A proud founder of: Climate Action 100+

Signatory of: PRI Principles for Responsible Investment

MORPHIC ETHICAL EQUITIES FUND

Monthly Report
June 2024

Fund Objective

The Morphic Ethical Equities Fund Limited (MEC) 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.

MEC 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*

	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)	5 Years (p.a.)	ITD (p.a.)
MEC[1]	-0.87%	-5.96%	4.04%	1.12%	-0.37%	6.89%	6.66%
Index[2]	1.80%	0.49%	13.72%	18.98%	9.63%	11.86%	11.94%

* Past Performance is not an indication of future performance.
Source: Ellerston Capital

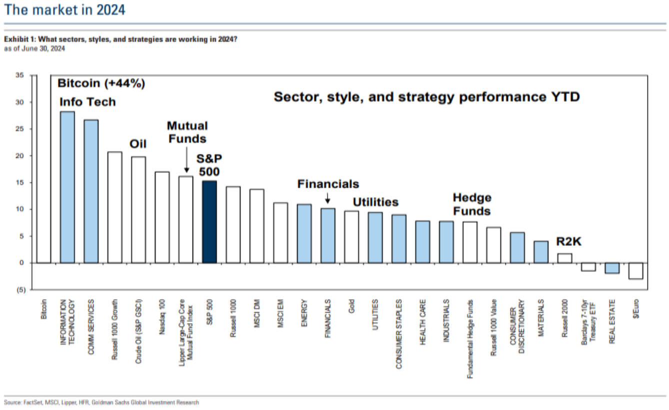
Performance Summary

MEC decreased -0.87% net during the month, underperforming the MSCI All Countries World Daily Total Return Net Index which increased by 1.80% over the same period.

Market Commentary

The portfolio's top three contributors GFL, Iron Mountain and Zillow Group added 209bps to performance while Cellnex, Option Care and SIG Group detracted 112 bps during the month.

The S&P 500 was very strong during the first half of calendar year 2024 with the largest stocks (MSFT, NVDA, AAPL, GOOG, AMZN and META) contributing over 60% of total returns, which according to Goldman Sachs represented 10% outperformance relative to the equal weighted S&P 500. The markets continue to be driven by a small number of stocks as concentration in the large meg-caps remains the investment strategy of choice.



The tech outperformance is clearly being driven by the secular theme associated with AI, as the potential economic and earnings impact associated with its adoption remains a north star for the sector. The capex buildout required for expanding AI infrastructure is maintaining its momentum however we will need to see some real time consumer and enterprise use cases to drive the next phase of adoption.

The carrot associated with the spending boom in AI capabilities lies in next generation applications which should drive a rebound in productivity, similar to what was experienced with other "disruptive technologies" such as the use of steam engines, which morphed into electricity enabled mass production and more recently, the internet.

Net Tangible Assets (NTA)	
NTA value before tax[3]	$1.0716
NTA value after tax[3]	$1.0792

Source: Ellerston Capital

Investment Returns since inception[4]

Source: Ellerston Capital

Outside of AI, the rest of the economy continues to come in mixed with notable weaknesses in consumer names including Walgreens, Nike, Levi Strauss and General Mills to name a few. The common thread here is particular weakness in the low-end consumer which remains under pressure from the sustained high cost of living and depletion of pandemic induced cash infusions.

The manufacturing economy seems to be stabilising and improving from recent levels as inventory de-stocking seems to have generally run its course and supply chains are becoming more predictable. When attending a recent conference, the common feedback around the current operating environment was that after a few quarters of weakening, conditions today appear to be steady, however, too early to call whether the next move inflects up or down.

We can see this in the following chart where global PMIs had been trending down for some time however now look to be picking up. The key will be a continuation of this trend for a broadening out of earnings growth beyond just the technology sector.

