Alphinity Sustainable Share Fund

MONTHLY REPORT – JULY 2024

Changing horses

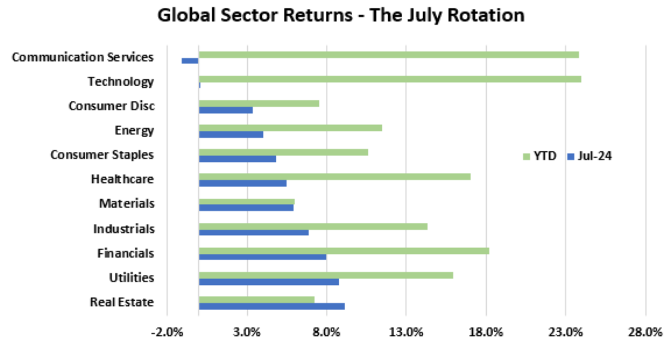
Market comment

We're pretty sure there's a proverb warning against changing horses midstream so for US President Joe Biden, a few months out from the November election, to decide against running again goes against centuries of human wisdom. Having said that, the clamouring for him to go was loud and ultimately irresistible, especially after the many physical and verbal stumbles, not to mention an attempt on the life of his main opponent which seems to have made him untouchable. Who said politics was boring? All this seemed not to worry equity investors in July however, with markets here and overseas touching record highs before some concern around US earnings led to a reversal in those high-flying tech stocks late in the month.

Our shares rose a tidy 4% in August, marginally outperforming the broader global market in $A terms, despite a 2% fall in the Aussie dollar flattering offshore returns. Japan's equity market either turned in a strong return or a meagre one, depending on the currency used. The Topix fell 0.6% in Yen, but large currency move translated that into a +6% move in $A. Currency is the perfect zero sum game, where there is always a winner and always a loser. The popular Yen carry trade, in which investors borrow in Yen to invest in dollars, came undone when the Bank of Japan raised its benchmark interest rate. Although only from zero to 0.25%, the BoJ also outlined plan to unwind its huge bond buying programme.

There was a huge sigh of relief on the last day of the month when our June Quarter inflation number was released. While still not good, it was less scary that the May number had been and was taken to be enough to keep the Reserve Bank at bay, for now at least. It's quite extraordinary how quickly market expectations can change. The market had been pricing in up to 50bps of interest rate hikes only three days before; now supposedly the US Fed is too slow to cut and the RBA needs to cut before the end of year! Inflation not exceeding expectations was enough to quickly change the narrative.

July was a month of rotation, driven mid-month by selling of Tech stocks as the US earnings season got underway. There was a degree of caution around the outlooks of some of the high flying mega cap tech stocks and investors were ready to hit the sell button on any vaguely bearish signal. A little of the AI hype deflated with semi-conductor stocks retreating from intra-month highs, while a slight miss on cloud growth hurt Microsoft and a miss on YouTube hurt Google, despite it over-achieving in its core search business. The chart below compares the global sector returns in July against the returns those sectors have achieved on a year-to-date basis. The rotation from Communication and Technology stocks into 'old world' sectors was clear, with some of those gaining most, even all, of their year to date performance in July alone. Property, Financials and Industrials were the best performers, and this broadening out in leadership is an encouraging sign.



Another disappointing move in commodity prices held back our Resource sector with iron ore falling 5% to $US100/tonne, oil losing 4% to $US80/barrel and copper also reversing much of its year-to-date rally. Weaker spot lithium prices continued to punish companies exposed to this metal which will likely be so important for the future.

Portfolio comment

The Fund performed in line with the market in July, with solid performances from positions in sleep apnoea machine maker Resmed and building materials company James Hardie; owning no Woodside Energy or Fortescue Metals also helped. This was partially offset by positions in resource companies South 32, Capstone Copper and Rio Tinto.

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)	4.1	7.0	15.3	5.4	8.0	9.0	9.9
S&P/ASX 300 Acc. Index	4.1	6.0	13.3	7.1	7.5	8.0	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 July 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 2010. The inception date for the returns for the Fund is 1 September 2010. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 1300 721 637 during Sydney business hours.

