

# Morphic Ethical Equities Fund Limited – July 2017

## Ethical Investing in Focus

During July Morphic Asset Management, as manager of the Morphic Ethical Equities Fund (ASX: MEC) became a signatory to the [United Nations Principles for Responsible Investing \(UN PRI\)](#), joining over 1,700 signatories with \$68tn of Assets Under Management.

The PRI are six principles that Asset Managers agree to abide by, centred on incorporating Environmental, Social and Governance (ESG) issues into decision making and promoting better ESG with the companies we own shares in. The MEC is now a signatory of both PRI and Responsible Investment Authority of Australia.

## Performance Report

The Fund fell 1.2% in July, as the strong rise in the Australian Dollar offset the 2.7% rise in global markets in US Dollar terms. The Fund outperformed global markets over the month. Since inception (May 2017) the Fund is down 2%.

## Market Recap

The enthusiasm for all things risky in 2017 continued, with yet another strong month for global markets. The love of risk extended to the Australian Dollar. It's all very different from a year ago where investors fretted about recession risk.

Emerging Markets continue to be the favourite destination for capital and rose 5.5% for the month, led by Brazil (10.8%) and China (8.3%). The USA (1.9%) and Japan (2%) were the laggards. The love of technology shows no sign of abating. Software was up 5.4% for the month and 27% YTD. Lagging over the month were defensive sectors such as Health Care (0%) and Consumer Staples (0.6%).

After last month's sell off in bonds, buyers returned to drive yields down. This led to broad based falls in the US Dollar. A more dovish outlook from the US Federal Reserve was cited, yet our read was nothing changed: The Federal Reserve remains on track to reverse its Quantitative Easing program of 2008-14 and kept the option open for another rate hike in December.

## Portfolio Review

The Fund outperformed global markets over July. Hedges added value over the month. Stocks were a positive contributor; outright shorts detracted value. The MEC's mandated zero exposure to negatively screen stocks was a headwind over the month.

The largest contributor was our long-short pair in European Freight companies, DSV (long) and Panalpina (short). Panalpina reported a disappointing set of results towards the end of the month, which saw the stock fall heavily. Analysts' earnings expectations still seem too optimistic due to their misplaced focus on the potential for rising freight volumes from improving global growth while ignoring what we believe will be continuous margin pressure in the industry.

## 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 <sup>1</sup>	Index <sup>2</sup>
1 Month	-1.22%	-1.24%
Since Inception (p.a.)	-2.03%	-1.13%

## Key Facts

ASX code / share price	MEC / 1.125
ASX code / option price	MECO / 0.032
Listing Date	03 May 2017
Management Fee	1.25%
Performance Fee <sup>3</sup>	15%
Market Capitalisation	\$51m
Shares Outstanding	45,315,627
Options Outstanding	43,565,626
Options Exercise price	\$ 1.10
Options Expire	30 November 2018

## Net Tangible Assets (NTA)

Net tangible asset value before tax <sup>4</sup>	\$ 1.0405
Net tangible asset value after tax <sup>4</sup>	\$ 1.0567

## Top 10 Holdings

Long Stocks (Shorts)	Theme	Region	Weighting
Power Grid	Indian Infrastructure	Central Asia	3.8%
Alstom	Global Rail	Europe	3.1%
SES	Global Satellite	Europe	2.7%
Wells Fargo	US Quality Banks	North America	(2.6%)
Service Corp	US Healthcare	North America	2.5%
Samsung Electronics	Global Tech	Asia Pacific	2.3%
Rural Electrification	Indian Infrastructure	Central Asia	2.3%
DSV	Global Freighters	Europe	2.1%
Panalpina	Global Freighters	Europe	(2.1%)
Bank of Internet	US Quality Banks	North America	1.8%

Analyst estimates imply Panalpina will have its best two quarters in the last seven years. We remain sceptical and short.

The second best contributor came from Bank of Internet. Investors are divided between optimists and sceptics on the bank's business model. The quarterly results showed earnings remain on track, and gave the clearest statement yet that rumours of regulatory issues are baseless, giving the sceptics pause for thought. After a 20% rally last month, we have taken profits on part of the investment.

