Alphinity Sustainable Share Fund

MONTHLY REPORT – APRIL 2024

Sticky data

Market comment

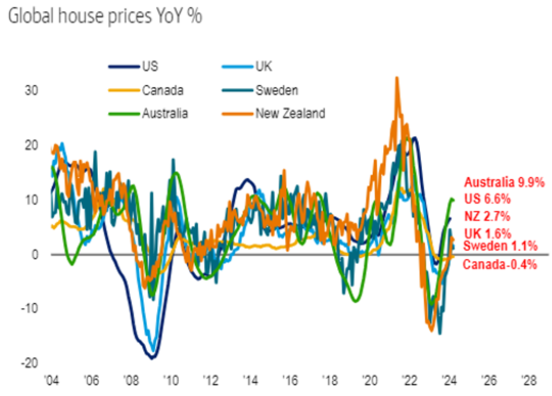
The share market (ASX300 including dividends) took a breather after five consecutive positive months, losing almost 3% in April. Moves like this are often referred to as a 'healthy correction', or 'rebasing', or 'restoring value' but when it's happening it just feels like losing money. Markets around the world started to re-assess what some of the Big Things going on around the place might mean for us all. Bond yields spiking in both the US (4.2% up to 4.6%) and Australia (4% to 4.4%) were key, moving sharply higher with the developing realisation in both countries that the highly-anticipated easing of rates would be further delayed after the release of disturbingly strong inflation and employment data. "Sticky" is not a term anybody likes when it comes to inflation, but we are stuck with this for now. After a brief sojourn into normality, we seem to have returned to the odd situation that good (economic) news is actually bad news (for markets).

Might the monetary authorities even actually consider raising rates one more time? That would be a definite negative for share prices here and elsewhere. Our market was soft but less so than those of the US, even in $A terms. The broad S&P500 fell by 4% and the tech-heavy Nasdaq by 4.5%, largely a result of those bond yields. Japan's was the worst of the major markets, falling 8% in April. Most parts of the world also experienced negative returns although some fared better, with flat or small positive returns in China, the UK and parts of Europe.

A major flow thematic over the last year or so has been foreign equity flows out of China/HK and into Japan/India, and also into Australian China-proxy stocks such as large cap miners. However in April we witnessed some large unwinding of that positioning, with flows coming out of Japan into the Hong Kong and China markets, which helped contribute to these returns. Hong Kong closed 8% higher last month in $A terms; it still has a lot of ground to make up however given the degree to which it has underperformed over the last three years.

Signs of life in the Chinese economy, as confirmed by our own on-the-ground research (see TT on p4) was reflected in commodity prices. The bulk commodities, Coal and Iron Ore, rose by between 6 and 12%. Base metals were very strong, particularly Zinc (+22%) Nickel (+16%) and Copper (+15%). Gold continued to be firm, rising 3% in $A to a fresh all-time high. Not surprisingly, resource-exposed companies were among the better performers in our market in April. Those bond yields however cruelled sectors which might be thought of as 'long-duration', such as Real Estate, the worst performer. It fell a little more than 7%. Utilities (+4.5%) and Materials (+0.5%) were the lone outperformers on a sector level.

Inflation for March came in above expectations at a 3.5% annualised rate. The effect was more severe in the US, where annualised monthly inflation has not only increased every month this year, but also printed above expectations in each of those months. One month doesn't make a trend, but it's harder to ignore three months of stubbornly higher numbers. Further exacerbating the challenges for Central Banks is the sharp lift in house prices despite interest rates remaining high, not only in Australia but also in the US, NZ and even the UK as shown in the chart above.



Source: BofA Global Investment Strategy, Bloomberg

Portfolio comment

The Fund lagged the market in April as some of the big winners from March reversed course. Glimmers of hope out of China sent iron ore exposures higher, with Rio Tinto a meaningful positive contributor, along with not owning Woodside Energy. On the other side of the ledger, two former top contributors – building materials company James Hardie, affordable residential provider Lifestyle Communities, and pallet pool provider Brambles the only meaningful detractors.

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)	-3.9	0.4	8.1	5.1	8.5	8.6	9.5
S&P/ASX 300 Acc. Index	-2.9	1.2	9.0	7.1	8.0	7.9	8.5

* 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 April 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

This month we saw stubborn inflation combine with robust economic conditions to shift market expectations away from delayed cuts to short term interest rates to even contemplate a possible hike, and this helped lift bond yields sharply. Having largely ignored the gradual rise in yields since the start of the year, rate fears became a drag on equity returns in April. Interest rate-sensitive sectors such as Real Estate, Consumer Discretionary, and Building Materials were the most negatively affected. Banks also came under pressure as higher-for-longer might come with more increased bad debt and lending competition. Insurance companies, on the other hand, benefited as higher rates support higher investment earnings.

