We remain underweight Resources and pay close attention to the developments in China as we hold an over-weight exposure to iron ore producers. We remain underweight Property although retain a solid exposure to Goodman Group, which sits in the sweet spot of logistics and Data Centre developments around the world.

While we manage the portfolio bottom-up based on earnings revisions, quality and valuation, we have in aggregate continued to shift the portfolio from what could have been described as a defensive posture a year ago to a more balanced positioning with increased exposure to growth and cyclical names. Although the tone of companies' commentary is becoming more confident, we need to see this confidence translating into positive earnings revisions in order to make larger adjustments. A more resilient economy could also mean high interest rates for longer, so it is important to keep that balance in mind.

We believe that the focus on earnings imposed by our investment process will continue to identify attractively valued, quality companies with idiosyncratic drivers, pulling the right levers to deliver earnings above market expectations and, as a result, share price performance. Our focus on finding these companies remains unabated.

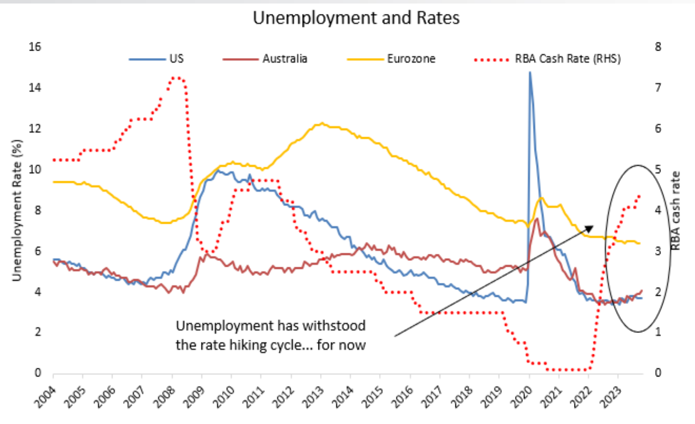
Top five active overweight positions as at 29 Feb 2024	Index weight %	Active weight %
Rio Tinto Limited	1.9	3.1
Goodman Group	2.2	2.6
Medibank Pvt Ltd	0.4	2.4
QBE Insurance Group Limited	1.1	1.8
CAR GROUP LIMITED	0.6	1.8
Asset allocation	**29 Feb 2024 %**	**Range %**
Securities	98.4	90-100
Cash	1.6	0-10

BTW

One of the biggest factors keeping interest rates at elevated levels, aside from the level of inflation of course, is the very low rate of unemployment. When people have jobs, they also have security and an income stream which means they can afford to consume goods and services, and pay their rent or mortgages. They can also more easily argue for higher wages. Unemployment rates, both globally and locally, have been very low recently, exacerbated by Covid, when many people left the workforce and didn't return. The participation rate of the workforce is also expected to reduce as the population ages. The demographic timebomb is ticking more loudly in some places, however, and various countries are trying to address the issue.

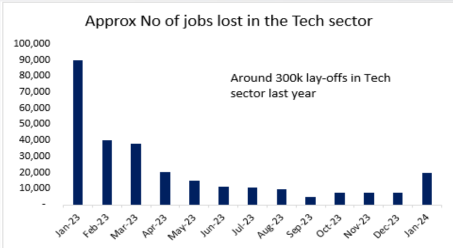
France, for instance. Famous for its rather bolshy workforce, long holidays, generous state-funded pensions and quirky labour laws such as the one banning having lunch at one's desk – one must go out to a café like a civilised person – its government passed a law last year raising the country's retirement age from 62 to 64. Still pretty good, compared to our current primarily self-funded retirement age of 67, but in France it resulted in riots and violent protests and even threatened the Macron presidency at one point. Although surely still being forced to enjoy a glass of vino or two over a long lunch for a couple of extra years isn't that bad! From the government's point of view, however, early retirement and long lives means huge and growing pension liabilities.

Japan is another case in point. Its demographic challenge has been evident for decades: a low birth rate combined with a cultural resistance to immigration has meant that the workforce has aged more rapidly than most, and elderly people are being encouraged to keep working or return to work, helped by technology.



Notwithstanding such measures to attract more labour participation, the reality is that in many industries, especially in services and trades, there are still many more jobs than available workers. The chart above shows that, after the spike in unemployment rates thanks to wide-spread Covid shutdowns, it quickly fell to historic lows and has remained low even during the rate hiking cycle of the past two years. This helps to at least partly explain the resilience of the consumer: most of us still have a regular income.

One part of the market that has been experiencing job cuts is the US technology sector. We're all aware of just how concentrated the tech industry is, and you're probably sick of us calling out the performance of the Magnificent 7 stocks in the US, where all but Tesla now have market caps well over $US1 trillion. But it's also interesting to go back over the last year and see how many workers have been laid off by technology companies. Admittedly, many of these had been on huge hiring sprees during the pandemic, but their focus has clearly shifted from growth to profitability, and are protecting margins by cutting costs.



