Alphinity Australian Share Fund

QUARTERLY REPORT – MARCH2024

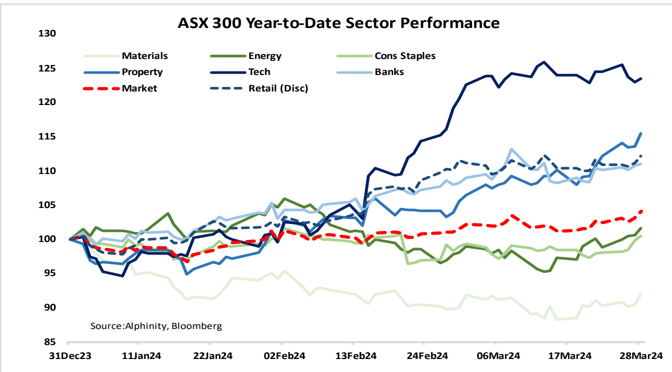
Marching forth

Market comment

The share market (ASX300 including dividends) continued its march upward during the March quarter. It was a period of solid returns, up 5.4%, although more than half of that came in March itself. Australia's market lagged many of those offshore, particularly the US where the large tech stocks kept racing away. Economic growth in Australia is ambling along, still positive but only mildly and a little below the rate of population growth. Inflation is falling, although not as quickly as the monetary authorities would like, which likely delays any prospect of rate cuts until much later in the year, or even into 2025. There was no change to official cash rates during the quarter.

Australian shares lagged some global share markets in the quarter, with the strong tech sector driving an impressive 16% rise in the US S&P500 (in $A terms). Japan did even better, with 18%, but there was a wide disparity between other major markets. Asian markets were generally softer, with Hong Kong and Singapore up only 2% and China matching our 5%. European markets were in between, with returns between 4% (Switzerland) and 17% (Italy).

Looking at relative sector performance, there was notable dispersion with Tech stocks being the clear winners, while Banks, Property and Consumer Discretionary also outperformed. Materials was the largest detracting sector, led by the large cap miners as the iron ore spot price fell more than 25% over the quarter. The price of Iron Ore in the back end of 2023 had perplexed the market, considering the weak economic backdrop in China as it diverted its steel usage away from housing into autos, defence, infrastructure and exports – this all combined to keep iron ore prices high. In this context, the price falling 22% in $A terms thus far in 2024 is understandable, exacerbated by weakness in general activity around the Lunar New Year. Other bulk commodities were also lower in the March quarter, Metallurgical Coal off 15% and Thermal Coal, used in power generation, down 8%. Base metal prices were generally a bit better though, partly thanks to the soft $A. Of these, Copper is arguably that most important, being seen as it is as a precursor of global economic activity. As an essential input into most manufacturing, and particularly the energy transition from fossil fuels to electricity, the fact that its price has risen by more than 10% in the past six months is quite encouraging.



Energy stocks were weak over the March quarter, even though the various types of Oil rose by between 13 and 21% in $A in that period. Within Consumer, weaker performance in the supermarkets led Staples lower while Discretionary stocks outperformed. One surprisingly resilient pocket in consumer discretionary is Retail, with many retailers managing to maintain margin and deliver earnings surprise to the upside, despite ongoing cost pressures.

Economic data continued to print positively across most of the developed world, with the US continuing to add jobs above expectations while inflation was reasonably inline, with annualised US CPI hovering around 3.1-3.2%. Rate cut expectations continue to be pushed further out, while in Australia, there is a growing view that cuts may not come at all this year. Jobs data back home also gave some credence to this more hawkish view, with the unemployment rate dropping from 4.1% to 3.7%, even though inflation remained steady at an annualised rate of 3.4%, keeping the Reserve Bank in hold mode.

Portfolio comment

The Fund outperformed the market in the March quarter. Logistics and data centre developer Goodman Group was the top contributor to returns, along with global insurer QBE, global ad platform CAR Group, domestic insurer Suncorp and not owning either iron ore miner Fortescue Metals or gold producer Newmont Mining. The detractors of note during the quarter were diversified miners Rio Tinto and BHP and supermarket operator Woolworths.