Exhibit 1: Breadth of manufacturing PMIs in expansion has rebounded from 25% in September-2023 to 53% now
Based on 40 countries as of today

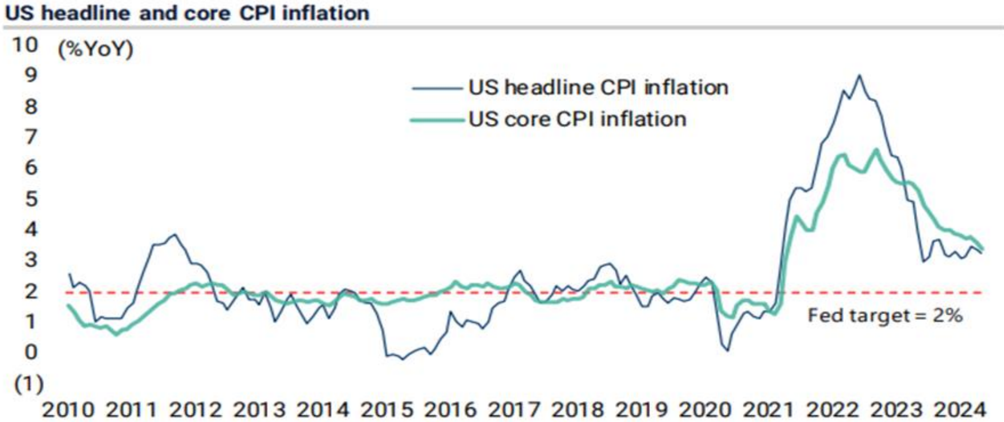
Source: BofA Predictive Analytics, S&P Global, Haver. *Notes: In the absence of manufacturing PMIs, whole economy PMIs are used. June data is available for 30 countries, May data is used for the remaining 10.

BofA GLOBAL RESEARCH

While earnings growth traditionally drives medium to long term equity performance, the market right now is really being driven by the aforementioned top 6 mega-cap stocks and expectations around inflation/interest rates. While inflation is clearly trending down, the market remains laser focused on the monthly CPI prints as this dictates the timing of the first rate cut out of a data dependent Fed.

Although US inflation data came in better than expected last month, it remains above the Fed's 2.0% target (not sure if it ever gets there outside of a significant slowdown). That said, Chairman Powell has maintained the view that the next move will be down as the economy and price pressures continue to moderate. There is currently a very strong correlation between stocks and bonds (which is not typically the case) as the market is predominately focused on inflation to determine the next move in asset prices.

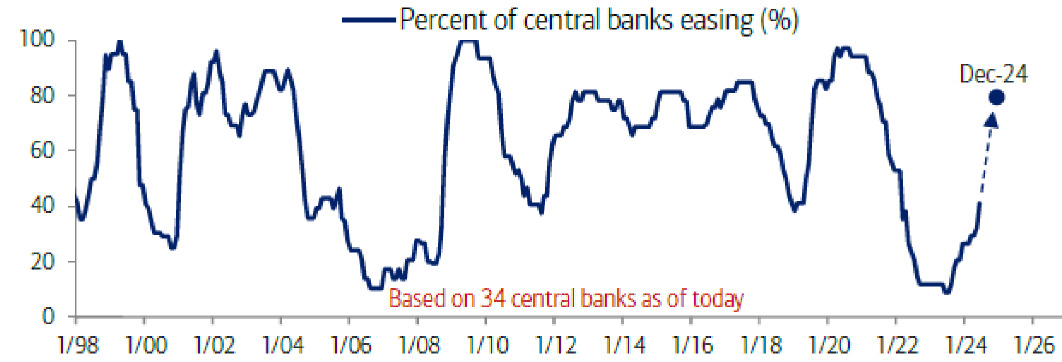
US headline and core CPI inflation



Source: Bureau of Labor Statistics

With expectations for a Fed cut in its meeting in November, it will join a growing list of central banks which are already in easing mode. According to Ned Davis Research, the disinflation momentum has resulted in an interest rate easing synchronization globally with 42% of the 34 global central banks in easing mode compared with 10% this time last year (clearly there are outliers including the RBA here in Australia) which is expected to increase to almost 80% by year end.

