

Alphinity Australian Equity Fund



QUARTERLY REPORT – JUNE 2024

Election Fever

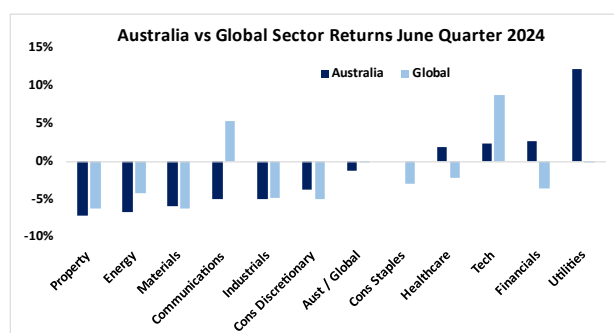
Market comment

The world is in an election frenzy this year, and the middle of the year feels a bit like the crescendo. The UK called a surprise election for July and the world's largest democracies, Indonesia and India, have already held theirs, as has the European parliament. Russia re-endorsed Putin decisively. France's president Macron also got into the act, squeezing two in during the Tour de France, in between Roland Garros and the Olympics, but it didn't turn out that well for his party. Of course the big one will be in the US on Melbourne Cup Day. June finished with the first debate between the two chief protagonists which only served to underline the invidious choice facing American voters. Closer to home, it's possible that Albo might call an election before Christmas, although considering the speed at which the world seems to be shifting to the political right (with the exception of the UK) he might be well advised to hold off until next year.

The share market in the June quarter was reasonably flat, the ASX300 (including dividends) falling by 1%, with steady May and June performances not quite enough to make back April's loss; still, it finished the quarter only a fraction off its all-time high so it was no disaster. Over the financial year, the market returned a creditable 12% - a little better than the long term average return from Australian equities. Relative to other major markets over the June quarter in \$A terms, we fell in the middle of the pack: not as good as the US (+1.5%) or Nasdaq (+5%) but there wasn't much joy elsewhere. Most of Europe returned between -8% (France) and +3% (Switzerland); while Asia varied between -10% (Japan) and +3% (Singapore). The \$A itself was stronger, appreciating 2% against the \$US, 3% against the Euro and 8% against the Japanese Yen.

Commodity prices were mixed: the price of Oil fell about 4% in \$A terms; the price one of our major bulk exports, hard coking coal (used in steelmaking) fell by 13%. Lithium also fell by 13%. Pretty much everything else was up: all the base metals including Zinc (+17%), Tin (+15%), Copper (+7%) and Aluminium (+5%). Iron Ore rose 4% over the quarter, even in \$A terms. From a sectoral viewpoint, the best returns by far came from the Utilities sector, thanks to higher wholesale electricity prices, followed by Financials, Technology and Health Care. Laggards included Real Estate, Energy and Materials.

Comparing sector returns of Australian and global stocks, most were reasonably in line, with the exception of the relative strength in Communication Services and Technology sectors offshore versus here. The dominance of mega-cap US companies drove this gap, although our Financials held up much better than their offshore peers. Strong utilities companies was purely an Australian phenomenon.



Economic news was mostly about inflation, the main precursor of interest rates. Despite falling substantially from its peak of 8% in 2022, it appears to have bottomed out last December at 3.4% and has risen since then – the opposite of what the Reserve Bank is looking for in order to allow interest rate cuts. A much higher than expected May inflation number, coming in at 4% versus expectations of 3.6%, pushed rate cut expectations further into the future, and even had some speculating that there might need to be another rate rise in this cycle

Portfolio comment

The Fund performed a little better than the market in the June Quarter, with strong performances from positions in gaming machine company Aristocrat Leisure, energy company AGL and insurer Suncorp; not owning iron ore miner Fortescue Metals also added to returns. These however were partially offset by positions in building materials company James Hardie, pallet pool operator Brambles and fuel marketer Viva Energy Group.

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)	1.6	-1.1	11.6	6.1	7.4	8.1	9.8
S&P/ASX 300 Acc. Index	0.9	-1.2	11.9	6.1	7.2	8.0	9.1

* Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance. Source: Fidante Partners Limited, 30 June 2024.

^The Fund changed investment manager and investment methodology on 12 August 2011, 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

Global share markets continue to appear expensive, with earnings downgrades seeming to have bottoming out but not yet showing signs of the positive earnings revisions phase needed to justify the current level. While inflation is gradually falling in most countries, which potentially provides the option to cuts rates should economies deteriorate, inflationary forces remain and could be exacerbated if, for instance, tariffs are increased sharply in the US, as is the promise/threat of one of the Presidential candidates. Unless this were to be accompanied by a boost economic growth, stagflation could be the unwelcome result. At least market persistency, which is the proportion of months the market moves in the same direction as the previous month, is on the increase. This is encouraging as it indicates better stability.

