



MUNRO

Quarterly report

Munro Climate Change Leaders Fund

MCCL.ASX

September 2022



Munro Climate Change Leaders Fund & MCCL.ASX

September 2022 – Quarterly report

MCCLF Fund quarter return

8.8%

MSCI quarter return

-0.3%

MCCL.ASX Fund quarter return

8.8%

MSCI quarter return

-0.3%

QUARTERLY HIGHLIGHTS

- The Munro Climate Change Leaders Fund and MCCL.ASX returned 8.8% in the September quarter.
- Climate stocks with US business units were given a boost by the recently announced US Inflation Reduction Act (IRA) which we see as a “game changer” for the decarbonisation of the US. The IRA extends wide-ranging policy support to US renewables and associated industries (see Munro’s communications discussing the IRA: watch video [here](#) or listen to the podcast [here](#), as well as an abbreviated write up in the Fund Commentary on page 2).
- Outside of this, the third quarter of 2022 remained difficult for global financial markets. High inflation numbers were the key catalyst for the decline in markets, leading to the US Federal Reserve to continue raising rates and the US 10-year bond yield spiking to an intra-quarter high of over 4% for the first time in more than a decade.
- From a stock attribution perspective, positive contributions included energy transition company Constellation Energy, water management leader, Advanced Drain and electric vehicle power semi conductor company, On Semi. Detractors included insulation company Kingspan and wind turbine manufacturer Vestas Wind Systems.
- As financial markets have become more difficult, we have worked hard to improve the overall quality, valuation profile and diversification of the companies in the Fund as well as researching new climate companies set to benefit from the US IRA.

MUNRO MEDIA

ABC News The Business, 14 September, 2022
[Interest rates and stock volatility will be higher for longer after US inflation shock](#)

Forbes Australia, 23 September, 2022
[How to invest in innovative health](#)

Munro Partners Youtube, 15 September, 2022
[Climate Tailwinds Video](#)

CONTENTS

Fund Commentary	page 3
Market Outlook	page 4
Stock Story: Constellation Energy	page 6
Stock Story: ADS	page 7
Key Statistics	page 8

QUARTERLY COMMENTARY

Fund commentary

The Munro Climate Change Leaders Fund and MCCL.ASX returned +8.8% (+5.2% from equities and +3.5% from currency) while the MSCI ACWI in AUD returned -0.3% (-4.9% from equities and +4.5% from currency) in the September quarter.

Climate stocks with US business units were given a boost by the recently announce US Inflation Reduction Act (IRA) which we see as a “game changer” for the decarbonisation of the United States. The IRA extends wide-ranging policy support to US renewables and associated industries (see Munro’s communications discussing the IRA; watch video [here](#) or listen to the podcast [here](#)).

Some of the more important measures in the IRA include:

- Extending tax credits for wind, solar and for energy storage;
- Enhanced tax credit for carbon capture and sequestration;
- Tax credits for biofuels;
- Tax credit for green (renewables powered) and blue hydrogen (natural gas powered);
- Tax credit for nuclear power;
- Subsidies for US manufacturing of solar, wind and batteries; and
- Tax credits for electric vehicles.

All of the above measures further increase the tailwind to the companies that provide these technologies and drastically improves visibility into the industry’s long-term future.

Outside of this, the third quarter of 2022 continued the downtrend in global financial markets that had occurred in the first half. High inflation numbers were the key catalyst for the decline in markets, leading to the US Federal Reserve raising rates by 75bps in their July meeting and a further 75bps in September.

The MSCI All Country World Index rallied through the first half of the quarter until the Jackson Hole symposium in late August, when Federal Reserve Chair Jerome Powell reiterated the Fed’s “overarching focus right now is to bring inflation back down to our 2% goal” and he warned that this will cause some pain to households and businesses. The Index closed the quarter at its low, declining 16% since the short-term peak in mid-August.

As financial markets have become more difficult, we have worked hard to improve the overall quality, valuation profile and diversification of the companies in the Fund as well as researching new climate companies set to benefit from the US IRA.

In our market outlook, we share the guideposts that we are focused on in plotting the path ahead. We remain confident in the ability of our portfolio investments to grow earnings through this uncertainty and ultimately deliver meaningful returns for our clients.