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)	3.1	5.8	13.7	9.4	9.4	8.3	9.4
S&P/ASX 300 Acc. Index	3.3	5.4	14.4	9.5	9.2	8.3	8.8

* 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 March 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

The March quarter saw equity markets remain strong and longer-term bond yields trade in a reasonably narrow band despite ongoing speculation around inflation, economic growth and central Bank action/inaction. Market confidence has been supported by a strong underlying economy in a US election year that might see further fiscal support, coupled with the prospect for interest rate cuts. Should the economy hold up better than expected these cuts might be delayed, however if the economy deteriorates, the cuts will come earlier. The optimal scenario, of course, is that the economy remains firm, inflation falls, and interest rates are cut swiftly. Either way the market appears to have the Fed's backing. Neither the prospect of an interest rate rise nor stagflation appear to be in the market's current thinking.

Inflation, however, is proving a little stickier than expected although still largely on track to move gradually towards central banks' long-term targets. On balance, there is a building argument for short-term interest rates to stay higher for a little longer. There is now only a couple of interest rate cuts expected in the US this year, down from seven a few months ago. That is not to say central banks won't start cutting rates sometime this year, which is what they have been signalling, complicated by the timing of US elections, but maybe the urgency or scale of near term rate cuts has reduced. An "insurance cut" or two isn't out of the question, but it would likely be accompanied by rhetoric designed to discourage extrapolation of the rate cut trend.

Overall, our economy continues to hold up well and this appears to be a key reason, along with the largely US-based "AI" driven thematic, that equity markets have continued to push forward. Strong economies with falling cost pressures tend to lead to decent earnings outcomes, and earnings is ultimately the key equity market driver over time. The major bank sector in Australia is a case in point. While market commentators scramble to explain the strength of bank share prices this year, despite stretched valuations, the underlying reality is they have had better earnings outcomes and upgrades because the economy has turned out better than expected.

The issue the market overall is facing is that the strong run has largely all come about through multiple expansion, and not yet because of better-than-expected earnings outcomes. We now need positive earnings surprises to lift the market materially from here, all else being equal. Of course, all else is never equal! Earnings appear to have stabilised/troughed: over the last three months there have been reasonably persistent low single digit downgrades globally, with the US standing out by recording flattish earnings revisions. In Australia, earnings downgrades actually turned a touch positive the last three months – but only a touch.

The outlook for China is an important driver for the Australian resources sector. So far, the economic recovery post the Chinese New Year has underwhelmed due to a soft construction bounce. The iron ore price, a significant exposure for Australia, will be dictated by whether a recovery will take place: so far the 30% fall in iron ore price this year infers earnings downgrades for producers should we not see an activity bounce . We are travelling to China in April to find out more on the ground. Meanwhile, a global economic recovery coupled with significant energy transition investments and low supply growth are proving significant tailwinds for base metals, copper and aluminium in particular. Of note, gold has been incredibly strong reaching record levels despite real yields barely moving and the $US actually strengthening. This rise appears to be largely driven by central bank buying and retail purchasing, both largely out of China. Increasing geopolitical tension is again lifting the oil price, which is a headwind to the inflation recovery.

In conclusion, without a valuation boost from lower bond yields, the market increasingly needs better earnings which itself requires ongoing recovery in the economy. A more likely outcome for the moment we believe is a resilient (but not strong) economy with pockets of weaknesses and sticky but gradually falling inflation, accompanied at some point this year by small rate cuts. That seems to equate to a market which is fairly well priced at the moment: the opportunities seem to be more within the market than in the market overall. Having largely already priced in a soft landing, we wouldn't be surprised to see a bit of market consolidation around current levels until more certainty exists around the direction and scope of rate movements and the direction of earnings this year.

Portfolio outlook

Having made a number of changes to the portfolio during and coming out of reporting season earlier in the year, we made few further changes to the overall portfolio in the last month. We remain largely balanced, with a slight defensive skew. Insurance remains our biggest sector overweight, driven by individual bottom-up stock stories rather than a particular view on the sector. The underlying premium pricing thematic continues to be supportive, as does a moderation in claims cost inflation. Higher short term bond yields and strong markets are supportive of potential upgrades to come.

