Alphinity Australian Share Fund

MONTHLY REPORT – MAY 2024

Deal or No Deal

Market comment

The share market (ASX300 including dividends) essentially trod water in May, rallying sharply at the start of the month then selling back down at the end for a +0.8% total return. Even this modest result put us in the middle of the pack of global markets in $A terms, however, with negative returns in China, Japan and Korea and small positives in the UK, most of Europe and the US. The best major market was Switzerland, with +6%, followed by the techy US Nasdaq, which was again largely driven by graphics processor company Nvidia. The $A rose by almost 3% against the $US.

After a few tough years of limited deal flow, equity markets re-ignited in May, both here and offshore. Our own resource giant BHP Group Ltd bid for the UK/South Africa-listed Anglo American PLC, in an attempt to become the world's largest producer of copper. BHP took a couple of bites, peaking at a total value of $49 billion which is almost double what Anglo American was trading at prior, but BHP ended up walking away – for now – by month end: No Deal. In the US, however, there were several deals summing to over $US100 billion in the energy sector. With many of these, it appears the prime focus is on synergies for the acquirer rather than growth, which does beg the question of what the companies will look like in the future.

The weakness in the second half of the month was driven by a rise in bond yields as CPI came in a little higher than expected (3.6% YoY vs expectations of 3.4%), further dampening any rate cut hopes. Weakness in resources relative to the tech sector once again drove a wedge between value and growth stocks, and led to outperformance in tech-heavy markets like the US over those more exposed to Energy and Materials like ours.

May also saw the budget released by the Federal Government, although the biggest news had happened some months before when it re-jigged the so-called Stage 3 tax cuts to spread them to all taxpayers, rather than just the higher echelons. When combined with wide-spread energy cost subsidies, which the Treasurer confidently asserted will bring inflation lower by year end, and upcoming pre-election spending measures, the Government is in a sense pitted against the Reserve Bank in a fiscal tug-of-war, working against the likelihood of interest rate cuts this year, notwithstanding that Europe and Canada have both cut rates recently. There has even been some chatter from monetary authorities about further rate hikes and, while it seems too early to back that call, we wouldn't like to see the recent inflation trend continue. There was again no change to the official cash rate in May and it appears increasingly unlikely that there will be interest rate cuts in 2024, and possibly even before for the next election which needs to be held in 12 months at the latest

Commodities were broadly weaker in May, led by a double digit % fall in oil prices in $A terms while the prices of the bulk commodities, Coal and Iron Ore, weakened modestly during the month in $A. Base metals were also slightly softer in May, although that was largely a function of the firm $A, in $US terms they were mostly slightly higher. The price of Gold was also up slightly in $US but 1% lower in $A. Our ten year bond yields started and finished May at about 4.4% but traded quite widely during the month, between 4.2% and 4.5%.

Portfolio comment

The Fund outperformed the market in May, with strong performances from positions in gaming machine company Aristocrat Leisure, industrial property and data centre developer Goodman Group and logistics company Qube Holdings; not owning iron ore producer Fortescue Metals also helped. This was offset partially by positions in building materials company James Hardie and retailer Super Retail Group, both of which warned of challenging operating conditions.

Top five active overweight positions as at 31 May 2024	Index weight %	Active weight %
Rio Tinto Limited	2.0	3.2
Goodman Group	2.5	2.0
QBE Insurance Group Limited	1.1	2.0
Brambles Limited	0.8	1.9
Aristocrat Leisure Limited	1.2	1.8

Asset allocation	31 May 2024 %	Range %
Securities	97.6	90-100
Cash	2.4	0-10

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)	1.3	0.4	11.9	6.2	8.0	7.7	9.1
S&P/ASX 300 Acc. Index	0.9	1.1	12.8	6.5	7.8	7.8	8.6

* 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 May 2024.

^ The Fund changed investment manager and investment methodology on 12 July 2010, at which time Alphinity Investment Management commenced managing the Fund and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2011. The inception date for the returns for the Fund is 1 September 2011. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 1300 721 637 during Sydney business hours.