QUARTERLY COMMENTARY

Market Outlook

Global equity markets continue to be in a bear market. As a reminder, this is the third bear market we have seen in the six years we have been managing money at Munro and the fifth bear market in our collective experience as investment managers. To remind readers, a bear market is classified as a 20% fall from peak in equity indices (e.g. S&P 500).

Having experience in bear markets, we continue to stick to our mantra that discipline needs to outweigh conviction. This is what our risk management and stop loss processes were created for, and we have relied on them heavily through this period. We have flagged for some time now the three things we are looking for to help identify the end of this bear market - below we update our current thoughts and detail why we have become more defensive.

Long term interest rates to peak

It has been our view that bond yields can only go up so much as there is simply too much debt in the world for long-term interest rates to get much higher than 3%. Initially, during July, there were signs that this was correct with US 10-year treasuries dropping from 3.5% to 2.5% on slowing economic data. This proved short lived. Persistently high inflation data, increasingly hawkish rhetoric from Fed president Jerome Powell and three 75bps rate hikes have seen long term interest rates back up to touch 4% in September.



Earnings estimates to come down

Higher interest rates have caused havoc to valuation multiples throughout 2022, however we have only just started to see the economic damage that higher rates will do. Earnings estimates have only come off marginally for 2022 and analysts still expect 8% earnings growth in 2023 for the S&P 500. This seems highly unlikely. A US 30-year mortgage has just hit 7%, having started the year at 3%. Even if the Fed stopped hiking interest rates tomorrow, it will be very difficult to avert a recession in 2023. Interest rates have simply moved too far too fast, if the Fed hikes further to kill inflation, then this will simply make the slowdown worse. The next few months is likely to see a significant and necessary reset of earnings expectations for 2023. Lower earnings estimates will eventually lay the foundation from which the market can sustainably recover.

QUARTERLY COMMENTARY

US 30 Year Fixed Mortgage Rate

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Source: Bloomberg Finance L.P 3 October 2022

Time

The average bear market lasts just over 300 days and falls 37% and if history is any guide, it pays to be patient in this environment. We continue to be wary of further exogenous shocks that could be precipitated by the higher interest rate environment. Obvious candidates include leveraged property players and leveraged countries. The UK's recent mini budget has seen an unprecedented sell off in UK bonds and points to the government being less likely to be able to fund their deficits. This is a warning shot to governments all over the world and suggests an era of fiscal austerity could be required exactly when most economies are going to require the opposite. Elsewhere the Russia / Ukraine and China are a source of much uncertainty and could provide further negative or positive shocks to markets should these issues worsen or be resolved.

UK 10 Year Gilt

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Source: Bloomberg Finance L.P 3 October 2022

The sun will shine again.

Longer term the sun will shine again, it always does. As time passes, the Fed will regain control of inflation, interest rates will peak, and the economy will bottom. Investors will eventually start looking over the valley of uncertainty and toward what normalised earnings look like for stocks and take a longer-term view. The average bull market lasts 64 months, and you do not need to pick the bottom to enjoy the good times when they return.

Across all our portfolios, we own large capitalisation stocks with fortress balance sheets. Longer term, we know that these companies are positioned to benefit from some of the most significant structural changes occurring in the world and hence remain confident that these companies can grow earnings through the current uncertainties. We remain excited about the opportunities presenting themselves out of this current bear market and are simply attempting to remain prudent, disciplined and patient in what is a difficult time for markets.



STOCK STORY: CONSTELLATION ENERGY



SUB AREA OF INTEREST: **Clean Energy**
MARKET CAP: **\$27.2B USD**



Constellation Energy contributed 269bps to Fund performance for the September quarter.

Constellation Energy (CEG) was recently spun out of Exelon Energy in January and is an independent power producer that owns and operates the largest nuclear fleet in the US, holding more than 55% of the nation's unregulated capacity. With plants stretching from the Midwest across to New York, Constellation provides greater than 165 Terawatt-hours (TWh) of carbon-free electricity to Americans each year, which amounts to approximately 120mn metric tons of CO₂ avoided annually.

We view nuclear as the cornerstone of the US energy transition.

