

MORPHIC ETHICAL EQUITIES FUND

Monthly Report
December 2022



Signature of:



Fund Objective

The Morpic Ethical Equities Fund Limited (the Fund) seeks to provide investors a way to grow their wealth and feel confident they do so without investing in businesses that harm the environment, people, and society.

The Fund excludes direct investments in entities involved in environmental destruction, including coal and uranium mining, oil and gas, intensive animal farming and aquaculture, tobacco and alcohol, armaments, gambling and rainforest and old growth logging.

	Investment returns*					ITD (p.a.)
	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)	
Morphic Ethical Equities Fund ¹	-5.73%	2.57%	1.47%	-25.17%	3.25%	4.98%
Index ²	-5.13%	4.07%	3.71%	-12.48%	5.26%	8.94%

* Past Performance is not an indication of future performance.

Portfolio Commentary

Global markets were generally weak during the month of December as the widely anticipated “Santa Claus” rally failed to materialise, thereby closing calendar year 2022 with a difficult finish. During the month most major markets ended lower with the S&P 500 and Nasdaq closing down 5.8% and 8.7% respectively. In Europe, stocks fared a little better with the DAX and CAC down 3.3% and 3.8% while the Japanese Nikkei came in lower by 6.6%.

The Morpic Ethical Equities Fund declined 5.73% net during the month compared to the MSCI ACWI (AUD) Index which was down by 5.13% over the same period.

Despite lower than expected inflation prints in November, and subsequently in December, US Federal Reserve (Fed) Chairman Jerome Powell made it abundantly clear in a speech to the Brookings Institute that inflation remains far too high and it will take substantially more evidence to give comfort that inflation is actually under control. He remains steadfast in his goal that price stability must be restored as without it, “the economy does not work for anyone”. Chairman Powell is clearly realistic about the broader project and indicated the need to raise interest rates to a level restrictive enough to return inflation to 2.0% with the ultimate level of rates required to achieve this objective now likely higher than previously anticipated.

Growth is clearly slowing as global economies cycle the strong demand associated with post pandemic re-opening (which China is only now benefiting from) and significant pandemic fiscal support which is now waning. Additionally, the continued implications from the Russian incursion of Ukraine, along with the aforementioned growth headwinds, have all coincided with one of the fastest interest rate tightening regimes we have experienced in generations. The conundrum here is that over the past several months we have seen subdued real economic growth, yet inflation is still running red hot as labour and housing costs are still upwardly biased.

While there were many geopolitical events during 2022, the main impact on market valuations and growth outlooks was the outbreak of inflation globally and the corresponding dramatic increase in interest rates delivered by central banks around the world. As liquidity was, and is, removed from the system the era of cheap and abundant financing has now reversed to an environment characterised by higher cost of capital and lower availability of capital. Marginal business models or those promising earnings far out into the future (especially those with questionable capital structures) have been marked down materially.

Net Tangible Assets (NTA)