While we have reduced exposure to Iron Ore , we remain slightly overweight for the moment, subject to our findings about the Chinese economy. Overall, we remain underweight the commodities sector largely through underweights in Lithium and Gold. The resilience in the gold price as a result of Central Bank buying has potentially moved the sector into upgrade territory and is therefore of interest to us. Our issue has long been though an inability to find quality businesses in the sector which don't experience persistent production and cost issues, and ongoing low conviction in forecasting the gold price. The price of Oil continues to creep up, potentially leading also to further upgrades in the Energy sector, to which we have a small overweight.

We remain a little underweight Banks on valuation grounds. However we do see some potential for further upgrades with margin pressures relieving a bit this year, volumes holding up and a resilient economy combining to give scope for a provision release at some point. With valuations at current levels we suspect the market would have little tolerance for any earnings misses.

As has been the case for a while, material rate cuts leading to a large cyclical rally is likely the biggest thematic risk in the portfolio, although we see this as unlikely in the near term. We focus on bottom-up stock picking to identify undervalued, quality companies which are likely to surprise positively earnings wise. In a high multiple world, earnings delivery will be paramount. We believe our proven investment philosophy and process positions us well to keep capturing alpha generating opportunities.

Top five active overweight positions as at 31 Mar 2024	Index weight %	Active weight %
Goodman Group	2.4	2.7
Rio Tinto Limited	1.9	2.5
Brambles Limited	0.9	2.2
Medibank Pvt Ltd	0.4	2.0
QBE Insurance Group Limited	1.1	2.0
Asset allocation	**31 Mar 2024 %**	**Range %**
Securities	98.3	90-100
Cash	1.7	0-10

BTW

There's been a lot of chat around EVs – Electric Vehicles – in recent years and regular readers might be tired of us going on about the company that pretty much created the sector, Tesla, and its flawed genius CEO. There was a lot of squawking recently when Chinese EV maker BYD surpassed Tesla's quarterly units of production, making close to half a million units each. Of course, the average price of Tesla's vehicles is much higher than BYD's so Tesla's revenue still far surpasses that of BYD, but it made good headlines for a few days.

The sheer numbers show that Chinese manufacturers are making great strides in the EV area, and not just with the cheap and cheerful models that are increasingly evident on Australian roads. There is increasing concern in EV-producing countries about the low price for which they are selling, and European producers are having difficulty competing. There is currently an anti-dumping enquiry being conducted by the EU to establish whether there is unfair competition going on; at the same time, hefty tariffs effectively keep Chinese EVs out of the US.

The EV space is an area of high-value manufacturing China identified some years ago as being critical to its economic success in coming decades. Clearly if it is able to take so much market share through its low selling prices that non-Chinese manufacturers are unable to compete, its long-term ambition will ultimately be achieved. If China's price advantage is purely the result of more efficient manufacturing processes and labour costs then there's not much anyone can do about it, other than slap on protectionist tariffs. But if it is because there are large direct or indirect government subsidies taking place then this should be called out and equalised. It must be noted that a number of European brands make their EVs in China, and many source batteries there too. There are ways of competing other than just price, however. The buyer of, say, an electric Porsche Taycan is unlikely to consider a BYD Dolphin at a sixth of the price – that person is primarily looking for the prestige and performance that comes with the Porsche badge. The Chinese feel that European manufacturers are too concerned about the driving experience, whereas their customers primarily want connectivity and gadgets, and their current focus is on delivering those.

Chinese EV manufacturers, of which there are many, have been innovating furiously in recent years and claiming lots of patents, some of which might end up being useful features. You want a bed in your electric SUV for camping perhaps, or even just to while away those long waits at the charging station? The Xpeng G9 is your car: it can come with a double air mattress in the back which unfolds and inflates at the push of a button. It also a 3D user interface and "5D multimedia". You like fishing? Zeekr is developing a "vehicle-mounted fishing system" that incorporates a rod, line and hook, a device which will enable accurate, long distance casting, and software that will give the driver information about the best fishing spots in the local area. Rox Motor Tech's Polestones 01 has a rear-mounted kitchen complete with an induction cooktop (no gas bottle of course!), presumably for all those fish you catch from your Zeekr.

More realistic perhaps is the very high end (around $A250,000) Yangwang U8. It has an imposing form, reminiscent of a Range Rover or Rolls Royce, but its main trick the incorporation of a drone station on its roof. The drone can be launched while the car is in motion and follow you, taking high-definition video of your journey and either broadcasting it to the car's internal screens or saving it to be edited, hopefully not while driving.

