Quarterly Commentary

December 2022

Investment Manager

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Message from the CIO

Jordan Cvetanovski
CIO and Portfolio Manager

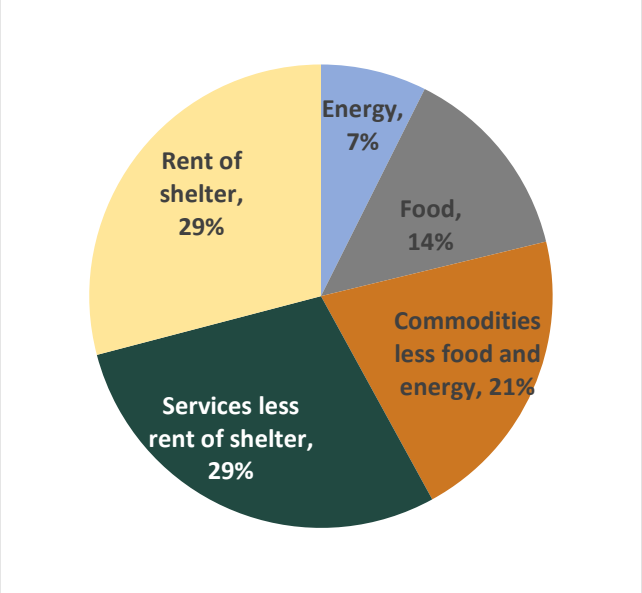
The market and the US Federal Reserve (Fed) are in a tug-of-war. The market is currently pricing Treasuries using a 2.4% CPI in calendar year 2023[1] and a peak Fed Funds rate of 4.9%. Meanwhile, the Fed's most recent forecasts point to inflation (as measured by the core PCE) of 3.5% in 2023 and the Fed Funds rate peaking in the 5.0%-to-5.5% range.

The realised outcome for inflation and interest rates in 2023 could have a profound impact on equity markets. If market expectations are proven correct, and provided there is no Black Swan event, it is fair to expect sanguine equity markets in 2023. If the Fed's expectations are proven correct, there are likely to be some major market shifts and headwinds. Pella's current expectation aligns more closely with the Fed than the market.

Consensus expectations are largely based on the Oct-22 and Nov-22 CPI figures, which were decelerating and lower-than-expected. This prompted a view that inflation is under control and the Fed won't need to increase interest rates much further. Pella does not dispute the fact that inflation may have peaked and is subsiding. Where we differ from the market is how much we expect inflation to decelerate over 2023.

To gain some perspective of where inflation is heading it is helpful to disaggregate inflation into its components. Figure 1 illustrates that CPI can be decomposed into five factors: Energy, Food, Commodities less food and energy ("Goods"), Services less rent of shelter ("Services") and Rent of shelter.

Figure 1 – Components of CPI



Source – US Department of Labor

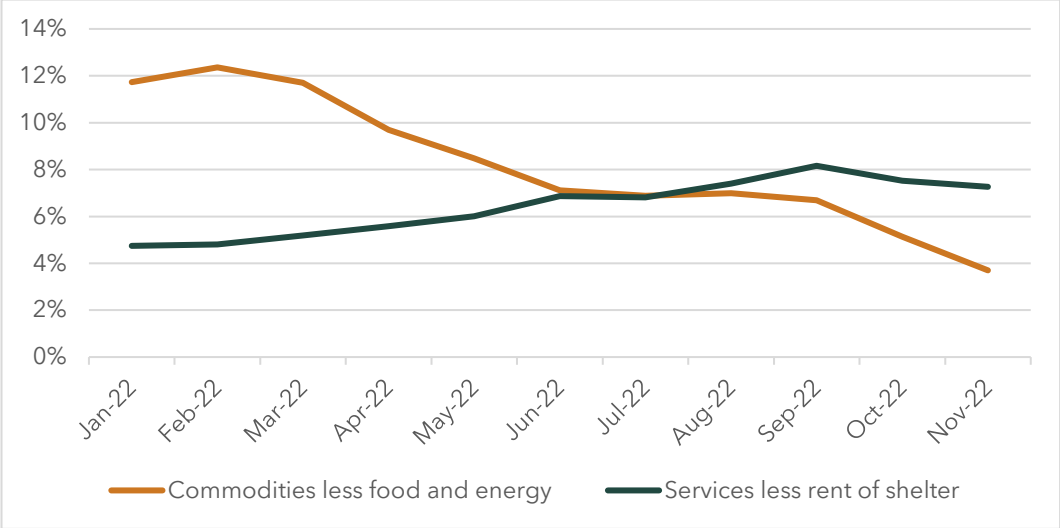
Energy and Food are primarily driven by global and volatile forces, rather than domestic demand, meaning they are not heavily emphasised when analysing underlying inflation. Rent of shelter is also not a contentious variable in assessing underlying inflation as it is a lagging indicator, and it is relatively easily controlled through monetary policy. That leaves Goods and Services as the key considerations when assessing underlying inflation and the inflation outlook.

