Alphinity Sustainable Share Fund

MONTHLY REPORT – FEBRUARY 2025

Weeks, Months and Years

Market comment

Russian revolutionary Lenin supposedly said "There are decades where nothing happens; and there are weeks where decades happen." It feels as if we've been through several decades since the coronation of King Donald of Florida in January. A few words from him and the whole world order seems to have been turned on its head. Wars are being ended (maybe); trading relationships are being up-ended; alliances which have lasted almost a century are being brought into question. And some of the answers to those questions are quite disturbing.

We feel as if we've used our four-year quota of "Trump" in these pages already and we're only a few weeks in. The US President has been all over the place in the weeks since his inauguration, making waves wherever he goes. Meanwhile his unelected sidekick has been creating veritable tsunamis, prowling through the government in the name of efficiency and following the classic Silicon Valley principle to 'move fast and break things'. What could go wrong when you're dealing with millions of civil servants and a federal budget of trillions of dollars?

At home, reporting season brought with it the usual rich seam of information. Coming at a time of great volatility offshore it turned out to be a fairly spiteful period, with companies reporting small misses to earnings or giving soft commentary being trounced mercilessly. Tiny beats were sometimes ignored, sometimes rewarded generously. How much of either reaction has longevity remains to be seen but, looking at it from a high level, it is possible that a rotation of market leadership is underway. The huge Bank sector, which had boomed in 2024, suffered a modest intra-month reversal but still accounted for about a third of our overall market (ASX300 including dividends) fall of almost 4%. The much smaller Tech sector was the worst performer, falling 12% while Healthcare (-8%) and Property (-6%) were close behind, as was Energy (-4.5%). The best outcomes were in Utilities and Telecoms, both up around 3%.

The equity market moves offshore have been interesting, and we saw what might be the beginning of a rotation out of the US into Europe and China. After becoming accustomed to seeing US tech stocks lead market returns over the past couple of years, it was strange to see performance being driven by European stocks (+4%) and Emerging Markets (+1.3%). Hong Kong rallied 13% in $A terms while US stocks fell, down 0.5% (S&P500) and down 3% (Nasdaq).

The run in the Magnificent Seven (large US tech stocks) showed signs of waning and, with valuations that had been inferring perfection, even delivering good results didn't satisfy the market. The US market finished the month on a multiple of 19.5x next year's expected earnings, which compares with Europe at 13.4x and Emerging Markets at 11.4x. After de-rating slightly this season, Australia is currently trading at 16.7x its next year's earnings, sitting between Europe and the US in terms of valuation but with the heavyweight Commonwealth Bank, the most expensive bank in the world, being partly to blame.

The Reserve Bank (RBA) delivered to us its first rate cut in almost five years, providing some relief to homeowners, lowering the benchmark rate 0.25% to 4.1%. The hope that this might be the first of many cuts appeared to be dashed, with Governor Bullock saying this is likely to be a 'one-off' in the short-term. There were some notions of Albo calling the election slightly early to capitalise on the cut but it now looks like being closer to its May deadline.

Commodity prices were mixed, with Iron Ore fairly flat, Thermal Coal 11% lower and the base metals all rising, and Copper +6%. Oil has been in a $US70-$80 trading range pretty much for the last three years but OPEC's recent decision to increase oil production by 139,000 barrels per day from April has applied a degree of downward pressure, sending it into the high $60s. This will be good for economic growth but, of course, not so good for oil and gas producers.

Portfolio comment

The Fund performed in line with the market in February. The best contributors were health insurer Medibank Private, packaging company Amcor, insurers QBE and Suncorp, and airline Qantas although not owning software group WiseTech Holdings (see BTW) contributed nicely. These however were partly offset by detraction from payment platform Block, property developer Goodman Group, hearing device maker Cochlear and not owning registry company Computershare.

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)	-3.7	-2.7	11.6	8.2	9.3	8.7	9.8
S&P/ASX 200 Acc. Index	-3.8	-2.6	9.7	8.9	8.8	7.5	8.7

* 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, 28 February 2025.

^ 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

What happened to the market's euphoria of January? We were expecting the return of a degree of volatility, and volatility we've certainly had! An intense flow of geopolitical and macro-economic news combined with a reporting season at home and in the US kept us and the market busy in February.

In the US, the euphoria since Trump's election is starting to give way to fears there that tariffs might not just be headwinds to global growth but might also be inflationary for the US consumer. Government jobs are very much at risk too. Consumer sentiment dropped sharply, economic activity in the Services sector started to contract for the first time in years, and retail sales appear to be softening. If the economy is weakening just as inflation lifts again, the US Federal Reserve's (Fed) job will become quite tricky.

