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Morphic Ethical Equities Fund Limited – August 2017

Ethical Investing in Focus

During last month, Chad Slater, one of the founders of Morphic Asset Management, wrote for the AFR [an article](#) about why diversity of teams is not just something that is “nice”, it’s something that is essential for improving performance. You may be surprised by some of the conclusions.

Morphic’s Head of Research, James Tayler, will be presenting a Q&A video as part of Ethical Investing Week this month. We will upload the video later this month to our website for investors that are interested in learning more.

Performance Report

The Fund fell 0.2% in August, despite a slight softening of the Australian Dollar pushing global markets up 1.0% over the month in local currency terms. Since inception (May 3rd 2017), the Fund is down 2.2%.

Market Recap

Market jitters caused by aggressive rhetoric from North Korea and its growing nuclear and missile capacity resulted in high intra month volatility.

At various periods during the month, we raised cash levels as high as 30%. This less reflected genuine fear a shooting war would break out on the Korean peninsula, than concerns a perhaps over-stretched market might be looking for reasons to trigger a sell-off.

Prudence required us to raise cash briefly when fragility looked greatest, even if this insurance proved to be a slightly expensive exercise as calm prevailed. By month end we felt that the markets’ resilience confirmed the bull market remained intact.

Emerging markets once again did better than developed markets, while amongst the developed markets the US did slightly better than Europe, Japan or Australia.

Portfolio Review

The Fund underperformed global markets over August. Asset allocation to South Asia and a handful of individual long stock positions were mainly responsible. Rates, currencies and commodities made a small positive gain overall. Shorts were generally of assistance.

Two of the major positive contributors came from recent established long positions in smaller Japanese companies. [Investors Cloud is a virtual property developer](#) offering individual investors entry into the build-for-rent small apartment block market. Ateam develops games for mobile devices, owns various market share-leading internet portals as well as a newer e-commerce business. Both are growing fast and have innovative business models.

Fund Objective

The Morphic Ethical Equities Fund Limited (the Fund) seeks to provide investors a way to grow their wealth and feel confident they do so without investing in businesses that harm the environment, people, and society.

The Fund excludes direct investments in entities involved in environmental destruction, including coal and uranium mining, oil and gas, intensive animal farming and aquaculture, tobacco and alcohol, armaments, gambling and rainforest and old growth logging.

Performance

Name	Fund ¹	Index ²
1 Month	-0.19%	1.04%
3 Month	-4.28%	-2.71%
Since Inception (p.a.)	-2.22%	-0.10%

Key Facts

ASX code / share price	MEC / 1.12
ASX code / option price	MECO / 0.029
Listing Date	03 May 2017
Management Fee	1.25%
Performance Fee ³	15%
Market Capitalisation	\$51m
Shares Outstanding	45,455,627
Options Outstanding	43,425,626
Options Exercise price	\$ 1.10
Options Expire	30 November 2018

Net Tangible Assets (NTA)

Net tangible asset value before tax ⁴	\$ 1.0387
Net tangible asset value after tax ⁴	\$ 1.0552

Top 10 Holdings

Long Stocks (Shorts)	Theme	Region	Weighting
Power Grid	Indian Infrastructure	Central Asia	3.7%
Samsung Electronics	Global Tech	Asia Pacific	3.2%
Alstom	Global Rail	Europe	3.1%
Panalpina	Global Freighters	Europe	(3.0%)
SES	Global Satellite	Europe	2.6%
Service Corp	US Deathcare	North America	2.6%
Wells Fargo	US Quality Banks	North America	(2.4%)
IRB InvIT	India Infrastructure	Central Asia	2.4%
Western Alliance	US Quality Banks	North America	2.4%
DSV	Global Freighters	Europe	2.3%

Our long-short pair in European Freight companies, DSV (long) and Panalpina (short) again made a good contribution. [We have written extensively](#) about our views on the declining prospects of the sector.

Our largest detractor for the month came from US retailer Office Depot, which reported slightly disappointing quarterly results, and gave a very unimpressive management update on its turnaround strategy. The office and home stationery supplies business is in long term decline and big box retailers are facing challenges from the likes of Amazon. Even at a mid-single digit earnings multiple the stock was pricing into too much hope that earnings could be stabilised by the new management team. We have exited the position.

