Alphinity Concentrated Australian Share Fund

QUARTERLY REPORT – September 2024

Fed shrinks, China blinks

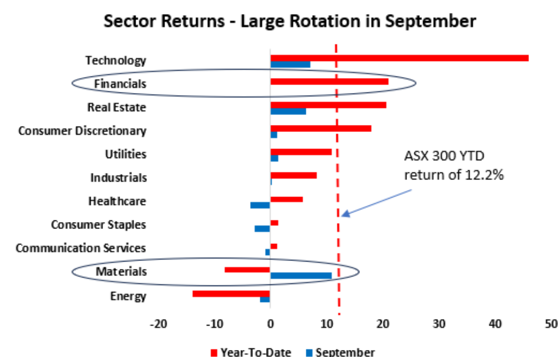
Market comment

The Australian share market (ASX300 including dividends) delivered a pleasing 8% return over the quarter ending September, beating most major markets in $A terms. US markets were in the doldrums, made worse by the $A which rose by 4% during the period, finishing at a 20-month high above US69c. Developed Markets overall rose by just 2.5% in the quarter, while Emerging Markets did a little better at 4%.

The US Federal Reserve Bank cut its short term interest rate in September, and by a chunky 0.5% rather than its normal 0.25% move. While widely anticipated, it does raise the question as to whether the Fed was panicking a bit, or just recognising that inflation is moderating quite quickly and that the Funds rate was too far above neutral and unnecessarily risking the labour market.

Not wanting to miss out on being globally relevant, China tried yet another round of stimulus in an attempt to put a stop to its rapidly deflating property market. While its last few attempts were a bit half-hearted, disappearing with little trace, this time the market took it much more seriously, sparking yet another rotation in the equity market. China started with cutting key interest rates but also added half a trillion RMB of extra liquidity and changed regulations to make it easier for people to buy second properties. This was backed up a few days later by calls for more forceful collaboration between government agencies to drive key investment projects in high tech manufacturing, transport, energy and water conservation. If successful, demand for Australian Iron Ore and Coking Coal could be on the improve, and shares of the steel trifecta (BHP, Rio Tinto and Fortescue) each rallied ~15% as a result. A number of companies linked to trade with China also rallied sharply, regardless of how tangential any benefit might be.

Commodity prices were mixed across the quarter. Notwithstanding the boost at period end, the prices of iron ore and coking coal both fell by mid-teen percents over the quarter, and most base metals were softer, due in part to currency moves. Battery inputs also fell, with Lithium and Cobalt also down mid-teens and Nickel down a more modest 5%. Copper rallied however, suggesting an improvement in the global economic outlook.



The China stimulus that took place at the end of September sparked a sharp reversal in positioning, particularly in Financials (year-to-date winners) and Materials (year-to-date losers). Defensive sectors like Consumer Staples and Healthcare lagged, while sectors more levered to falling interest rates, such as Technology and Property, outperformed.

Aside from the large moves made by the Fed and also from China, our own RBA is under increasing pressure around the timing of possible rate cuts in Australia giving inflation trends have continued to moderate throughout most developed markets. Over the quarter, the Reserve Bank stood firm with rates on hold, although its language became a little less hawkish from previous meetings, suggesting that rate hikes are now off the table. Inflation come down from 3.8% in the year to June to 2.7% at the end of August, not dissimilar to the trend in the US although still at a notably higher level.

Portfolio comment

The Fund performed in line with the strong market over the September quarter. The biggest contributors to returns were pallet pooler Brambles Industries, gaming machine maker Aristocrat Leisure, and major bank Westpac; not owning Woodside Energy also helped. The main detractors were gas-producer Santos, gaming machine maker Light & Wonder, global insurer QBE, hearing device maker Cochlear and not owning IT company WiseTech.

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)	2.8	7.6	20.6	8.0	8.2	9.8	10.2
S&P/ASX 200 Acc. Index	3.0	7.8	21.8	8.4	8.4	8.9	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 September 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 1300721637 during Sydney business hours.

Market outlook

After months, even years, of anticipation two major economic events occurred within days of each other in September, sparking a strong rally and sharp rotation in equity markets. The US Fed finally started to lower short term interest rates with a hefty 50bp cut, immediately kicking off speculation about just how soon and large the next cuts will be. Perhaps more surprisingly, China announced a comprehensive and coordinated monetary stimulus package aimed at halting the falling property market and support asset prices. Maybe not the 'bazooka' that might ultimately be required, but a double barrelled shotgun nonetheless. At the very least it showed meaningful concern from the government and an intent to make an impact, with the potential for more to come over the next few months.