Exhibit 13: 80% of global central banks are expected to be in easing mode by the end of 2024 vs only 10% in July 2023
Percent of central banks in easing mode



Source: Ned Davis Research. Notes: December-expectation based on Bloomberg consensus.

BofA GLOBAL RESEARCH

So to sum up, we continue to see returns very concentrated in a small number of large mega-cap stocks, and this is not surprising given the generational investment opportunity they are exposed to. However, going forward we do expect returns to broaden out as the productivity benefits associated with the spend around AI proliferates through the ecosystem – this will not be evenly spread or come in a straight line as corporates are in AI "learning mode". There doesn't seem to be a more apt time to use the William Gibson phrase "the future is already here; it's just not very evenly distributed" as the AI learning engines currently reside in a select few hands.

Economic conditions remain mixed however seem to be stabilising to improving from recent levels (outside of consumer pockets), inflation appears to be under control and the bias of central banks is toward easing conditions, not tightening. While we remain mindful of continuing geopolitical risks and the potential for inflation to reverse course, which would clearly be market negative, the investment backdrop of lower rates, steady growth and expanding market breadth bodes well for the global mid small cap space.

Shifting to June global equity performance, markets were quite mixed as election news (specifically in Europe) drove regional volatility. The NASDAQ composite increased 6%, followed by the S&P500 which was up 3.6% with both highlighting the preference for large cap stocks as the Russell 2000 was down almost 1%. Global markets outside US were generally weak with the French CAC index down 6.2%, Germany's DAX and FTSE 100 lower by 1.0% although Japan had a good month, with the Nikkei 225 up c3.0%

Regional discussion

As discussed earlier, the S&P 500 achieved a return of 3.6%, driven by strong corporate earnings and positive economic data. Technology giants continued to lead the market. However, the Russell 2000, representing small-cap stocks, declined by 0.93%. This decline was primarily due to economic concerns, profit-taking, and higher volatility, particularly within the industrial and utilities sectors. Despite these mixed results, overall market sentiment remained cautiously optimistic as investors balanced strong corporate performances against economic uncertainties.

European markets, on the other hand, faced a more challenging environment in June. Persistent inflation concerns and uncertainty over energy supplies, exacerbated by ongoing geopolitical tensions, weighed on investor sentiment. The French stock market struggled due to weak economic data and uncertainty surrounding upcoming elections. The Spanish market also saw a decline over the month, driven by investor concerns about economic stability and the impact of inflation.

Japan's stock market performed positively, driven by strong corporate earnings and favourable economic policies. Investor sentiment was buoyed by solid performance in high-tech stocks, particularly in the semiconductor sector. The Bank of Japan's continued accommodative monetary policies also supported market growth. Overall, the Japanese equity market showed resilience and growth amid broader economic uncertainties.

Sector discussion

In June, the Information Technology sector performed well across both large-cap and small-cap stocks. The sector's robust performance was driven by continued advancements in artificial intelligence and significant progress in semiconductor production. The substantial investments in AI infrastructure and the ongoing digital transformation across industries played a crucial role in driving the sector's growth. Small-cap IT stocks also performed well, driven by innovation and niche market opportunities.

The Communication Services sector performed well in global markets, bolstered by digital advertising, AI advancements, and growing demand for digital connectivity. Investments in AI and digital advertising efficiency helped communication services companies maintain strong growth trajectories, even amidst broader economic challenges. Market opinion remained optimistic, as investors continued to see significant growth potential in the sector due to its pivotal role in the ongoing digital transformation.

The Materials sector faced significant challenges in June. Persistent inflation concerns, reduced demand, and economic uncertainties were the primary drivers of this decline. Higher input costs and lower-than-expected demand particularly impacted major chemical and construction material producers. Broader economic uncertainty also led to cautious investor sentiment, further weighing down the sector's performance.

