# Alphinity Sustainable Share Fund

MONTHLY REPORT – October 2024

# Interesting times

## Market comment

October and November have become a little like mini-reporting seasons, with vast numbers of AGM updates being delivered to the market and three of the major Banks releasing their results. With little in the way of positive vibes the share market faded a little this month, the ASX300 (including dividends) falling by 1.3%. The recent trend of disappointing operating conditions and earnings downgrades largely continued, with some notable exceptions, but the overall market fell only a little which has resulted in an already expensive market becoming even more so. We're not sure how this will be resolved: experience tells us it can go on for some time but not indefinitely; something will have to give at some point. Either earnings upgrades will resume or the market corrects to return it to a more "normal" valuation multiple.

The old curse is: "may you live in interesting times". The next few years are shaping up to be interesting indeed with the election of Donald Trump as US President. The election has been the big caveat over everything for some time. The campaign had been bubbling away for ages but since the current President dropped out of the race in July the two parties have been so close it would be foolhardy to make any investment decisions on that basis alone. Even now it is very hard to predict given the range of possible outcomes is so wide.

Another caveat is China. It has made several attempts to jump-start its struggling economy using monetary and fiscal stimulus. So far those attempts have fallen into the void but at some point the Chinese central government might get serious and do something with tangible impact. In addition to all this, the market had to contend with the US third quarter reporting season, with two thirds of companies having reported by the end of the month. Despite a solid beat rate on earnings, share price moves have tended to be more sensitive to guidance outlooks, and this was particularly noticeable among mega caps like Microsoft and Meta/Facebook. There does seem to be a degree of investor fatigue emerging among some of those high-flying stocks: while they are still delivering impressive earnings growth, wide ownership and quite expensive valuations means they need to deliver both solid results and guidance upgrades in order to maintain their current levels, let alone attract further buying.

October was a month the Bond market would like to forget. Yields rose sharply, up 0.5% in both Australia and the US, the largest monthly move in some years. With the benefit of hindsight, the large rate cut by the US Fed last month has left many wondering…why? Admittedly the jobs data were a concern, but there are many more measures such as stock markets, bitcoin, gold, home prices and national debt which are still at all-time-highs. The Consumer Sentiment survey asks households in the US whether they plan to take a foreign vacation, the most discretionary type of consumer spending, in the next six months. This also hit an all-time high, with 22% of US households planning a trip. Let's hope this is because people are confident about their prospects rather than just wanting to escape the USA!

Commodities were broadly weaker in October with iron ore falling 5%, giving back some of the gains from the prior month as China stimulus excitement faded. Lithium stocks resumed their downward trend after miners delivered underwhelming quarterly reports, while the price of Copper, usually considered the best economic 'barometer', fell by 5%. With the incoming US President promising much higher spending, the already large deficit will be increasing further so the inflationary trade could be back on: this should support commodity prices. Perhaps the most certain outcome is that market volatility is going to increase.

## Portfolio comment

The Fund outperformed the market nicely in October. Contributors to returns included finance platform HUB24, sleep apnoea device maker Resmed, QAN, safety app Life 360, being underweight supermarket Woolworths and not owning IT company WiseTech; partially offsetting those however were positions in Super Retail Group and miner 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) | -0.7 | 2.8 | 26.8 | 5.9 | 8.8 | 9.4 | 9.9 |
| S&P/ASX 200 Acc. Index | -1.3 | 2.2 | 24.9 | 7.6 | 8.1 | 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 October 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

October was characterised by a reversal of the prior month's sector rotation as bond yields rose sharply and China failed to sustain the stimulus hype, pushing most markets lower. A focus back on earnings, with various quarterly updates and AGMs, was good for the Fund which performed well during a challenging month.