NTA value before tax ³	\$ 1.0246
NTA value after tax ³	\$ 1.0771

Investment Returns since inception⁴

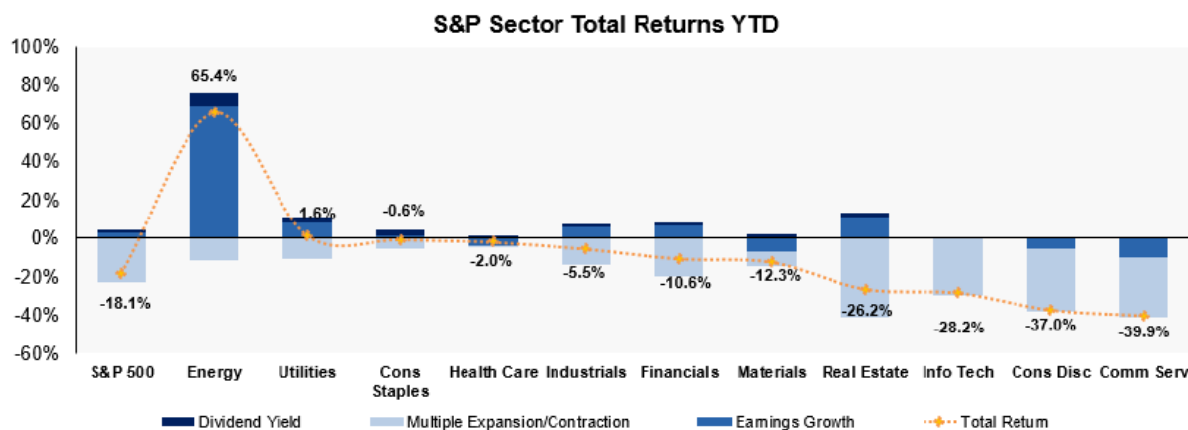


With this in mind, it has never been more important to be exposed to companies with strong secular or structurally growing end markets, high or growing market shares with commensurate pricing power driving sustainable cash flows and strong balance sheets. We consider companies with mission critical tangible assets are becoming even more valuable as the earnings certainty associated with these assets will prove increasingly attractive to both public and private investors.

The portfolio's top three contributors **Coupa Software, Ciena and hedging added 71bps to performance** while **Digital Bridge, Chart and Webster Financial detracted 211bps** during the month.

In recapping the relative sector performances of the S&P 500 during the calendar year of 2022 we see a real regime change to that experienced over the past several years. Energy was clearly the only real port in the storm during the calendar year with Consumer Discretionary and Communications Services leading on the downside. Over the past decade, Information Technology had led the market higher however with rate increases weighing on valuations and business models, IT was amongst the sector laggards this year.

As we have highlighted previously, earnings held up relatively well during the year and were not the source of capital drawdown. The downward move in the market was entirely driven by valuation compression as interest rates and economic uncertainty increased. Calendar year 2022 can be characterized as inflation and rates (Fed) being bad news stories, while earnings remained a good news story.



Source: Morgan Stanley, Bloomberg.

Looking into 2023, the risk around a potential recession has been increasing over the past several months and as shown in the chart below, it has clearly become consensus with aggregate conviction levels not seen for some time. If consensus proves to be right, the better and unknowable question would be duration and depth of the potential economic decline, and this is currently the more debated topic rather than if there will be a downturn:

Philadelphia Federal Reserve Anxious Index 1968 – Current – Quarterly Chart

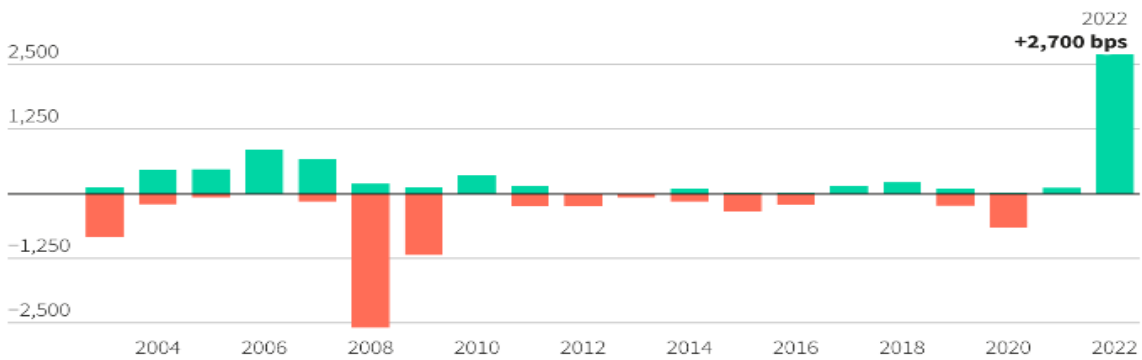


Source: WSJ / Federal Reserve Bank of Philadelphia / Canaccord Quarterly Data

As you can see in the following chart, global central banks have ended the era of cheap money with 2,700 cumulative bps of interest rate increases delivered by the global banks of the top 10 currencies over the past year. This has and will continue to feed into increased funding costs for consumers and businesses alike. While many anticipate that the Fed may look to cut rates sometime later in 2023, Chairman Powell has made it pretty clear that rate cuts are not on the agenda as **“The historical record cautions strongly against prematurely loosening policy”**.