The impact of both these events was a quick rotation out of previously outperforming stocks (sell banks, growth, defensives) into what were underperforming stocks (buy commodities, value, small caps). The general market view so far is that lower US rates is good for its economy (soft landing and a new cycle) and by extension the world; while China's stimulus will be good for commodity prices, and by implication Australia, so it was "risk on" and time to buy some cyclicals, for now at least.

While we wouldn't want to stand in front of a tsunami, as rotations like these can take on a momentum of their own, we do have some reservations. China's stimulus to date, and the prospect of more if needed, could well halt the deterioration in its property market and stop the negative news of falling prices. Injecting liquidity might also lift consumer sentiment in general. However, will it actually make people buy new houses and therefore increase the quantity of Iron Ore China requires? We doubt it. China is, after all, trying to address its problems by reducing the oversupply of property and steel, not increase it. Excess steel from China is currently being exported to increasingly upset neighbours, raising the risk of import tariffs. While a more stable China is better for commodity prices than a weakening one, we argue there would need to be a material increase in economic activity – especially construction activity – across the board in order to increase demand for Iron Ore. Having said that, increased liquidity is a welcome tailwind for commodities, especially if it drives demand for lower-priced discretionary items such as cars and white goods, which flows into demand for base metals.

The US economic outlook is still open to some interpretation. Clearly it has been slowing in parts, and the "neutral" interest rate is well below current levels, hence the oversized rate cut in a non-crisis time to start the cycle. At least we now know the Fed will act decisively if the data requires it. So the soft landing (no recession) camp probably has the upper hand, but that isn't to say things aren't still a bit soft. There still seems some discrepancy between what the equity market is pricing in (i.e. happy days) and the bond market (more concerning days). It is ironic that, if the equity market is right, it might be disappointed with where interest rate cuts stop, but if the bond market is right, the equity market might be disappointed with the outcome.

At least the US has inflation under control, a level of rates that justifies a cut and a central bank willing to defend growth. We appear to be still some time away from rate cuts or inflation coming back sustainably within the target band, although there are increasing signs that growth is now slowing. Earnings downgrades are accelerating in Australia, not decreasing. Maybe with commodity prices lifting we will get some respite in some parts of that sector? Otherwise, outside banks and a handful of defensive sectors, it is not great news for earnings. Yet we are unlikely to get any interest rate relief anytime soon as it seems our Reserve Bank prefers inflation targeting over unemployment targeting. However, as was pointed out to us recently, the worst predictor of the interest rate direction in Australia over time has been the RBA, so never say never! An early start to rate cutting here would likely be taken well by the market unless it was caused by economic retraction.

Geopolitics should also not be underestimated. The US election is in November. It is true that, on average, the US share market tends to rise in the year after an election regardless of which side wins, but has the difference in potential outcomes ever been this wide? We remain cautious but, as with interest rate cuts, maybe we just need to get past the result so the market can focus back on fundamentals. In addition, as we write the Middle East is becoming increasingly unstable, potentially threatening oil supplies. This uncertainty in itself will no doubt bring more market volatility.

So while we see strong US rate cuts and Chinese stimulus as clear positives for both sentiment and underlying economic stability, and therefore justifies some rotation/covering, there remain enough questions as to not go "all in" on a strong cyclical recovery everywhere. As usual, we will let company earnings guide us, but at present we continue to see more risks than opportunities in the possible outcomes. Higher commodity prices might help, or at least diminish the downgrades, and that would be helpful for a sector we can see some value in. More broadly, we worry about the overall market multiple and the extent of positive outcomes that are being priced in. We know Banks are expensive, yet it is one of the few sectors to be seeing earnings upgrades right now, so it is hard to become too bearish. Industrials have also been expensive for some time, but that hasn't stopped them from performing. Has the outlook really improved so much that we should expect even more market upside? That is hard to say definitively, considering what we currently know, so some caution needs to remain.

Portfolio outlook

While we retain a broadly neutrally-positioned portfolio, it has tended to be slightly less cyclical than average given earnings weakness in the more cyclical sectors year-to-date. We have responded to the changing events in September and valuation discrepancies by adding to cyclicals through some commodities, at the same time continuing our measured profit-taking in Banks after such a big run this year. While we don't yet see material earnings risks for Banks, it is clear that loan arrears are starting to lift and the economy slowing at the same time as valuations have become extreme. More importantly in the near term, if the world is going to be better economically with US rate cuts and an improvement in China, then commodities will become more attractive and capital will flow from Banks to Resource companies given the valuation differential. We are now moderately underweight Banks.