Utilities and Resources were the main outperformers in April. Utilities driven by higher electricity prices, and Resources driven by higher gold and base metal prices. The rally in gold may seem to conflict with lifting yields but can be explained by ongoing geopolitical tensions and Central Bank buying. The base metals lift was driven by an improved global demand, further fuelled by new sources of consumption, with the acceleration of the energy transition, demand for power from Artificial Intelligence and the boom in Data Centres and, importantly in the case of copper, supply disruptions which has brought the expected supply deficit forward by a year.

We went to China in April and met with economists, consultants, property developers, steel mills and many downstream industries to get insights on the direction of its economy, and to assess how this translates to specific commodity demand, and therefore their prices. We came back mildly encouraged, with a sense that small but positive momentum will likely build for the rest of the year as the Chinese government at last appears to be taking actions to address deflation and the real estate collapse through measures that will cushion the property market but at the same time support manufacturing, infrastructure, and consumption. While a rising tide typically lifts all boats, in the case of commodities it is critical to be very selective as each commodity exhibits different demand/supply dynamics.

The month of May contains a mini reporting season for companies with March or September balance dates. The bank reporting season provides not only information on their own financial results but also provides a read on the pulse of the economy. Valuations appear stretched for this very large part of the market, which likely has negative earnings growth in both FY24 and FY25. That in itself could cap the level of the market for a time.

May is also a period of company updates accompanying a local investment conference. This often provides insights into company performance and the way in which they are holding up in the current economic environment. With earnings revisions having stabilised year to date, along with a fairly resilient market, it will be interesting to see if these updates are enough to tip the momentum one way or another.

Overall, as it currently stands, we believe that a somewhat cautious approach is still required to take into account the ongoing uncertainty in the inflation and yield path, whilst recognising that the world overall seems to be in a better place economically than it was a year ago. The optimism around numerous rate cuts here and in the US might have progressively faded due to stickier inflation, but it appears at this stage this stickiness is at least caused by a more robust economy in both countries. ‘Not as bad’, or a ‘better’ economy of course is not the same as a strong economy and a number of risks remain. Sticker inflation with even a mildly deteriorating economy would be quite negative for the market overall. Should stubborn inflation shift the market narrative towards rate hikes, rather than the number and timing of rate cuts, the current market valuation could be challenged.

Despite the correction in April, the overall market multiple remains quite elevated. Earnings growth is most likely required to push our market higher. While earnings revisions have stabilised in aggregate for the past few months, they have not yet turned positive. This will be our focus in coming months.

Portfolio outlook

While we continually adjust the portfolio based on the new insights we gather, it is currently positioned in a reasonably balanced way which reflects the uncertain macro-economic environment we are currently facing and, importantly, where we see valuation support and positive earnings revisions in individual companies.

We maintain an overweight to Insurance names who are exposed to rising premiums and where moderating inflation should start to reduce claims cost in coming periods. Higher yields also support their investment earnings. These two factors are a powerful combination.

We hold overweights to Industrials and Health Care through idiosyncratic stories such as stevedoring company Qube Holdings, pallet pooler Brambles, audiology device maker Cochlear and, since the beginning of the year, sleep apnoea machine maker Resmed. We have a small underweight to Banks as their high valuation and low-quality earnings revisions (as they are coming through provision releases rather than operational improvement) make the investment case less compelling. We are also underweight diversified financials as we believe the short term outlook for Macquarie Group is more challenging than what the market expects.

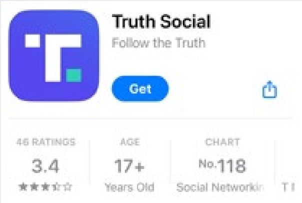
We have an underweight to Consumer stocks as high valuations, various inquiries into supermarkets, and economic pressure from those higher-for-longer rate expectations remain headwinds to the sector. We do however hold select positions in companies where we believe expectations have become too negative. We have been a little underweight on resources but are reviewing our positions in light of a moderately more positive view on China and base metals, as discussed in Traveller’s Tales on p4.

