PERENNIAL GROWTH MANAGEMENT

Perennial Socially Responsive Shares Trust

Quarterly Report
31 March 2015

	Quarter	FYTD	1 year	2 years	3 years	5 years
	%	%	%	% p.a.	% p.a.	% p.a.
Perennial Socially Responsive Shares Trust*	10.9	10.5	13.3	14.2	15.3	7.7
S&P/ASX 300 Accumulation Index	10.3	12.9	13.9	13.4	15.3	8.3
Value Added (Detracted)	**0.6**	**-2.4**	**-0.6**	**0.8**	**0.0**	**-0.6**
Net Performance	10.6	9.7	12.2	13.2	14.3	6.7

* 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 31 March 2015):
AUD54.0 million

Income distribution frequency:
Half yearly

Team FUM (as at 31 March 2015):
AUD2.6 billion

Minimum initial investment:
$25,000

Trust inception date:
December 2001

APIR code:
IOF0117AU

- **After a lacklustre December quarter, the Australian market performed very strongly through to the end of March.**
- **Top contributors included Henderson Group PLC, Mayne Pharma Group Limited, Woolworths Limited and Woodside Petroleum Limited.**
- **Companies which possess strong fundamentals for growth will continue to outperform.**

Trust performance overview

The Perennial Socially Responsive Shares Trust (The Trust) closed up 10.9% in the quarter, outperforming the S&P/ASX300 Accumulation Index (the Index) by 0.6%, with the Index closing up 10.3%.

After a lacklustre December quarter, the Australian market performed very strongly through to the end of March, registering its largest first quarter return ever. Consumer discretionary (up 14.3%) and banks (up 14.3%) were the strongest performing sectors, closely followed by utilities (up 13.7%), healthcare (up 11.8%) and Australian REITs (up 9.4%). As would be expected given the trajectory of commodity prices, resources (up 3.1%) and energy (down 3.7%) lagged.

Quarterly Investment Themes and Stock Performance

Top contributors included Henderson Group PLC, Mayne Pharma Group Limited, Woolworths Limited (not held) and Woodside Petroleum Limited (not held).

Top detractors included Karoon Gas Australia Limited, Transfield Services Limited, Brambles Limited and Seek Limited.

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

This quarter we added six new positions in M**acquarie Group Limited (up 31.5%), AMP Limited (up 19.5%), Incitec Pivot Limited (up 27.6%), Caltex Australia Limited (up 3.5%), Fairfax Media Limited (up 11.5%)** and **Carsales.com (up 1.9%)** owing to our estimation of their strong growth prospects and management teams.

Macquarie Group is a global provider of banking, financial advisory, investment and funds management services. Supported by a strong management team we feel that Macquarie Group is well positioned for growth as it benefits from its leverage to foreign exchange translation, higher market volatility supporting trading volumes and rising asset prices as bond yields continue to decline. Supporting this thesis, the group upgraded guidance for profit growth for this financial year during the month. The group now expects that profit growth will be approximately 10% to 20%. The change in forecasts is driven by continuing levels of activity particularly in the commodities trading segment of the business with the falling oil price seeing oil and gas customers participate more actively in hedging programs.

AMP Limited is Australia and New Zealand's largest independent wealth management company, with an international investment management business and a retail banking business in Australia. It serves customers in Australia, New Zealand, Asia, Europe, the Middle East and North America. We see two main avenues for growth in the business

of AMP. In the first instance, record low interest rates combined with low business confidence in Australia are encouraging retirees to explore different options when generating income for retirement and in the second instance the decline in the Australian dollar (AUD) is helping encourage (albeit slowly) local retirees to invest offshore. Concerns about AMP's life insurance division have abated in recent months following continued favourable experience against assumptions and the division continues to receive solid business inflows.

Incitec Pivot Limited manufactures and distributes a range of industrial explosives, fertilisers and related products and services to the mining and agricultural industries. The near term growth outlook for the company has materially improved recently due to the depreciation of the AUD, strength in fertiliser prices and sustained lower US gas prices. Incitec is among the greatest beneficiaries to a lower AUD among our research universe, via US dollar (USD) fertiliser prices translated to Australian dollars, improved competitive position of Australian mining and agriculture customers, and translation of US earnings (currently 30% of group earnings, rising to more than 50% post the opening of the Louisiana ammonia plant in FY17). Construction of the Louisiana ammonia plant is progressing well and should be completed late this calendar year and the plant will be the major driver of earnings in 2016 and 2017. The economics of the plant have improved further since sanctioning due mainly to lower gas prices, but also a lower AUD. Incitec Pivot will be in an extremely strong cash generative position post Louisiana with an underleveraged balance sheet. The company has been clear that following this major project, shareholders will be rewarded with increased dividends and capital management.