Portfolio Commentary

Turning back to June performance, key contributors for the month were:

GFL Environment Inc (+1.39%) is the fourth largest diversified environmental services company in North America, providing a comprehensive line of solid waste management, liquid waste management and soil remediation service in Canada and in more than half of the U.S. states. GFL was upgraded by a significant brokerage based on its strategic investments and M&A activities, which are expected to expand margins and double free cash flow over the next three years. There was also increasing speculation of a potential asset sale regarding its Environmental Services business which would significantly deleverage the company.

Iron Mountain (+0.36%) is a global leader in information management services, offering digital transformation, data centres, secure records storage, information management, asset lifecycle management, secure destruction and art storage and logistics. Iron Mountain reported its first quarter results in May with stronger-than-expected earnings and robust earnings growth, driving positive sentiment and contributing to a strong stock performance. Iron Mountain is developing one of the only self-funded data center platforms which operates on a global scale – it is a beneficiary of the AI demand for data centers.

Zillow Group (+0.35%) is the No. 1 U.S. residential real estate app. In addition to its for-sale and rental listings on Zillow.com, Zillow also provides home loan, affiliated lender, mortgage pre-approvals and financing as well as real estate professional services. Zillow had been under pressure following the National Association of Realtors (NAR) settlement, however this now seems to be having only a marginal impact if any. Additionally, real estate exposed stocks such as Zillow have been gaining ground as cooler than expected inflation renewed speculation of the Fed cutting rates earlier than expected.

Conversely, the major detractors during June were:

Cellnex Telecom Group (-0.48%) is a leading independent mobile tower company in Europe with over 130,000 sites across Spain, France, Italy, UK, Portugal, Poland and more. Cellnex was upgraded by a global independent investment banking advisory firm in June, citing the potential for increased cash returns over time following the sale of its Austrian unit. However, this positive news was offset by Criteria Caixa selling a stake in the company at a discount.

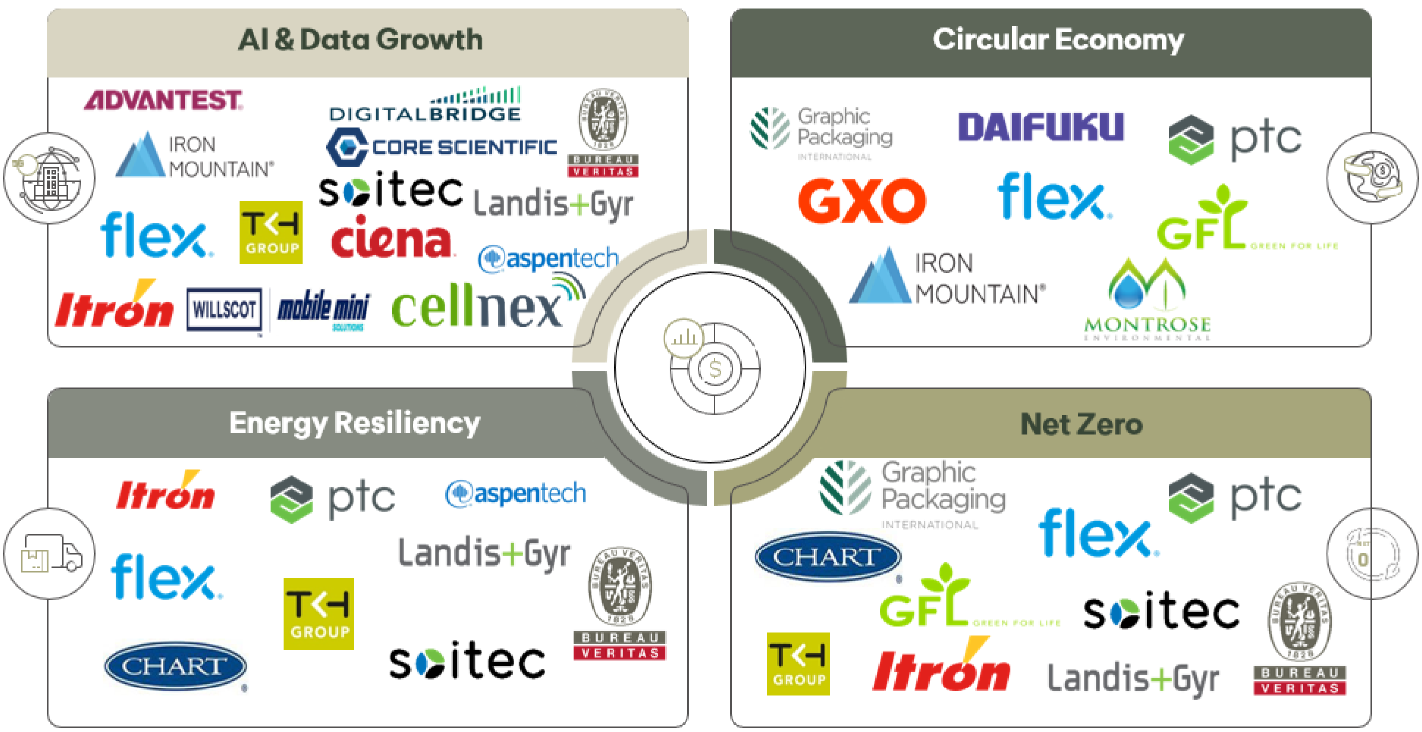
Option Care Health (-0.33%) is the largest independent provider of home and alternate site infusion services in the U.S., operating in all 50 states. Management reaffirmed their commitment to expanding their product portfolio and increasing market share at a global healthcare conference in June. Aside from this, there was no material company-specific news.

