Direct Equities Portfolio Performance

Responsible Investment Portfolio – September 2024 Quarter

Perpetual Direct Australian Equities Responsible Investment Portfolio

Returns including dividends*	3 months (%)	1 year (%)	3 years (%†)	5 years (%†)
Responsible Investment model portfolio	5.0	18.6	5.3	7.3
S&P/ASX 300 index	7.8	21.7	8.1	8.3
Excess return (model return above benchmark)	-2.8	-3.1	-2.8	-1.0

*Past performance is not indicative of future performance. Client performance may differ due to timing of alignment with the model portfolio, advice fees, administration fees and transactional costs associated with the client's portfolio. Performance is indicative of the total return of the model portfolio's stocks over the period.
†Per annum, compounded.

The September quarter saw a strong rebound across equities markets, as the Federal Reserve moved to slash interest rates in the US while the prospect of an Australian easing cycle edged closer. This stood in stark contrast with mounting geopolitical instability in the Middle East but thus far, markets have remained undeterred. In this context, the RI Portfolio delivered a 5.0% total return, falling short of its benchmark ASX 300 Index by 2.8%. We view the outlook for equity markets as relatively benign, with a mix of economic and geopolitical risks being offset by the reintroduction of economic stimulus globally, with Australia likely to follow in 2025.

The September quarter marked a strong start to FY25 and reinforced our long-held view of a 'muddle through' scenario playing out across most major markets. Though inflation has been characteristically sticky during this post-Covid normalisation, unemployment has remained very low. This has provided the backdrop for the kind of soft-landing that has been historically rare in similar inflationary cycles. We may yet see significant hurdles along this path but in our view, this is less likely now than a year ago.

In a soft-landing scenario, activity would be constrained by cost-of-living pressures and a return to low wage growth however, a recession would be avoided. This would likely result in low but positive GDP growth which would support earnings across a range of cyclical sectors that have thus far been under pressure and out of favour with investors. Small caps in particular have underperformed and should see a strong recovery.

During the August reporting season, commentary among senior executives was cautious but seemed to reinforce expectations of a soft landing. Nevertheless, we have seen companies rethink capital deployment strategies to account for higher borrowing costs, from reducing debt to more targeted M&A. Many corporates remain in a protection mindset, preserving profit margins, defending market share and divesting underperforming businesses. We have observed that the market has generally

Meet your Portfolio Manager

Daniel Nelson, Portfolio Manager

Daniel Nelson manages the Responsible Investment portfolio in Perpetual Private. Daniel is also the analyst responsible for research and advice on the Mining, Energy and Materials sector. Daniel joined Perpetual in 2011. He is a CFA charterholder and holds the CFA Institute Certificate in ESG Investing.

The Perpetual Direct Australian Equities Responsible Investment Portfolio has been certified by the Responsible Investment Association Australasia according to the operational and disclosure practices required under the Responsible Investment Certification Program.
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rewarded this conservatism while punishing more aggressive moves like large-scale acquisitions.

Warren Buffet once remarked that 'only when the tide goes out do you learn who has been swimming naked'. Without the support of ultra-easy monetary policy, we have seen a bifurcation of performance outcomes between ostensibly similar businesses. It is in periods like this that deep fundamental knowledge and bottom-up analysis is more imperative than ever.

The two biggest contributors to performance during the quarter were **Brambles** (+33%) and **ResMed** (+21%). Brambles has been a high conviction call for several years and we have backed management to deliver a more profitable and capital efficient business model which thus far, they have. ResMed has also impressed with expanding margins during its post-Covid recovery phase while holding its market share in the US, as supply chain pressures ease.

This was more than offset by underperformance from **Audinate (-38%)** which fell heavily following weaker earnings guidance for FY25. We see Audinate's short-term headwinds as cyclical as it experiences the last phase of Covid-related supply chain disruptions. **Lifestyle Communities (-32%)** was also a significant detractor as mounting scrutiny over aspects of its business model and negative media coverage weighed on its share price. We ultimately chose to exit Lifestyle and **Ramsay Health Care (-15%)** during the quarter. Sell discipline in such positions where we have had waning conviction continues to be an area of focus for the investment team as we seek to represent our best ideas at all times.