Market outlook

The market continues to dance around the questions "will they or won't they? And if they do, then when?", in regard to much-anticipated cuts in interest rates, and the subsequent flow-on effects to the market was again evident in May. Mixed economic signals during the month did little to resolve the puzzle, but we saw bond yields fall a little from the levels they surged to in April which helped the local equity market eke out a small gain. However, not without a fair bit of intra-month volatility in both rates and equities, continuing the choppiness we have seen in markets through much of this year. There has not been a lot of direction from an investment point of view. It is likely only later in the year, once we have more of a definitive guide both here and in the US, around rate cut timing – if at all – that a more stable direction may be found. We expect more volatility between now and then.

That said, compared to last year company earnings continue to be showing more market leadership, and May provided a number of company updates, either from earnings results for those companies with a March period end, AGMs, or updates related to a large investment conference held in May. It is a good thing when earnings are the ultimate driver of share prices. May has in the past been seen as a 'downgrade' season as companies used the conference to reset expectations heading into the end of financial year. This year, however, there were fewer concerning updates than usual, which is largely consistent with the economy continuing to hold up better and for longer than we all thought a year ago. This augers well for a market in which valuations are a little stretched. If the economy were to falter, here or offshore, we expect there would be growing concerns around earnings, and valuations would come into focus in a negative way. We seem delicately poised at the moment, with the economy performing not as badly as feared, although certainly not strong. Should it break materially either way, that would likely become the key driver of market direction near term, not just interest rates.

Companies that announced positive results or updates responded well in May, and are likely to continue to do so going forward as long as we see some persistence in the economic and inflationary outlook for more than a month! The one area in Australia that does appear to be having a tougher time is the consumer. The longer interest rates stay high, the more challenging it is for the consumer to remain resilient, and they are indeed becoming more cautious. Anecdotally and through company contact and updates, we are starting to see some cracks as the consumer spends less and/or looks increasingly for value. No cliff, as might have been expected a year ago, but a general drag in activity. High inflation numbers in Australia in May did not help, that turned the discussion even more to pushing out rate cuts further, and raised the question as to whether they might in fact need to rise a bit more first. It must be remembered that Australia wasn't as aggressive as the US and our rates remain rates well below theirs. The combination of slower sales and rising costs, such as wages and rents, doesn't bode well for retailers. So we could well have a situation later this year whereby the US cuts rates but Australia holds or even raises ours. While this would no doubt have exchange rate impacts, it highlights once again the need to take a company-specific approach rather than trying to guess large sectoral swings.

China continues to be an important gauge for Australia. This month we at last saw some real intent from the Chinese government to stabilise and improve their housing market, with changes to rules and regulations aimed at restoring confidence. While the initial reaction was positive we need to see it flow through to the real economy and the demand for commodities important to Australia. At least it has seen the iron ore price stabilise following its dip earlier in the year. The focus has now turned to base metals, with commodity prices in areas such as copper and aluminium spiking at the start the month, but cooling off towards the end. The key medium and long term question for us is around the demand versus supply for these future-facing commodities in a world going through an energy transition, increased electricity demand and, thus far at least, a resilient global economy. In the longer term, the supply/demand imbalance will likely support copper prices, explaining BHP's tilt at Anglo American, but in the shorter term it is less clear whether more transitory factors are impacting.

Market valuations continue to look a little stretched, especially against bonds. As we have been stressing all year, that is fine providing earnings growth comes through better than is presently expected. While that hasn't yet happened in any meaningful way, we have largely seen the downgrades dissipate, and some broadening in the sectors seeing modest upgrades. The bellwether major Banks saw upgrades after their reporting season early this month, which supported the market overall. Commodity price trends suggest we should see Resource sector upgrades before long. On the other hand, more weakness is likely to be seen in Consumer sectors. Overall, the market has recently been reasonably directionless as we wait to see where earnings are going. Without help from rate cuts, earnings will become an increasingly important driver of the market.

