PERENNIAL GROWTH MANAGEMENT

# Perennial Socially Responsive Shares Trust

**Monthly Report**
30 September 2015

| | Month | Quarter | FYTD | 1 year | 2 years | 3 years | 5 years |
|---|---|---|---|---|---|---|---|
| | % | % | % | % | % p.a. | % p.a. | % p.a. |
| Perennial Socially Responsive Shares Trust* | -0.8 | -2.4 | -2.4 | 2.4 | 4.6 | 11.5 | 7.1 |
| S&P/ASX 300 Accumulation Index | -2.9 | -6.5 | -6.5 | -0.7 | 2.5 | 9.1 | 6.3 |
| **Value Added (Detracted)** | **2.1** | **4.1** | **4.1** | **3.1** | **2.1** | **2.4** | **0.8** |
| Net Performance | -0.9 | -2.7 | -2.7 | 1.3 | 3.5 | 10.4 | 6.1 |

* Gross Performance. Past performance is not a reliable indicator of future performance.

## Perennial Socially Responsive Shares Trust

The Trust aims to provide a total return (after fees) that exceeds the S&P/ASX 300 Accumulation Index measured on a rolling three-year basis, by investing in a selection of listed companies which also embrace and engender social performance in their corporate culture.

Portfolio manager:
Lee Mickelburough

Risk profile:
High

Trust FUM (as at 30 September 2015):
AUD3.9 million

Income distribution frequency:
Half yearly

Team FUM (as at 30 September 2015):
AUD2.3 billion

Minimum initial investment:
$25,000

Trust inception date:
December 2001

APIR code:
IOF0117AU

- **The Trust outperformed the Index by 2.1% in September.**
- **Biggest contributors to portfolio performance during the month were Veda Group Limited, Macquarie Atlas Roads Group and Incitec Pivot Limited.**
- **While the market is still focussed on capital management, we are looking for companies that are investing capital to sustainably grow their businesses.**

## Trust performance overview

The Perennial Socially Responsible Shares Trust (the Trust) outperformed the S&P/ASX300 Accumulation Index (the Index) by 2.1% in September, finishing down 0.8% against the Index which fell 2.9% for the month.

A combination of negative signalling from the US Federal Reserve, poor economic data from China and concern over debt levels of commodity companies eroded investor confidence in September. Of the Australian market segments, Information Technology (up 4.9%) was the strongest performer followed by Industrials (up 2.0%). Consumer Discretionary (down 1.1%), REITs (down 1.4%), Consumer Staples (down 1.6%) and Telco's (down 2.2%) also outperformed. Energy (down 8.1%) was the worst performing sector along with Materials (down 4.5%), Healthcare (down 3.8%) and Financials (down 3.5%).

## Investment Themes and Stock Performance

**Companies which possess strong fundamentals for growth will continue to outperform.**

Several companies we have mentioned in recent commentaries performed strongly in September.

**Veda (Overweight, up 27.8%)** received a non-binding cash expression of interest of $2.70 from US listed information solutions business Equifax, representing a 35% premium to the last closing price of $2.00. Equifax is attracted to the strategic potential earnings from Veda's Comprehensive Credit Reporting (CCR) opportunity which is in its infancy in Australia. Veda's recent result was in-line with the expectations, however guidance for FY16 underwhelmed the market with NPAT growth guidance to be 'somewhat below' low double digit EBITDA growth as management continues to invest in CCR. CCR is forecast to generate a strong uplift in earnings over the medium term and investors are closely monitoring the point when revenue and earnings start to flow from the investment in structural reforms around comprehensive reporting.

**Mantra (Overweight, up 17.3%)** is expected to deliver solid earnings growth from rising occupancy and improving room rates. Mantra is benefiting from improving macro-economic conditions for Australian tourism, especially in its Queensland operations. The sharp fall in the AUD has made Australia more affordable for inbound tourists and offshore travel more expensive for Australians, with both groups electing to holiday in places like the Gold Coast, Sunshine Coast and Port Douglas where Mantra is well positioned. The fall of the AUD from 90c to 80c helped contribute to the May 2015 earnings upgrade and was a reason why the result came in at the top of this upgraded range. Now that the AUD has continued its fall from 80c to 70c, it is providing an additional tailwind to current earnings. With this strong backdrop and strong bookings visibility we increased the size of the position during the month as two private equity firms exited their positions.