Fairfax Media Limited is a multi-platform media group with a range of activities including publishing of news, information and entertainment, advertising sales in newspaper, magazine and online formats, and radio broadcasting. Amongst its business mix, we are most strongly attracted to Domain, its residential property advertising service. With strong underlying growth supported by two synergistic acquisitions namely MMP and Allhomes, it is our opinion that Domain's earnings will increase rapidly. We expect Domain to pass 50% of group EBITDA during FY18, a rapid rise from the 23% in 1H15. The growth in Domain & ongoing decline in print revenues, leads us to view Fairfax as an online business with legacy print assets. We expect the stock to re-rate as this transition occurs.

Caltex Australia Limited was added by participating in the sell down of Chevron's 50% shareholding in the company. We believe that Chevron's exit from the register is significant given the majority of shareholders will now be Australian, and they will likely be in favour of liberating the $1.1 billion of excess franking credits that sit on Caltex's balance sheet. Post the closure of the Kurnell refinery late last year (which has reduced earnings volatility and freed up substantial working capital), Caltex is arguably under geared and well-placed to materially increase dividends or undertake off market share buybacks to distribute the franking credits. Caltex has an improving growth outlook, boosted by a company-wide cost out program which will deliver up to 10% earnings upside by FY16 and fuel retailing is assisted by the ACCC's decision to limit supermarket fuel discounts at 4 cents per litre.

We exited from our position in **Lend Lease Group (up 3.0%)** during the quarter. The stock has enjoyed a period of very strong performance and has been a significant positive contributor to the returns of our portfolio over the period that we have held it. It is now all but certain that the East West Link in Melbourne will not be built and we see this as a significant negative as it represented a material part of Lend Lease's construction order book and 1H15 profits (finance structuring fees). The Consortium is currently negotiating with the Victorian government regarding compensation, and we believe Lend Lease's share price does not reflect the possibility of an unfavourable outcome. While we otherwise remain positive on the short term outlook, this is increasingly looking like peak of cycle earnings for the company and we expect earnings growth to slow.

We exited **Asaleo Care Limited** as it traded closer to our assessed valuation. While Asaleo's hedge positions for key commodities are effective today, later in the year when the hedges roll off the group will need to recover higher costs of production with price increases and we believe this poses a significant risk to earnings.

Mayne Pharma Group Limited (up 51.3%) announced two very important pieces of news and in the process highlighted that the market is beginning to look for, and reward, growth. The first announcement was the end of litigation by Pfizer to stop the company launching its generic version of Pfizer's Tikosyn drug. Tikosyn is used for the treatment of irregular heartbeat. Annual sales of the drug in the US are approximately USD150 million. As Mayne Pharma was the first to file an Abbreviated New Drug Application (ANDA) for this molecule, if it is approved by the FDA, Mayne Pharma should be entitled to a six month period of exclusivity whereby no other generic version of the drug could be launched in the US. The earnings implications for Mayne are very significant. We estimate this drug may contribute up to USD23 million in the first full year to market. The second announcement that Mayne made to the market was the acquisition of the Doryx brand and related assets from Actavis for USD50 million.

Actavis had mismanaged the distribution of Doryx and we feel that bringing the distribution in house to Mayne should result in at least a recovery in prescription volumes to previous levels. Mayne also announced smaller acquisitions of two other key existing generic products for a payment of up to USD15.7 million. After taking into account the acquisitions mentioned and associated capital raisings, the deal is highly accretive to growth and returns.

The market remains cautious about **Transfield Services Limited (overweight, down 16.8%)** owing to the status of their Manus Island Immigration contract which is currently up for tender, and their exposure to the energy sector. While acknowledging these factors, we believe Transfield has plenty of growth opportunities outside of these two areas with Government outsourcing in the Defence, Social and Property sectors. Transfield has undergone a significant amount of change in the last two years diversifying their business mix, consolidating their balance sheet and strengthening their management team. In our view the company is now well placed to grow earnings through new contract wins and based on our estimates we see a great deal of potential upside.