Other drags on performance can primarily be ascribed to sector positioning, with the spectre of lower interest rates driving better performance among A-REITs to the RI's detriment. This was a similar story in Resources, where the announcement of large-scale Chinese fiscal stimulus rekindled optimism for bulk commodity prices.

Investment outlook

As we wrote at the end of September, we are in the final throes of a post-pandemic normalisation. These 'echoes' of Covid have manifested in a variety of ways, from inventory destocking, to debt shedding in order to compensate for higher borrowing costs. This is to say nothing of the pressures placed on commercial relationships, where contracts have been re-engineered to preserve profitability as higher wages and volatile input costs threaten margins.

Yet, in the face of an ongoing cost-of-living crisis and reduced access to debt funding, we are buoyed by the resilience of the Australian consumer, businesses and economy. While we retain a sensible level of caution in the way we approach the investment landscape, there remains a healthy and compelling degree of opportunity in the markets at present and we are regularly identifying companies with attractive growth trajectories and competitive positioning.

We expect the near-term movements in the Australia equity market will continue to be influenced by inflation data, as well as the pace of interest rate changes both domestically and globally. Domestically, the market is still in no man's land in terms of a likely interest rate trajectory over the next 12 months. This continues to drive volatility and negative near-term sentiment around equities, as investors recalibrate expectations around valuation and the risk of another rate hike before the cycle turns.

From a fundamental perspective, cost of living pressures continue to erode consumer spending albeit gradually. The RBA will need to strike the right balance of easing inflation by lifting rates without crippling consumers, which thus far it has.

We expect that markets could continue to lack clear direction for some time, against the backdrop of economic and geopolitical uncertainty. However, increasingly this should evolve into a stock picker's market, and while equity markets may be vulnerable to a near term correction, this would present bottom-up fundamental active managers with opportunities to deploy capital into quality companies at more attractive valuations.

Portfolio strategy

During the quarter, we reduced banking exposure, redeploying capital into resources and non-bank financials, primarily on valuation grounds. We exited **Virgin Money UK** ahead of its takeover and **Ramsay Health Care** and **Lifestyle Communities** as our conviction in their outlooks waned. **South32** (+26%) was added during the quarter after it shed its fossil fuel exposure, allowing us to invest in the mining group after several years of ownership in our Core and WA portfolios. **Webjet Group** (+25%) was also added by default following its spin-off from **WEB Travel Group**.

As we have gained confidence of a soft economic landing, we have re-positioned the RI model portfolio over the past few months towards growth despite ongoing volatility. We have gradually removed the conservative bias that we originally held following the end of the pandemic and with it, our reticence to invest in cyclical names. The benefits of this strategy were evident in the September quarter with cyclicals like **Nick Scali** (+23%) and **Flight Centre** (+12%) among the key drivers of alpha. We expect Australia to follow the US recovery path albeit lagged by 6-12 months, as it has been for most of this current cycle.

With a relatively balanced outlook of potential threats and opportunities in the global economic landscape, we remain focused on finding long-term secular growth stories driven by the quality criteria that lie at the heart of our investment philosophy. Sustainable profitability, dominant market positions, conservative balance sheets and experienced management teams remain vital to the kind of medium-term outperformance that we are seeking to deliver.

As a result, we will continue to look for ways to exploit any excessive undulation in prices that we feel is not fundamentally driven. A good example of this would be using the week-to-week volatility in the interest rate outlook as new datapoints keep investors looking in both directions. We expect the rising threat of escalating geopolitical conflict will produce similar volatility without much in the way of long-term consequences for company earnings. In other words, we are seeking to look through the key issues that have flooded headlines rather than being led by them.

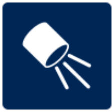
As stated earlier, we remain cognisant of the role of our model portfolios in our clients' wider investment strategies. We seek to maintain concentrated portfolios of high conviction positions that reflect our best ideas at all times. Now more than ever, we believe high fundamental quality drives longer-term outperformance more than the unending swings and roundabouts of the global economy.

