EthicalPartners
FUNDS MANAGEMENT
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ETHICAL PARTNERS FUNDS MANAGEMENT

OCTOBER 2019

Ethical Partners Australian Share Fund		
As at 31 October, 2019	**Unit price**	**APIR code**
Investor Class	$1.0085	EPF9951AU
Class A	$1.0060	-
Class B	$1.0088	EPF3813AU
Class E	$1.0102	-

Performance since inception annualised p.a (9 Aug ’18): -8.16% (after fees) vs S&P/ASX 300 Accum

To the clients of Ethical Partners and their advisors:

During October 2019 the Ethical Partners Australian Share Fund returned -3.52% versus the S&P/ASX 300 Accumulation Index of -0.38%, underperforming the market by -3.14% (after fees). A small number of stocks contributed the majority of the underperformance during October and we detail our reasons for our positions and their outlook below.

Over the last quarter the Fund benefitted from an underweight position in Materials and an overweight position in Industrials. Key detractors over the last quarter included an underweight position in Health care and an overweight position in both Financials and Consumer Staples.

Investor class	**1 Month %**	**3 Months %**	**6 Months %**	**Since Inception (annualised %)**
Fund (after fees)	-3.52	-3.13	1.12	1.97
S&P/ASX 300 Accum	-0.38	-0.79	7.73	10.13
Excess	-3.14	-2.35	-6.61	-8.16

It is times like these where the market is focused on a narrow band of perceived high growth companies that leaves other stocks of companies that are experiencing low cycle earnings but have real assets and better prospects ahead, trading cheap. We believe these are the times that provide a once in a cycle opportunity to purchase large quantities of stock where there is significant upside with little downside risk.

Graincorp: The stock fell -8.6% during October on no company specific news other than continued general tough conditions in the agricultural industry. Graincorp reported its full year results on the 14th of November and these were in line with guidance. While conditions for the domestic Grains business are still at the low point of the cycle the Malt business is steady and has some good prospects for growth. Importantly to take some of the volatility out of the earnings stream of the Grains business the company has put in place a long term insurance arrangement with Aon plc whereby Graincorp receives an insurance payment if the east coast winter crop production is below 15.3m tonnes and pays the insurer when grain production is above 19.3m tonnes. This is the first time that we know of, in the company’s 100 year history, where the Board and management have put such an arrangement in place. This should ensure that the Grains business now has positive cash flows at all points in the cycle, thus increasing the value of the business. Pre result the stock was trading 8% below book value (the net value of its tangible and intangible assets on the balance sheet) and is close to eight-

year lows. Companies often de-merge divisions at the bottom of the cycle because that is when the pressures on the Board are the greatest. With the upcoming demerger we believe there is excellent value on offer here with the prospect of upside and a low chance of downside in the stock.

Bega Cheese: The company announced at the AGM on 29 October that FY20 earnings would fall primarily due to higher domestic milk prices, which is the company's key input, and lower demand for certain export products. The stock fell -21% during the month but as at 13 November it has recovered +10% back to levels it had traded at before the downgrade (around $4 per share). At $3.58 where it closed at the end of October the stock was trading 7% below book value of $3.85 (the net value of its tangible and intangible assets on the balance sheet). It is typical for a cyclical company to trade below book value at the bottom of the cycle and the domestic milk industry continues to face its challenges. The company continues to refine it cost base and rationalise assets. With respect to the outlook we own the stock because it is cheap amidst the lower dairy volumes and associated pressures. Rising milk volumes would obviously help but our investment case is predicated on the continued rationalisation and consolidation of the industry as it goes through this part of the cycle including existing players shutting excess processing capacity as well as the prospect of better returns from rising product prices (amidst short supply). These factors will improve industry returns now and should milk volumes return in the future this would only add to the outlook.

CSL Limited (not owned): The stock increased +9.6% over the month adding around $11bn of market cap after reconfirming guidance at the AGM (effectively a further PE re-rating). CSL is now trading at all-time highs and has an all-time high valuation. At present, most sell-side analysts covering the stock rate it a buy (8 out of 11 analysts), presenting almost the opposite situation when we were buying Telstra a year ago around 25% lower and almost every analyst had it rated a sell. CSL's index weight is now over 6% and as the largest underweight position versus the market the stock's move over the month was the second largest detractor from relative performance at -0.6%. Our analyst recently caught up with competitors in the USA and conditions remain favourable for the company's keys products but at almost 40x PE (vs a five year average of 27x PE) we believe the stock remains overvalued and the future risks are not being focussed on, which is usually the case when a business has reported a good run of profit growth.