**Incitec Pivot (Overweight up 11.1%)** enjoyed a strong share price recovery in September after hosting an investor day at its ammonia plant in Louisiana and updating its earnings guidance for the year ended September 2015. The updated earnings commentary was encouraging, revealing record Di-Ammonium Phosphate (DAP) fertiliser production in Australia, and flat $US earnings from the US Explosives operations. This is a commendable performance considering the weak demand from US coal customers, and reflects tight cost control and growing volumes from the more profitable Quarrying and Construction segment. We attended the Louisiana investor day and were impressed by Incitec's risk management with a fixed price construction contract and guaranteed production from contractor KBR and ammonia off-take arrangements once the plant is online. The Louisiana investment capitalises on low-priced US gas and looks set to be a profitable contributor to Incitec's growth across FY16-18. While in the US, we also met with nitrogen industry heavyweight CF Industries which gave us increased confidence that the US ammonia market will remain import dependent and orderly, a key plank of the investment thesis in Incitec Pivot.

**Chinese economic data has remained underwhelming and policy response is demonstrating concern.**

The Chinese leadership face the reality of balancing long term reforms on corruption, the environment and market liberalisation with maintaining economic growth. There are signs that the Chinese government is becoming more aggressive in their management of the economy as they implement monetary policy to stimulate growth. We have select exposures to China facing companies. These companies are in commodities or industries that have solid long term prospects. These stocks should rebound once the shorter term growth concerns in China ease.

The market's reaction to Chinese economic weakness recently has weighed on **Alumina (Overweight, down 14.1%).** Alumina reported a strong first half profit result which was supported by a significant increase in the fully franked interim dividend. We believe that the investment program from the last few years will place the company in a very good position to weather the current alumina price weakness. We see valuation support and strong cash flow growth driven by a continued focus on lowering costs and a change in sales mix over the next few years that will result in higher priced spot sales relative to contract sales, to Alumina's advantage.

**Western Areas Limited (Overweight, down 22.1%)** underperformed with underlying nickel prices continuing to decline in-line with weakness in global commodity markets. We believe that Western Areas is a well-run company with a clean balance sheet that generates cash, even at current nickel prices.

**Bluescope Steel (Overweight, down 15.9%)** reversed some of its recent outperformance as weaker Chinese economic data weighed on sentiment in the steel industry. We remain attracted to the company's strategy to either successfully work with stakeholders to achieve an A$200m cost out program or close Port Kembla. We feel that the range of options that management has at its disposal gives them the ability to pursue improvements to profitability in the business to the benefit of shareholders in the longer term.

In a similar vein, **BHP Billiton (Restricted, not held, down 8.6%)** underperformed in September, thus contributing to the Trust's outperformance. While the weakness of commodities was a significant driver of the BHP share price this month, the company began to face increased scrutiny of its progressive dividend policy in light of the weaker commodity prices. The market is beginning to question the logic of returning capital while in a weaker revenue environment.

In contrast, **Newcrest Mining (Not held, up 13.4%)** performed strongly, thus detracting value as investors became increasingly concerned about the trajectory of Chinese economic growth and the timing of US Fed Fund rate rises. During periods of instability, investors typically turn to gold stocks for their traditional safe haven status. Despite Newcrest's strong run, spot gold actually closed the month down 1.7%.

**The economic recovery in the US continues as evidenced by generally supportive economic data.**

We are seeing the gradual normalisation of US monetary policy, ongoing recovery in the US dollar and general upward pressure on US interest rates. While this is now a consensus view, the market appears to be losing confidence that the first interest rate rise will occur this year. We are of the view that the theme remains intact and believe an interest rate hike would send a positive signal regarding the global economy.

Income producing stocks generally performed well after the US Fed elected not to raise rates during September. Within this peer group **Macquarie Atlas (overweight, up 16.7%)** performed particularly strongly given its offshore assets and earnings base. We believe that an additional driver of share price was the emerging realisation that the company's US assets may have material value following extremely high prices achieved in recent US toll road transactions. Macquarie Atlas' investment in Chicago Skyway could potentially be worth as much as 20c per share based on similar multiples, and the 50% of the Dulles Greenway could be worth well in excess of $1 per share. Both assets are currently in equity lock up (ie not contributing to current cash flows) and so simple yield-based valuations have failed to ascribe any value to these assets.

**Henderson Global Investors (Overweight, up 2.3%)** was reduced after a period of outperformance as it benefitted from the weaker AUD.

**Where is your Growth plan?**

Where most segments of the market are still focussed on capital management, we are looking for opportunities to invest in companies that are investing capital to sustainably grow their businesses.

Encompassing this theme, we added new positions in **Cochlear** and **Qube Holdings** this month.

