Alphinity Concentrated Australian Share Fund

MONTHLY REPORT – August 2024

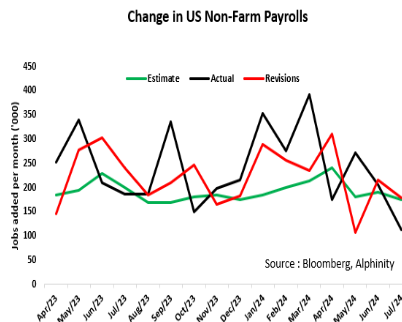
Down 20%, Up 20%

Market comment

You'd be forgiven for thinking moves of 20% both ways in a matter of days must be a speculative small cap miner or biotech stock, not the world's second-largest stock exchange. However, this is what took place in Japan, all within a rather crazy two week period. By the end of the month, however, its TOPIX index had recovered much of its losses following the Bank of Japan's decision to raise interest rates slightly above zero, which ignited a flurry of Yen carry unwind trades that moved currency markets and caused great volatility in bond and equity markets.

After a very strong July, August started with these severe wobbles in Japan which spread briefly to the US and Australia. A couple of days into the month our market was down a troubling 6% before reporting season got under way and the focus shifted back to fundamentals: how well the various companies were doing rather than just the interplay between macro forces driven from offshore. The market (ASX300 including dividends) spent most of the month grinding up from those early lows, finishing 0.4% higher for the month. The $A was quite strong in August, rising 3.4% against the $US. Global markets were equally volatile, most trading lower in $A terms with the better markets being NZ and some European markets, while US shares fell 1%. So not a great month for equities, and Australia's very modest return made it one of the better markets.

A catalyst for the US Federal Reserve (Fed) to consider cutting rates was the downward trend in the revisions to jobs growth in the US. The Bureau of Labor Statistics' preliminary annual review of employment data suggested that 818,000 fewer jobs were added than had been initially reported over the year to March 2024.



This was also evident in the monthly downward revisions as shown in the chart below for the US non-farm payrolls. The revisions (red line) has been below the reported (black line) for the majority of months.

A large part of the reason for the Fed to not cut rates had been the stronger-than-expected jobs data, but the downward revisions could give further weight to the argument of a possible policy error from the Fed. Despite many thinking the Fed has left it too late, its still quite surprising that the market is now pricing in more than 100bp of rate cuts between now and mid-December. With only three meetings left this year, this seems unlikely; and if it does, it might well come across as panic and have the undesired effect of spooking the market rather than stimulating it. The imminent US election, and the need to appear impartial, just adds to the Fed's dilemma.

Back home, our own Reserve Bank poured cold water over any notion that we're close to cutting rates with Governor Bullock saying they won't hesitate to lift interest rates further to reduce "persistently high inflation". This would be a very unwelcome development in both financial and real asset markets as the current expectation is very clearly that the next move in rates will be down, it's just a matter of when. The cash rate has been unchanged at 4.35% for the last six meetings but it looks like it will be staying there for a while, barring some unforeseen macro shock.

Commodity-related stocks were weak across the board, with Energy (-2%) and Materials (-6.9%) the worst performing sectors. Oil fell a further 4% to be almost flat so far this year, while iron ore declined to USD95/t. Copper prices rebounded a little off their lows, but are still some 17% off their highs in May as inventories built up in warehouses, although there are recent signs of these being drawn down as demand recovers.

Portfolio comment

The Fund outperformed the market slightly in August. Contributors to returns included pallet pooler Brambles, energy company AGL and sleep apnoea device maker Resmed; offsetting those however were global insurer QBE, hearing device maker Cochlear and not owning IT company WiseTech Holdings.