In recent months the key driver of disinflation has been Goods-based inflation. This is explained by improving supply chains and declining used vehicle prices. Meanwhile,

[1] The Intercontinental Exchange, Inflation Expectations, 14 December 2022

there has been de-minimis, if any, respite in Services prices (Figure 2). With Services being the single largest component of CPI, it has a profound impact on where US inflation settles.

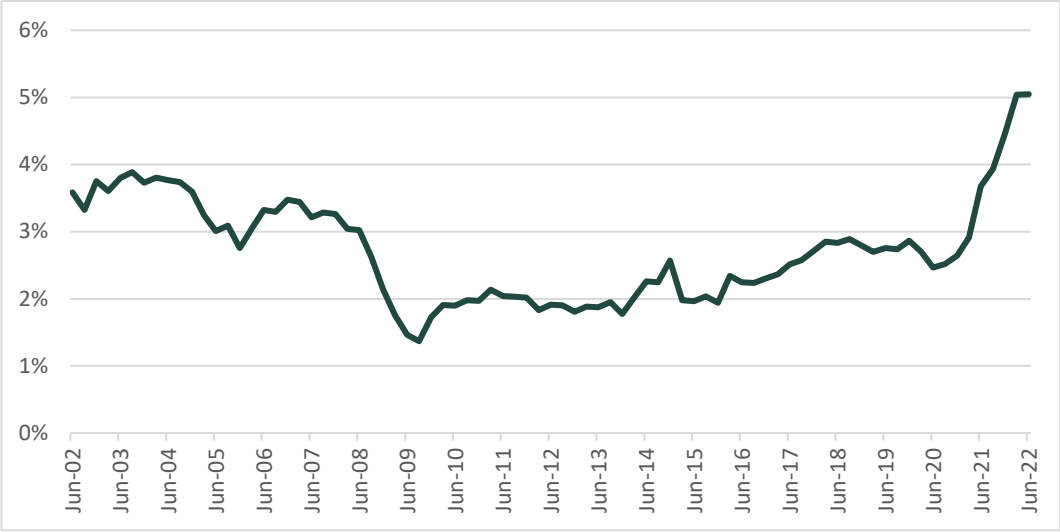
Figure 2 – Goods and Services CPI; Y/Y



Source – US Department of Labor

Services are labour intensive, meaning Services-based inflation is driven by the labour market. With the US labour market being the strongest for at least fifty years there is overt wage pressure, and in 2022 the US employment cost index increased at its highest rate on records going back to 2001 (Figure 3).

Figure 3 - Year-on-year change in the US employment cost index



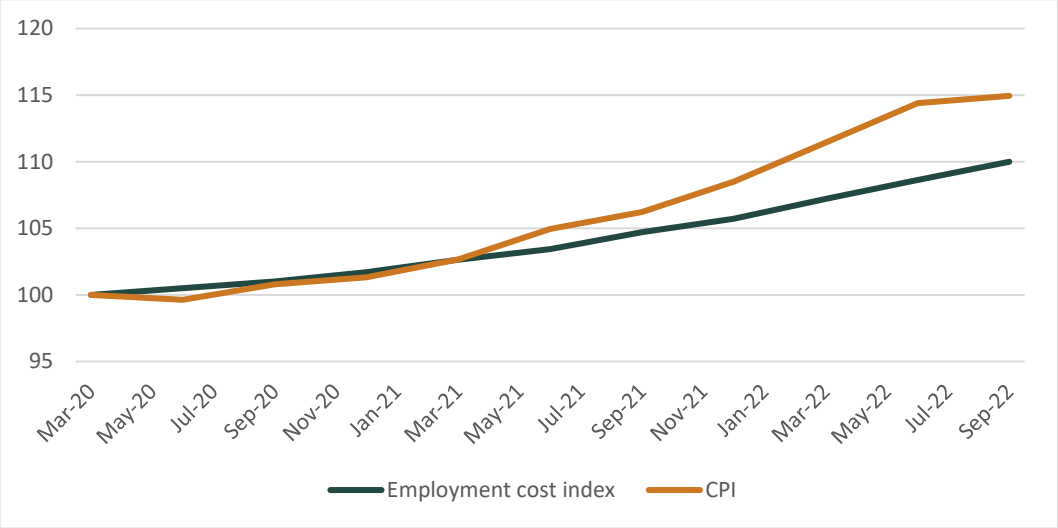
Source – US Department of Labor

Recent data offers scant reason to expect wage pressure to subside. Employment remains strong, job openings exceed the number of people unemployed in the US and the participation rate is at a standstill. Further, labour productivity has been in decline, meaning more people are required to get the same amount of work completed! These data points to labour gaining an increasingly upper hand in wage negotiations.