Portfolio outlook

The Fund continues to have reasonably neutral positioning, with a modest defensive tilt driven by the relative earnings certainty we see in a range of companies, and uncertainty around direction and timing of rates and economic outcomes. We continue to position the portfolio to areas we see earnings upgrades coming through now and in the future. We remain overweight the Insurance sector, for example, driven by strong valuation appeal coupled with earnings upgrades due to the higher premium rates we've all seen come through on our cars and houses, and now falling claims inflation beginning to come through. Higher interest rates also help on their investment income.

The stretched valuations and paucity of earnings growth stops us being more positive the Banks despite potential earnings upgrade appeal from the resilient economy. It does leave banks vulnerable to any tightening in economic conditions or credit quality issues, should they arise, as the prevailing view has become that margins are stable, volumes are stable, cost growth is under control and strong credit quality will see provision releases and capital management going forward.

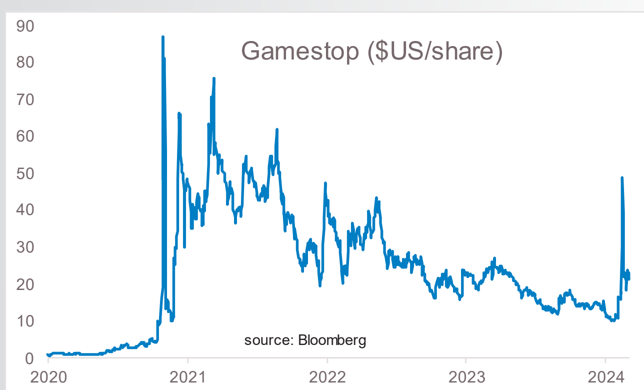
Mining company appeal remains divided by commodity. We continue to be a little overweight iron ore on a stabilising to improving China, and overweight base metals driven by tight medium term fundamentals, but underweight lithium which is experiencing ongoing price pressure. We remain well underweight domestic Consumer companies but find some appeal in some of the more internationally-focused exposures, although very company-specific given the current patchy data.

In Healthcare, we continue to like the combination of defensiveness and growth in companies such as Cochlear and Resmed, although avoiding the hospital and pathology operators. Finally in Technology, we have again taken a very company-specific view with companies that are focussed on growing actual earnings and cash, with a valuation we can justify through the likely earnings growth of the company, and seeing the company beat expectations. Our two main tech holdings are Xero and TechnologyOne. While Nvidia shares have been powering the US market, its performance has been largely earnings driven. While there is really no direct Artificial Intelligence exposure in Australia, our position in Goodman Group has given us direct exposure to the growth in global demand for data centres, of which AI is a key driver.

BTW

We might have summoned up the forces of darkness in with our piece on Trump Media and Technology Group last month, and referencing the meme stock phenomenon of 2021. No sooner had we hit 'publish' than the quintessential 2021 meme stock, Gamestop, a moribund collection of 1990s-era US computer game shops exhibited some extraordinary market activity.

Meme stocks first arose during Covid, when there were plenty of people cashed up and sitting at home with nothing to do other than punt stocks. Some on social media took exception to US hedge funds taking short positions in challenged companies and willing them to go broke, or at least get worse. Small holders were corralled by influencers, the most prominent of which was Reddit member Roaring Kitty [language warning!], to gang-up on some of the hedge funds and squeezed the shares higher. This forced the funds to cover (i.e. buy back their shorts), which sent the shares higher still. Gamestop shares, which sold for as little as 81c in April 2020, traded as high as $US86 in January 2021. Some of the hedge funds lost so much they had to close down, the most famous being Melvin Capital. We're not great fans of hedge funds but we feel some sympathy, >100x in less than a year would be hard to manage. It was a lifeline for the company though, which might have gone broke without being able to exploit that high share price to raise more capital.

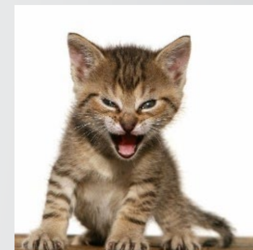


Not surprisingly, Gamestop shares have gradually returned closer to fundamentals and were trading at around $US10 in April before all of a sudden zooming higher, as can be seen in the chart above. This frenzy was sparked by Roaring Kitty (a.k.a. Keith Gill) posting a meme on rival social media platform X in May after a lengthy absence. Followers assumed 2021 was back on and jumped on board. He later revealed he had bought hundreds of millions of dollars in Gamestop shares and options prior to his tweet.