Remaining on the theme of divisive stocks, our largest detractor for the month came from our long Magellan, short Platinum Asset Management pair. Despite Platinum reporting very large outflows in May of \$500m and a larger than expected (forced) outflow of over \$1bn in June, the stock has rallied over 30%. The stock is now trading on over 20x earnings, up from 15x, pricing Platinum as a growth stock, and indeed one of the most expensive listed Fund management businesses in the world.

A common explanation for this is improved performance in the main International Fund, and the belief that with this, flows will go from negative to positive. Our issue with this thesis is that the correlation between flows and performance is tenuous. Flows are driven by a number of factors, of which performance is just one. We remain in the position but have reduced our short position sizing based on our risk rules, and await the earnings results.

## Outlook

Our confidence [last month](#) that a surging Australian Dollar had reached its limits again proved premature. Fool me once, shame on you, fool me twice, shame on me. Interest rate differentials can't account for the move, so we are left with speculative positioning as the most plausible explanation. Though a bit chastised, we still think that the second half will be tougher for Australian Dollar bulls and US Dollar bears, but with lower conviction!

Our main hedges are focused on hedging Japanese Yen risk against the Euro along with hedging out some risks associated with rising interest rates globally.

The Fund remains fully invested, although optimistically cautious, rather than cautiously optimistic best describes our stance. Our emerging market overweight remains but has been reduced reflective of the less compelling value proposition caused by recent gains. This is funded through a US market underweight.

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

## Hedge Positions

Name	Risk Limit Utilisation (%)*
Short Yen vs. Euro	0.4%
Short Global Bonds	0.3%
Long French Bonds vs. Germany	0.3%
Long AUD	0.3%

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

## Risk Measures

Net Exposure <sup>5</sup>	101%
Gross Exposure <sup>6</sup>	144%
VAR <sup>7</sup>	1.02%

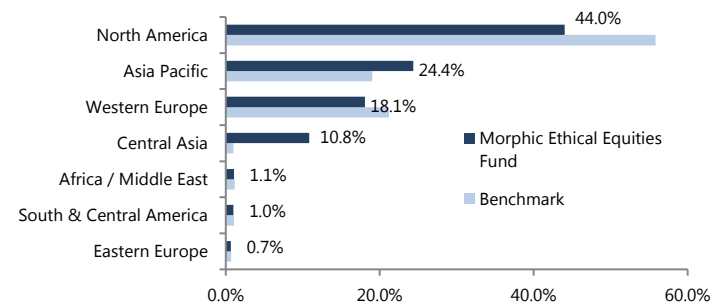
## Top 5 Contributors<sup>8</sup> (bps)

<i>Panalpina</i>	37	<i>Platinum Asset Mgmt.</i>	-26
Power Grid	29	D.G. Khan Cement	-25
Bank of Internet	23	HCA	-20
Macromill	17	Bank of the Ozarks	-15
<i>Wells Fargo</i>	15	<i>People's Insurance</i>	-9

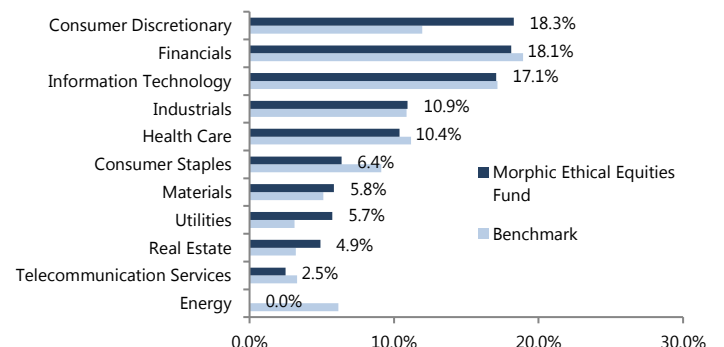
## Top 5 Detractors<sup>8</sup> (bps)

## By Region

## Equity Exposure Summary



## By Sector



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<sup>1</sup> Performance is net of investment management fees, before company admin costs and taxes; <sup>2</sup> The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD; <sup>3</sup> 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; <sup>4</sup> The figures are unaudited; <sup>5</sup> Includes Equities and Commodities - longs and shorts are netted; <sup>6</sup> Includes Equities, Commodities and 10 year equivalent Credit and Bonds - longs and shorts are not netted; <sup>7</sup> VAR is Value at Risk based upon the 95<sup>th</sup> percentile with a 1 day holding period using a 1 year look back; <sup>8</sup> Attribution; relative returns against the Index excluding the effect of hedges.