To date, labour has not exerted its newfound power to its full capacity and real (inflation adjusted) wages in the US have declined since

early 2021. Pella anticipates that this is a temporary phenomenon and labour will increasingly bargain for higher wages and, given wage inflation tends to be sticky, this source of CPI pressure is unlikely to fade away.

Figure 4 – Indexed US CPI and employment cost index



Source – US Department of Labor

For real wages to catch up on lost ground they need to increase by 4.5% plus a CPI adjustment of 2-4% in 2023, implying that wages ultimately need to increase by 7-9%. However, those increases just bring wages up to a level that is commensurate with the inflation rate and do not reflect labour's improved bargaining power. If labour is to make real wage gains, wages could increase by more than 9% in the short term.

To put some numbers around the inflation issue: if we assume that the CPI on all inflation categories ex-services is an optimistic 2.5% in 2023 and services-based businesses only pass through 50% of their labour cost increases, the implied CPI in 2023 would be 3.1%. Pella regards this as a best-case scenario because the non-service sectors will also face wage pressure, which implies they too will need to increase prices by more than 2.5%.

Table 1 – CPI calculation

	Weight	CPI
Services	30%	4.5%
Everything else	70%	2.5%
Total		3.1%

Source – Pella Funds Management

There are several implications of the above analysis. Firstly, it will be extremely difficult for corporates to pass on such significant wage increases, which will pressure their margins. Secondly, the wages that are passed through will place a floor under CPI, meaning inflation is unlikely to settle below 3%. Finally, with inflation remaining stubbornly high and the labour market potentially retaining its strength, the Fed will be forced to either raise interest rates higher than many expect and/or maintain high interest rates for longer than the market anticipates. The upshot is that consumer spending could decline due to higher interest rates, and companies will face earnings pressure due to increasing wages coupled with dampening demand.

Considering the above, rather than retreating and becoming decidedly defensive, Pella is emphasising investing in companies that have relatively high certainty of earnings, providing a clear growth pathway, and are trading at attractive valuations relative to those earnings. This entails investing in established businesses with proven, structural, and consistent earnings. We believe this is the cornerstone of delivering on Pella's objective of growing our client's wealth by beating the Fund's benchmark.

To avoid unnecessary risks in this higher-for-longer interest rate environment, we have also de-emphasised younger, disruptive companies that might have grown their top-line rapidly but have not demonstrated consistent earnings and we are highly selective on cyclical companies with large exposure to a slowing consumer. We believe this approach will be instrumental in delivering on Pella's other financial objective of delivering returns that are less volatile than the Fund's benchmark.

Pella's emphasis on earnings certainty is observable in the portfolio positioning and individual holdings. Approximately 80% of the portfolio is invested in the Core segment, which is the highest weighting since strategy inception and compares to a maximum weighting of 80% for that segment. Meanwhile, the Cyclical segment comprises 10% of the portfolio, and Innovation is just 1% of the portfolio, which is an all-time low for the strategy.

Table 2 – Pella's segmentation strategy

Segment	Core	Cyclical	Innovation
Definition	Stable and growing earnings	Earnings subject to cyclical conditions	Rapidly growing due to a company specific situation
Permissible portfolio weight range	60-80%	0-30%	0-20%
Current weight	80%	10%	1%

Source – Pella Funds Management

At the stock level, some of the features Pella is seeking from its investments to deliver earnings certainty include:

1. A large and guaranteed order book, such as ASML (ASML.NL), which has a near global monopoly on lithography machines that are ordered several years in advance; and IQVIA (IQV.US), which provides services to the health care industry under multiyear contracts. Further insights into IQVIA are provided in the Stock in Focus section of this Quarterly Report.
2. A large portion of repeat sales, such as Adobe (ADBE.US) which provides critical software applications under a subscription model, and Epiroc (EPI-SE) which sells mining equipment with equipment services contracts.
3. High customer retention rates, such as Marsh & McLennan (MMC-US), which provides complicated insurance brokering services that require in depth knowledge of customer needs, making it challenging for clients to replace their incumbent provider.
4. Consumer necessities in a trade down environment, through exposure to discount retailers such as Dollar General (DG.US), 3i Group (III.GB) and B&M European Value Retail (BME.GB).