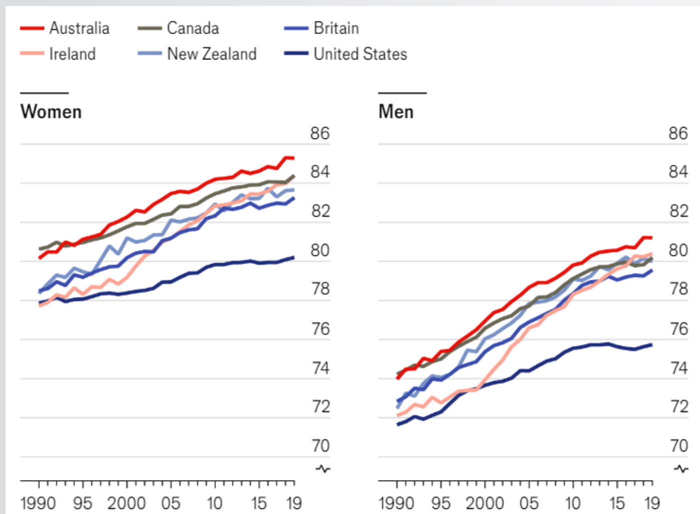
Outside those two mega sectors, we see the key drivers being primarily stock-specific. We remain overweight Insurance, although less so than earlier in the year given lower bond yields and the maturing cycle, but we continue to anticipate earnings upside from margin expansion as a result of higher premium rates and lower claims costs. While a little underweight Consumer Discretionary, we do retain selective exposure to offshore and domestic consumers. We also retain a decent weighting to growth through Healthcare and individual Technology names in which we can see earnings upside, and falling interest rates will likely help valuations as well. Energy remains a difficult sector to call: the Oil price has been weak, despite everything that's been thrown at it from geopolitics to potentially better growth in China, but it still can't be dismissed. A neutral approach appears prudent for this sector at this stage.

We remain disciplined around quality. While a rapid rotation such as we've seen can test that discipline in the short term, as low quality companies often rally a lot initially just because they are perceived to be "cheap" we find that, over time, quality earnings provide far more sustainable performance and generate less volatile returns.

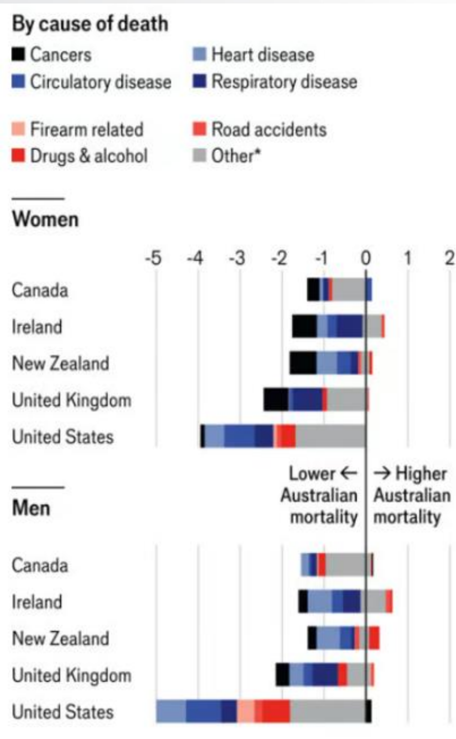
BTW

A couple of articles in The Economist caught our eye recently: "Why do Australians live so long?" and "What makes Australia so liveable?" Any mention of Australia in that publication is quite rare – especially positive ones – and those you do see are usually a tad condescending, and even these couldn't resist making a jibe about our supposedly dangerous fauna! But this what The Economist was saying about us.

Turns out that, of Anglophone countries, Australians live on average two years longer than Brits and four years longer than Americans. Even though the research from the British Medical Journal was freshly published, the data it used only went to 2019 and, knowing what we do about our massively lower death rate from Covid than both the US and UK, it is likely our figures today would look even better.



Why do we live longer? Maybe it is because we want to! Australia is truly a blessed place to live: so much natural beauty, good weather, fairly well-governed, reasonably equal, and quite prosperous. Life for many of us is pretty good, as anyone who has lived through a dreary London winter can attest. There are many other factors of course, including our comprehensive health care system with short waiting times (relative to most of the peers), and a low rate of smoking. And despite the regular tabloid frenzies, deaths on our roads are much lower than in most places.



[source: The Economist]

The study also found that Australia has a relatively low rate of what they term geographic inequality, the gap between groups like rich/poor and city/country. Our men still die on average about four years earlier than our women but our enduring shame is the gap between indigenous and non-indigenous Australians, who live on average eight fewer years than the overall average.

