Quarterly update

Perpetual Ethical SRI Fund

Performance as at 31 March 2021

Period	Fund	Index*	Excess
1 month	3.7%	2.3%	1.4%
3 months	8.4%	4.2%	4.2%
6 months	26.8%	18.5%	8.3%
1 year p.a.	52.1%	38.3%	13.7%
3 years p.a.	8.1%	9.7%	-1.7%
5 years p.a.	7.6%	10.3%	-2.7%
10 years p.a.	10.8%	7.9%	3.0%
Since Inception p.a. #	11.0%	8.3%	2.8%

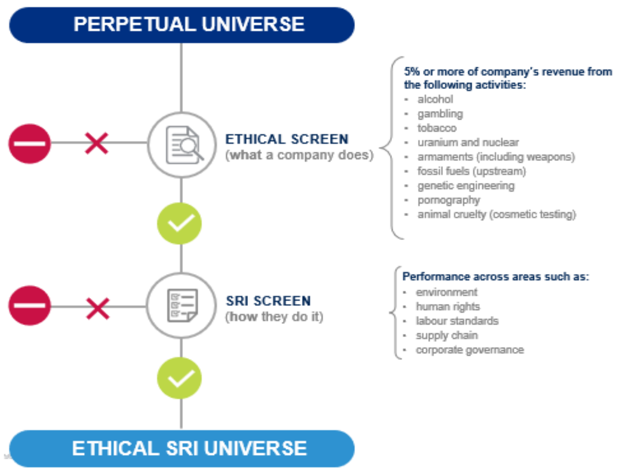
* ASX/S&P 300 Accumulation Index. Inception date April 2002

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.

Investment Philosophy

- Perpetual Investments 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 match the ethical and SRI (socially responsible investing) preferences of the Fund's investors.
- Our analyst team of seventeen, with an average of fourteen 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



Fund Performance

The Perpetual Wholesale Ethical SRI Fund returned 8.4% for the quarter, outperforming the market by 4.2%. The Fund returned 52.1% for the twelve-month period to March, outperforming the market by 13.7%.

Market Overview

The Australian share market, as measured by the S&P/ASX 300 accumulation index, returned 4.2% for the quarter. The market returned 38.3% for the rolling year as we cycled the panic-induced lows of late March 2020.

The economic recovery in Australia continued, with ongoing improvement to the labour market and further strength in commodity prices reflecting a better global economic backdrop. As a result, longer-dated interest rates have been rising. The US ten-year bond yield, one of the most closely watched financial indicators globally, has almost doubled over the quarter to 1.72%. The Australian ten-year yield has also risen to 1.76%. The magnitude of those moves inflicted sharp losses on bondholders and caused volatility in long duration equities.

Whilst the yield curve has steepened (the gap between long-term and short-term interest rates has widened) the short end remains firmly anchored by policymakers. For example, the Australian three-year bond yield is pegged at around 0.10%. The Reserve Bank is adamant that the cash rate of 0.10% will not be lifted for years. Given this monetary policy stance, it is not surprising that the Australian housing market, boosted by excess consumer savings through 2020 and record low servicing costs, has risen so sharply.

The great debate in markets is whether sustained fiscal stimulus will lead to a spike in core consumer price inflation, and the flow-on effects this will have on long-term rates and by extension, global asset pricing. In coming months year-on-year inflation data will likely rise. This is both the base effect of COVID weakness in 2020 and supply chain disruption (the last thing supply chains needed was a large boat the size of four football fields to park across the Suez Canal!). Whether this proves temporary or persistent will have profound implications for monetary policy and asset markets.

Reporting Season update

Pleasingly, many of our largest holdings reported strong results that compared favourably to market expectations in February:

- **ANZ Group (ASX:ANZ)** delivered an improved first quarter update driven by market share gains in Australian home loans, better than expected net interest margins and flat costs. The bank's capital position is sound at 11.7% Common Equity Tier 1, and collective provisioning remains prudent given ongoing uncertainty with the conclusion of the JobKeeper stimulus program. This is despite continued unwinds in mortgage deferrals and the strong economic recovery Australia is experiencing. We expect ongoing tailwinds from funding costs to support margins.
- **AUB Group (ASX:AUB)** reported a fantastic first half result with underlying profits up 44% year over year. The core Australian broking division was the standout, increasing profits by 60%. Commercial premiums continued to grow strongly, and this trend looks set to continue, based on disclosure from large companies who continue to call out significant increases in insurance costs. The listed general insurers also support the view the rate cycle will remain prolonged, as price rises are still needed to restore profitability to commercial lines. AUB Group also completed the exit of the Altius health and rehabilitation business on 31 March for consideration of approximately $57m.
- **Orora (ASX:ORA)** also surpassed market expectations. The Australian business was resilient with earnings up modestly; however, the troublesome US business showed early evidence of a turnaround. The second half ought to be supported by very favourable conditions for the US manufacturing assets, with strong demand for containerboard leading to increased pricing and improved utilisation.

In our last newsletter I shared our view that the initial approach from Essity for the outstanding shares in **Asaleo Care (ASX:AHY**) was inadequate. Essity subsequently returned and gained a unanimous board recommendation in support of a scheme of arrangement. Essity will now pay $1.40 in cash per share, plus holders will receive up to $0.05 in dividends which are expected to be fully franked. This is a material improvement from the initial proposal of $1.26 in cash, less dividends, and is a tremendous outcome for unitholders of the Fund, realizing a 45% return on a position accumulated in large part over the second half of 2020. The scheme is expected to be effective on 1 July 2021.

Portfolio Activity

Over the quarter I added to our holding of **Deterra Royalties (ASX:DRR),** which was discussed in the December quarterly. I also added to real estate group **Dexus (ASX:DXS)** and private health insurer **Medibank (ASX:MPL)**.

The Medibank first half result was overshadowed by the announcement of CEO Craig Drummond's upcoming departure. However, he is leaving the business in rude health and in our opinion, this was one of the strongest quality results delivered in his tenure. The traditional Medibank brand grew policyholders, which in addition to the continued growth at subsidiary ahm health insurance, allowed the company to take almost 30bp of market share growth in the half. Provisioning for COVID claims catch up appears conservative and underlying claims inflation is well contained.

Progress on important customer metrics such as Net Promoter Scores are translating to improved business outcomes. Even if the recent improvement in industry wide participation rates stalls, we believe Medibank can continue to gain market share and grow earnings, supplemented by targeted deployment of excess balance sheet capacity.

On the opposite side of the ledger, the Fund's holding in **NIB Group (ASX:NHF)** was materially reduced as the stock rose to a valuation that in our view better reflected the long-run earnings potential of the business, allowing for a recovery in inbound students and travel insurance sales. I have exited the position subsequent to quarter end.

Net Zero

Australian corporates have been taking the lead on net zero emissions by 2050 despite a reluctance by Federal Government to adopt a formal target. Eleven companies held within the Fund, or approximately 33% of the Fund by weight, now have net zero targets in place. **Platinum Asset Management (ASX:PTM)** is not included in this list but has acquired credits every year since listing in 2007 to completely offset the (relatively low-intensity) emissions of its business activities.

Net zero targets by 2050 are a step in the right direction but the reality is the CEO's and directors making these promises are unlikely to be at the helm three decades from now. Further, executives are often aiming to please us as investors, who in turn face constant short-term performance pressure from clients. It is easy to see how existing monetary incentives and incompatible time horizons can lead to distant promises lacking substance and accountability.

Climate Action 100+ has provided a useful framework for assessing the quality of pledges, for example, assessing the measurement and treatment of Scope 3 emissions within net zero targets, how capital expenditure investment is aligned to the target, whether sustainability targets are explicitly incorporated in to executive remuneration, and what interim targets are in place to set company's on the right path.

Near-term interim targets are critical given the size of the challenge. **Telstra (ASX:TLS)** has in some parts been criticised for relying on low-cost credits to achieve carbon neutrality, however a target to halve gross emissions by 2030 is far more ambitious. **Dexus (ASX:DXS)** is targeting net zero emissions across the entirety of its managed portfolio by 2030, and to obtain 70% of electricity from renewable sources by 2025.

We believe Dexus' standing as a sustainability leader holds their portfolio in good stead and provides downside protection as the cyclical challenges arising from COVID impact office markets. We anticipate that Dexus's office portfolio, which is 86% prime and five-star energy rated will fare much better than less efficient buildings of inferior grade through a market downturn. Our average, purchase price of around $9.00 is materially below NTA of $10.96, noting that the capital-light funds management business presents further value upside.