Without nuclear energy, it is highly unlikely that the US can meet their Paris Agreement targets to reduce carbon emissions by at least 50% by 2030 (see diagram below), with renewables only accounting for 18% of US power generation today. Nuclear energy also boasts the highest utilisation rates for carbon-free energy sources, and therefore its ability to provide 24/7 baseload power to the grid is pivotal to ensuring energy security and reliability. This will be particularly important as the transition progresses, with variable weather conditions (wind speeds, sun shading etc.) impacting the utilisation rates of renewables.

We like Constellation for their hedged exposure to rising power prices (that are determined by natural gas prices as the marginal cost of fuel), while their operating costs remain relatively constant, resulting in strong earnings growth and cash flow generation.

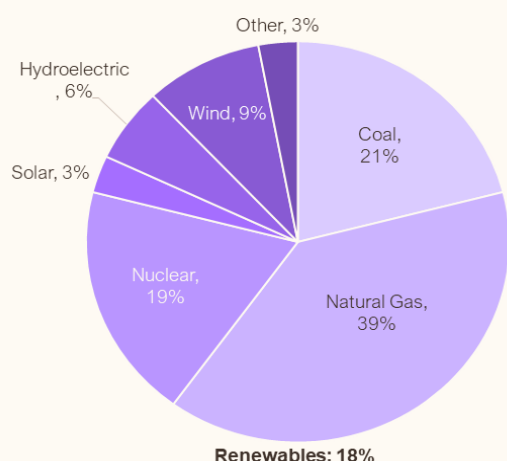
More recently, the Inflation Reduction Act (IRA) has drastically improved the prospects of nuclear energy in the US, providing production tax credits (PTCs) over the next 10+ years that give operators like Constellation long-term certainty by effectively setting a 'floor' on the power price they receive on their carbon-free generation.

We see numerous options to the upside - from aggressive capital allocation plans to investment in pink hydrogen (where electrolyzers are powered by nuclear energy to produce clean hydrogen) - allowing Constellation to also claim the generous hydrogen PTCs as they lead the decarbonisation of today's approximately 90 million ton fossil fuel hydrogen market.

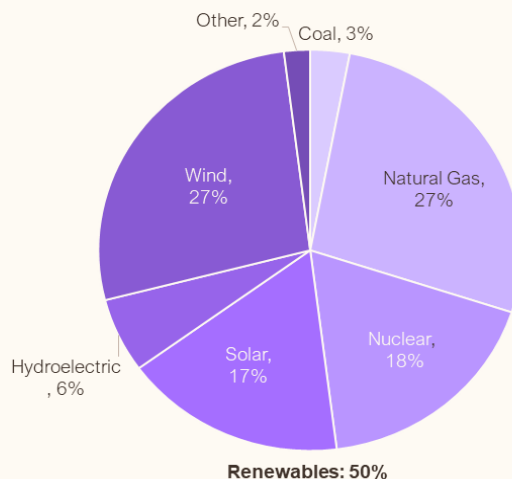
Nuclear is pivotal for the US to meet Paris Agreement commitments

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US Power Generation by Fuel (2021)



US Power Generation by Fuel (2030)



Energy Information Administration, Morgan Stanley, Munro Partners estimates (September 2022)

STOCK STORY: ADVANCED DRAINAGE SYSTEMS



SUB AREA OF INTEREST: **Circular Economy**
MARKET CAP: **\$10.4B USD**



Advanced Drainage Systems (ADS) contributed 150 bps to Fund performance for the September quarter.

ADS is a mid-cap US-based company that is headquartered in Ohio. The company makes resin drainpipes for both residential homes across the US in addition to a range of commercial buildings such as offices, retail stores and data centres. The company also has an international presence in Canada and Mexico, as well as an agriculture business providing solutions into the agriculture industry to help manage the water table and create a more efficient use of water.

The company's residential and commercial drain solutions have a structural penetration opportunity, in that ADS is taking market share from traditional concrete pipes.

The competitive advantage the company is creating are more environmentally friendly, allow for a more efficient use of water, have greater longevity that prevents replacement and maintenance, and are more cost-effective. These solutions are becoming increasingly important in new residential construction in the US and in modern commercial buildings, such as data centres, that are now being built with a water management plan in place.

