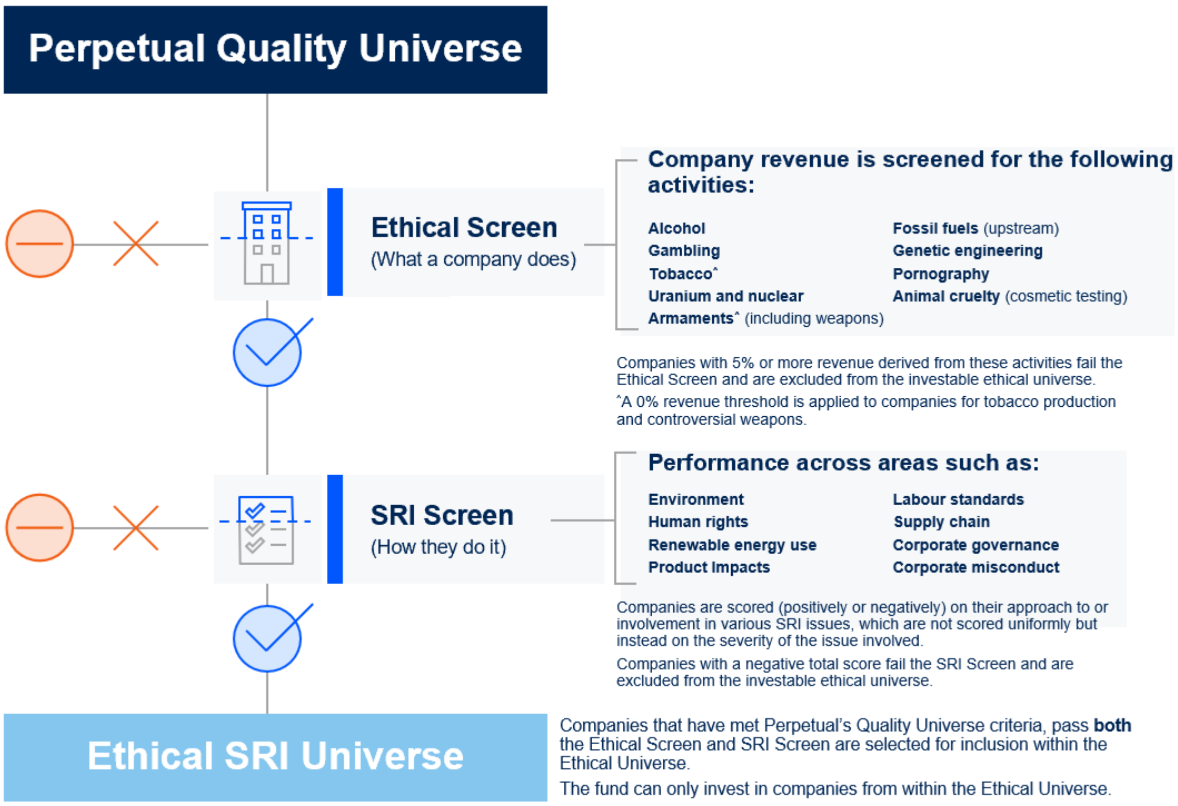
Fund update

Perpetual Ethical SRI Fund

Investment philosophy

- Perpetual Asset Management Australia is a fundamental, bottom-up stock picker, meaning that we find attractive investment opportunities by visiting and understanding companies.
- We operate a Quality and Value-based investment process. In practical terms the benefits to investors are that we avoid poor quality stocks that appear cheap and we have a strong buy and sell discipline that assists performance.
- This process is combined with independent screening to ensure the companies held in the Fund more closely match the ethical and SRI (socially responsible investment) preferences of the Fund's investors.
- Our analyst team of seventeen, with an average of nineteen years' experience, generates proprietary investment ideas.
- The Fund has the benefit of moving into or out of small and large cap stocks depending on relative opportunities.
- The Fund is focussed on investing in the best opportunities, and usually finds these away from the mainstream and away from companies that are heavily represented in market Indexes.

Investment Process



Perpetual

Fund Performance as 31 March 2022

Period	Fund	Index*	Excess
1 month	2.3%	6.9%	-4.6%
3 months	-1.5%	2.1%	-3.6%
6 months	2.7%	4.3%	-1.7%
1 year	14.2%	15.2%	-1.0%
3 year p.a.	13.2%	10.9%	2.3%
5 year p.a.	7.8%	9.4%	-1.6%
10 year p.a.	11.8%	10.1%	1.7%
Since Inception p.a. #	11.2%	8.6%	2.6%

* ASX/S&P 300 Accumulation Index. Source: FactSet.