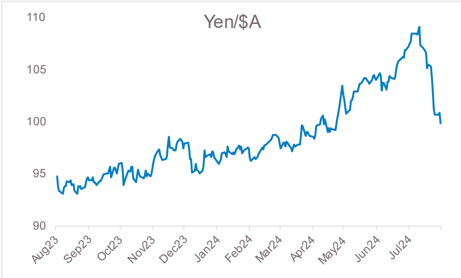
Market outlook

We've taken to waiting until the very last second to write our monthly outlook, given how much seems to materially changee day to day, never mind week to week. Just in July there was an assassination attempt on Trump; the incumbent US President forced to step aside from running; weaker inflation measures leading to a greater likelihood of a rate cut in the US and concerns evaporating here that we might raise; an initial strong rotation out of US large cap growth (despite the lower bond yields) into cyclicals, value and small caps. A somewhat different sector dynamic has applied in Australia with Banks taking another leg up; the weaker reporting season in the US and a move into defensives on heightened economic risks; and of course the distraction of the Olympics, not to mention even more geopolitical risks in the Middle East – if that is possible! Now we have to deal with the August reporting season in Australia, during which we can focus on fundamentals for a brief period.

What we do know is that inflation appears to be slowing in line with what western Central Banks want or expect, even if at times haltingly. That has already sparked interest rate cuts in a number of western economies (Canada, Europe, UK). A cut in the US now seems pretty much assured for September and a further two priced in by Christmas. The consequent fall in bond yields initially drove the market higher in July and sparked a rotation into cyclicals and value on the premise that the rate cuts will drive stronger economic growth. We have long been making the point that the context of rate cuts is just as important as the rate cut itself. Cutting rates to normalise from an elevated level in a stable economy with stable inflation (positive for markets), is very different to cutting rates into a weakening economy with still slightly elevated inflation (tricky). While western economies have been more robust than expected to date, they haven't been strong, and the latest data points and company anecdotes suggests things are slowing further at the margin. While unemployment rates remain by low historic standards, they are off their lows and slowly deteriorating, and any acceleration of that trend would be concerning for markets. There is no cliff in activity evident, but the risk of a cliff is certainly growing. The US Federal Reserve made the point recently about its dual mandate – maximum employment and price stability – for a reason. As such, while we think it is as fair to say that the US is about to enter a rate cutting cycle (and while not immediately here in Australia, the next move is most likely down as well), focus will likely then move quickly to the economic environment into and through that cycle.

That is very relevant for Australia, which has seen much of the market's recent strength coming from multiple expansion rather than earnings upgrades. In other words, it has been rising in anticipation of either lower rates (pushing valuations up) and/or materially better future earnings and any meaningful weakness in the economy could leave our market quite vulnerable. Weaker earnings will typically trump lower rates, at least initially, given the unknown multiplier effects. We saw that during the rapid selldown in large cap US growth in late July, despite lower bond yields, when earnings were weaker than expected. While we think expectations of earnings growth for our market of around 5-6% in FY25 and FY26 are largely achievable, it is likely that any sharper economic slowdown than is currently expected would be taken quite negatively. Tax cuts are coming through, immigration is ongoing if at a slower rate, and a generally lower starting point for rates versus elsewhere helps us relatively. The August reporting season will give us invaluable insights into the pace and likely path of the domestic economy. The focus is clearly moving from if and when they cut rates, to why and how much – at a time when market valuation is feeling a little vulnerable.

Two other factors we all need to take into account are China and Japan. Commodity prices have been soft lately and the lack of positive news out of China, particularly from its recent third Plenum, suggests ongoing weakness or, at best, lack of support in the near term. That matters for our market given the size of the Resource sector, even before we contemplate any future impact a China-hostile Trump administration in the US might have, should it eventuate. While the Resource sector appears cheap, we await some kind of catalyst or positive news flow from China to suggest a trough before we would get more enthusiastic. That said, we are more interested in some commodities (such as copper) than others (such as lithium) although this is more likely next year. It is difficult to see much support for the iron ore price near term.