Australia is clearly the place to be but if you had to live anywhere else, Canada would appear to be next and New Zealand comes pretty close. The place to avoid for both sexes however is the US, the lowest line on both charts. It is also the only country whose bar chart shows anything in pink, which is deaths from firearms. For a country which owns 393 million firearms, 1.2 for every citizen, this should not come as a huge surprise! Despite our heavy controls there are still 3.5 million firearms in Australia, which is less than a tenth per capita than the US.

These things all no doubt contributed to the second article: our cities are pretty good places to live. The Economist conducts this study to help global companies work out how much of a hardship it would be to move execs around, and what sort of pay premium is needed to compensate them for any hardship. It rates various factors – Stability, Healthcare, Culture & Environment, Education and Infrastructure – to come up with the city's score. It suggests that any city that rated above an index of 80 are pretty good and shouldn't require much compensation, while below 50 means most aspects of living are severely restricted, so a 20% premium was warranted. Way more than 20% would be needed to get us to move to the lowest, which is Damascus!

Melbourne was judged the fourth most liveable city in the world with an index of 97 (after Vienna [98.4], Copenhagen [98] and Zurich [97.1]), while Sydney was only a faction behind, #7 [96.6]. Calgary and Geneva were 5 and 6. Auckland came in at #9 with a score of 96 while Adelaide fell just outside the top ten at 95.9.

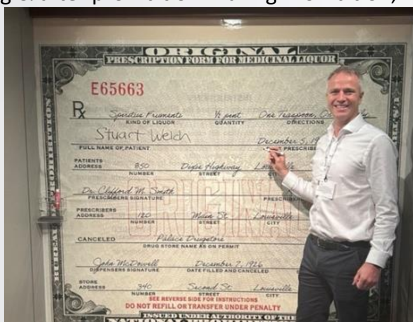
With 173 cities in the survey, it is instructive to look at the other end of the table too. Syria's Damascus scored 30.7, with Tripoli in Libya [40.1], Algiers in Algeria [42] and Lagos in Nigeria [42.2] just ahead. The ongoing war with Russia took Ukraine's Kyiv down to #165 [44.5], but even Kyiv beat the capital of our close neighbour, Port Moresby.

Big improvers included Hong Kong, up 11 spots to #50 [90.2] and Singapore, up 8 to #26 [92.9]. In the other direction, the worst move was Israel's capital Tel Aviv fell a whole 20 slots to #112 [70.7], which we suppose is what fighting wars on several fronts will do.

Travellers' Tales

The August reporting season is generally followed by a bout of travel, and September was no different – in fact it stepped up a gear. Travelling all over the world for research might sound glamorous but it rarely is: the process of putting a trip together, arranging meetings, dealing with all the last minute contingencies and actually getting to the various locations is rarely much fun. Air travel within the US is particularly miserable.

Domestic PM Stuart set off for the US, ending up in Louisville, Cincinnati and San Antonio. He saw a number of US homebuilders, Australian companies exposed to the US such as Brambles, and some of the big US consumer-facing stocks like Mondelez, the owner of Cadbury and Oreo; and Procter & Gamble, which makes laundry and cleaning products, beauty care among other things. Along the way he visited Brown-Forman, the spirits company that owns Jack Daniels and many other spirits brands. Interestingly their first brand, which happened to be America's first bottled bourbon, Old Forester, was launched in 1870. It is the only bourbon to be continuously sold by the same company before, during & after prohibition. During Prohibition, only six Kentucky distilleries were granted permits to bottle bourbon for medicinal purposes. Brown-Forman secured Permit KY-3. Apparently there were 11 million scripts written during the prohibition era and Stu was able secure one.



Andrey also went to the US but to Dallas, Atlanta, San Francisco and Salt Lake city. He visited some exciting locations including an explosives storage depot and a quarry in rural Georgia, as well as a copper mine in Utah. He attended the Goldman Sachs technology conference saw Australian explosives companies Orica and Incitec Pivot, and met with a number of companies and experts along the way. This is him→ pressing the button to set off a (small) blast.

There was one tourist hot spot in Salt Lake City he really couldn't miss: the museum at the headquarters of the Mormon Church. He received a warm welcome there and had the beliefs of the church explained to him by a very kind old lady. Andrey's natural scepticism was not overcome on this occasion (the prospect of a compulsory 10% tithe on his income didn't help!) and he escaped with a little more knowledge and a complimentary Book of Mormon to (possibly) read in his spare time.