Gamestop is not a great company and it doesn't deserve this attention. It hasn't made a profit since 2019. It lost $US269 million last year, and while it might break even in 2024, its cash flow will still be solidly negative. It was saved from even greater losses in prior years by $US2.8 billion of equity raises in 2021, but that is little consolation to those who bought that equity – they would be nursing hefty losses. Gamestop raised a further US900m+ of equity courtesy of this month's spike at about $US20/share.

What conclusions should one draw from this? We suggest that following the crowd by buying or selling stocks in response to posts on social media is not a great way to make money. It's all good for those leading the crowd, such as Keith Gill, and maybe also for those lucky enough to get in early on the trend and nimble enough to sell before it all falls apart. The chances are it is the smart money – those who put the scheme (scam?) together in the first place – that will profit the most and, in a what is largely a zero-sum game, that will be at the expense of their followers.

This is not investing. Investing doesn't take place that quickly, it actually takes time and intellectual effort. You need to do proper research on an opportunity, come up with an idea of what it's really worth and compare that to the price at which you can buy it, and then monitor it over time. If things remain on track and the thesis plays out, great. Corrective action might needed if it looks like it is going off-track. If the entire potential of the investment looks like it has been realised, action might be required there too. One thing is for sure: activities like day-trading (i.e. buying and selling a company within a very short period of time) or treating memes as stock research is at best speculating, and you might as well take your capital and put it on a horse at the racetrack or on a number at the roulette wheel. There are probably examples of people making a lot of money on meme stocks, as with gambling, but whether they make or lose will primarily come down to luck. Some of those who are lucky will think it is their innate brilliance that has caused their good fortune and will be emboldened to do it over and over again. But the odds of being lucky multiple times is increasingly low, as any punter will tell you.



The Gamestop story isn't over yet. As we headed into June the Kitty was roaring back, pumping up the shares again. He's also been brought to the attention of US market regulator, the Securities and Exchange Commission (SEC), for possible market manipulation but there don't seem to be any regulations prohibiting establishing positions in stocks and then posting about them about them on social media. One former SEC official put it this way in the Wall Street Journal: "He is using his celebrity and influence to draw people to buy the stock. The rules that exist do not permit the SEC to prosecute that conduct unless there is an element of deception."

Gamestop of 2021 was made into a movie, Dumb Money, by a major studio last year but Gill is anything but dumb. He's been a stockbroker and was even Chief Compliance Officer for an investment advisory firm in the past. He knows what he's doing, has been very careful not to engage in actions that fall foul of SEC pump-and-dump regulations, and he doesn't have privileged knowledge of the company. He's not advocating that people buy the stock, he's just putting his own position out there. He can't help it if some if his 97,000 followers choose to do the same! It's an uncomfortable position which regulators need to grapple with. It might be within the law but it still doesn't feel right, and the likelihood is that the little people – those slavishly following his lead – will get burned again.

Travellers' Tales

May was a busy month for both local and offshore travel across both the domestic and global equity teams. Andrey went to France and the UK, looking at and meeting with a number of Australian-listed industrial companies. Jacob went to China, primarily to research the markets for both wine and infant milk formula. Landing in Shanghai, he was impressed by both the history and modernity of the city. He took the shot above of the Bund Area in Shanghai, a historically significant area which was central to trade between China and Europe from the mid-1800s up to the 1930s. It has some very interesting western architecture, and the place was packed with locals and tourists.

Possibly the most efficient way of travelling around China is on its impressive high speed rail network. There are more than 40 high speed train trip on the Beijing – Shanghai line daily, covering more than 1200km in less than six hours. For context, that's about the same distance from Sydney to Melbourne then back to Albury again. Jake was also impressed that it reached 350km/h and the quietness at high speed. The focus of the trip was largely on Infant Milk Formula (IMF) and wine, with A2 Milk and Treasury Wines being the two most relevant listed companies directly involved in these industries.