A more recent phenomenon is the Bank of Japan raising rates in July to 0.25%, the highest level since 2007. This, along with rate hike fears in Australia dissipating, caused a rapid unwind of some carry trades, highlighted by the sharp movement of the $A/Yen rate in July. Time will tell whether there are any other carry trades that need to unwind in our market.

No doubt the election in the US will become even more front-of-mind in upcoming months and will create more volatility until November – and potentially after then as well – interest rates and the economy remain front of mind for now. The key anchor to have in these times is individual company earnings: get those right and you have the best chance of a positive investment outcome despite an uncertain environment.

Portfolio outlook

The Fund ended July in a reasonably balanced position but with a slightly defensive tilt. It maintains a modest underweight to the bank sector, given their high valuations and minimal earnings growth. Banks have seen a modest uptick in earnings expectations over the last year on the back of a resilient economy, and adding buybacks to the mix has seen that sector attract flows this year. In a market with minimal earnings upgrades and few good news stories we are reluctant to be too underweight banks. We are however conscious that any unwind of credit quality outlook (e.g. slower economy with no rate cuts) could spark weakness in the banks given their valuation starting point.

The upcoming reporting season will always throw up new individual ideas or reinforce existing ones. However given weakness in China, and potentially a lacklustre global economy, we see limited upside in commodity-exposed names apart from perhaps Gold. While valuations appear reasonable in the commodity sector, the earnings momentum appears less so, with some limited exceptions. Domestic cyclical companies continue to face the headwinds of a slowing consumer, reducing immigration support, less price leadership and ongoing wage pressures, and while we may no longer get a rate rise after the moderately better inflation number released this month, rate cut relief still feels some way away for now in Australia, unless the economy were to get noticeably worse.

So that leaves us to focus on owning the individual names that are showing earnings leadership in sectors such as Healthcare, Industrials, Insurance and the more defensive parts of Technology. Despite all the various macro machinations of the past year or two it is clear that positive earnings outcomes remain imperative for outperformance, and the portfolio therefore continues to be tilted towards companies in an earnings upgrade cycle.

BTW

There was a small frisson of excitement in some circles in July when a couple of indices hit big numbers for the first time: the US Dow Jones Industrial Average index (the Dow) passed 40,000 for the first time, and our own bellwether, the ASX300, finished at a record high 8026 at the end of July. Less noticed was that the ASX300 Accumulation index also passed 100,000 for the first time – but more about that later.

The Dow Jones is a pretty weird index: it is share price weighted, rather than market cap weighted like pretty much every other index in the world. That means a company with a $100 share price has twice as much weighting as one with a $50 share price. This makes absolutely no sense: when Apple undertook a 2:1 stock split in January this year, which had the effect of halving its share price, Apple's weight in the Dow also halved. Stupid. The Dow Jones is a poor marker of market returns and is rarely used by serious investors. All it really has going for it is longevity, having been around since the 1800s, but even that is a mirage as the components change frequently. Anyway, the reason it was of interest was that we recently watched an old movie that referred to the Dow, and the context was striking.

Local Hero is a classic, made in 1983 and set mostly in a quaint seaside town in Scotland. It is the audiovisual equivalent of comfort food, a familiar, gentle comedy with a poignant message and a great cast. It's a story before its time which addressed, among other things, corporate greed, environmental concerns and the conflicting motivations playing out in communities when large projects are being proposed. It was a treat seeing a very fresh-faced Peter Capaldi (then and now→) in one of his first screen roles, a reluctant oil executive with a talent for languages. Capaldi has since been in pretty much everything in UK film and TV, most famously spending a few seasons as Dr Who and as the grumpy star of political satire The Thick of It. Anyway, that's beside the point.