The mine outside SLC also had a Mormon aspect to it. The Bingham Mine was established by pioneers Sanford and Thomas Bingham. In 1850, they found an ore body and took a sample to one of the church founders, Brigham Young, for his advice. He told them not to mine it. The discovery of silver and gold nearby a few years later led them to re-examine the site and it turned out to be one of the biggest copper deposits ever found. It has been churning out copper ore since the late 1800s and the Bingham Mine was bought by our own Rio Tinto in 1989.

Ty, from our Global team, went to Europe: Sweden, Germany, the Netherlands, UK and France, covering six cities and 28 company meetings. The one-line summary is, unfortunately, that there continues to be slim pickings in Europe. The consumer there is weak and the traditional manufacturing industries which used to be the driving force of the European economy are still suffering. Even European luxury, once the shining light, has faded. The message from uber-luxurious Louis Vuitton Moet Hennessy was pretty clear: its major market, China, is bad and getting worse. There would need to be a decent recovery in that market to move the needle in a positive way for European luxury companies. It should be noted however that this trip took place prior to the bout of China stimulus which may or may not drive better demand, although also before China slapped tariffs on European brandy in retaliation for EV tariffs being imposed in Europe. The longer-term question is whether growth will reset at a lower rate than in the previous decade, as the key drivers (Dior and LVMH, corporate activity, pricing, China) seem to have run out of puff, with no obvious engine for the next five years. It will be interesting to see if the China stimulus announced in late September will be enough to make much difference.

Ty also visited global mining equipment manufacturer and mining services provider Atlas Copco's test mine site in Stockholm. Having had a foray into construction work in a past life he couldn't help himself and jumped right back on the tools. The drill he is holding here → was an important innovation – the addition of the supporting arm stabilised the tool and changed drilling from a three-person job to being manageable by a single worker. There was an Australian connection there too: in the 1980s Atlas Copco provided equipment and support for excavation works at Dinosaur Cove in Victoria which uncovered bone fragments from a number of entirely unknown species. In honour of the assistance received, one of the new species was named Atlascopcosaurus Loadsi (Bill Loads was the Atlas Copco manager in Victoria at the time who supported the project). Not every company has a dinosaur named after it!

After the mining stuff, it was time to get onto something a little cooler (no offence to mining equipment): luxury cars. While they might be more relatable, and more desirable, the current investment landscape remains very challenging. EV is demand slowing, there is strong Chinese competition both within China and in Europe, and a weaker consumer auto makers are struggling, as are suppliers to the industry. Some of this is cyclical but a large part is structural as the very cheap Chinese EV alternatives could reshape the market longer term. He also went to BMWs iconic headquarters in Munich, which is shaped like engine cylinders.

Alphinity Concentrated Australian Share Fund

QUARTERLY REPORT – SEPTEMBER 2024

Travellers' Tales (cont)

BMW is facing pressure on a number of fronts and recently had to downgrade its earnings guidance due to weak Chinese demand and delivery issues in its third quarter. At Mercedes, Ty was lucky enough to get a look at its latest concept car, shown here. It has no steering wheel, being controlled instead by a joystick between the two front seats. It also has the ability to move sideways without forward motion, making parking a dream. We're not entirely sure that it will make it to production but some of the ideas might end up in your next Merc in a few years time.

There are luxury cars and there is THE car, one that has been able to withstand the pressures facing all other auto makers: Ferrari. Global team members Chris and Matisse met with management at Ferrari's HQ in Maranello, Italy. A tough gig but someone had to do it! It was all very top secret though, there were no photos allowed inside and Ferrari even went as far as taping up the cameras on their phones and laptops, so these pics→ are the only photographic evidence we have of their visit.

Matisse did get to test drive a Formula 1 car – or at least a simulator in the Ferrari Museum. She was quick to point out that it's a lot harder than it looks, after crashing about ten times. Who said race car driving was easy? On the walls of the museum were various quotes from the great Enzo Ferrari, such as: "*the best Ferrari ever built is the next one*". Ferrari (the stock) has been in our Global Equity portfolio for some time and has been a good contributor: a quality compounder throughout various market cycles and, having delivered a steady stream of earnings upgrades, a good example of an Alphinity stock.

Top five active overweight positions as at 30 Sep 2024	Index weight %	Active weight %
Aristocrat Leisure Limited	1.5	3.5
Brambles Limited	1.1	3.3
Westpac Banking Corporation	4.5	2.9
Goodman Group	2.6	2.8
ResMed Inc	0.8	2.7

Asset allocation	30 Sep 2024 %	Range %
Securities	98.0	90-100
Cash	2.0	0-10

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