At home, while the earnings and multiple pictures looks similar, stubborn inflation and solid growth in employment makes the situation tricky for our Reserve Bank to navigate, especially in light of the July tax cuts, and an interest rate lift might now be required in order to apply the brakes on the economy. If this turns out to be the case, consumers could be particularly negatively affected. We have witnessed since April a softening of consumer conditions which, combined with higher wages and rents, will likely put further pressure on the earnings of retailers. Banks' bad debt levels thus far remain benign, allowing the Banks to smooth their declining earnings by releasing provisions. A change in economic conditions could however bring an end to this which – given their elevated valuations – is a risk we are cognisant of. The consumer has remained resilient so far thanks to high savings and high employment, but another rate lift could be the tipping point for some cohorts. While negative earnings revisions across the market seem to have stabilised, the only sectors in which we are seeing some upgrades are Energy, Utilities, Banks (although largely through provision releases), and Insurers. We are however on the cusp of reporting the FY24 season so much will likely change in the next month or two.

Geopolitics remains a risk to keep monitoring as any further escalation in the various conflicts would likely result in higher oil prices and higher transportation costs, both of which would add further to inflation. China is showing the early signs of stabilising its problem child, the property market. Sales and prices are showing encouraging improvements in Shanghai, the first city in which incentives encouraged buyers to come back. The Resource sector however is experiencing mixed revisions: gold remains elevated, base metals have corrected downwards although fundamentals appear supportive in the medium term, and lithium keeps disappointing. The energy transition appears to be on pause for now as the studies conducted over the past few years have come back with challenging economics which will require government subsidies and/or customers willing to pay even higher costs. Given all the elections going on around the world, more certainty is required before these are progressed.

Asset allocation	30 Jun 2024 %	Range %
Securities	97.3	90-100
Cash	2.7	0-10

Portfolio outlook

While inflation in the month of May was concerningly high, it was one of the less-reliable partial measures, unlike the full-survey June quarter number which will be released late July, on which the Reserve Bank will place the most weight. If the June number confirms the recent upward trend in inflation the pressure to raise rates could become irresistible, and that might well be the final nail in the coffin of economic growth. Having said that, taxpayers are about to share in a meaningful amount of government largesse through income tax cuts. Some econometricians have estimated these as being equivalent to two 0.25% interest rate cuts, so it may end up being a case of giving by one arm of government and taking with the other. In the end, the most important indicator could end up being the employment numbers, which have been surprisingly strong for a long time.

The portfolio overall remains positioned in a reasonably balanced manner ahead of the all-important August reporting season. While much insight will be gleaned from that, in our view it is too early to add to cyclicals. On the other hand, we feel it is also too soon to become too defensive. Our bottom-up focus on identifying positive idiosyncratic earnings stories remains key to generating robust portfolio returns.

Our conviction in earnings has been tested over the past few months by meeting with companies in the US, Asia and Europe, as well as in various parts of our own beautiful country. As we head towards reporting season we maintain an overweight position in Insurers, which are still benefiting from rising premiums and deflating claim costs. We have lifted our exposure somewhat across Health Care as well as to some names in the Technology space. We hold a small number of Materials companies, and some Industrial and Utilities exposures, adjusting our positions based on rising or falling conviction around our companies' ability to deliver positive earnings surprises relative to the market's current expectation.

We continue to be underweight the Australian consumer but maintain decent weighting to some of the more internationally-exposed consumer stocks. Real Estate remains well out of favour with the exception of one company which has very strong stock-specific characteristics. We remain underweight Banks and Diversified Financials. We are fairly neutral Resources but maintain some selective exposures to diversified miners and base metals producers. We also remain neutral Energy. While the upcoming reporting season will test or prove many of the investment theses of companies in the Fund's portfolio, our focus on earnings should help us to pick winners, even in the current uncertain environment.