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	6.4	14.0	6.4	8.1	8.9	10.0
S&P/ASX 200 Acc. Index	0.5	5.7	14.9	6.7	8.1	8.0	8.9

* 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 August 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 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 month of August is generally one we particularly enjoy. Even though macro news is still influencing the market on a day-to-day basis, it is the focus on companies reporting results and their outlook statements that captures investors' attention, if only briefly. As Alphinity's research is focused on finding quality, undervalued companies that are delivering positive earnings surprises, the August reporting season is a welcome 'reality check' point to assess whether our investment thesis still holds and if new opportunities are emerging. It is a period of intense insights on how companies are faring across sectors. So, what did we learn?

On the macro front, the US appears to be at an interest rate turning point and, potentially, its economy as well. While we saw a sharp sell-off in early August, associated with a perceived increase in the risk of a US recession, along with the Japan wobble as they raised rates, it proved to be short-lived. Subsequent hard data continued to suggest resilience, and the US Federal Reserve (Fed) making it clear it was ready cut rates fuelled a sharp market recovery.

The prospect of an imminent US rate cut became much more definitive when the Fed Chair said the time has come to cut rates as inflation is further progressing towards price stability, and as downside risks to employment have now increased.

At home, we are a long way from that turning point. The Reserve Bank of Australia (RBA) couldn't have made it clearer during August that stubborn inflation and a resilient economy meant it was not even considering cutting rates at present, rather it was looking at holding or even raising them. Notwithstanding the RBA commentary, Australian bond yields followed the US lead, pricing in cuts as well. This impacted on yield-sensitive stocks through the month, at times unrelated to earnings outcomes.

On the company reporting front, whilst actual FY24 earnings tended to slightly beat more often than miss, roughly in line with past reporting seasons, the management commentary overall tended to the disappointing side. This led to negative FY25 EPS revisions despite delivering small FY24 beats. We saw a reduction of 1.5-2% in earnings expectations going forward, and the overall market is now expecting low single digit growth for the new financial year. How conservative these outlooks and earnings expectations will be depends on both the domestic and global economies, which in turn will be impacted by actual and expected interest rate levels. On that front, the economy to date remains slow but resilient, despite the cost of living challenges and still-high interest rates. Other trends we noted were better outcomes for dividends than earnings and a lift in buy-backs, despite higher share prices. This likely reflects companies maintaining conservative balance sheets since the pandemic and, in some cases, ongoing low locked in interest rates.

Share price reactions tended to be more pronounced than usual on both up and downsides. The already high market multiple actually lifted a little further. Investors need to "look through the valley" and hope that monetary conditions around the world are indeed loosening and that an economic recovery is just around the corner. When we see tangible evidence of a rate cutting cycle, rather than just constant speculation, we may at last be able to differentiate between companies which have largely only had a multiple re-rate on interest rate expectations, versus those that genuinely have achieved better earnings outcomes over time.

From a sector perspective, the Banks continue to stand out on the positive side as lower than expected bad debts continue to lead to provision releases and incremental EPS upgrades, even if of the lower quality variety. But even low quality upgrades stand out in a market with very few upgrades. Valuations are however quite stretched. The Consumer is holding up generally better than feared, yet spending is mixed with elevated cost-of-living conditions, leading to trading down. Trading updates for the first few weeks of FY25 surprised on the upside despite evidence that tax cuts appear to have largely been saved rather than spent, at least so far. Some growth sectors, such as Tech, tended to surprise to the upside on better margin delivery.

Resources stood out on the downside as conditions in China remain subdued leading to commodity price weakness while wage and capex inflation continues to put pressure on costs, not a good recipe for earnings. Some property exposures ran on the decline in yields combined with a view in some parts that this is as bad as it gets, ignoring a series of earnings downgrades which suggest that fundamentals remain challenged. Some of the beneficiaries of higher rates, such as general insurance underwriters, came under pressure despite ongoing very strong pricing power, as bond yields declined and rate cuts became imminent in the US.