SIG Group (-0.30%) operates in a global duopoly in the aseptic packaging market alongside market leader, Tetra Pak. With continued weakness in consumer end markets there is increasing concern around margins and organic growth in the business. As such we decided to exit the position and concentrate exposure where we have higher conviction on earnings and subsequent share price performance.

During the month we trimmed our position in GFL Environmental to take advantage of the c24% share price move (still remains our largest position), while also taking some profits in Radnet and Iron Mountain. Conversely, we added to Cellnex Telecom, Ciena and Aspen Technology to take advantage of short-term price weakness. A new shift during the month was a concerted move into strategic content plays as in a recent conference in the US, it was clear that first party, user generated, and unique content will become increasingly valuable as AI generated "spam" becomes more prolific. As such we initiated positions in TKO Group and Warner Music – both are must have content plays in sports entertainment and music listening respectively. With the proliferation of AI data center spending, there is growing concern around the availability of power to operate these facilities. We already have positions in electricity resilience plays such as AspenTech, Itron and Landis+Gyr and have added Core Scientific which controls 1.2GW of power, of which a material portion can be repurposed to power AI data infrastructure. We funded the positions by exiting SIG Combibloc and Nextracker – SIG due to growth and margin concerns and Nextracker due to reaching full valuation.

We continue to have differentiated exposure to some pretty powerful long term thematics which should drive long term compounding benefits to us all as investors. These include:

- AI and the growth in data as Industrial IoT and large language networks such as ChatGPT and next generation applications drive data demand;
- companies that enable our push to a circular economy;
- beneficiaries of deglobalization; and
- those helping to improve the resilience of our energy grids as the world looks to electrify and companies which are levered to the multi trillion-dollar spending required for our "Road to Net Zero".



Source: Ellerston Capital

These businesses as well as idiosyncratic opportunities in the fund should provide solid absolute and relative returns over the long term as secular and structural business drivers help mitigate earnings risk in times of economic uncertainty.

As always, we thank you for your continued support and look forward to providing further updates in the future.