Top five active overweight positions as at 30 Jun 2024	Index weight %	Active weight %
Goodman Group	2.5	2.1
Rio Tinto Limited	1.9	2.1
Aristocrat Leisure Limited	1.3	2.1
QBE Insurance Group Limited	1.1	2.0
Medibank Pvt Ltd	0.4	1.8

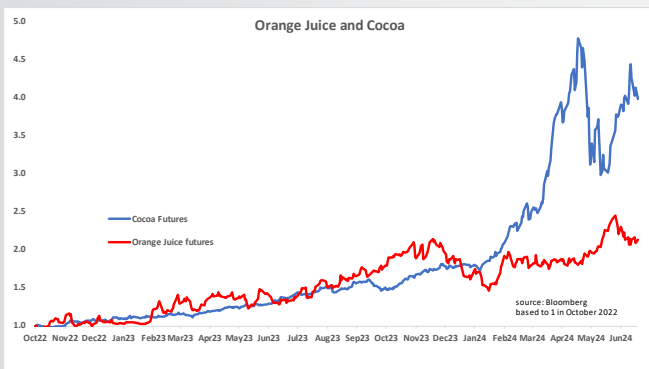
BTW

The threat of inflation and the response to hike interest rates by Central Banks worldwide is often seen as the biggest risk to equity markets. This is because it has a direct effect on stock valuation, more so than many other factors such as geopolitical tension or even war. Somewhat perversely, if there are huge macro risks in the economy, there is still the expectation that Central Banks can act quickly and cut rates if necessary. This is commonly referred to as the ‘Fed Put’, whereby the US Federal Reserve is thought to stand ready to cut rates quickly if conditions deteriorate rapidly enough.

We are presently in a Goldilocks situation: we still have economic growth, a strong labour market, and inflation looks to have at least stabilised. Some countries have started to ease interest rates, including Canada, Switzerland and Sweden. Even the European Central Bank cut rates in June, from an all-time high of 4% to 3.75%.

While the most important sources of inflation such as the oil price, food and rents dominate the basket of goods and services used to calculate inflation, there are often some interesting quirks in the data especially around the myriad of different commodities. Two commodities that have experienced high price increases recently have been items most of us regularly eat or drink. Remember the avocado squeeze a few years ago? Spending so much on smashed avo on toast was a reason given for the younger generation’s inability to get into the housing market. But the basic economics of supply and demand meant the high prices caused a surge in avocado production, and supply came into the market which reduced prices.

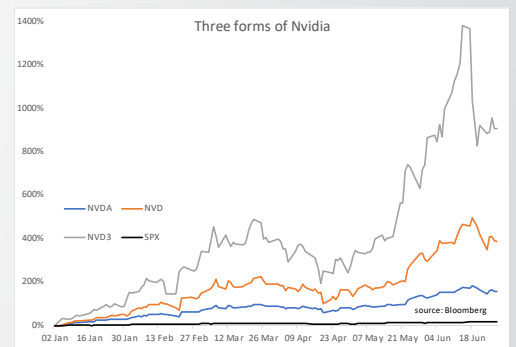
Lately there been something of a frenzy in the prices of orange juice and cocoa. Most commodities have active futures markets, and older readers might remember the classic 1983 markets movie [Trading Places](#), in which a very young Dan Akroyd and a very young Eddie Murphy teamed up with the very young Jamie-Lee Curtis to burst a squeeze on FCOJ (frozen concentrated orange juice) on the New York Commodities Exchange. Well, orange juice futures on that Exchange recently hit a multi-decade high of almost \$US5/lb, nearly doubling in a year. Similarly, this year cocoa futures almost trebled, from \$US4000/t to more than \$US10,000, before moderating slightly. What is driving such extreme price moves? It’s always going to be the balance of supply and demand, but at the moment it is primarily a result of disruptions on the supply side of the equation, more specifically, weather and disease which have curtailed production of both commodities sharply. Meanwhile, demand for both is steadily growing with population.



In equity markets, active ETFs and options over stocks can have meaningful impacts. For example, the rapid rise of weight loss drugs, known as GLP-1s, has led to the creation of ETF baskets such as ‘GLP Winners’ and ‘GLP Losers’ baskets. Winners are obvious: drug companies Novo Nordisk and Ely Lilly which can’t make enough GLP-1 to keep up with demand. The Losers are those which might suffer from the weight loss thematic, including companies like Australia’s Resmed, which makes sleep apnoea devices (maybe thinner people will sleep better and won’t need breathing devices?), and equipment companies like Intuitive Surgical in the US (will a reduction in obesity will result in better health and fewer surgeries?). Whether the facts are correct is not important – the mere inclusion of companies in one basket or the other can drive share prices noticeably in the short term. These types of thematic ETFs are often created for hedge funds to trade, introducing the risk that nobody knows how much leverage those funds are using when going long or short the baskets. We frequently see large moves in stock prices despite there being no fundamental news to change the company’s outlook: it is often just the outcome of an ETF basket trade. While this can occasionally be frustrating for fundamental long term investors such as ourselves, it can also provide opportunities to buy or sell when share prices are dislocated too far from a company’s value.