IMF is a huge market in China with almost all young mothers choosing formula over nursing the children themselves. The market comprises numerous domestic and international players, the latter of which includes A2 which is prominent and growing. The Chinese birth rate has been in a downward trend for almost a decade now and this is clearly an important headwind for IMF as a category, given that consumption is for a relatively limited period of time, with children aging out of the category. Jake met with A2 management, some IMF retailers and distributors and even had a (translated) interview session with a panel of young mothers to get a sense of the important issues. The summary of all these meetings was that the birth rate is essentially in structural decline without significant government intervention, which doesn't seem to be on the agenda at the moment. The one-child policy is long gone but there remains great resistance to larger families. The key reason young women don't want to have more children appears to boil down to the cost of raising and educating, not to mention the stress involved in securing one of the very limited number of places at higher level education institutions – high schools, not just university. Essentially only ~2 million people will be accepted into a domestic university out of the ~20m people in that cohort. Most view the probability of their child having a good life as very low if they don't get to university. This dynamic is the primary driver behind demand from Chinese students at international universities.

Jake wasn't quite able to link those stressed mothers with consumption of wine but a huge barrier to our wine industry in recent years has been the highly punitive tariffs implemented in 2021, which basically trebled the price of Australian wine to Chinese consumers. These were recently removed so it was an opportune time to undertake some market research. Penfolds is the most prominent and popular Australian brand in China, and remains a highly prestigious product. Jacob went to retailers and met with distributors and wine consumers, in order to understand its prospects now the tariffs have been reduced.

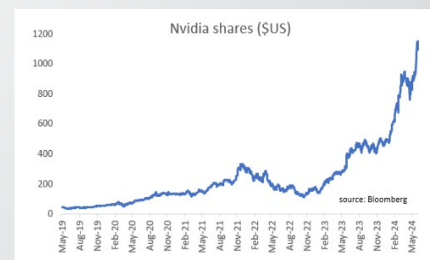
Penfolds did a good job of maintaining its brand in China during this barren period, although there have been some suggestions that wine was still finding its way into the market through unofficial channels. While this is positive in some ways, it also likely indicates that the latent demand for Penfolds product could be less significant than the boom conditions the market expects. The local liquor preference remains Moutai, a clear, grain-based spirit popular in business settings, which can run into thousands of dollars per bottle. This makes Grange look cheap!

TT (cont.)

A trip to China is not complete without some culinary exploration. Jake broadened out his knowledge of local Chinese food and tried duck's tongue. These are sold in individual packets and are apparently a common snack. According to Jacob, it had a very interesting texture but didn't taste too bad at all.

During the course of visiting companies in Boston, global technology PM Trent opted out of a standard Hotel for business travel accommodation and went for the AirBNB option instead, a stock held in the global portfolio. While it looked cozy and was more cost-effective than an expensive hotel, Trent found himself deep in the suburbs of south Boston. It conjured up for him images of the Southie Projects and gang violence, although that area has become gentrified in recent years. Uber coverage however was poor so he ended up hopping on a share bike to get back home after a dinner with management from semiconductor company Cadence Design Systems.

No US tech trip would be complete without a pilgrimage to portfolio holding Nvidia Corp in Silicon Valley, the $US3 trillion processor company that has been setting the world – and equity portfolios – on fire in recent years. Nvidia shares have trebled in the past year and are up ~35x in five years, from $US33 to $1100. When companies outperform as strongly as this, it's important to keep revisiting your investment thesis to make sure the share moves are for good reasons (such as improving earnings expectations) not just because people are piling in (which would be shown by the earnings multiple rising sharply). It is encouraging to see that while Nvidia is trading on a reasonably punchy multiple, around 40x this year's earnings, that is just in line with its five year average. It's quite incredible to think that expected earnings for this year has moved from $5 a share in May 2023 to $27 now. In addition, the high rate of earnings growth takes its multiple back down to about 32x next year's so, while not cheap, it is justifiable especially if the well-established earnings upgrade trend continues.



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