At home, the highly expected rate cut was well received but it came with a hawkish tone, essentially warning that the market should not expect too many more cuts this year given the strength in employment, political parties' spending promises ahead of the imminent election, and the soft currency. We also expect that renewed inflation pressure in the US will also make the RBA cautious.

We have observed over the last few months that the Australian market had become quite expensive, having been pulled along with the US tech-driven euphoria for the past two years despite ongoing broad-based negative earnings revisions across most sectors. For the market to justify its current multiple, let alone continue growing, we really needed to see earnings revisions start turning positive. Yet the February reporting season brought with it more downgrades, almost -2% across the whole market. The heightened volatility experienced during the month – one of the more extreme we have witnessed outside times of crisis – highlights the market's desire to rotate from expensive winners into cheaper laggards, although this would break the normal correlation between earnings surprises and share price performance.

On average, while high multiple stocks with positive earnings revisions kept beating many didn't outperform, while those with poor momentum often outperformed, despite not beating expectations. In-line, or even a hint of bottoming, was the new up for prior poor performers this reporting season, although whether they become true earnings upgrade candidates going forward remains to be seen. The rising tide can lift all boats but only for so long; those with holes in them tend to sink eventually. Price reactions were severely amplified this reporting season for a host of speculated reasons, including increasingly stale earnings forecasts, increased hedge fund short squeezes and selling in longs that failed to upgrade. From a fundamental perspective, looking at earnings – which ultimately drive the share price trajectory of stocks over time – and having spoken with most large company CEOs over the past month a few observations stand out. Firstly, the earnings leadership and price momentum of the big banks began to wane a little. This sector really carried the market in 2024 as it was one of the very few to post ongoing positive earnings revisions, even if they were small ones. In this reporting season we saw some potential cracks. Net interest margin on average disappointed a little as their funding costs went up and customers looked for higher yielding deposits.

While the economy and consumer has been resilient, some aspects of credit quality showed small signs of deterioration, potentially lowering the potential for earnings upgrades from better bad debts. This could be an important inflection point given the elevated valuation of the Banks. While we wouldn't yet call it definitive, especially as the rest of the market got decent downgrades, it is certainly making it harder for bank outperformance to the same extent as last year. General Insurers reported their first fall in the rate of premium growth in recent years, which triggered concerns for some. The other side of the coin, however, is that claim costs are deflating, keeping margins at elevated levels.

Resources, the cheap end of the market and the obvious beneficiary of any market rotation that might take place, disappointed once more as lower commodity prices and higher operating costs keep pressure on earnings. The threat of US tariffs is not helping. All eyes are now on China's National Party Congress in March. Will it provide the boost required to offset trade war concerns and drive commodity demand up? We have doubts but will be on the ground there to get insights into any changes.

The market also wants to buy the unloved retailers (amongst other unloved stocks). Here too, despite the rate cut and strong employment numbers, the down-trading pattern persists. It does feel, however, that spending is stabilising, and not deteriorating any further. The Property sector, which has also been unloved, is at last seeing signs of stabilisation too. Retail mall values were well supported and Industrial remains strong but this time there was also some early signs of improvement in the beaten-up Office market, where the occupancy of good assets is lifting. Some have called the bottom of the Residential construction activity too, which could at some point translate into positive earnings revisions.

Despite the market's desire to change we don't think earnings leadership in the market has shifted sufficiently to warrant a wholesale rotation of the portfolio. We suspect that a number of positive reactions may be hard to sustain for long. For this reason, we remain somewhat defensively positioned, with the only changes to the portfolio either way being earnings surprise related. We are however alert to the 'vibe' that the mood is for change (Trump inspired?), but any change in leadership needs to be supported by an actual change in earnings direction which is largely yet to happen.

Portfolio outlook

We believe the portfolio is well positioned for a continuation of the current volatile environment. We have shifted over recent months to become a little more defensive, trimming some of the more 'expensive' exposures, where expectations have run ahead of ours, while holding onto some select growth stocks where valuation remains reasonable and our conviction on earnings upside is still above market expectations.

We have further fine-tuned our positions this month on the back of company results and outlooks. We have further slightly reduced our Bank exposure, as earnings upgrades are more challenged and valuations remain elevated. We have reduced some of the more expensive exposures in the Health Care and Technology sectors, taking profit and selling out where our earnings upside conviction has reduced.

We have taken Resources back to an almost neutral sector position with higher gold and iron ore spot prices, although we will re-assess the earnings outlook after our trip to China in March. We have also added to select consumer names and taken a small number of new positions where we see earnings upside. We do however remain underweight staples as we continue to see the sector being challenged with micro, macro and regulatory headwinds. We have added to some of the defensive stocks in the property and telecoms spaces where reasonable valuation has combined with earnings upgrade potential to provide a compelling exposure.