Top five active overweight positions as at 30 April 2024	Index weight %	Active weight %
Goodman Group	2.3	3.5
Rio Tinto Limited	2.1	3.0
QBE Insurance Group Limited	1.1	2.6
Medibank Pvt Ltd	0.4	2.4
Brambles Limited	0.9	2.3

Asset allocation	30 Apr 2024 %	Range %
Securities	98.3	90-100
Cash	1.7	0-10

BTW

One person we'll probably hear way too much about this year is Donald J Trump: former US president, aspiring US president, serial defendant and now media entrepreneur. After being kicked off Twitter back in 2021 when, following the storming of the US Capitol building prior to the Biden inauguration, the quality and tone of his tweets were deemed to contravene even the modest standards of that platform, he started his own version, Truth Social. The company was recently admitted to the NYSE under the name of Trump Media and Technology Group (TMTG, ticker DJT) via a SPAC.



What is a SPAC? In most cases it is a company with a bunch of cash looking for assets to buy, although in this case the SPAC, initially called Digital Worldwide Acquisition Corp, which listed in September 2021 at $US10 per share, seems to have had Truth Social in its sights from the start. It took a couple of years to consummate the deal, however, due to two Securities and Exchange Commission investigations: one proving insider trading by two early investors who made $US23m of illicit profit, and one for misrepresentations made in DWAC's IPO documents. In late March, DWAC finally bought TMTG for 78.5 million shares at $40 each. This effectively listed Truth Social without needing an IPO.

IPOs have been on the nose a bit recently, at least in our market. Most that have been offered to us in recent years have been either way over-priced or of poor quality – often both – so we haven't bought into any for ages. We pine for the days when companies of the quality of JB Hi Fi or Carsales.com were being brought to the market, companies that were at early stages, reasonably priced and with a lot of runway remaining. We like the discipline involved in a company coming to the market via an IPO, as it forces the proponents to disclose a wide range of useful information that help investors assess risk and judge the upside/downside. Listing via a SPAC evades that process.

TMTG can't avoid filing financial reports but it has decided not to disclose any Truth Social user metrics. A recent SEC filing of the company said that at "this juncture in its development, TMTG believes that adhering to traditional KPIs like sign-ups, monthly active users and average revenue per user could potentially divert its focus from strategic evaluation with respect to the progress and growth of its business." That is a huge red flag to us: what else do shareholders have to judge them on? Its first lot of financials was not a pretty sight: $US4m of revenue and $62m of expenses, which somehow supported a multi-billion dollar market capitalisation.

Trump initially owned 57.6% of TMTG, but he also had some options that recently took him to 84%. Having an earnout is normal and quite healthy: it means that should the business that was bought turn out to be worse than promised, the seller gets a bit less. Trump's 'earnout' was quite unusual in that it was triggered merely by the share price staying above $17.50 for 20 days. The company had just been bought for $40 a share. At the end of April, only a month after the deal closed, Trump was awarded another 36 million shares, $US1.8 billion worth. This must be the quickest 'earnout' in history, well before anything has actually been earned. Whoever approved that earnout should be in jail. An award of Muskian proportions, and one that will only play into Trump's vision of himself as a business genius. As a result, Trump's stake was 'worth' $US5.7 billion at the end of April. But was it really?

We know a bit about share prices. We know that, in the short term at least, they are often not perfect analogues for what's going on in the guts of a company. We hate it when people quote Buffett but here goes: he once said that in the short term a company's share price is a voting machine, in the long term it is a weighing machine. The day-to-day price is set by the how enthusiastic or desperate the buyers and sellers are but, in the longer term, it has to come back to the weight of earnings, how much the company makes. The two can stay apart for a long time though, as we saw during the meme-stock phenomenon of 2021 when a bunch of moribund companies like AMC Cinemas and Gamestop were pumped up by thousands of people corralled by social media in order to damage hedge funds which had shorted them. The shorts were actually correct, but they were all stopped out well before their payday. The economic reality is that things were not good: after highs of ~$400 a share in 2021, AMC is now trading below $4. The victory was pyrrhic however as, by the time the truth was reflected in the share price, many of the shorting funds had gone bust.

In the case of TMTG shares, similar forces are likely at play. Looking at similar companies, Reddit hit the boards pretty much the same time as TMTG, but after a proper IPO. It has traded well since and even has a similar market capitalisation. Reddit however had revenue of ~$US800 million in 2023, so it's trading on a revenue multiple of about 9x. TMTG had revenue of only $4m, so its $6.8 billion market cap puts it on 1600x. TMTG must be the most obvious short in the market! We would say caveat venditor to any aspiring shorts, however. As with AMC Cinemas a few years ago, there are a lot of unpredictable market participants out there who might have something other than a financial motive to buy TMTG shares. They might interpret a weak share price as a slight on their preferred President, and equate buying his shares as an expression of support for his brilliance. With no metrics being released to judge it on, it will be the ultimate supply and demand stock that could trade away from fundamentals longer than you could borrow the stock. Not that there will be much borrow around with a 16% free float.