China's intent around stimulus has so far been long on words but short on numbers. Investors started to conclude that China has really been pursuing risk mitigation and stabilisation rather than seeking economic expansion, and this led to falls in the prices of most commodities. As a result, September's rotation of "sell expensive banks, buy cheap resources" faded, with banks outperforming miners once again in October. Gold was an exception: it continued its rising trend (up 33% in 2024 to date) despite the stronger $US. And even with elevated tension in the Middle East, the price of Oil remained relatively subdued as the market focused on excess supply. This situation however remains highly volatile and could change any day.

Of more concern at home is the continuation of earnings downgrades on the back of disappointing quarterly results and overall soft AGM updates. Despite the market trading at the reasonably punchy multiple of around 20x earnings, those earnings keep being revised the wrong way. In order for the stock market to sustain its current level, we need to see a sizeable amount of stimulus in China and/or rate cuts which translate into meaningful earnings lifts. Earnings downgrades have been taking place across most sectors with only Banks and Insurance companies, which should benefit from sustained higher cash rate and bond yields, standing out on the positive side. The only other positive sector has been Healthcare, with pleasing AGM outlooks from Resmed and Ansell as they recover from the chaos of Covid and optimise their operations for a more predictable environment.

On the other side, AGMs so far have highlighted ongoing cost of living pressures with consumers trading down further and smaller basket sizes. In addition, increased competition, discounting, and high transportation costs are all putting pressures onto Retailers. There have been company-specific downgrades across both Staple (Woolworths, Metcash) and Discretionary names (Wesfarmers, Nick Scali, Flight Centre, Webjet, Lovisa). Companies exposed to housing activity also continue to face pressure as elevated interest rates dampen demand (e.g. Reece, Reliance, James Hardie). Mining company quarterly production reports were disappointing across the entire commodity spectrum, with lower realised prices and higher costs.

The "G" of ESG – Governance – also came to the fore this month with the share prices of both Mineral Resources and WiseTech Holdings (neither owned by the Fund) under great pressure as their founders faced intense scrutiny around their personal behaviour.

We are all too aware of two events that will no doubt shape the market's direction in November: the tightly contested US election, and the expected announcement of the quantum and allocation of the Chinese stimulus to be deployed. The two are somewhat inter-related as a Trump victory could trigger larger Chinese stimulus to offset the anticipated tariff lift. November is promising to be another turbo charged macro-driven month! However as we have seen repeatedly through this year, the macro usually reverts quickly back to an earnings focus as the question we and the market will be asking is "how will this affect future earnings?".

Overall, the market feels expensive right now and at this stage we have doubts as to whether either the US election or the China stimulus will meaningfully lift underlying demand, and therefore the trajectory of earnings, we could well be facing a period of market consolidation. Having said that, the cut to the corporate tax rate proposed by Trump could be a decent source of earnings upgrades for US companies, even if only one-off. Equally, "higher for longer" interest rates as a result of inflationary tariffs also need to be factored into valuations, as does the earnings trend. We don't have perfect foresight so, given the significance of these events, prefer to take a reasonably balanced approach.

## Portfolio outlook

In light of the earnings pressure facing most sectors and the macro events detailed above, the Fund is holding a broadly sector-neutral position, which we believe to be the most appropriate strategy for now. It remains overweight the Insurance sector given the ongoing positive combination of premium growth, cost deflation and higher yields. It also has an overweight to Healthcare, Technology, and some companies in the Industrials and Utility sectors which have idiosyncratic positive earnings surprise stories. The Fund remains underweight both Consumer Staples and Discretionary but still retains some companies with offshore consumer exposure as well as a couple of domestic retailers which are better able to manage the present challenging conditions.

There are some defensives and market-sensitive companies, but no large tilts either way. It is neutral Resources, holding some exposure to gold, base metals and bulk commodities like Iron Ore rather than steel makers or lithium or rare earth miners. We will carefully revisit these positions after another research trip we are taking to China in November, and of course in the light of any additional stimulus announcement.

The Fund has slightly increased the modest underweight to the major Banks but maintains a solid exposure, despite elevated valuations, as their positive earnings revisions stand out relative to the downgrading market. To go more underweight we would need to see either a deterioration in their earnings prospects and/or an improvement in the earnings outlook of other parts of the market. We will be watching with interest the upcoming Bank reporting season.