While we expect some change in earnings leadership this year, convincing genuine new leadership is not yet apparent, despite there having been an initial swing to the more unloved parts of the market. Our focus on valuations, earnings revisions and the quality of those earnings provides us with a good anchor to navigate this volatile market.

Top five active overweight positions as at 28 Feb 2025	Index weight %	Active weight %
Medibank Pvt Ltd	0.5	3.4
QBE Insurance Group Limited	1.3	2.9
Rio Tinto Limited	1.7	2.6
Suncorp Group LTD	0.9	2.5
Qantas Airways Limited	0.6	2.4
Asset allocation	**28 Feb 2025%**	**Range %**
Securities	97.7	90-100
Cash	2.3	0-10

BTW

ESG (Environment, Social and Governance) has become a bit of a dirty term in the US under the new President, with active hostility towards people making decisions based on anything other than strict financial grounds. That's not happening in Australia (yet, at least!) and certainly not at Alphinity: ESG has always been and will remain an important part of the way we look at companies. Considering risks and opportunities is a key input to our investment analysis and wilfully ignoring ESG would not be doing a good job, in our view. While sometimes non-financial, they usually ultimately are and we've found that thinking about all aspects of a company's performance often gives you a good 'heads-up' on emerging issues that will become financial at some point.

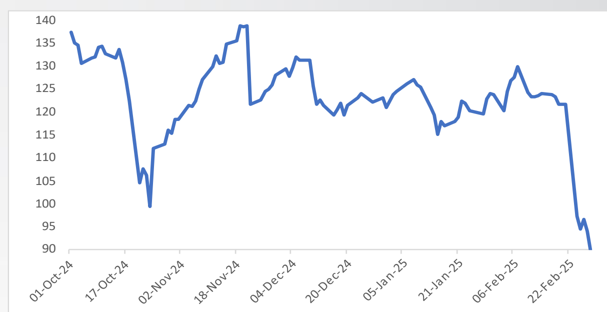
Notwithstanding the very real potential costs of E and S, academic studies suggest that Governance is generally the area in which most value is destroyed. While there are examples of companies which have poor governance but still performed well from time to time, most of the time it is a predictor of the opposite.

The cost of poor governance on shareholder value was once again brought home to us and the market this month with the widely-reported shenanigans involving logistics software company WiseTech Holdings. WiseTech has been a market darling in recent years, a strong share price performer with a good product (logistics software). It has executed well and grown earnings nicely. We have been more wary on the basis of its sky-high multiple and concerns around governance.

The governance issues came to the fore in October last year with media stories around a court case involving the founder and CEO and a former (shall we say) 'love interest'. It exercised the attention of the press for a few weeks and the WiseTech share price fell from $130 to $100. The difficulty for the WiseTech board was that while any other CEO would probably have been out on their ear, this particular CEO still owns 37% of the company. In normal companies the CEO is there at the behest of the company's directors; the reality at WiseTech was/is that the directors were actually there at the behest of the CEO – not a comfortable position when the principal's principles are involved!

The board said it would remove the founder as CEO role and create a new consulting role with a fat salary but no legal standing, with the advantage that all payments to him (and apparently $250m worth of share sales by him during blackout) would no longer need to be reported to the market, as is the case for key management personnel. A shadow CEO in effect. Not an optimal governance outcome but one the board obviously felt necessary to keep WiseTech's access to the founder's apparent brilliance. Anyway, the true believers held their noses and looked away. Everyone thought it had been dealt with and sort of forgot about it, and the shares recovered most of those losses fairly quickly.

The company revealed this month however that the new arrangement was not working. Then fresh media stories surrounding the founder's personal life came out. We won't go into all the salacious details about what was allegedly done and said to whom (we'll leave that to our premier business journal, The Australian Financial Review!) but one can only surmise that the founder was seeking conditions the directors were not willing to provide. The founder also threatened the board with defamation action if it released an outside legal investigation into his behaviour, which doesn't suggest much confidence in the outcome on his part. Four of the six directors, including the Chair, resigned on the same day. The impact on WiseTech shares was substantial and immediate, not dissimilar to the October incident. They dropped more than 20% that day and kept going; despite that fall, at $90 which it closed the month on, its multiple only improved it to ~80x this year's forecast earnings: still far from cheap.