Portfolio outlook

We managed to avoid many of the disappointers across sectors while being exposed to many companies delivering better than expected earnings. Of course, we did not get it all right, with a couple of stocks we held missing expectations or providing troubling outlooks and some stocks we didn't own surprising positively. In aggregate, positive stock selection once again kept us in the game, resulting in positive alpha. Having so many net earnings upgrades in the portfolio generally sets the Fund up for a positive outlook, all else remaining equal.

The market is still expensive with a lack of clear sector earnings leadership. In areas where some leadership exists, (e.g. banks), valuations are at, or are approaching, all time highs given the scarcity of upgrades in other sectors. Our bottom-up fundamental research combined with our valuation discipline allows us to stay exposed to quality companies undergoing positive earnings revisions which retain some value appeal. We find them across a range of sectors.

From a sector level however, while we have a small underweight exposure to the banks, their very stretched valuations have caused us to trim positions further and progressively increase the underweight. Any improvement in earnings outlook elsewhere is likely to see a rotation away at some point, however we are cognisant that EPS upgrade outlook is still likely positive here, so we need to retain exposure for now. The Resource sector is another where we have increased our underweight as we believe earnings expectations for FY25 remain in general too elevated.

We have lifted our exposure to specific names in the Tech, Industrial and Utilities sectors, while reducing areas of earnings disappointment in sectors such as Materials. We maintain a sizable, if smaller, exposure to insurance through underwriters and health care insurers. While pricing power and cost control suggest further strong margin expansion going forward, we realise we are closer to the end of the cycle than the start and falling bond yields are a short term hurdle. Valuations however continue to be relatively appealing compared to other sectors. Our consumer exposure gravitates mainly around US-exposed gaming companies, however the domestic consumer continues to hold up better than expected and many companies are generally managing the slower environment well as such we have added to that sector selectively where earnings merit an increase.

With downgrades persisting and, in cases, spreading we remain a little cautious about the current market environment and believe that a balanced portfolio composed of a mix of high quality growth, cyclical and defensive companies is appropriate for the time being.

BTW

There is a really interesting dynamic that appears to be emerging in the car market, possibly driven by (as most things seem to be these days) Elon Musk and his background in technology. Car making is almost the ultimate heavy industry. Cars are hugely complex things which require huge investment to develop and huge factories to build. The price of conventional internal combustion engine (ICE) cars tend to be set by competition with similar cars from other manufacturers rather than what they have cost to make. The price of vehicles has tended to march inexorably higher over time, justified by new features and technology, and instances of price reductions are rare indeed and generally only take place when a strategic mistake has been made when setting the price in the first place. Mass manufacturers struggle to make much from actually building cars: they tend to make most of their money from parts and servicing.

By contrast, EVs are relatively simple things. Rather than an ICE car's thousands of moving parts, an EV has relatively few. The electric motor itself is inherently simple: essentially copper wire spinning around a magnet which is actuated by the battery. By rights, an EV should really be meaningfully cheaper than an ICE car. They've typically been more expensive in an attempt to recoup the R&D spend (it costs a lot to develop any type of car, even a relatively simple one, and you need volume to amortise that cost over) and the cost of the battery.

Back to the interesting dynamic however. The heavy manufacturing nature and steady increase in prices of ICE vehicles runs counter to the general pricing dynamic of technology. We've all seen what happens with electronics: the products being sold keep getting cheaper and better over time. For instance, 20 years ago a relatively small plasma TV cost say $10,000, whereas much larger and better quality LED TVs today can be bought for just a few hundred. PCs first became available in the 1980s and cost $3000+. According to the RBA inflation calculator, that would more than $10,000 in today's money, and vastly superior machines can now be bought for just a few hundred dollars.