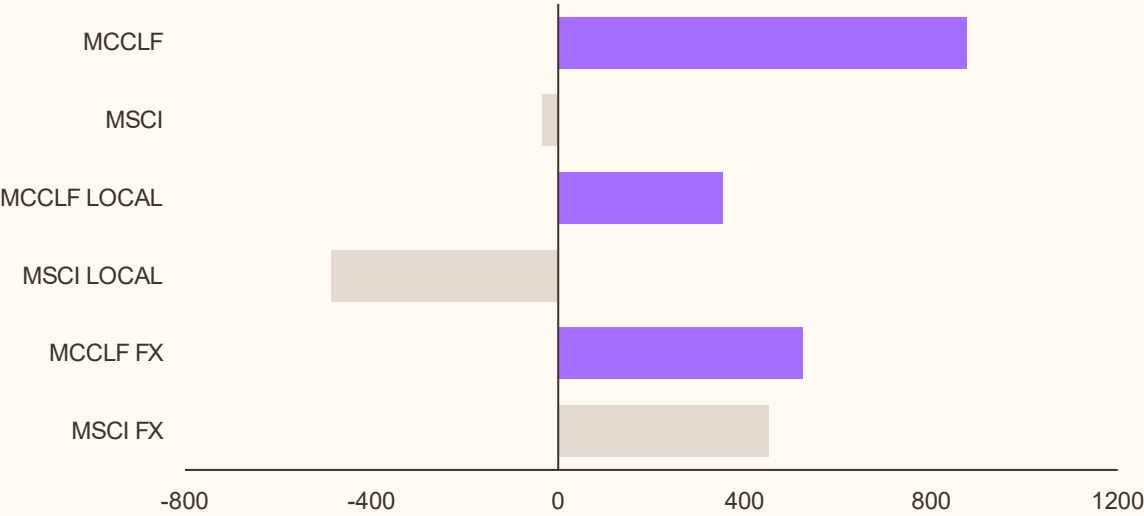
ADS is also a significant plastic recycler. In fact, it is the second largest plastic recycler in North America given it can take hard plastic waste and create a water management solution.

The company has a very committed and reliable management team which has allowed ADS to enjoy a dominant market position in their industry. This dominant position has allowed the company to make a relatively recent highly accretive acquisition of Infiltrator Water Technologies. Because of this strength in its market positioning, the company recently announced EBITDA margins in the low 30% range, already surpassing management's expectations for a high 20% margin over the next 3-4 years.

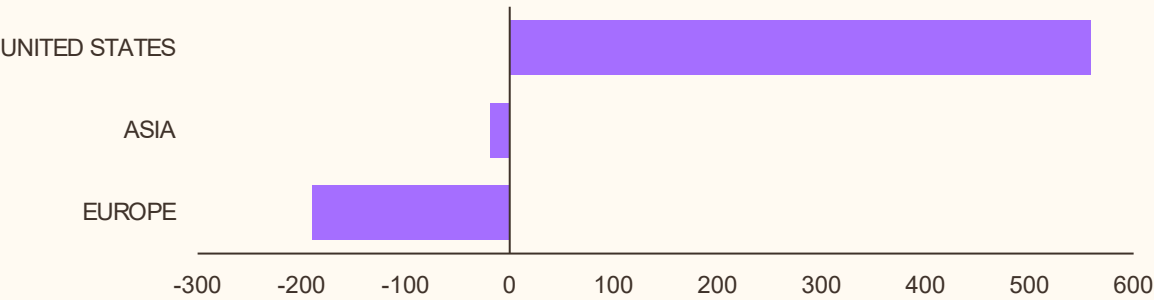
We view ADS as a relatively undiscovered climate change champion given its importance in water management and plastic recycling. We believe with the company's prospects and climate structural tailwinds, their multiple has the potential for rerating.