European QE is increasing, driving down the value of the Euro (EUR) against the USD and lowering bond yields.

As we have noted under this theme previously, **Henderson Group PLC (overweight, up 36.2%)** has been a beneficiary of the QE process. This has continued following confirmation by a number of industry surveys that have shown strong flows into a broad range of European asset classes which Henderson manage. We will continue to monitor retail flow momentum with the report of the first quarter of the year, expected in April, the next significant data point.

We exited **Brambles Limited** given our concern over the EUR/USD exchange rate falling more than 10% in conjunction with the AUD/USD exchange rate falling 10% since November.

We believe this rapid decline will begin to impact Brambles reported earnings numbers as we move into FY16. We have also taken a negative view on the ill-timed acquisition of the Ferguson energy business which we believe will reduce the likelihood of reaching the top end of the FY15 guidance range. The 1H15 results showed some concerning trends in the Pallets Americas business which posted a weaker result (EBIT -8% to USD190 million) impacted by higher plant costs as the pallet pool ages and increased transport costs.

The economic recovery in the US continues as evidenced by the third quarter GDP upward revision and generally supportive economic data.

This remains a central theme in our portfolio construction. We are seeing the gradual normalisation of US monetary policy, ongoing recovery in the USD and general upward pressure on US interest rates. We have chosen to play this central theme through tilting the Trust towards those companies that have operations whose fundamentals will be supported in this environment.

In past commentaries we have spoken about our exposure to Real Estate Investment Trusts (REITs). When selecting REITs for investment, we are focused on the sector (retail, residential, industrial, office), offshore earnings, strong development books, and the leasing environment in the countries in which they operate. As there is a relationship between bond yields and the valuation of REITs, normalisation of monetary policy and the subsequent rise of bond yields are likely to play an important role on REIT valuations.

This quarter we reviewed our holdings in light of the normalisation of US monetary policy and our forecasts for global bond yields. In light of this review we elected to exit our position in **Stockland (position sold),** our most domestically focussed REIT in favour of retaining greater offshore exposure. We also decided in favour of trimming our exposure to **Goodman Group (overweight, up 11.6%).** We have been pleased with the performance of Goodman over the time that we have held the position; however we elected to reduce the size of the position due to our expectations of rising US interest rates in 2015. Our position in **Westfield (overweight**, **up 5.9%)** was left intact as we see the greatest upside in its core US and European businesses as well as great potential in its development portfolio and likelihood for engagement in corporate activity.

Early in the quarter we elected to exit **QBE Insurance Group** owing to the continuation of the fall in US Bond Yields. We believe that the continuation of the fall in US bond yields will impact their investment earnings in the short term and that is not reflected in the current share price and we will continue to monitor the progress of the company.

Chinese economic data has remained underwhelming.

The Chinese leadership face the reality of balancing long term reforms on corruption, the environment and market liberalisation with maintaining economic growth. Despite the weaker growth we have not observed any change of government policy; this is consistent with our view that the leaders are maintaining a long term view of China's growth trajectory.

As has been a recurrent theme in recent times, both **BHP Billiton Limited (not held, up 8.5%)** and **Rio Tinto Limited (not held, up 1.1%)** underperformed the market as iron ore prices continued to fall on weak demand from China. While we have articulated our negative stance numerous times in previous commentaries, it is worth reiterating that we currently forecast negative cash flow growth. We believe that consensus market estimates for cash flow are likely to be downgraded given the current trajectory of commodity prices. In our view, decreasing cash flows will result in increasing debt levels for both companies unless there are significant capital expenditure cuts. The issue with significant capital expenditure cuts is that they may negatively impact the future growth potential of these businesses.

As part of the decision to increase our **Asciano Limited (overweight, up 6.1%)** position, we exited our position in **Aurizon Holdings Limited** to manage our exposure to the coal haulage sector. In our view, Aurizon has a higher degree of leverage to underlying demand for Australia's weakening bulk commodity resources of coal and iron ore and as such we prefer the diversification in Asciano's business mix. With increased efficiencies and productivity improvements across the Aurizon business already largely factored in by the market in our view, we also see Aurizon close to valuation and greater valuation upside in Asciano.