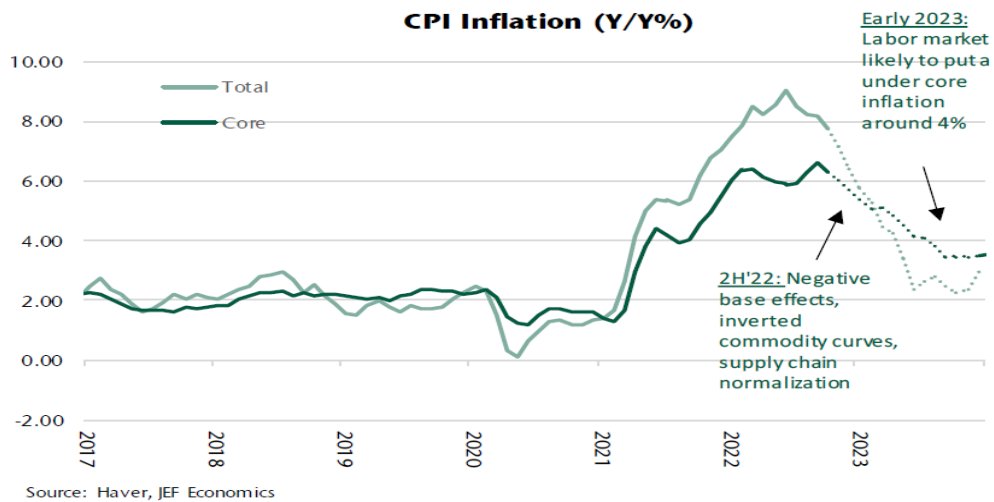
Major central banks deliver rate hike bonanza in 2022

Policy rate **hikes** and **cuts** by central banks overseeing the 10 most traded currencies



Note: Australia, Canada, Euro zone, Japan, New Zealand, Norway, Sweden, Switzerland, United States and UK
 Source: Refinitiv Datastream | Reuters, Dec. 23, 2022 | By Vincent Flasseur and Karin Strohecker

While the Fed has certainly not been our friend during 2022 (and we don't expect it to be our friend in 2023 either) it is likely that the bulk of the current hiking cycle is pretty much complete as inflation should continue to move lower over the coming months. Supply chains continue to heal, commodity costs drift lower, durable goods deflate and we will also soon cycle the major moves from last year. That said, the risk is around trying to get to a 2 handle on inflation especially when considering wage inflation remains very high due to tight labour markets.



While we are admittedly not macro experts, it is important as ever to understand where it sits to ensure the portfolio is positioned appropriately. To sum up the previous commentary and charts we see:

Headline inflation and the Fed were bad news stories in 2022 while the economy and especially earnings were generally a good news story. While we don't expect the Fed to be our friend in 2023, we do expect the bulk of rate increases to be complete and therefore the Fed is not our enemy either. Headline inflation will moderate into 2023 however wage inflation will likely keep it elevated above past levels. The focus will now shift from inflation and rising rates to that of the real economy and earnings with most expecting general weakness in both over the coming quarters.

While cost of goods inflation for many businesses is now stabilising or declining, we won't see the benefits of this in company income statements for a couple of quarters as they generally work on a first in, first out accounting treatment. That is, current inventory has high embedded commodity and transportation costs and this needs to be worked through before many companies can leverage margins on lower cost of inputs that we are now seeing in the commodity markets.

Those companies with significant pricing power that have already passed through elevated cost of goods will be fine, however there will be many that are trying to sell inflated inventories into a slowing demand and revenue environment. When coupled with higher wage and interest costs, these marginal businesses could be faced with a monumental margin squeeze. In a nutshell, earnings risk is high and therefore a focus on relative earnings stability is paramount going forward.

With a focus on earnings resiliency we have exposure to some pretty strong secular and structural drivers including re-shoring and onshoring of production as companies are increasingly concerned about security and robustness of supply chains (PTC, FLEX, WSC and XPO), data growth and the digital transformation cycle driven by AI, Cloud and Automation which is underpinned by 5G (CLNX, PTC, FLEX, SOI, Adventest, CIEN and DBRG) and companies which will help decarbonise our economy over the coming decade (ST, TKH Group, FLEX, SOI, BVI and GTLS).

We also own some great companies with idiosyncratic stories such as the shift from plastic to paper packaging driving organic growth and pricing at Graphic Packaging, the environmental assessment and treatment capabilities (especially in PFAS) of Montrose Environmental and significant cost and health benefits delivered by Option Care Health in the US home infusion market.

We consider that in this environment, strong companies will exit stronger as solid Management teams understand that they have commanding or growing relative market share in their respective large addressable markets and will look to build on this opportunity. Marginal companies will get squeezed out and this market share gain by natural attrition will provide long term capital growth for us as shareholders.

As always, thank you for your continued support and we look forward to discussing our businesses with you in 2023.