Total returns shown for Perpetual Ethical SRI Fund have been calculated using exit prices after taking into account all of Perpetual Investment Management Limited's ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance. Portfolio and Index return may not sum to Excess Return due to rounding. # Inception date April 2002

Market Overview

The Australian market, as measured by the S&P/ASX 300 Accumulation Index, returned 2.1% for the quarter. Markets grappled with increasing inflationary pressures and changing central bank rhetoric, acknowledging the persistence of inflation, and abandoning the belief this would prove "transitory".

This change led to an abrupt repricing of interest rate expectations, led by the US but also here in Australia, where 2-and-3-year yields have exploded, all while the cash rate remains at 0.10%. This is unlikely to remain the case for long, given broadening signs of wage growth in a tight labour market. The unemployment rate is at multi-year lows at 4%, with participation increasing, and leading indicators such as job advertisements looking positive.

The Russian invasion of Ukraine and resulting sanctions have disrupted commodity flows globally, particularly in energy markets, only adding to inflationary pressure. Russia and Ukraine are key participants in many commodities including wheat, gas, nickel, and timber, amongst others. For the quarter nickel rose 55% (and more intra-period!), thermal coal rose 53% and brent crude rose 39%.

Resource stocks were favoured with the resource index up 20.1% for the quarter while the industrials index was *down* 2.8%, or a relative spread of just under 23%. Small industrials fared even worse, down 9.1%. We are finding select opportunities in this part of the market.

Fund Performance

The Perpetual Wholesale Ethical SRI Fund returned -1.5% for the quarter, underperforming the benchmark by -3.6%. Over the last twelve months, the fund has returned 14.2%, underperforming the benchmark by 1.0%.

The gains in resource stocks were the largest drivers of relative underperformance, with BHP Group (not in the ethical universe) alone impacting performance by 1.83%. As a sector, energy also detracted 0.85%. Some of our key holdings also struggled over the quarter – Ferguson fell 25% on fears of a US housing market slowdown due to rising mortgage rates, whilst our discretionary retail names gave back performance after having contributed strongly in 2021. Medibank also underperformed despite an excellent first half result, and an improved outlook for the full year. Both stocks remain meaningful holdings in the portfolio.

Reporting Season and Portfolio Update

The **Orora** result was a key highlight of reporting season, led by continued improvement in the company's US packaging distribution business, which was a core part of our original investment thesis. The Australian business has proved resilient and has secured tenure and volume growth from key customers in the cans division, whilst also replacing some lost volume in glass. An additional buyback was announced given the strength of the company's balance sheet.

National Australia Bank's quarterly update was a key standout amongst the major banks, with evidence of strong momentum and good performance on net interest margin. **Insurance Australia Group** displayed signs of improved underlying momentum, however poor weather has resulted in greater natural perils costs for FY22 and led to underperformance. The appeal on Business Interruption insurance was judged largely in favour of insurers, however the appeal process remains ongoing and is unlikely to be resolved until much later in the calendar year. We continue to believe IAG's business interruption provisioning is conservative.

We have exited our investment in **AUB Group.** This has been a very successful investment for unitholders of the fund thanks to the strong performance of Mike Emmett and his management team. AUB have allocated capital well, divesting the underperforming health and rehab business, whilst consolidating and simplifying the core broking network. Scale has been added to the agencies division, and sensible bolt-on acquisitions have been made, including an astute investment in Bizcover, which offered exposure to a fast-growing business and access to a technological capability that could be deployed more broadly through the group. AUB is well placed moving forward, however given the stock has re-rated significantly, the decision was taken to realise our investment.

Proceeds from sales were reinvested largely into existing holdings, most notably **GWA Group** and **Bapcor**.

Bapcor

The Fund had a modest position in Bapcor over 2020, however we have increased this significantly following the news of Daryl Abotomey's departure and the subsequent violent share price reaction. Under Abotomey's tenure the business grew significantly, and rightfully he was well regarded by the market. However there are several appealing characteristics to Bapcor's business that remain despite the departure of a very successful CEO.

Bapcor's core business is automotive trade, which is a resilient end market heavily influenced by kilometres driven and the ageing fleet of used cars in Australia that need servicing and ongoing repairs. Together with Repco, Bapcor operate as a market leader with breadth and depth of product range, store density and distribution capability key differentiators of performance.

The company's balance sheet is sound and continued growth potential exists from rollout, sensible M&A and private label penetration. We believe the reaction to the prior CEO's departure has created a compelling opportunity in a quality business.