Domestically, consumer confidence and business conditions have continued to weaken and the AUD will likely continue to slide.

There will be a transitory period between the current weakness and subsequent recovery as the falling AUD should assist in rebalancing the Australian economy in the longer term. As such, we have maintained a general underweight position to the Australian retail sector.

In our December commentary we flagged our negative view on **Woolworths Limited (not held, down 1.6%)** as we believed the company was not well equipped to deal with the rising level of competition in the markets in which it operates and was losing market share as competition escalates in a weaker retail environment. In line with our thesis, Woolworths delivered a poor 1H15 result, cut FY15 guidance, replaced the Head of Supermarkets and announced a strategic review. Sales trends continued to deteriorate in supermarkets with like for like sales up just 1.2% in Q2. Margins will now likely be re-based as management announced a $500 million investment in price reductions over the coming years. This is being done to improve price perception which, despite management denial, is now a major issue for the company. We also believe costs have been unsustainably cut: Management conceded labour was cut too aggressively in-store, and that this impacted in-stock positions, service and sales. While the re-investment has begun, it will take time to deliver any benefits which suggest further downside risk to sales in the near term. We have been concerned for a number of years that Woolworths has been aggressively expanding its store roll out at declining returns. This unsustainable strategy is now being laid bare by competitive forces in the market.

Oil has entered a period of structural supply / demand imbalance in favour of supply.

This will create economic imbalances between countries leveraged to production and those leveraged to consumption.

On the back of a dry well at Kangaroo West, **Karoon Gas Australia Limited (overweight, down 11.5%)** underperformed in the energy sector and the broader market. While disappointing given the potential target size, Karoon still retains a 50% exploration success rate in this campaign and we note that there are some significant exploration events over the coming months. The next well in the Brazil campaign is the "Echidna" well which the company rates as having a 43% chance of success and a mean estimated resource of circa 100 million barrels of oil. Given the proximity to the Piracuca and Bilby oil discoveries and the geologic similarities to Kangaroo we like the look of this prospect. It is worth noting

that Apache has contracted a rig to drill a well on which Karoon is 90% carried in the Carnarvon basin with drilling to commence in May. We have retained our overweight position and still feel it is the best way to approach this structurally challenged sector.

Woodside Petroleum Limited (not held, down 4.4%) was a positive contributor for the month given our underweight position. Woodside reported their December quarter production which was slightly above the top end of expectations however their FY15 guidance of a decline in production of 8.5% and the fact they delayed capital expenditure guidance to the FY14 financial results, disappointed investors

Market overview

The major equity market indexes were broadly stronger in the quarter. European Quantitative Easing (QE) helped the Euro Stoxx, outperform returning 17.5% for the quarter. The Nikkei also performed well, with a 10.1% gain. The North American markets lagged the rest of the world, as fears of a rate increase by the US Federal Reserve (the Fed) roiled markets. The Dow Jones fell 0.3% while the S&P 500 managed to rise 0.4%.

Geopolitical risks that have been roiling markets continued to diminish over the quarter. The only significant sign of tension was in the Middle East, when Saudi Arabia bombed Yemen in March.

The European Central Bank (ECB) began broad-based bond purchases in March as part of its 1.1 trillion Euro programme.

Despite experiencing a weak quarter, the S&P500 still managed to record its ninth straight positive quarter in a row. The Fed left the federal funds rate on hold during the quarter, and while upbeat FOMC commentary regarding the US economy fuelled speculation that a rate hike was imminent, March's statement appeared to push back the timing of potential increases. Fourth quarter GDP growth moderated to a 2.6% annualised rate, slightly below the 3.0% expected and down from the 5.0% recorded in the previous quarter. Consumer spending was strong (rising 5.0%), while capital spending and exports slowed. Nonfarm payrolls continued to rise with the economy with both January and February readings well ahead of expectations. The unemployment rate ended February at 5.5% from 5.8% in November. ISM PMI's continued to expand while the manufacturing PMI fell to 52.9 at the end of February, substantially down from November's reading of 59.0. Non-manufacturing PMI in February, 56.9, was also lower than the reading of 59.3 recorded in November. Consumer confidence remained buoyant throughout the quarter.