GWA Limited: The company reported first quarter sales down -8% at the AGM on 25 October. This did not come as a surprise given the well-known deteriorating environment for building approvals and home renovation activity. The stock fell -14.5% over the month, which we believe is an over-reaction. During November the stock is up +6%. We continue to add to our position on a medium term view, aware that we are adding in an environment of weaker sales but also at a relatively attractive valuation for a quality, well managed business. We like that management has reshaped the portfolio over the past few years by selling non-core businesses and exiting lower returning assets, focussing on the higher ROE bathroom and kitchens business and augmenting this with additional investment. As a result of these actions the ROE of the company has increased from 7.5% in 2014 to over 15% in 2019. We believe the worst quarter of the financial year has passed with respect to sales and that customer restocking as well as improved demand will return as many of the future indicators of the housing cycle improving off a low base.

Nick Scali: The company reported difficult trading for the first three months of the financial year with store traffic down 10-15% and like for like sales down -8%. The stock was down -15.8% over the month but we had reduced our position at higher prices post the full year result. Housing sales turnover has been at a low level despite recovering house prices and forward indicators are suggesting that turnover will increase in the period ahead, which will assist the company's sales growth. Although current conditions have been tough we like the net cash balance sheet, the owner–management style of leadership and the close management of gross margins and expenses. Over the medium term the company remains leveraged to further store rollout. Looking back over the last four years profit is up 2.5x at the same time store numbers are up 1.4x demonstrating good profit leverage

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to increasing stores (on fixed costs). The business continues to produce solid cash flows allowing the Board to increase the dividend payout ratio earlier in the year. In our view the stock remains good value here.

CSR Limited: The company underperformed in October into the half year result in early November in an environment where building related stocks fared poorly amidst weak data for building approvals. At the result the company reported an expected decline in building materials earnings, better forward property sales and an improved cost base in the Aluminium division. Despite the Building Materials EBIT declining -18% year on year, the stock has rallied +16.7% so far in November and it has now outperformed the market over the month, quarter and year. The result featured strong cash flow and the company has a net cash balance sheet. The value of the property holdings of the group is steadily being realised with CSR announcing the sale of stage 2 of their 20ha Horsley Park land asset for $140m (6% of the market cap and just 1.4% of total land holdings in the group). Looking ahead the value of the retained property assets is significant, the building products division margin has held up better than market expectations and aluminium earnings seem to have stabilised at a lower base. The Fund had a significant overweight position this year and in November with the stock in our view becoming relatively fully valued we lightened the position.

We continue to be disciplined about what we choose to own and what we choose to avoid, applying our investment process consistently and using conservative valuation measures. At times, in various market circumstances, this can lead to underperformance but we look ahead at the value on offer in the portfolio and continue to expect the gap between what we value our holdings at and what they are trading at will be realised.

Annual General Meetings

Ethical Partners takes an active approach to voting at AGMs on behalf of our clients. We utilise various proxy voting advisor research services, engage with companies and NGO’s and then make our own determination on voting. During October we voted on 95 separate resolutions. We exercise our discretion carefully and during the month we voted Against Board recommendations in a number of cases including Against the re-election of a Director, Against two Remuneration Reports and the Issue of shares to management and Against the renewal of Proportional Takeover Provisions.

Some details on some specific resolutions are below.

Climate Change: IAG has a stated aim at being a leader on climate change and we feel that its business model remains vulnerable to shifts in extreme climactic events. We believe that whilst IAG has reduced its exposure to fossil fuels in the investment book to 0.13% (from 0.43% 2 years ago), we still feel that it would be prudent to set a target as per the AGM resolution to ensure that in future this remains the case. We supported the Board in their other recommendations but also voted For resolution 7(a) and (b).

Human Rights: We supported the Qantas Board in some of its recommendations but we also voted For resolutions 5.1 and 5.2 relating to Human Rights Risks. In our view it would be prudent for Board to at least review its policies in relation to their processes for involuntary transportation. In doing this we weigh the financial risk of such a review and conclude it is not material.

Nathan Parkin
Investment Director

Matt Nacard
Chief Executive Officer

Ethical Partners Management Services ACN 623 503 720 as Corporate Authorised Representative of Ethical Partners Funds Management Pty Ltd ACN 623 475 454; AFSL 504749.

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