Where will it go from here? There still seems to be a lot to play out. WiseTech released its first half result in February. The result itself was fairly irrelevant, missing expectations a little and getting small earnings downgrades. More importantly when all the directors resigned the founder appointed himself Executive Chairman. This is a big governance red flag even though fairly common practice in the US. He also appointed a couple of new directors, none of whom could really be considered independent, and is searching for some more so the company can comply with ASX listing rules. He also said "I am WiseTech. There is no WiseTech without me." This might be accurate but, in our view, to have the fate of a $30 billion company inextricably tied to a man in his 70s who doesn't look particularly healthy at the best of times surely must trouble shareholders. In fact, we struggle to see how people with anything other than a very short-term view could be prepared to remain invested in such a company.

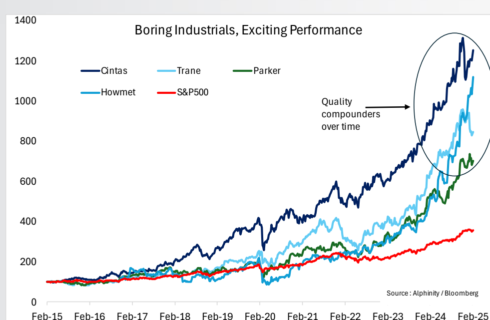
The fact remains that, even after the recent share price fall, WiseTech trades on a multiple of >80x FY25 forecast earnings and ~60x FY26. We doubt that the founder will still be there for enough time for the company to earn enough to recoup the current share price! It seems like a good business but we've found, over the years, that tiny cracks in the dam wall such as we've just seen can easily turn into a flood. What's the right multiple to apply – is it 100x as it was recently, or 60x, or 30x, or maybe 10x? The outcome of a smaller number would be very costly for shareholders, especially any new shareholders buying in at this "cheaper" price.

To some extent we can understand the founder's frustration: why are you criticising me after all I've done for you? I am the company, you minority shareholders are just being dragged along by my brilliance so don't criticise, just be grateful! Thing is, though, when you take other peoples' capital, which is what happened when he listed WiseTech on the share market, the people who provide that capital have a right to ask questions and get reasonable answers. So we are remaining on the sidelines for now, watching the show with fascination and a degree of horror.

Traveller's Tale

After a volatile fourth quarter earnings season in the US many of our global PMs hit the road to meet with companies and get a deeper understanding of recent results and to help find new ideas. Chris went to the US to attend two conferences and also visited a large of number of companies across various industries taking in aerospace, equipment manufacturing, waste management and uniform making.

While areas like uniform cleaning and waste management might see some readers tune out due to boredom, and we acknowledge they're not as 'hot' as companies like Netflix, Apple or Tesla, these seemingly boring' companies can actually be 'quality compounders' over time. Chris met with Cintas, the largest US manufacturer and distributor of corporate uniforms; Trane, industrial air conditioning and heating equipment; Howmet, provider of engineered materials for aviation; and Parker Hannifin, which makes aerospace systems. This chart shows the extent to which these companies outperformed the US market over the past ten years.



Cintas, the uniform company, gained 1150% since 2015 in $A terms, which compares with the overall US market at 260%. Not only is Cintas a great quality compounder, it has a fascinating history and is a great example of American capitalism. After their circus closed during the Great Depression, Doc and Amelia Farmer (pictured here) saw the opportunity to collect old rags factories had thrown away, wash them and sell them back to those same factories. That was the foundation of the company that would become Cintas.

On to some of the learnings of his trip, the US industrial vibe could be best described as 'low and slow' in terms of economic recovery, although there were glimpses of green shoots. While there were subtle positive trends, the overall trajectory suggested a gradual industrial recovery rather than any rapid resurgence. Perhaps the exception to this may prove to be those companies'activities outside the US, as activity in Europe and China had seen sharp declines and therefore might experience a more pronounced, albeit optically stronger, recovery phase.

Two themes Chris saw in his trip were the potential impact of tariffs and the presence of a short-cycle manufacturing recovery. Management teams in general were cautious, a wise stance considering the prevailing uncertainties surrounding inflation, tariffs, politics and the economic landscape in China. While CEOs were reluctant to make definitive predictions, it is notable that no executive reported a deterioration in business conditions. All confirmed either the continuation of the previous trend or nascent signs of improvement. Investor sentiment, however, remained relatively subdued and somewhat confused by what to do next. One person he spoke to called it as "peak not sure what to do".

Given the conference was in Miami, the divide in the US between the haves and the have-nots was plain to see, although there seemed to be more 'haves' in Miami. Chris didn't need to walk far from the conference centre to see expensive cars and luxury fashion stores. It was quite a contrast with the relatively boring industrial companies he was talking with. Not that he is unfamiliar with expensive cars, he covers Ferrari shares too.

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