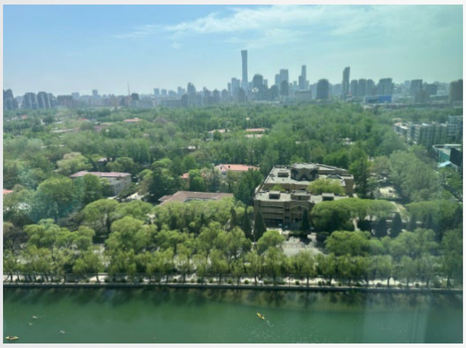
One commentator even connected Trump's situation with David Bowie, possibly the first time those two names have ever been linked. In 1997, Bowie (or more likely his financial advisors) came up with the 'Bowie Bond', issuing a ten year debt security and collecting $US55m. The idea behind it, which was genius, was that bond holders would receive ten years of payments linked to the royalties from 280 songs on the 20 albums that Bowie had released prior to 1990. On maturity, the rights reverted to Bowie but if the bonds had defaulted during the period, investors would have taken ownership of the songs. The bonds didn't default, and the money he raised meant Bowie could go out and buy other parts of his back catalogue he didn't own.

As Bowie Bonds were, owning TMTG stock is a bet on the individual himself. If Trump becomes President again TMTG could well have some value. If he loses, TMTG stock will likely become a footnote in history. No revenue, no earnings, and if he's not in power, no prospects and no relevance. Trump's own holdings of TMTG – 114,750,000 shares – are locked up for six months so his escrow will be lifted not long before the election in November. It will be interesting to see (and could be telling) if he starts to sell down his shares when he's allowed. It would be the smart thing to do but might be interpreted as conceding defeat.

Traveller's Tale

Stephane, our fearless resource-focused Portfolio Manager, went to China again in April in an attempt to better understand how that critically-important economy is placed for the rest of the year. It's the team's third trip to China in recent months and, given how quickly the dynamics are changing in the world's second largest economy, more trips are in the pipeline. Jacob is going to China in May to get a read on the outlook for some of our consumer-exposed companies.

Let's start with an unusual photo Stephane took of the Beijing skyline, showing sunshine and blue skies. As a lover of nature, this is a scenic photo. As a commodities analyst, however, the first thing that comes to mind is concern for steel mill inventories and what a clear sky means for industrial production and steel demand. To get clear skies in Beijing you usually need a special event like an Olympics or the annual flower festival, during which factory output is purposely limited in order to reduce smog and make the place more visually appealing.



During the week-long trip, Stephane met with several steel mills and steel traders, China's national development body, and various property consultants and developers. He also met with scrap steel specialists and some downstream companies. To summarise his high-level views on various commodities post the trip, he came away mildly positive for iron ore, and lot of more positive on the outlook for Copper and Aluminium. Gold is still a 'black box' and is generally as unpredictable as forecasting exchange rates but one thing is clear: the Chinese are buying lots of it, both individuals and the government. Stephane came away with a more negative view of rare earths, and a marginally negative view on lithium. The spot price of Lithium has been under immense pressure, but could become an opportunity closer to 3rd quarter re-stocking. We will need to closely monitor battery production and inventory levels at CATL, the world biggest battery maker.

Moving away from commodities to technology, during this trip Stephane interacted with robots more than he wanted to. Arriving back in his hotel late one night in Shanghai and ordering room service, the doorbell rang but there was no one there. He looked down and saw a small winking robot looking back up at him. Its top opened and out came his dish. After incredulously thanking the bot for his meal, it disappeared down the corridor to the next room. These robots were seen often in China, zipping through reception halls quietly and efficiently making deliveries. We've seen similar innovations at restaurants here in Australia (like Din Tai Fung in Chatswood, Sydney and The Spirit of Punjab in Halls Gap, Victoria), where happy little robots dutifully serve up the meal of your choice. Look out for this innovation coming to hotels here soon.

The main company behind these robots is Shanghai Jingwu Intelligent Technology, established in 2019. Its algorithm that calculates a robot's route of travel for deliveries apparently has an accuracy rate of 99.8%, and multiple types of robots and various pieces of equipment can be linked through its cloud platform. The robots can make 70-80 deliveries per day, and a study from a large hotel chain in China showed that the workload of one robot was equivalent to the workload of one hotel staff member and one security guard, reducing labour costs by around $US1400 per month. The technology comes at an interesting time in China, where youth unemployment is still very high. Productivity gains like this through innovative technology will allow for different kinds of new jobs in the future, but the timing of productivity gains and new job creation is often lagged, and can be quite tricky in the short term.

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