So, a lot of impressive ambition being exercised in China's booming EV market. Back in the US, however, Tesla's polarising Cybertruck is finally in the hands of end users and it is creating waves. People either love or hate the design (we lean towards the hating side). Apparently it's an impressive piece of machinery, leaving most other electric trucks in its wake. They can be hard to handle though, as 23-year-old rapper 2Rare found. A few hours after taking delivery of his new truck in Los Angeles, 2Rare misjudged the driveway into the iconic Beverley Hills Hotel and ended up in its garden, as this picture from Inside EVs shows. And ended up with an expensive repair bill. There have been several other accidents involving Cyber trucks but their incredible strength, and lack of crumple zones, which raises some safety concerns for occupants, has usually meant the other vehicle comes off much worse. Despite all the attention Cybertruck has gained around the world, it is unlikely to be sold outside the US and maybe Canada – it doesn't meet the safety standards of most other countries. Still, North America by itself is probably a big enough market. The Cybertruck's stainless steel body has come in for some criticism from new owners however: it seems to show signs of corrosion after being left in the rain, something that probably wasn't foreseen. While the stainless steel body itself will not rust, it will show rust-like marks. The marks can be removed fairly easily but still, having an apparently rusty truck detracts from the image somewhat. Apparently the last stainless steel-bodied car, the DeLorean, was the same.

What next for Tesla? The company is apparently prevaricating over whether to build a smaller, cheaper ($US25,000) vehicle which would allow it to compete better with Chinese cars and grow the company's addressable market substantially. But one thing is for sure, regardless of the personal habits, preferences and opinions of its CEO, the company has been remarkably successful. Its Model Y was apparently the highest-selling individual car in the world in 2023, a stunning success considering it is not a cheap vehicle. Tesla is now quite profitable, with likely net earnings of around $US10 billion this year and $14 billion in 2025. Whether those earnings justifies its half trillion dollar market cap (50x for a heavy manufacturing company?) is a topic for another time.

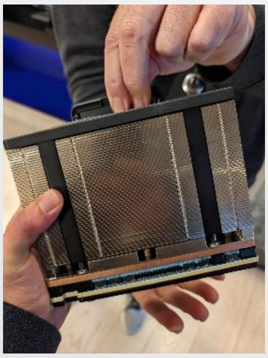
Travellers' Tale

As fourth quarter earnings wrapped up for the Global team, it was time to once again pack their bags and venture off on overseas research trips. During March, Alphinity had four of its global portfolio managers on separate trips; Jeff to the US and the UK, Chris to the US, Jonas to the US and Trent to the US and Asia. Mary was back in the Gateway building minding the fort, although she will be visiting the HQ of Fund holding Ferrari in Italy in May, a trip that probably trumps all the others. Ferrari has been a great performance contributor to our Global Fund, a true Alphinity stock in a sustained earnings upgrade cycle that benefits from unique pricing power and great order visibility. We're looking forward to sharing some of Mary's insights post that visit.

Back to the extensive March travel. Trent's adventures across US, Korea, Taiwan and Japan could supply a year of Traveller's Tales by itself but we'll do our best to filter out the best bits. The US TMT conference he attended delivered some memorable moments, not least of which

was Elon Musk delivering an almost incomprehensible rant that had many struggling to understand what he was saying. Replays of conference presentations were available but the link to Elon's has mysteriously gone missing. The companies Trent met with included AI chip powerhouse Nvidia, AMD, ServiceNow, Korean memory play SK Hynix, Perplexity, Anthropic, Apple, Towa, Wistron and Asia Vital Components. Some of these are key holdings in our Global Equity Fund, while some are being carefully considered as stocks on the warm-up bench. It's always nice to have a solid bench of companies waiting for their opportunity to enter the Fund.

Trent had to wear a hat → while visiting Towa Corp, a Japanese Semiconductor equipment-making company to make sure no stray hairs would be getting into any of their sensitive equipment. While visiting Nvidia, Trent got his hands of one its latest Graphics Processing Units→. GPUs are the AI chips that many of the largest companies are desperate to get their hands on. Imagine having a customer base that includes Microsoft, Meta, Google, Amazon and Tesla: essentially the other six of the Magnificent 7 are your biggest clients. Nvidia's latest Blackwell platform will set you back a cool $US30-40,000 per unit!