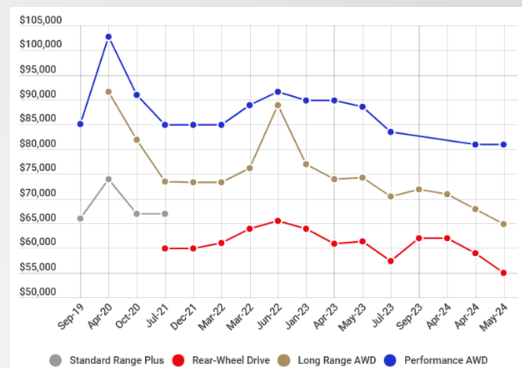
EVs could go the same way. They need to really, in order to become sufficiently competitive with ICE vehicles to attract mass adoption. The steep premium that has been charged for much of their short history was fine until demand from the less price-sensitive early adopters was satisfied, but mass market adoption demands better affordability.

A traditional auto maker would most likely improve affordability by introducing new models at lower price points. Musk has done it differently, as with most things. In order to keep the manufacturing facilities as fully utilised as possible, Tesla frequently changes prices to limit or drive demand far more than a traditional car maker would ever dare. The price of a Tesla changes frequently, both up and down. Musk has found this an effective way of optimising capacity but there has been unwelcome collateral damage.

No one who buys a new car expects it to rise in value. All cars, with the possible exception of some collectables, are on their way to the crusher: it's just a matter of when. But equally, no one who puts tens of thousands of dollars into a new car wants to see it depreciate more quickly than it has to, and one effect of car companies making those incremental price increases over time is to support the resale value of their customers' vehicles.

By cutting prices, Tesla has disrupted that paradigm with the result that some Tesla buyers have become wary about buying one because they are concerned that next week Elon might cut the price again. US Car rental behemoth Hertz owned 100,000 Teslas in its rental fleet at the peak in 2022 but sold off many of them earlier this year citing a few factors, including hirer resistance, expensive repairs, and poor resale values, writing off $US250m as a result.

The cuts have been meaningful too. A base Model 3 cost Australians $75,000 not long after its launch in 2020, as this chart (sourced from whichcar.com) shows. An improved model is now just $55,000. That's a sweet deal for new buyers but a bitter pill for owners to swallow. In the meantime, newer EVs from established manufacturers have been released, many at competitive prices. New entrants from China in particular have been very keenly priced, some as low as $35,000 and some are quite well featured.



There is certainly a philosophical case for EVs to follow the technology price cycle rather than the manufacturing price cycle. The cost of batteries makes up a huge proportion of the total cost of the car. It's hard to get good data on the cost of replacing an EV battery as it's such a new field but the numbers from road service organisation, NRMA, are quite scary. EV batteries tend to have eight year warranties from the manufacturers, whereas an eight year old ICE vehicle probaby has a lot of life left in it. While battery prices should fall over time, the idea of paying $15-20,000 for a new battery after eight years is not at all appealing. Batteries should last more than eight years, but that's all that is warranted.

Highly technical to make, there are only a few factories in the world which can produce good quality car batteries at scale. Most are in China, which might account for some of the price advantage of Chinese car makers. Most batteries use lithium, and the cost of lithium was a huge issue – for a while. Its price rose from ~$US120 a tonne in 2020 to $1200 at the end of 2022, at which point battery makers were hurting a lot. Lithium then halved in the first half of 2023 and has since come down to a bit below $US200. Similar story with other major battery components: Nickel and Cobalt had rides of roughly similar magnitudes at the same time. In theory, the price of batteries should have come down a lot but it's not a transparent market. The true benefit will probably be when the next generation of batteries is available. No one is sure what or when that will be because the promise of cheap, high capacity, fast charging solid state batteries has been out there for years – they just need to be proved and commercialised. That should drive affordability even further, at the cost of used car values.

Traveller's Tale

August is usually a little light in terms of Alphinity travels as most of us are engaged in the depths of company earnings. It's a frantic month during which the global quarterly reporting season intersects with the Aussie reporting calendar, the financial year end for most companies. It's a rare occasion where most people are in the office at the same time; the domestic team on earnings calls and meeting with management while the Global team was also keenly plugged into earnings results mostly from the US and in Europe.