**Cochlear (Overweight, down 2.3%)** was one of the more interesting results from the reporting season, with 10% constant currency revenue growth driven by a very strong result in the Americas and 50% growth in processor upgrades. In addition, the FY15 result was very conservatively presented with $10m one offs (inventory write-down and doubtful debt provision) taken above the line. The company now has arguably its most exciting product offer with clear industry leadership comprising: two electrodes, two implants, a relatively new processor with full wireless streaming capability, a hybrid system and a new generation BAHA (bone anchored) device. We believe that Cochlear is set for a period of strong earnings growth through a combination of product leadership, currency tailwind, and a new CEO ideally suited to commercialising the pipeline.

**Qube Holdings (Overweight, down 10.0%)** was added to the portfolio early in September after it was aggressively sold down by small cap managers following its inclusion in the ASX100. Qube has built a diverse business across Logistics and Port & Bulk services with the level of diversity providing some resistance in the challenging environment. New contracts and the full-year impact of acquisitions provide some support to FY16 earnings, while the strong balance sheet will ensure management can make further attractive acquisitions to continue to drive earnings growth. Qube is a business we know well and have owned in the past. We believe they have a first class management team who are executing their strategy well in the current environment.

We also added to our position in **SEEK (Overweight, down 2.8%)** with recent share price weakness presenting an opportunity to add to the position. SEEK has been aggressively reinvesting back into its businesses, with Chinese business Zhaopin, JobStreet and its core domestic business the focus of increased investment with management seeing large opportunities in these markets.

We exited our position in **Dulux (Sold, down 5.0%)** during the month. The stock has traded solidly (in relative performance terms) since reporting a disappointing interim result and had limited valuation upside. The interim result comprised an extremely strong result from the core Australian Paint division, offset by poor results from B&D Garage Doors and Parchem Construction Products. We believe that risks are to the downside for the upcoming full year result, given the possibility of reversion from the Paint Division and unfavourable movement of the Australian dollar/New Zealand dollar exchange rate. In addition, the company is testing consumer loyalty to the Dulux brand, by raising prices to the extent that the price differential to competing products is almost 10%. Market share trends from here will be interesting to monitor. Oil has entered a period of structural supply/demand imbalance in favour of supply.

Given the significant fall in oil prices, most energy names significantly underperformed the index and **Karoon Gas Australia (Overweight, down 14.3%)** was no exception. In the case of Karoon, we would highlight the company's strong balance sheet with current cash backing of approximately A$2.20 per share compared to its month end share price of $1.65 and with minimal drilling commitments reinforcing the company's very strong position. We would also note that the company has recommenced its share buyback.

At the end of the month the portfolio held 41 stocks and had effective cash of 1.1%

## Market Overview

The Australian market (S&P/ASX 300 Accumulation Index) fell 2.9% in September as a combination of negative signalling from the US Federal Reserve, poor economic data from China and focus on the debt levels of commodity companies eroded investor confidence. European markets fell with the FTSE down 3.0% and the Eurostoxx 50 down 5.2%. US markets performed a little better with the S&P 500 Index down 2.6%, the Dow Jones down 1.5% and the NASDAQ down 3.3%. Chinese markets continued their recent poor performance with the CSI 300 falling 4.9% and the Hang Seng falling 3.8%. The Nikkei 225 finished down 8.0%.

The US Federal Reserve announced that US interest rates would remain on hold in September. In what amounted to a tactical retreat, the Fed's policy statement cited "Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term". The statement also added that while risks to the US economy were close to balanced, it was "monitoring developments abroad". While the decision of the Fed not to raise interest rates was intended to support global markets, the accompanying negative commentary was interpreted as a lack of confidence in global growth prospects. A global equities sell-off ensued.

Chinese data has remained disappointing. The Caixin Manufacturing PMI continued its downward trend resulting in a preliminary reading of 47.0 in September, lower than the 47.5 expected and the 47.3 reading recorded in August. China's August CPI increased 2.0% year on year, greater than the 1.8% increase expected and July's reading of 1.6%, while PPI deflation accelerated to -5.9% year on year against the -5.6% expected and the -5.4% prior reading. M2 money stayed steady at 13.3% year on year in August, in line with the 13.3% expected and up from the 13.3% in July. New loan creation totalled 809bn Yuan in August against the 850bn Yuan expected and the 1480bn in July.

US economic data continued its positive trend. The ISM non-manufacturing PMI continued its recent strong returns with a reading of 59.0 ahead of the 58.2 expected. The August ISM manufacturing PMI, while remaining in expansionary territory, decreased 1.6 points from July to 51.1, behind the 52.5 expected. Housing starts declined, down 3.0% for the month of August after two consecutive prior periods of gains. Labour market conditions remained firm as the unemployment rate fell from 5.3% in July to 5.1% in August. Non-farm payrolls remained in positive territory totalling 140,000 in August, below the 204,000 expected and 210,000 prior. The participation rate remained steady at 62.6%. Headline CPI for August fell 0.1% for the month in line with the 0.1% fall expected, reversing the 0.1% gain in the month of July.