Top 10 Active Positions

Stocks	Industry	Region	Position Weighting %
GFL Environmental Inc	Industrials	North America	6.49
Cellnex Telecom S.A.	Communication Services	Europe	4.66
Option Care Health Inc	Health Care	North America	4.10
GXO Logistics Inc	Industrials	North America	4.03
PTC Inc.	Information Technology	North America	3.82
Webster Financial Corporation	Financials	North America	3.61
Zillow Group, Inc. Class A	Real Estate	North America	3.21
Chart Industries, Inc.	Industrials	North America	2.98
Bureau Veritas SA	Industrials	Europe	2.96
Acadia Healthcare Company, Inc.	Health Care	North America	2.91

Source: Ellerston Capital

Risk Measures	
Net Exposure[5]	91.14%
Gross Exposure[6]	91.14%
VAR[7]	1.30%
Best Month	9.59%
Worst Month	-8.94%
Average Gain in Up Months	2.70%
Average Loss in Down Months	-3.10%
Annual Volatility	13.23%
Index Volatility	10.73%

Source: Ellerston Capital

Top contributor[8] (bps)

GFL	139 bps
Iron Mountain	36 bps
Zillow Group	35 bps

Source: Ellerston Capital

Top detractor[8] (bps)

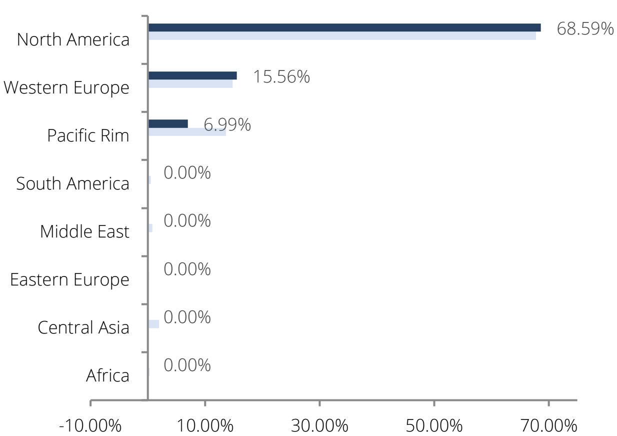
Cellnex	-48 bps
Option Care	-33 bps
SIG Group	-30 bps

Source: Ellerston Capital

Key Facts	
ASX code / share price	MEC / 0.980
Listing Date	3 May 2017
Profit Reserve[9]	$0.549
Management Fee	1.25%
Performance Fee[10]	15%
Market Capitalisation	$37.6m
Shares Outstanding	38,405,218
Dividend per share[11]	$0.14

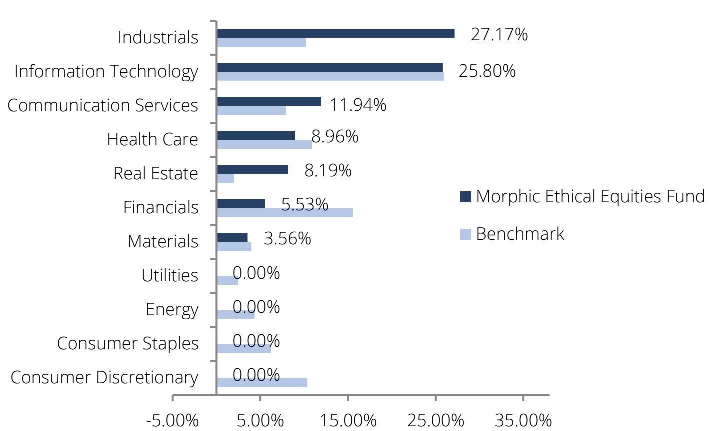
Source: Ellerston Capital

Equity Exposure Summary[12] By region



Source: Ellerston Capital

Equity Exposure Summary[12] By sector



Source: Ellerston Capital

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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] Contribution; absolute returns against 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 MEC realises taxable profits and generates franking credits; [10] The Performance Fee is payable annually in respect of MEC's out-performance of the Index. Performance Fees are only payable when MEC 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.