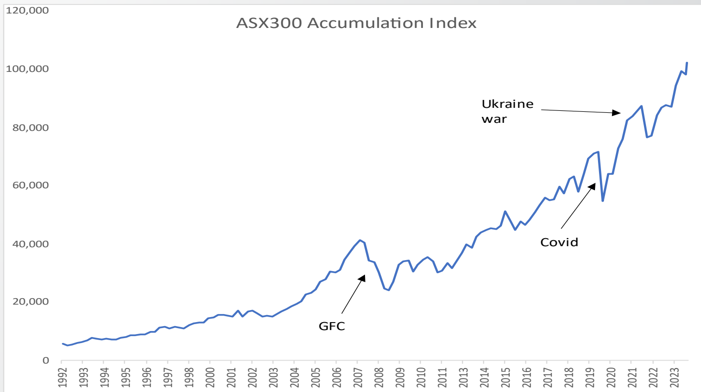
The point that prompted this reminiscence occurred in the opening scene of the film which shows the main character, Mac, speeding towards his office at Knox Oil in Houston and his car radio reported that the Dow was at 800. This month it punched through 40,000. Up 50x in 40 years! What a great thing it would have been back then to put all your money in the Dow stocks and go to the beach.

Well, yes and no. The Dow you would have bought in the early 1980s is very different to the Dow of today so you would have had a fair bit of active management to do along the way. Fewer than half its current companies were in the Dow 40 years ago, and many of today's Dow companies didn't even exist back then. Buying the Dow of then would have landed you with now-defunct companies like Union Carbide, Sears Roebuck, Kodak and the old General Motors, before its bankruptcy in 2009. You'd also have owned Tobacco stocks, if you had the stomach (lungs?) for that.

The Dow only includes 30 of the "best" US companies, as determined by some faceless committee in New York. It was founded by the Dow Jones media company, which also owned the Wall Street Journal. That company was bought by News Corporation in the early 2000s, but News subsequently sold the index business to Standard & Poor's, which also owns the more credible US benchmark, the eponymous S&P500. The 500 was launched in 1957 so doesn't have as much history as the Dow, which stretches back to 1885. S&P also owns our own ASX300 which is made up of the 300 most liquid Australian listed companies. The ASX200 and ASX300 were launched in 1992, prior to that all we had was the All Ordinaries Index, which contains all ordinary listed shares in it, about 500, hence the name. That's owned by S&P too. Hmm, sounds like a bit of a monopoly going on there. There are other index providers, like MSCI, so maybe just a cosy oligopoly, but the ASX200 and ASX300 dominate in this market.

One of the things about all equity price indices is that they ignore one of the most important components of equity returns: dividends. We and other equity fund managers always use the Accumulation Index as a comparator of returns, rather than the price index. While it's nice that the ASX300 price index almost quintupled since 1992, from 1650 to 8026 at the end of July, the real story is that the Accumulation index is up 17x over the same period, from 5767 to 102,375. Reinvesting dividends makes a huge difference to returns as Australian companies tend to pay out quite high dividends. There are tax advantages from dividend franking on top that are not captured in indices. But the media invariably looks at only the price index in its reporting and we are constantly annoyed by statements like "the market was only up 5% this year" when the real answer is more like double that!

For instance, there was a lot of angst about the market remaining below its 2007 (pre-GFC) highs until 2019. Twelve years going nowhere, what a waste! That's if looking at the price index: when you include dividends, the market topped its 2007 peak in 2013 and has hardly looked back. Admittedly, six years is still a long time to wait, but the GFC was an extreme event, narrowly avoiding financial meltdown is hopefully a rare event. The more relevant point is that the Accumulation Index has been reaching progressive highs for years now, notwithstanding the occasional pullback, and passed 100,000 recently. The Asian Debt Crisis in 1998? You can't even see it in the chart below. Same with the tech-wreck in 2000-01. "Dislocations" of size more recently, like the Financial Crisis in 2008-9 and Covid in 2020 are visible but, unless you panicked out at the bottom, you've been well rewarded by the share market.



This is one of the key tenets of investing: over time, equities tend to produce pretty good returns, even if you need to be willing to accept volatility in those returns. You wouldn't want to plunge all your money into the market the day before one of its occasional big vomits but they are quite rare and, if history is any guide, the big falls generally don't last forever. So, unless you panic and sell at the trough, you can usually make it back before too long. Particularly if you look at it correctly – total return, with dividends included.