The Australian economy continued to generate mixed readings over the month. Of particular interest, building approvals for August fell 6.9%, significantly more than the 2% decline forecast. While the building approvals series is typically volatile, it is widely thought that the restrictions on investor lending that APRA has implemented are beginning to take hold. Adding to this effect, it is believed that residential construction for Chinese investors has slowed on concerns the Chinese government will restrict capital outflows and prevent Chinese buyers from settling on property purchases.

Australian retail sales declined 0.1% for the month behind the expected 0.4% growth expected and the previous month's reading of 0.7%. The labour market was positive in August with 17,400 jobs created, ahead of the 5,000 expected. The unemployment rate remained unchanged at 6.2%. After experiencing strong falls in business conditions and confidence in July, NAB business conditions rose 5 points in August to a reading of 11, while NAB business confidence continued to fall, declining to 1 from 4 points. This may reflect the divergence of current business conditions to more pessimistic views of the future.

Toward the end of the month, the spotlight fell on the commodity space after an analytical report questioned the balance sheet strength of a global commodity trader, Glencore. The resultant circa 30% fall in the share price and subsequent rout of the commodity market highlighted the increasing concern around the balance sheets of mining companies given current commodity prices and shed a spotlight on commitments to the aggressive dividend policies many are adopting. The Australian market's broad 3.8% (S&P/ASX 300 Accumulation Index) fall the day after the analysis was released, reinforced the global view of the country's reliance on the resources industry.

Spot Brent crude oil experienced a significant fall in September declining 8.1%, this takes the commodity's decline to nearly 27.3% since the end of April. Similarly, base metals experienced a fourth straight month of declines falling with the LME Index falling 2.9% in September which takes it to near a 20% fall since the end of April. Somewhat surprisingly iron ore bucked the trend of the commodity and equity markets, rising 0.2%. Spot gold declined 1.7% in September.

| Best/Worst Performers | | | |
|---|---|---|---|
| **(Best) company** | **Month Return %** | **(Worst) company** | **Month Return %** |
| Veda Group Limited | 31.4 | Bluescope Steel Limited | -15.9 |
| Macquarie Atlas Roads Group | 16.9 | Alumina Limited | -14.1 |
| Incitec Pivot Limited | 11.1 | Western Areas Limited | -20.9 |
| BHP Billiton Limited (restricted, not held) | -8.6 | Karoon Gas Australia Ltd | -14.3 |
| Mantra Group Ltd. | 19.1 | Mayne Pharma Ltd | -7.3 |

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| New/Increased positions | |
|---|---|
| Cochlear Limited | New |
| Qube Holdings Ltd | New |

| Exited/Decreased positions | |
|---|---|
| Dulux Group Limited | Exited |
| Henderson Group | Reduced |

| Top 10 Holdings | | |
|---|---|---|
| **Stock name** | Trust weight % | Index weight % |
| Westpac Banking Corp | 9.4 | 7.1 |
| ANZ Banking Grp Ltd | 8.4 | 5.9 |
| National Aust. Bank | 7.2 | 5.9 |
| Commonwealth Bank. | 6.8 | 9.3 |
| Asciano Limited | 4.5 | 0.6 |
| Caltex Australia | 4.0 | 0.6 |
| Westfield Corp | 3.7 | 1.4 |
| Macquarie Group Ltd | 3.7 | 1.9 |
| Incitec Pivot | 3.6 | 0.5 |
| Telstra Corporation. | 3.5 | 5.2 |

| Asset Allocation | | |
|---|---|---|
| **Sector** | Trust weight % | Index weight % |
| Energy | 5.6 | 4.0 |
| Materials | 12.7 | 13.9 |
| Industrials | 15.0 | 8.0 |
| Consumer Discretionary | 4.9 | 4.7 |
| Consumer Staples | 0.0 | 7.1 |
| Healthcare | 6.6 | 6.4 |
| Financials-x-Real Estate | 43.7 | 38.4 |
| Real Estate | 3.7 | 8.4 |
| Information Technology | 0.0 | 1.1 |
| Telecommunication Services | 3.5 | 5.7 |
| Utilities | 3.3 | 2.3 |
| Cash | 1.1 | - |

Rounding accounts for small +/- from 100%.

For all other enquiries please contact us on 1300 730 032 or visit www.perennial.net.au.

*Signatory of:*

PRI Principles for Responsible Investment