	Lay-offs in 2023 / 2024	Approx %age of workforce
Amazon	27,000	8%
Meta (Facebc	21,000	20%
Google	12,000	6%
Microsoft	10,000	8%
SalesForce	7,000	10%
Twitter	5,700	70%
Spotify	2,500	20%
Paypal	2,000	7%
Yahoo	1,600	20%
Zoom	1,300	15%
Coinbase	950	20%
Twitch	500	35%

Source : TechCrunch

We see two primary reasons for this. Firstly, higher bond yields have shone a spotlight on valuation. Tech stocks trading on lofty earnings multiples have come under increasing scrutiny from investors as bond yields challenged valuations, especially when the point at which the companies achieve positive cashflows in many cases didn't occur until well into the future: higher yields means the cashflows get discounted more in order to arrive at a present value. The many tech companies which still haven't reached profitability need to rely on a multiple of sales, or maybe even the size of the "TAM" (total addressable market) to arrive at a valuation metric. In the current climate, investors now care more about the bottom line, and unprofitable tech company CEOs have begun to respond by cutting costs. There is a critical difference between the current environment and the early-2000s tech wreck: back then no one made a profit. We note that the Mag 7 are generally highly profitable so should be largely exempt from that dynamic; notwithstanding, most still appear on the list of staff cuts above.

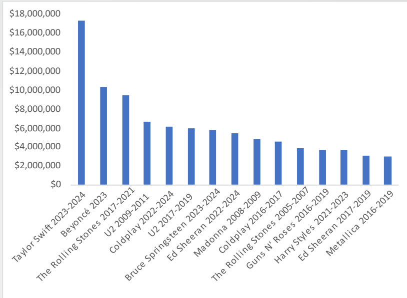
The second reason is associated with a step change from within the tech industry itself: the adoption of AI tools to increase efficiency. Klarna, the Swedish version of Afterpay, put some numbers around what AI has done for their business. What is the return on investment for an AI chatbot for a company? In just a month, Klarna's AI assistant, which is powered by OpenAI, had 2.3 million conversations, two thirds of the company's total customer service chats: equivalent to 700 full-time agents. Customer satisfaction with the chats was on par with humans. It was also more efficient in query resolution, on average resolving customer queries in about two minutes, versus 11 mins previously. The chatbot is estimated to boost Klarna's profits by $40m this year, yet the cost to Klarna of implementing it was minimal – at this point anyway. One of the challenges of the AI space is that the current providers are only charging a nominal price for the service – at some point this will change. It will be interesting to see how addicted we all are to it when the true economic cost of AI starts to be levied.

Traveller's Tale

He didn't have to go far, just to Sydney Olympic Park, but it was a trip that cemented his place in the affections of his 13 year old daughter. Yes, Andrew managed to get tickets to see Taylor Swift, making him the envy of all fathers with offspring of a certain age. And he did it with surprising ease: just logged on, waited a few minutes until it was his turn, and calmly handed over a vast sum of money. This was while his whole family was doing the same thing, on several devices each, with no success.

Of course, getting tickets was just the start, then he had to plan his own outfit and trek out to Homebush with the tens of thousands of Swifties either attending or listening from outside the stadium. Andrew went for the classic comfy suburban dad look of jeans + T-shirt + trainers, eschewing the pastel colours, sparkly stones and sequins most attendees seemed to go for. It was all aboard the "Taytay Express" dedicated train, complete with her music piped through the carriages. Also on that night, in an adjacent venue, was punkish US alt-rock band Blink 182: we'd love to see the Venn diagram of those two sets of attendees! There was a lot of excitement in the air, supplemented by the arrival of Swift's Superbowl-wining boyfriend, Travis Kelce. It was a stinking hot day which culminated in one of Sydney's typical summer evening thunderstorms which delayed the start briefly. At the end of the very long concert, there was the usual crush getting home but, unlike for some recent events, transportation overall ran smoothly and the crowd was overwhelmingly good-natured.

Our expertise is in finance, not music, so we'll restrain our commentary to that side of Taylor's activities. She is a financial phenomenon. This tour, known as Eras, has sold more than $US1 billion worth of tickets; merch and music sales (even cassettes for goodness sake!) will probably add another billion on top of that. These numbers are extraordinary. The closest gross revenue to Eras is Elton John's Farewell Yellow Brick Road tour, but he took five years (2018-2023) and performed 330 shows but still fell short of $US1 billion; Tay Tay is only doing 60 concerts for her billion. The chart (data sourced from Wikipedia) shows just how far ahead she is ahead of peers on an inflation-adjusted per-concert basis. Elton didn't even make it into the top 15. In addition, last year Swift released a movie version of the Eras concert to assuage the feelings of those who missed out on tickets. It is already the biggest grossing concert movie of all time, having taken more than a quarter of a billion US dollars.



Not only that, she is one of the few artists to have stared down music streaming giant Spotify, appearing on that platform on her own terms. She also found a way around the strange situation whereby a former agent sold the copyright to her early music to a private equity firm, reclaiming a large chunk of the royalties for herself. Taylor Swift has turned out to be a very savvy business person, and a rare public figure you probably wouldn't mind having your daughters emulate. The Trump campaign even fears that she could sway the Presidential election against him later this year. She's done OK for a Pentagon psy-ops experiment!

For further information, please contact:

Fidante Partners Investor Services
Phone: 1300 721 637 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

alphinity
INVESTMENT MANAGEMENT