Figure 1: Responsible Investment model portfolio total return for the September 2024 quarter

Brambles
South32
Webjet Group Limited
Nick Scali
ResMed
Macquarie Group
Integral Diagnostics
Flight Centre
Telstra
IGO Limited
ANZ
PEXA Group
Cleanaway
Suncorp
Virgin Money UK
National Australia Bank
Smartgroup
Medibank Private
IPH
AUB Group
CSL
Computershare
Webjet
Ramsay Health Care
Audinate
Lifestyle Communities Ltd

-50.00% -40.00% -30.00% -20.00% -10.00% 0.00% 10.00% 20.00% 30.00% 40.00%
Total return % (share price + dividend)

Source: FactSet, September 2024. Past performance is not indicative of future performance.



Stock in the spotlight

Brambles: Perfecting the Circular Economy

One would be forgiven for thinking Brambles (BXB) is a boring business – mature, commoditised and with limited scope for reinvestment. One might also be surprised to learn that Brambles was the top-performing position across our model portfolios over the September quarter.

Understanding 'why' requires some background. Brambles is the world's leading provider of pallet pooling solutions. The simplicity of Brambles' product – a simple structure comprised of no more than a few planks of wood – belies the complexity of the economics that drive its business model. This is because Brambles has pioneered a leasing system called 'pooling' whereby it loans its pallets out to its customers and is paid for the number of days they are kept. The pallets are then returned and can be reused.

Like most businesses, the volume of pallets being rented drives revenue. Where Brambles fell short however, was in the health of its pallet pool. Damaged pallets must be repaired or replaced, driving capex and reducing free cash flow. Brambles' provisioning of this loss (called IPEP) is typically a key driver of profitability and flows through to other key measure, such as 'pooling capex to sales'.

In our view, these historical struggles boiled down to a couple of key factors. Firstly, Brambles was not able to leverage its leading market position to negotiate contract pricing that adequately recovered its cost to serve. In other words, many customers were not being held accountable for excessive loss and damage rates when they occurred, driving IPEP higher.

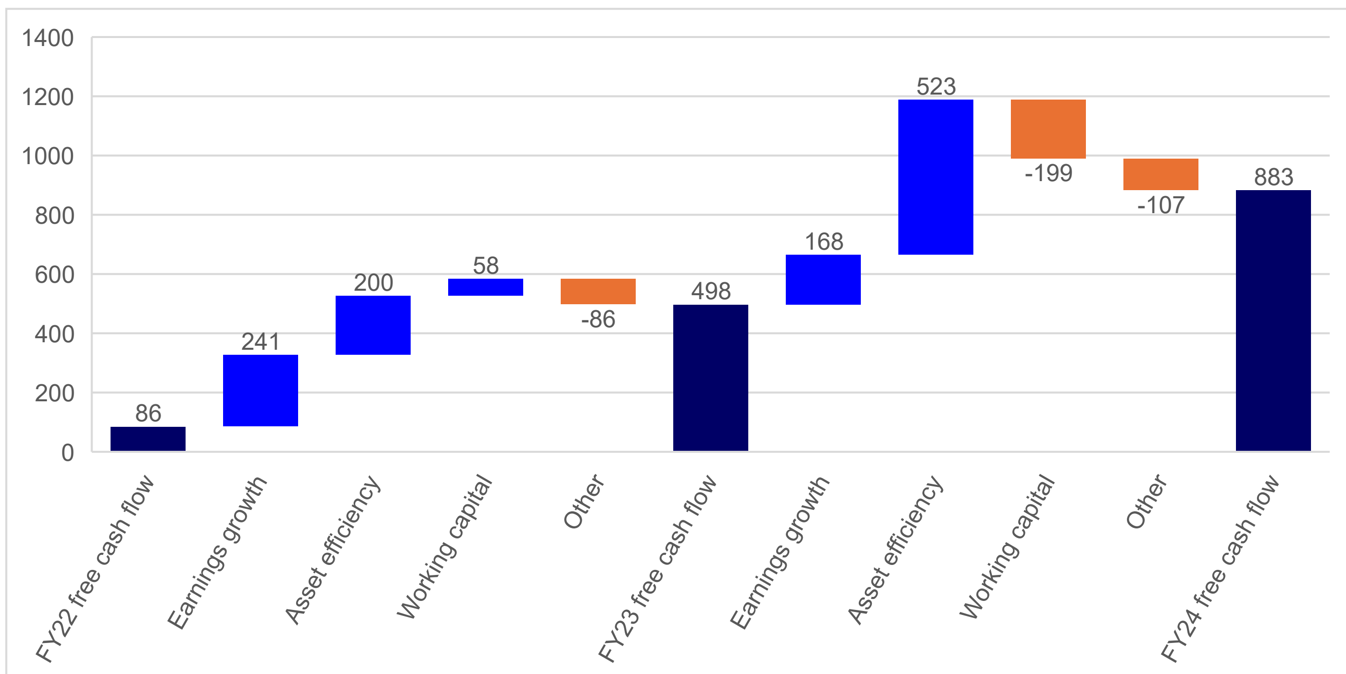
This in turn was impacted by a second factor, Brambles' poor tracking of its pool. Without visibility, accountability became impossible as blame for damage and loss was impossible to apportion.