The People's Bank of China announced cuts to benchmark interest rates of 25 basis points, effective from 1 March with the one-year benchmark deposit rate now reduced to 2.5% and the one-year benchmark lending rate at 5.4%. China's required reserve ratio was also cut by 50 basis points, effective 5 February. The cuts are aimed at helping the slowing economy, on this theme 2015 GDP growth expectations were lowered from 7.5% to around 7.0%. The NBS 70-city house price index continued to ease over the quarter as national house prices continued to decline. Fourth quarter GDP growth fell short of the 7.5% target, coming in at 7.3%, the same level as the prior quarter. CPI inflation came in at 1.4% y/y in February and PPI deflation accelerated with February's print coming in at -4.8% y/y. The HSBC manufacturing PMI eased to 49.2 in March compared to a reading of 49.6 in December.

The Reserve Bank of Australia (RBA) cut cash rates by 25 basis points during the February policy meeting. The bank commented that the economy's period of sub-trend growth was like to be "somewhat longer" and the peak in the jobless rate "a little higher". The Melbourne Institute Index of Consumer Confidence ended the quarter at 99.5, after recording an 8% gain in February. In contrast, the NAB Business confidence survey declined falling from 1 in November to 0 in February. The economy added 40,500 jobs from December to February, however the unemployment rate remained at 6.3%. Fourth quarter GDP was in line with expectations at 0.5% q/q.

Commodity prices continued to be weaker with spot brent trading below USD50/barrels of oil for the first time since April 2009. Brent recovered somewhat, yet still finished down 4.4% for the quarter. Iron ore was a significant loser falling 27.9% over the quarter as Chinese demand continued to weaken and the major producers continued to ramp up production. Gold ended the quarter largely unchanged, while the LME Index of base metals declined 5.6%.

Environmental, Social and Governance (ESG)

We have addressed the potential dangers of aggressive tax structuring previously in our ESG commentary and we now see this as becoming a greater issue for corporate Australia. Large companies invest millions in maintaining their corporate image and as we have seen through the actions of offshore governments, when they are called to task over their actions, it has the potential to cause significant brand damage. The large mining companies and News Corporation have been in the headlines as shifting hundreds of millions of dollars to low tax jurisdictions in rather creative transfer pricing arrangements. Multinational technology and consumer goods companies have been even more brazen exploiting the current tax loopholes. Given the state of the Australian budget, we would expect the Government to begin addressing what is now a flood of leakage from tax revenues.

Transfer pricing to reduce tax is not new, however the scale of the activity has grown completely out of hand over the past 10 years. How the Government acts will be interesting. While there are significant and well-funded parts of the economy that will attempt to block change we do not see that they will be able to convince the Government to move on from the issue. We believe that some of these aggressive tax practices are more widespread than just the companies that have been recently appearing in Canberra and our internal research tends to suggest that the gap between tax provided for and tax paid is widening across the top 100 companies.

If changes by the Government and the ATO lead to greater tax paid by large corporates, this will impact our valuations. If the UK style "name and shame" approach to companies that are seen as exploiting the system and therefore, the Australian taxpayer gains traction, that might also have an impact on their bottom line. We will watch the issue closely, it is unlikely to subside and it is very important to the economy.

Top 10 Holdings		
Stock name	Trust weight %	Index weight %
National Aust. Bank	8.8	6.2
ANZ Banking Grp Ltd	8.4	6.7
Commonwealth Bank.	8.3	10.0
Westpac Banking Corp	7.4	8.1
CSL Limited	5.1	2.9
Asciano Limited	3.2	0.4
Mayne Pharma Ltd	3.1	0.0
AMP Limited	3.1	1.3
Challenger Limited	2.9	0.3
James Hardie Indust	2.8	0.4

Asset Allocation		
Sector	Trust weight %	Index weight %
Energy	4.6	4.4
Materials	10.8	14.4
Industrials	10.7	7.3
Consumer Discretionary	4.2	4.3
Consumer Staples	0.0	6.8
Healthcare	10.9	6.1
Financials-x-Real Estate	43.5	40.4
Real Estate	4.7	7.7
Information Technology	1.3	1.0
Telecommunication Services	2.5	5.7
Utilities	2.4	2.0
Cash	4.4	-

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:

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