The continuing deterioration in the political outlook in Pakistan followed the court order sacking of President Nawaz Sharif, saw us cut our residual stake in cement maker D.G. Khan as it hit its stop-loss. This saw us exit completely our Pakistan positions, whilst over the medium-term we retain some confidence that this period of turbulence will pass, the increasing likelihood of a currency devaluation coupled with IMF risks and our stop-loss rules suggest that we wait to re-examine later in the year.

Outlook

The US Federal Reserve is still expected to announce a reversal of its Quantitative Easing program of 2008-14 later this month. However, there is growing market scepticism about there being any rate hikes this year, and very little baked in for next year either.

We expect North Korea to continue to feature in news headlines this month – and this might cause more market volatility. Nevertheless, we feel prospects for a shooting war are too remote to be worth taking the risk of raising cash, against the background of a strengthening global economy and accelerating corporate earnings.

The Fund remains fully invested, with increasing appetite for Japan, where intermittent geopolitical scares are presenting some interesting dip-buying opportunities in companies we already have a toehold in and know well. Our emerging markets overweight has been further reduced following the complete exit from Pakistan. We remain somewhat underweight the US market and have hedged a proportion of the Fund's risk to a rising Australian Dollar.

Jack Lowenstein, Chad Slater, Geoff Wood, James Tayler, Cameron Halkett, Claudia Kwan, Lucina Martin, Daniel Hayman, Irene Kardasis, Nadeem Ali, Eva Traubaud

Hedge Positions

Name	Risk Limit Utilisation (%)*
Long AUD	1.5%
Short Australian Bonds	0.6%
Long Copper	0.2%

* As a percentage of the Fund's Value at Risk (VaR) Limit

Risk Measures

Net Exposure ⁵	100%
Gross Exposure ⁶	150%
VAR ⁷	0.99%

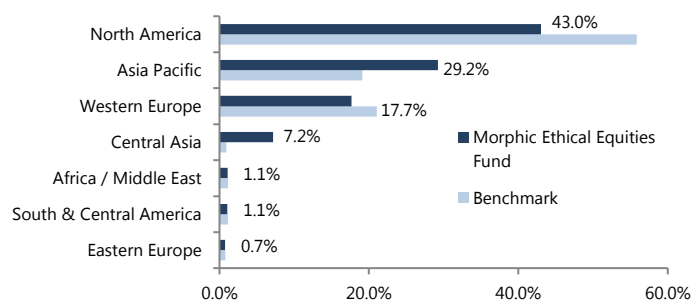
Top 5 Contributors⁸ (bps)

DSV	20	Office Depot	-29
Investors Cloud	14	D.G. Khan Cement	-15
Wells Fargo	13	Macromill	-14
Tsuruha	9	Samsung Electronics	-13
Ateam	8	Open House	-12

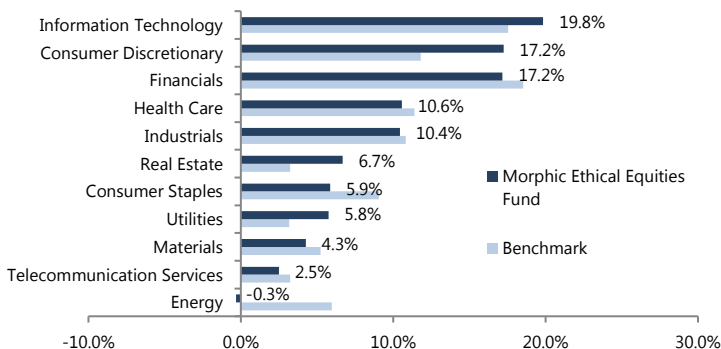
Top 5 Detractors⁸ (bps)

By Region

Equity Exposure Summary



By Sector



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¹ Performance is net of investment management fees, before company admin costs and taxes; ² The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD; ³ The Performance Fee is payable annually in respect of the Fund's out-performance of the Index. Performance Fees are only payable when the Fund achieves positive absolute performance and is subject to a high water mark; ⁴ The figures are unaudited; ⁵ Includes Equities and Commodities - longs and shorts are netted; ⁶ Includes Equities, Commodities and 10 year equivalent Credit and Bonds - longs and shorts are not netted; ⁷ VAR is Value at Risk based upon the 95th percentile with a 1 day holding period using a 1 year look back; ⁸ Attribution; relative returns against the Index excluding the effect of hedges.