QUARTERLY FUND ATTRIBUTION (BASIS POINTS)

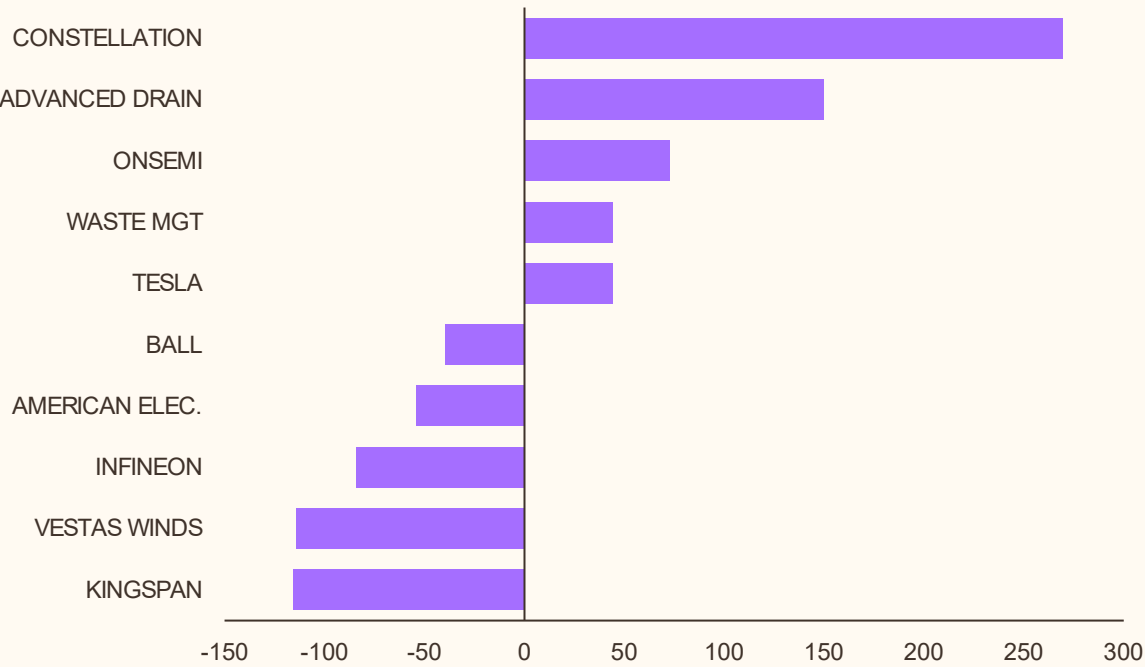
Category



Region (equities only)



Top & bottom contributors (equities only)



QUARTER END EXPOSURE

Category

LONG	91.3%
CASH	8.7%
NO. OF LONG POSITIONS	21

Sector

INDUSTRIALS	34.5%
UTILITIES	29.6%
INFORMATION TECHNOLOGY	9.3%
OTHER	17.8%

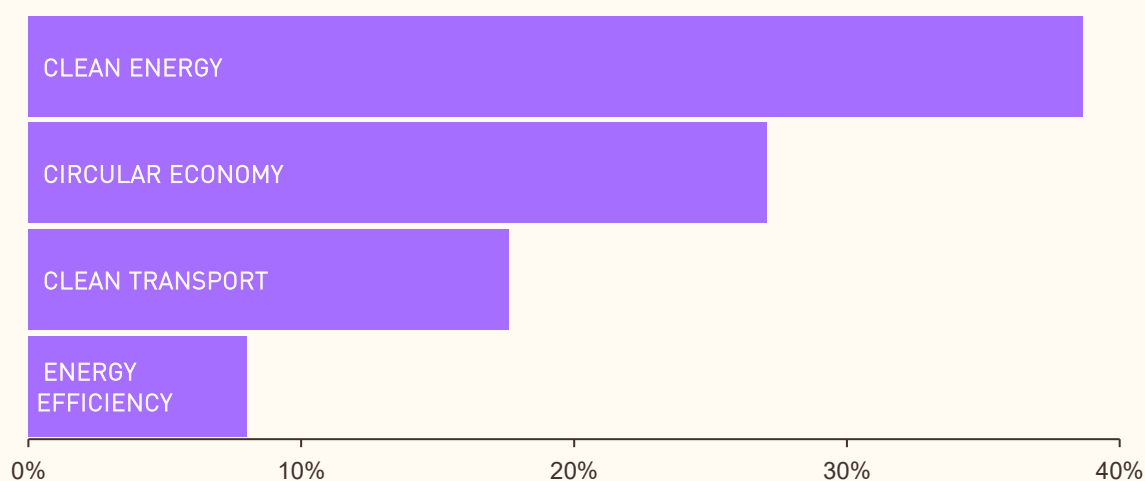
Region

	LONG
UNITED STATES	67.7%
EURO AREA	23.6%
DENMARK	3.8%
GERMANY	9.0%
IRELAND	4.3%
NETHERLANDS	3.0%
SWITZERLAND	3.5%
CASH	8.7%