In 2017 however, things began to change and it was at this point that we originally invested. Graham Chipchase was appointed CEO and he and his new team had a different vision for the business. They abandoned the volume-led strategy of the previous team in favour of one centred on profitability and cashflow. Volumes continued to grow through the pandemic but margins suffered as supply chains broke down and costs ballooned. Still, Brambles pushed forward with needed asset efficiency, network productivity and digital transformation programs.

Coming out of Covid, Brambles benefitted from longer lease times from its customers as they worked through a period of inventory destocking once demand normalised. This depressed IPEP and capex and hence, margins and free cash flow began to swell. However, it was the work that Brambles did to restructure its contracts, improve tracking and increase automation that most impressed us.

This has now led to a step change in free cash flow that was evident in Brambles impressive FY24 results and its guidance for FY25 and beyond. As shown below, the improvement has been dramatic but historical concerns about Brambles' profitability, pricing power, and market position have lingered. This has of course been assisted by customer destocking, but we see meaningful structural improvements to the way that Brambles does business, including how it negotiates contracts and manages its pallet

Figure 2: BXB Free cash flow (USD), FY22-FY24



Portfolio changes – September Quarter 2024

Weight changes	Date	Previous weight %	New weight %	Sector
⊘ Ramsay Health Care	9/09/2024	2.7	0.0	Health Care
⊘ Virgin Money UK	9/09/2024	2.1	0.0	Banks
⊘ Lifestyle Communities	9/09/2024	1.4	0.0	A-REITs
▼ ResMed Inc.	9/09/2024	6.3	5.6	Health Care
★ South32	9/09/2024	0.0	3.0	Metals & Mining
▲ CSL	9/09/2024	5.9	6.9	Health Care
▲ Audinate	9/09/2024	2.4	3.4	Communications & Technology
▲ Webjet	9/09/2024	2.5	3.5	Consumer Discretionary
▲ Smartgroup Corporation Ltd	9/09/2024	2.6	3.6	Industrials

Top 5 high-conviction holdings – as at 07/10/2024

Model portfolio stock	Relative weight‡ %	Holding weight %	Sector
ANZ Banking Group (ANZ)	+4.2	7.8	Banks
National Australia Bank (NAB)	+4.4	9.0	Banks
AUB Group Limited (AUB)	+2.5	2.6	Non-bank Financials
Macquarie Group (MQG)	+3.9	7.1	Non-bank Financials
Medibank (MPL)	+2	2.4	Non-bank Financials

‡Reflects portfolio manager conviction. Represents the percentage held above the stock's weight in the ASX 100 index.

[1] The Responsible Investment Certification Program provides general advice only and does not take into account any person's objectives, financial situation, or needs. Neither the Certification Symbol nor RIAA recommends to any person that any financial product is a suitable investment or that returns are guaranteed. Because of this, you should consider your own objectives, financial situation and needs and also consider the terms of any product disclosure document before making an investment decision. Certifications are current for 24 months and subject to change at any time.

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