Genworth Mortgage Insurance Australia

The other notable news flow for the portfolio in recent months was the acquisition of a 15% stake in **Genworth Mortgage Insurance Australia** by funds associated with Ares SSG for $2.90 a share. Our investment in Genworth was built over 2021, mostly in the low $2 range, when fears were heightened that the company might lose its largest customer Commonwealth Bank of Australia (indeed, the vast majority of revenue). Genworth has subsequently retained the business subject to agreement of final terms. It is likely volume will diminish slightly though the company could have lost the business entirely and the investment case would still have looked quite favourable.

As a mortgage insurer Genworth is a quite a unique business. The company operates in the riskier end of the housing market, insuring (the lender) against loss on high loan to value ratio borrowers, or to put it another way, borrowers with smaller down payments. This makes the company particularly sensitive to changes in macroeconomic conditions such as unemployment and interest rates.

The earnings model is also very different to many other listed insurers. Genworth receives payment in full at the inception of the policy, however this premium is effectively earned over a period stretching beyond ten years, to reflect the historical pattern of claims emergence. This means that any one reported period for Genworth will be reflection of the policies written for the preceding ten years, albeit heavily weighted to the last five.

Strong economic outcomes, the tailwind from prolonged low interest rates and meaningful house price appreciation has created significant buffers in what we call the "back book", or the significant sum of policies in force from prior years. Macroprudential measures such as restrictions on investor lending and interest only lending has further improved the quality of the book. This is not to ignore the risk of recent book years, which are likely higher given most loans were struck at very low rates. However, on balance, we think the total book will continue to season well.

Reserving has also been strengthened. Genworth have increased their reserving to account for loans that are currently not delinquent, but which have been delinquent (or behind on payments) at a previous point in their history. As a result, since listing, reserves as a percentage of insurance in force have more than doubled, and reserves on a per policy basis have increased by 1.8x. This is despite the average loan size insured increasing by only 30% over that period. Given the strong performance of the book over that period, we think this provides a meaningful buffer should economic conditions deteriorate.

Genworth is required to hold capital by the regulator in support of policies outstanding to cover potential claims. This capital constraint is heaviest in the early years of the policy life and reduces over time. As of 31 December, Genworth held capital at over 2x the regulatory requirement, and well in excess of the upper end of their guided 1.32-1.44x range. We think this capital can continue to grow as the book seasons and prior year policies earn through, generating underwriting profits. We applaud the management's decision to reduce this excess capital position by acquiring stock back on market, at meaningful discounts to net tangible asset value. This is a prudent and highly accretive use of surplus capital.

The last piece of the Genworth puzzle is the investment portfolio. Given the long-term nature of the policies, Genworth invests unearned premiums and technical reserves in investment securities. Lower rates have benefitted claims performance but severely hindered investment income – which historically was a meaningful driver of insurance profit. As of 31 December the group had some $3.7bn of cash and investments which had been making very little return, however the prospects for this running yield look much brighter moving forward.

There have been other, smaller mortgage insurance books in the Australian market transacted for book value and the investment by Ares has shone a light on some of the latent value in Genworth. The stock has been an excellent performer for the fund, and we still believe upside remains given the stock continues to trade well below NTA. The company has recently sought shareholder approval to buy back an additional 15% of shares on issue, further reducing surplus capital in an accretive manner.

ESG

Biodiversity is an area gaining increasing attention amongst investors. During March, the Taskforce on Nature-related Financial Disclosures released its initial disclosure framework. Much like the approach of the Taskforce for Climate Related Financial Disclosures, this is another step toward an aligned reporting approach.

The draft text includes definitions to aid assessment of nature related risks and opportunities, recommended disclosures and a process for undertaking risk and opportunity assessments. Risks may be physical, transition, or systemic – and opportunities can create positive outcomes by either reducing impact on the natural environment or restoring it.

The draft is open for consultation until 2023. Whilst there is much to be done, this is another clear example of the pace of regulatory change, following the introduction of EU Taxonomy, SFDR, and the formation of the International Sustainability Standards Board.

Outlook

With the federal election campaign firmly in full swing attention will no doubt turn to the prospect of a change in government and prospective policy changes, and the impact on certain stocks. Since 2016, Brexit, US elections and our own 2019 experience suggest just how difficult these events can be to predict.

Whilst markets have sharply repriced expected monetary tightening, fiscal policy is likely to remain supportive irrespective of who wins the federal election. Australian budget forecasts also assume commodity prices revert to far lower levels over coming years. This may yet prove accurate, however it is a long way from current spot pricing, which if persistent, will provide a meaningful boost to national income.

Recent market volatility has created some interesting new opportunities and the ability to add to existing core holdings on what we think are attractive terms. I am optimistic about our collection of businesses and their prospects over the coming years.

As always, thank you for your continued support.

For more information

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