It would be remiss of us not to include the cultural highlight of the trip. While in Kyoto with Geisha, he played the Japanese equivalent of Rock-Paper-Scissors, which is Tiger-Sword-Old Lady. In this instance, he won the game: Old Lady beats Sword (Samurai culture would not allow an attack on such a vulnerable person) but a Tiger will beat an Old Lady.

Skipping across to South Korea, Trent was able to meet with SK Hynix, a leading supplier of memory chips, one of only three companies in world to do memory, along with Micron and Samsung. Knowing all about Nvidia's H100 GPU, it became very clear the importance of High Bandwidth Memory. HBM is an acronym you're bound to hear a lot more about in coming months. Demand for it is ripping, which is tightening overall markets and driving ASP's (average selling prices) higher. SK Hynix is maintaining a leadership position in the HBM market, although Micron and Samsung are starting to close the gap.

The final leg of his tour, to the geopolitical hotspot of Taiwan, was an opportunity to gather more insights into the semiconductor supply chain. Pull apart an iPhone and more than half the components come from Taiwan. It was his final overnight, and when Trent got off the bus and was surprised to see all the locals scurry away rather than checking into the hotel recommended by the organiser. When he asked why, they replied "everyone in Asia knows that the Hyatt in Taipei is haunted". That memo hadn't reached Trent! By this stage of the tour, however, no ghosts or evil spirits could curtail the excitement and growth potential of semi-conductor stocks. There are many companies in Asia with a sliver of the AI pie who are now lining up to drink from the firehose of activity. One company worth mentioning was a server cooling manufacturer (currently making the fans in PCs but moving into full cooling systems): its units are meant to be growing from 200,000 to 4 million over the next two years.

We've hardly touched the surface of just one PM's trip, let alone the other three, so we'll save those for next time. For instance, Chris toured New York and Orlando, attending conferences as well as the GE Aerospace capital markets day, where he saw this cross section of wind turbine blade which is largely made of balsa wood, not the more common but energy-intensive aluminium.

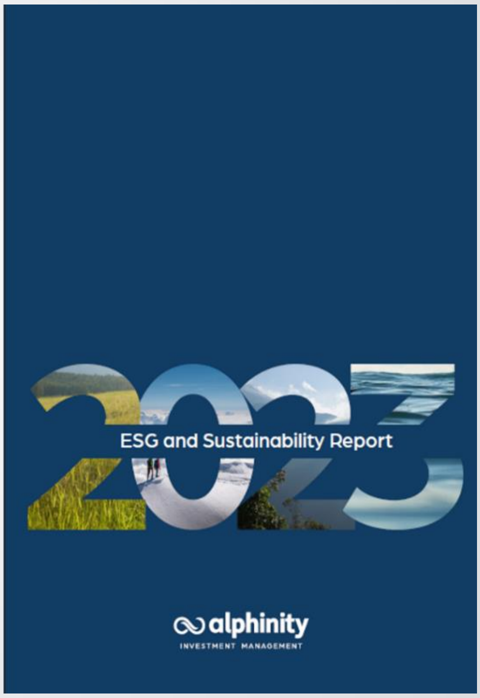
ESG Spot

The Alphinity ESG team has been as busy as ever. We have just published our third ESG and Sustainability Report which showcases our efforts in responsible investing during 2023. The report is full of case studies and have been structured around our five pillars of responsible investing: ESG integration, stewardship and active engagement, sustainable strategies, thematics; and transparency.

The following table is a snapshot of some the key insights from the report.

112 tonnes of carbon offsets purchased through Carbon Positive Australia as a donation to help fund nature-based projects across Australia.	**7 thematics** **24 ESG issues** Climate change Nature Workforce Modern slavery Social licence Digital technology Sustainability Governance	**60** **Company examples** and case studies showcasing ESG initiatives and outcomes
209 dedicated ESG meetings with 137 companies across the 18 month reporting period	**SDG3, SDG8, SDG9, SDG11** 100% of holdings across Our sustainable funds align to one of these four SDGs	**Financed emissions** Disclosed for the third consecutive year

Please click on the cover below to see the whole report.



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