Travellers' Tales

Jessica donned her workwear and headed to Western Australia this month to conduct some research into the activities of various mining companies with a focus on the environmental impact, worker conditions and their dealings with traditional owners. She travelled through various parts of the Pilbara and in traditional lands around Karratha.

It was a balmy mid to high 20s degrees during the daytime in the Pilbara – a welcome change from Sydney's midwinter – but quite cold at night. She stayed for part of the trip in a mining donga, the accommodation provided for fly in/fly out workers at a mine in the Pilbara. It wasn't fancy: far less glamorous than some she'd seen on previous visits, but it did the job. Breakfast and dinner were served in a communal mess hall and generally lacked fresh vegetables, an issue in many remote areas, but was still pretty good. The camp was not well-lit at night and, being so remote, there was little ambient light. She could imagine that it could be quite intimidating for young women staying at these camps away from their families and friends.

While the traditional owners have been in the Pilbara for millenia, mining and related industries have been there for several decades. Billions of tonnes of rock has been shipped off to other countries since the 1960s. The main destination recently has been China but South Korea and Japan were key markets in earlier days and India is moving up quickly. Despite the Pilbara's vast area the evidence of mining is still clear to see. Jess saw some mining sites from the 1970s that had not yet been rehabilitated.

It wasn't all mining – one of the great parts of trips like this is meeting with the locals, particularly the elders and traditional owners from the Robe River Kuruma Aboriginal Corporation. It is very much a double-edged sword for these communities: gaining royalties, employment and economic development in exchange for the impact on culture. This trip helped Jess to remember that culture is not just an artefact: a cave, or a single place for our indigenous people; it also a profound connection to land and their ancestors. During the trip, the elders shared dreamtime stories, talked about their childhoods and connection with Country, and shared some of the challenges in dealing with large multi-national mining companies. She heard some great stories about elders who started small design businesses which have since taken them far and wide around the globe, but also sad stories about the stolen generation, and the ongoing prevalence of addiction and mental health challenges that plague these communities.

The dynamic between mining companies and traditional owners has been challenging to say the least. Since the destruction of Juukan Caves several years ago, many mining companies have improved their cultural heritage practices and have been working very hard to avoid any unplanned impacts on heritage, especially in the Pilbara. However, there are still many areas that need improving, including rehabilitation, overuse of water and payment of past compensation under old agreements. Much of the challenge is related to the power imbalance between large mining companies with almost endless resources, and the small Aboriginal organisations that rely primarily on royalties and Government grants to fund their activities.

She also got to visit the Burrup Pensinsula and see some indigenous rock carvings. These carvings, nestled in the Dampier archipelago, tell the story of 50,000 years of human existence. They are described as the largest outdoor art gallery on the planet. They are also situated across the road from a new urea plant and very close to a proposed gas processing project. The local Aboriginal Corporation is rightfully concerned about the impact on those carvings as a result of air pollution from these developments.

An ongoing challenge for miners in remote areas, so far from the electricity grid, is energy. Until now it has been largely provided in the form of diesel which has been used to run generators and heavy machinery. Miners are just as concerned about their carbon footprint as the rest of us, and are going to great efforts to minimise their carbon footprint. The obvious answer is to use renewable energy and electrify everything they possibly can. The sheer scale of what they do increases the challenge though, especially the size of the enormous mining trucks they all use. Presently these can be refilled with diesel and back to work in just a few minutes but those that have been converted to running on electricity need a constant supply of batteries ready to be swapped in so as to minimise lost time. But the various companies are spending a lot on building their own generation, with vast wind and solar farms under construction, supported by grid-scale batteries.

Overall, the trip greatly improved our understanding of some of the issues involved in mining in traditional lands, and has generated many engagement topics to follow up with the companies involved.

Top five active overweight positions as at 31 Jul 2024	Index weight %	Active weight %
Goodman Group	2.5	2.8
QBE Insurance Group Limited	1.1	2.3
Medibank Pvt Ltd	0.4	2.1
Suncorp Group Ltd	0.9	2.1
Resmed Inc.	0.8	1.9

Asset allocation	31 Jul 2024 %	Range %
Securities	91.6	90-100
Cash	8.4	0-10

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