With a major investor presentation forum, research trips to China and the US and the macro events detailed above all about to happen, we expect November will be a time rich with new information. As always, our relentless focus on owning quality, undervalued stocks undergoing relative earnings upgrades remains a critical anchor that allows us to stay ahead in a very dynamic and challenging environment. We will continue to make decisions to shift positions in the Fund based on actual earnings leadership changes rather than sentiment changes driven by macro forces.

| Top five active overweight positions as at 31 Oct 2024 | Index weight % | Active weight % |
|---|---|---|
| Goodman Group | 2.6 | 3.2 |
| Brambles Limited | 1.0 | 2.8 |
| ResMed Inc | 0.9 | 2.8 |
| Suncorp Group LTD | 0.9 | 2.3 |
| Medibank Pvt Ltd | 0.4 | 2.1 |

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

## BTW

Nuclear energy has become a hot topic in many parts of the world. In Australia, the proposal by the Federal Opposition to use nukes to replace our ageing coal power stations has caused a lot of heat but, thus far, not a lot of light (so to speak). The biggest pushback is generally the risk of accidents, although the amount of intractable waste it would produce comes a pretty close second, and three examples are invariably given: Fukushima, Chernobyl and Three Mile Island. Fukushima in Japan (2011) was caused by an earthquake and tsunami; Chernobyl in the then USSR (1986) by incompetence and poor design, and Three Mile Island, in the US state of Pennsylvania (1979) because of incompetence and equipment failure. All required extensive and expensive clean ups and left decades-long legacies of pollution. The US and Canadian public, however, seem to have a good level of acceptance of nuclear power, a long way from the Simpsons' portrayal of evil nuclear power plant tycoon Montgomery Burns and his three-eyed fish, Blinky. But the staggering amount of power required to keep up with increasing demand, combined with the need to de-carbonise the world, means that nuclear power can no longer be ignored.

Remember a few years back when Bitcoin became the best way for computer geeks to make a quick buck? The biggest cost of mining crypto was the electricity needed to perform the hugely complicated mathematical tasks required. While Bitcoin mining could be done in garages or dorm rooms, new generation AI requires centralised data centres (DCs), huge warehouses filled with servers to process and store data, which need vastly more power. One of the biggest costs of running these centres is the cooling required to stop the chips from overheating.

It's an exciting time to be alive during the AI revolution, a technology which could rival other break-throughs like television, phones and the internet. Our kids and grandkids will likely live in even more exciting times as these technologies evolve – hopefully for the better. From an equity market point of view, some of the winners from AI are obvious. Shares in Nvidia, which builds chips for AI, and companies exposed to DCs, like NextDC and Goodman Group, have rocketed higher this year. But there are plenty of other possible winners, such as the cooling companies and the power companies supplying DC demand. Not to mention battery companies and uranium miners who have also found themselves in the middle of this arms race.

This little diatribe was sparked by a recent report on Bloomberg that Three Mile Island (pictured here) was being resuscitated, having first been re-named the Crane Energy Center, no doubt to remove some of the negative vibes from the meltdown. To be fair, it never completely stopped – the reactor that didn't melt down was mothballed in 2019 when nuclear became uneconomic at a time of low gas prices. It is now being un-mothballed and its entire output has been bought by IT behemoth Microsoft to power its AI activities. Consultant Northbridge Energy Partners summed it up well: "This global arms race for power arose pretty quickly, and it's like nothing we have ever seen before." It's hard to argue with that, especially when we've recently seen the so-called hyperscalers position themselves to secure their future power.

Big Tech is going nuclear in a big way. Earlier this year, Amazon paid $US650m to buy a 960MW data centre in Pennsylvania adjacent to a nuke and has many more data centres in planning. Constellation Energy, one of the biggest providers of nuclear power in the US, also signed a deal giving Microsoft the rights to receive power from nuclear sources. Constellation has renamed Three Mile Island the Crane Energy Center, no doubt to remove some of the negative association with a meltdown. Interestingly, Three Mile Island was also the scene of the epic battle with Wolverine in the move X-Men Origins, shown here in a clip from the film. Microsoft has also signed a nuclear carbon credits deal with Ontario Power Generation for its operations in Canada.