The rise of US graphics processor-maker Nvidia in recent years has been dramatic (and highly profitable for Alphinity’s Global Equity funds) but as we pointed out last month, its share price has so far been supported by its earnings power. Nevertheless, great stories like Nvidia inevitably attract short-term speculation. Take for example

GraniteShares 2x Long Nvidia fund (NVD) – essentially an ETF that only owns Nvidia shares but gears up the exposure. That’s pretty greedy considering if you’d just owned plain old



Nvidia stock you’d have been up 150% over the past six months; GraniteShares 2x was up 380%. If that’s not enough risk, there’s an even spicier version listed in London (NVD3) which is even more levered; that one would have given you 900%! This chart shows these three iterations of Nvidia along with the broad US market, the S&P500. Considering the scale, the S&P500’s respectable 15% year-to-date total return (that’s the black line hugging the bottom axis) barely registers.

Of course, geared ETFs work really well until they don’t. Leverage works both ways so, if/when Nvidia starts to fall, watch out below if you own the geared vehicles. For instance, when the Nvidia share price dipped by about 10% from its highest point during the month of June, the leveraged products fell by 30% and 40% respectively. Conceivably, with all that leverage, a large enough fall in Nvidia’s share price could send a geared ETF into bankruptcy. As with all things in financial markets, caveat emptor!

Travellers' Tales

There were a lot of air miles clocked up by team Alphinity in June, with domestic and global teams both travelling extensively. Domestic analyst Andrey went to the UK to see a bunch of companies including accounting software giant Xero. He attended its user conference, Xerocon, an event also known as 'Coachella for accountants'. Xerocon might evoke in some people images of accounting superheroes, with adoring fans desperate to get their hands on the latest software. The reality was more subdued than a Comicon but only a little, and Andrey came away feeling pretty good about the company's prospects.



Meanwhile, Stuart took a whirlwind visit to the US covering medical devices, building materials and various other things. First stop was a little town in the Temecula Valley, north of San Diego, to see a medical distribution contact. From there he went to San Diego, where the US office of sleep apnoea device maker Resmed is located. Then across the country seeing various people in the building industry before hooking up with a tour organised by fibre cement siding-maker James Hardie Industries. That took him to the Midwest where he was checking out homes under renovation. He chatted with one work crew, asking why they had just replaced the existing timber weatherboards on a house with very similar-looking fibre cement boards: because of woodpeckers. Both sides of the house with timber had been attacked by those destructive birds, leaving dozens of holes in the timber (Aussies living near flocks of cockatoos can empathise!) – fibre cement boards, however, are impervious to woodpeckers.



The global team on average travels tens of thousands of kilometres per trip, so it was refreshing for them to be able to do some research much closer to home when Jess, Jeff and Ty Ubered to a Costco (held in our global equity fund) store on the outskirts of Sydney. It is a US-based retailer of pretty much anything. It opened its first Australian store in 2008, under the now-defunct Ferris Wheel in Docklands, Melbourne. It has opened a store just about every year since then. It is a unique format, often thought of a place where growing families can shop to

stock up on bulk goods, but Costco is much more than that – it has become a cultural icon in the US and beyond. The company has a collaborative culture which helps them to retain and develop their employees, and its staff strive to always give the customer a great experience. You need to be a member to shop there which means paying an annual fee, but once you do you're part of the club Costco goes to great lengths to make you want to remain a member. The model is to mark up the products they sell by a fairly small amount which covers Costco's operating costs; the membership fee is effectively the company's profit.

Some fun facts from the tour included:

- the Costco "Hot Dog and Soda" combo has been the same \$US1.50 in its US stores for 40 years. It's even less expensive here, just \$A1.99. Take that, Bunnings' \$3.50 sausage sizzle!
- It's not just an importer. Costco claims to be the biggest international seller of Australian lamb and beef. It also sources unperishable food items here and sells them through its stores all over the world.
- the store they visited in Casula sells as many as 10,000 roast chickens a week.
- it's not cheap and cheerful. Costco sells some really expensive items, even \$17,000 watches. It sells diamonds and jewellery. In fact, Costco is the biggest retailer of diamonds in the USA.



Costco offers everything from fresh fruit to half-price ski lift passes, and makes Aldi's middle aisle look boring. You can even order a coffin or buy a concrete mixer. Just what you've always wanted! Jess was impressed by the quality of the meat and fresh fruit and vegetables, and the ability of shoppers to see behind the scenes in the bakery, the butcher and the ready-meal preparation section. It made the whole experience feel even more fresh. The ability to try loads of free samples including pork bao, choc treats and beef massaman curry was a highlight. Alphinity culinary top tip: check out Costco.



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