Since the onset of COVID, Dexus has sold approximately $3bn of assets at or slightly above book value, including assets with near-term income risk. A disconnect remains between the price at which quality real estate is transacting in private markets and the implied valuation haircut to Dexus' portfolio (holding industrial values constant). Management have sensibly used this opportunity to deploy surplus balance sheet capacity toward an accretive on-market buy-back.

Dexus is an example of the integration of ESG factors into an investment process. Dexus' sustainability performance is crucial to customers who are looking for high quality buildings that are energy and water efficient to manage their own environmental footprints. A safe, diverse and engaged workforce is the lifeblood of a business, Dexus' safety performance has been excellent, employee engagement improved through 2020 and absenteeism continued on a downward trend.

This is useful data that can assist in forming a view on the quality and culture of an organisation and therefore the risks and rewards of a potential investment. It is not about virtue or marketing gimmicks, but an acknowledgment that a company exists within a complex ecosystem of customers, suppliers, employees, regulators, communities, and market externalities. Returns to us as equity shareholders – which to us remain the main game – are a function of how a business manages all of the above as best as possible. Perfection on all fronts is elusive: that is where price paid becomes critical to maximise our potential performance.

More on carbon: The cost & implications for our portfolio

The push towards net zero is gathering steam globally, even if not Down Under. Europe is leading with the fourth phase of the EU Emissions Trading Scheme and Joe Biden has changed course dramatically from the previous administration. With regulatory momentum, and Europe openly contemplating a carbon border adjustment mechanism, it is worth pondering: what indeed is the right price for the allowance to emit one tonne of carbon dioxide equivalent? Or further, does a global price for carbon loom on the horizon?

Many schemes now exist, though the price of carbon varies dependent upon the nuances of each, such as geography, industry mix covered, and the scheme design (flat tax vs floating price cap and trade schemes). Australian Carbon Credit Units are currently priced at just under $20 and have been rising slowly but steadily. The European market is the most liquid market globally, and the price has moved in 2021 to above $A60. It has also been speculated that the price required to incentivize additional investment in renewables may be as high as $US100/tonne.

Considering rising prices in Europe and further schemes launching globally, we have recently conducted a scenario analysis on the largest direct emitters on the ASX to assess risks to earnings and valuation at various carbon prices. The sensitivity is likely overstated given that it does not account second and third order effects such as company mitigation, price rises to consumers, government support for challenged industries or compensation to the broader public.

At an illustrative price of $A50/t, the largest unmitigated impact to a single company in our portfolio would be a 9% hit to EBITDA, whilst some heavy manufacturing businesses (not owned) would stand to lose between 25-50% of earnings. Our largest exposures to emissions are in our building products investments. Due to our fund screening process and additional active investment decisions, <u>we do not own any of the top 15 emitters in the ASX 200 such as utilities and miners.</u>

Such an exercise is inherently imprecise but is still useful to stress test our portfolio. The emissions intensity of our portfolio in aggregate is much less than the benchmark index. I would encourage you to review our most recent portfolio impact report which is available on our website.

Outlook

Recent events such as the Reddit-inspired retail investor mania of January, the almost instantaneous evaporation of supply chain finance firm Greensill Capital and the disorderly unwind of the heavily levered Archegos Capital, have served as timely reminders of the incredible appetite for risk that still exists in today's financial markets. The underlying issues at the heart of these events are not particularly novel: wild speculation, excessive leverage, or a combination of the two. This movie has been seen many times before.

Such a buoyant environment is typically cause for caution, though 2020 was a stark reminder of the absolute impossibility of market timing. I have learnt from experience that my time is much better spent trying to construct a portfolio of good-quality companies at the right price than trying to second guess market movements. There remain plenty of interesting opportunities to add new ideas to the portfolio and I still regard the valuation of existing holdings as attractive.

The portfolio currently consists of a diverse mix of companies exposed to cyclical recovery such as banks, building products, media, travel, and discretionary retailers; and a raft of defensives such as telecommunications, food and beverage consumption, and other indirect exposures to fast moving consumer goods. We have recently added one software stock and one health care stock, though remain underweight both sectors as frothy valuations generally persist despite recent underperformance.

Thank you again for your support, and the trust you have placed in us to manage your investment.

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