According to UBS estimates, Microsoft will pay $US125 per MWh as part of the Power Purchase Agreement, $30 of which will come from a 45-year tax credit. To put this into context, the current price of power in the US is around $50, so Microsoft is willing to pay more than double the current market price in order to be more green. It is a so-called "front of meter" deal: Microsoft will not actually locate a data centre next to the plant, it is just paying for the nuclear power to go into the grid and taking the power they need back out of the grid wherever its DCs are located. Had they chosen to co-locate, the price of the power would have been even higher. There is a large premium required for the hyperscalers to get the faster time to power colocation would provide, so the already high $US125/MWh price would end up even higher, north of $175.

It's going to be an interesting few years ahead for nuclear power. The debate will rage on in Australia, and has evolved into a political issue with the Government solidly opposed and the Opposition coming under fire for its lack of cost estimates around the eventual build-out of nuclear reactors. Nuclear is being portrayed as a "cheap" form of energy, citing the experience of Ontario, but the cheapness there seems to come from substantial government subsidies rather than efficient operations. Global comparisons are usually fraught but no government could look at the time frames and budget blow-outs even in experienced nuclear nations and not pause for reflection. Anyway, what happens in Australia matters little, the nuclear demand outlook will be driven by other countries like France, Spain, South Korea and Japan, and especially the US. Google recently teamed up with start-up Kairos Power to build seven small nuclear reactors (SMRs) as it seeks the power it data centre needs and, not to be left out, Amazon has said will be building four SMRs with X-energy. In theory SMRs should be (relatively) quick and (relatively) cheap to build so they could end up being a solution to our energy needs too, but the uncomfortable fact is that no one has actually built and operated one yet, so the theory now needs to be confirmed by reality.

## Travellers' Tales

Jessica and Jacob both were in North America in October. Jake headed to Chicago and Las Vegas in the US and back within a week, mainly to see consumer companies. Las Vegas is conference central, there is always some business reason to go there. It is also quite a fun place to go, as long as it's for only a brief time and his three days was more than enough.

He stayed at the Trump Hotel In Vegas – not to express support for the soon-to-return US President but because it was offering a really good deal on accommodation. Unsurprisingly, there was a store in the hotel packed with Trump merchandise. There you could pick up many styles of MAGA hats, posters of Trump raising his fist after the first assassination attempt, a bathrobe, some Trump wine (which is hard to explain as Trump is apparently a non-drinker) or even an inflatable ring to take to the hotel pool.

Meanwhile Jess headed to Canada primarily to take part in a panel at the PRI (Principles of Responsible Investment) conference in Toronto. Alphinity has been a member of PRI pretty much since we started but it was an incredible honour for her (and by extension for Alphinity) to be asked to be part of an AI panel as a result of the industry-leading work she and her team completed this year on our behalf, in conjunction with the CSIRO, in the area of responsible use of Artificial Intelligence. Jess was one of only a few Australians on the big stage during the four day conference.

The conference was only part of her trip, however. She spent time in regional Canada with her ESG hat on, speaking to operators in the oil and gas industry as well as various indigenous groups. She also saw supermarkets and banks in Toronto before venturing to New York to meet with a number of financial companies, and spent a Saturday checking out the highlights of the Big Apple before flying home. One interesting takeaway from the trip is that in Canada, CCS (Carbon Capture and Storage) isn't the dirty abbreviation it appears to be in Australia. Despite public scepticism here, CCS technology is used in Canada and is generally accepted as a viable way forward for the Oil and Gas industry, with strong backing from the Canadian federal and provincial governments. We are ambivalent about CCS, willing to be convinced by the evidence one way or the other before discounting it completely as a partial solution to our own carbon emission problem.

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