Holdings

TOP 5 HOLDINGS	
CONSTELLATION ENERGY	10.0%
NEXTERA	8.7%
WASTE MGT	7.1%
TESLA	6.4%
RWE	5.5%

Sub-areas of interest



Performance - MCCL

	3MTHS	6MTHS	INCEPT CUM.
MUNRO CLIMATE CHANGE LEADERS FUND (AUD)	8.8%	-4.1%	-13.7%
MSCI ACWI TR INDEX (AUD)	-0.3%	-8.2%	-11.8%
EXCESS RETURN	9.1%	4.1%	-1.9%

	JUL	AUG	SEP	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY	JUN	TOTAL
2022FY					3.5%	0.8%	-10.5%	-3.9%	0.2%	-4.5%	-1.1%	-6.6%	-20.7%
2023FY	10.6%	0.7%	-2.4%										8.8%

Performance - MCCL.ASX

	3MTHS	6MTHS	INCEPT CUM.
MCCL.ASX (AUD)	8.8%	-4.1%	-8.7%
MSCI ACWI TR INDEX (AUD)	-0.3%	-8.2%	-12.5%
EXCESS RETURN	9.1%	4.1%	3.8%

	JUL	AUG	SEP	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY	JUN	TOTAL
2022FY							-1.1%	-3.9%	0.2%	-4.5%	-1.1%	-6.6%	-16.1%
2023FY	10.6%	0.7%	-2.4%										8.8%

Differences in performance between the Munro Climate Change Leaders Fund (unlisted fund) and MCCL (ASX quoted fund) relate to their respective inception dates, the buy/sell spread around the iNAV for MCCL, and the timing difference between the issuing of units during the day on the ASX for MCCL. This may result in reporting small differences in performance.

IMPORTANT INFORMATION: Past performance is provided for illustrative purposes only and is not a guide to future performance. Data is as at 30 September 2022 unless otherwise specified. GSFM Responsible Entity Services Limited ABN 48 129 256 104 AFSL 321517 (GRES) is the responsible entity of the Munro Climate Change Leaders ARSN 654 018 952 APIR GSF1423AU (Fund) (MCCL). GRES is the issuer of this information. Unit class A (MCCL) is an unlisted class of units in the Fund and Unit class E (MCCL.ASX) is an ASX Quoted class of units in the Fund. The inception date of MCCL is 29 October 2021, and the inception date of MCCL.ASX is 20 January 2022. Returns of the Fund are net of management costs and assumes distributions have been reinvested. Numbers may not sum due to rounding or compounding returns. The MSCI ACWI Index AUD refers to the MSCI All Country World Index Total Return Net Index in Australian Dollars. BPS refers to Basis Points. AOs refers to Areas of Interest. EM refers to Emerging Markets (including China). This information has been prepared without taking account of the objectives, financial situation or needs of individuals. Before making an investment decision in relation to the Fund, investors should consider the appropriateness of this information, having regard to their own objectives, financial situation and needs and read and consider the target market determination (TMD) and the product disclosure statement (PDS) for the relevant class of units of the Fund. The MCCL TMD is dated 28 October 2021, the PDS and Additional Information Booklet are dated 28 October 2021, the MCCL.ASX PDS is dated 10 December 2021, these documents may be obtained from www.gsfm.com.au, www.munropartners.com.au or by calling 1300 133 451. None of GRES, Munro Partners, their related bodies or associates nor any other person guarantees the repayment of capital or the performance of the Funds or any particular returns from the Funds. No representation or warranty is made concerning the accuracy of any data contained in this document. This document is issued on 12 October 2022.