Top 10 Active Positions

Stocks	Industry	Region	Position Weighting
Cellnex	Communication Services	Europe	6.15%
Graphic Packaging	Materials	North America	4.79%
PTC Inc	Information Technology	North America	4.80%
Rentokil	Industrials	United Kingdom	4.29%
Soitec	Information Technology	Europe	4.18%
Flex	Information Technology	North America	4.16%
Sensata	Industrials	North America	4.15%
Webster Financial	Financials	North America	4.10%
TKH Group	Industrials	Europe	3.96%
WillScot Mobile Mini	Industrials	North America	3.87%

Risk Measures	
Net Exposure ⁵	89.53%
Gross Exposure ⁶	89.58%
VAR ⁷	1.81%
Best Month	9.59%
Worst Month	-8.44%
Average Gain in Up Months	2.68%
Average Loss in Down Months	-2.68%
Annual Volatility	12.72%
Index Volatility	11.20%

Top alpha contributor⁸ (bps)



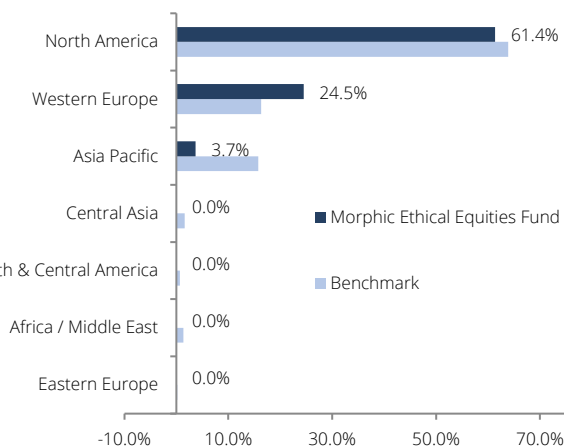
Top alpha detractor⁸ (bps)



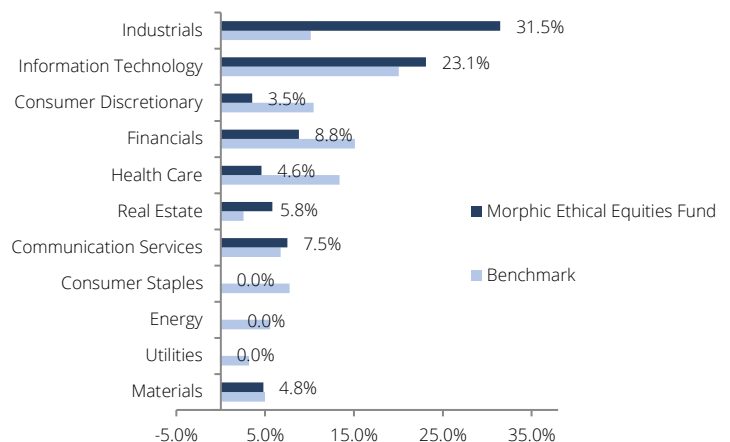
Key Facts

ASX code / share price	MEC / 0.900
Listing Date	3 May 2017
Profit Reserve ⁹	\$ 0.429
Management Fee	1.25%
Performance Fee ¹⁰	15%
Market Capitalisation	\$48m
Shares Outstanding	53,452,626
Dividend per share ¹¹	\$0.06

Equity Exposure Summary¹² By region



Equity Exposure Summary¹² By sector



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¹ Performance is net of investment management fees, before company admin costs and taxes; ² The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD; ³ The figures are estimated and unaudited; ⁴ Performance is net of investment management fees, before dividends, company admin costs and taxes. Fund listing on the ASX 3 May 2017. Past performance is not an indication of future performance; ⁵ Includes Equities and Commodities - longs and shorts are netted; ⁶ Includes Equities, Commodities and 10 year equivalent Credit and Bonds - longs and shorts are not netted; ⁷ Based on gross returns since Fund's inception; ⁸ Attribution; relative returns against the Index excluding the effect of hedges; ⁹ The reserve is made up of amounts transferred from current and retained earnings that are preserved for future dividend payments. The payment of franked dividends depends on the rate the Fund realises taxable profits and generates franking credits; ¹⁰ The Performance Fee is payable annually in respect of the Fund's out-performance of the Index. Performance Fees are only payable when the Fund achieves positive absolute performance and is subject to a high water mark; ¹¹ Annual dividend per share. ¹² Exposure Summary charts do not take into account derivative positions.