Monique managed to sneak in a trip to West Australia before being hit by the onslaught of FY24 earnings, taking to the streets of Perth to glean as much insight into the energy sector as possible and to assess how the major growth projects were tracking before results season kicked off. She met with company Chairs, ex CEOs, key execs and the middle management of listed and unlisted oil and gas companies in an attempt to work out what is going on in that complex sector.

Trent, covering Tech, is naturally acclimatised to the US West Coast, Silicon Valley in particular. The day after his 'mature age' soccer team, the Hammers, won its local comp he jumped on a plane with Jeff. They hadn't planned on being on the same flight and were doing completely different trips, they'd just coincidentally booked the same one.

But it's always good to have a friend on board for company, and Jeff was at least able to help Trent's aching, injury-ridden body onto the plane. Upon arrival in San Francisco, Trent jumped into one the many autonomous driving taxis operated by Waymo, a Google company. He's getting quite used to being driven around in these, and it's nice that they talk to you in a calming voice and play relaxing music so you don't get freaked out. During his rides, he observed the car having to react to to a person running across the road in front of him and a car pulling out aggressively, all flawlessly. Of course, a US trip wouldn't be complete without trying the latest food and drink flavours, guaranteed to give you that extra buzz. "Oreo Cookie" flavoured coke was the latest sample. Zero sugar, so it must be ok then.

Meanwhile, Ty celebrated the end of his reporting season with a two week trip covering five countries and 30 company meetings. From mining test sites in Stockholm, auto makers in Germany, semiconductor companies in Netherlands, the stock exchange in the UK and consumer products companies in France, the trip was diverse by geography and sector. Mercedes Benz, ASML, London Stock Exchange, BMW, L'Oreal and Novo Nordisk were just a sample of the companies he got to meet during the trip and many insights were gained.

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MONTHLY REPORT – AUGUST 2024

Top five active overweight positions as at 31 Aug 2024	Index weight %	Active weight %
Aristocrat Leisure Limited	1.4	3.1
Westpac Banking Corporation	4.5	3.0
Brambles Limited	1.1	2.7
Resmed Inc. CDI 10 to 1	0.9	2.6
Goodman Group	2.4	2.4

Asset allocation	31 Aug 2024 %	Range %
Securities	98.5	90-100
Cash	1.5	0-10

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Important information: This material has been prepared by Alphinity Investment Management Limited (ABN 94 002 835 592, AFSL 234668) Alphinity, the investment manager of the Alphinity Concentrated Australian Share Fund. Fidante Partners Limited ABN 94 002 835 592 AFSL 234668 (Fidante) is a member of the Challenger Limited group of companies (Challenger Group) and is the responsible entity of the Fund. Other than information which is identified as sourced from Fidante in relation to the Fund, Fidante is not responsible for the information in this material, including any statements of opinion. It is general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable to your circumstances. The Fund's Target Market Determination and Product Disclosure Statement (PDS) available at www.fidante.com should be considered before making a decision about whether to buy or hold units in the Fund. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. Past performance is not a reliable indicator of future performance. Alphinity and Fidante have entered into arrangements in connection with the distribution and administration of financial products to which this material relates. In connection with those arrangements, Alphinity and Fidante may receive remuneration or other benefits in respect of financial services provided by the parties. Fidante is not an authorised deposit-taking institution (ADI) for the purpose of the Banking Act 1959 (Cth), and its obligations do not represent deposits or liabilities of an ADI in the Challenger Group (Challenger ADI) and no Challenger ADI provides a guarantee or otherwise provides assurance in respect of the obligations of Fidante. Investments in the Fund are subject to investment risk, including possible delays in repayment and loss of income or principal invested. Accordingly, the performance, the repayment of capital or any particular rate of return on your investments are not guaranteed by any member of the Challenger Group.