5. Infrastructure businesses such as VINCI (DG.FR) which operates toll roads and airports in Europe.

Investing in companies with the above characteristics and skewing the portfolio towards the Core segment provides us with confidence in the stability of the Fund. Most importantly, as we are only ever investing in growing cashflow-generative businesses, this also increases our visibility towards achieving our capital growth expectations. In an economic environment where corporate earnings are likely to face notable headwinds, stability will be the key to the Pella Global Generations Fund targeting its financial goals of beating its benchmark, with lower volatility than its benchmark.

Fund Commentary
Portfolio Positioning

During 4Q22 the Pella Global Generations Fund ("Fund") delivered a return of 9.6%, outperforming its benchmark by 5.6%. This is a remarkable result given the Fund had no exposure to the best performing sector, Energy, owing to Pella's sustainability requirements. For the whole of 2022, the Fund outperformed the benchmark[2] by 2.8% and, on Pella's measures, delivered superior sustainability to the benchmark (discussed below). However, the Fund's volatility of returns (15%) was slightly higher than the benchmark's (14%)[3].

Key contributors to the Fund's 4Q22 returns were its meaningful exposures to the Health Care and Industrials sectors and to Western Europe. Relative performance was also aided by Pella's decision to meaningfully reduce exposure to the US tech sector owing to that sector's inflated valuations. However, after a material decline in prices within that sector, as demonstrated by the FANG+ index[4] declining 40% over the year, Pella is spending more time researching large, bellwether tech companies.

It was a challenging quarter to navigate with a myriad of often conflicting data points. Over the quarter oil futures prices barely budged, yet Energy (+12%) was the best performing GICS sector. At the start of the quarter, China maintained its tough Covid lockdowns, leading many people to believe that economic growth was no longer the Chinese Communist Party's key focus, only for the lockdowns to be abruptly reversed in Nov/Dec. Europe was widely expected to fall into a deep recession owing to its expected energy shortage, but surprised many and appears to have secured its energy needs for this winter and its GDP growth is beating expectations. Markets are pricing in US interest rate cuts during 2023, while The Fed is guiding to a 'higher for longer' tightening cycle. Across the world, fiscal policy is conflicting with monetary policy as governments spend big, while central banks tighten.

As always, Pella's primary reaction to the market environment was to shift our attention towards the areas that satisfy our valuation-to-growth and sustainability requirements and during the quarter we added three new stocks. One of the additions (3i) is domiciled in the UK, which is a market that experienced a sharp selloff following the Truss budget debacle, another is a US software company (Intuit) that had sold off with that sector, and the third is a semiconductor business (TSMC) that had sold off with the chips sector. Meanwhile, the Fund exited two positions, one due to its deteriorating valuation-to-growth relationship (Fiserv) and one due to it hitting a stoploss (RingCentral).

Post these changes and considering adjustments to existing positions, there was minimal change in the Fund's sectoral exposures, but a notable change to its geographical exposure. The Fund's US exposure declined by 10%, while its exposure

[2] MSCI ACWI ($A, net)
[3] Past performance is not indicative of future performance

[4] FANG+ index is developed by the NYSE and is composed of – Advanced Micro Devices, Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, Snowflake, Tesla

to Western Europe and Asia increased by the same amount. However, given the sharp selloff in US 'growth' stocks, an increasing number of stocks in that region/sector are approaching Pella's valuation-to-growth requirements and we stand ready to act should they hit those targets.

The key message is that Pella's portfolio structure will always be a diversified combination of companies that satisfy our valuation-to-growth and sustainability requirements; rather than being dictated by any top-down country or sectoral bias. We believe this is the best way to target consistently delivering on our three goals of better returns than the benchmark, lower volatility than the benchmark, and superior sustainability to the benchmark.

Portfolio Segments

Core:

The Fund increased its exposure to the Core segment to 80%, the highest allocation the Fund has had to that segment since inception. The large addition to the Core segment during the quarter included 3i Group, which is a UK-based private equity investor whose largest holding is Action, a European discount retailer that fits into Pella's consumer trade down investment theme. Other notable additions were Intuit, a US-based accounting software business, and TSMC, a Taiwanese semiconductor manufacturer.

3i and TSMC are ranked AAA by MSCI while Intuit is rated AA, meaning these positions improved the aggregate ESG characteristics of the Fund. 3i and Intuit have de-minimis carbon emissions, while TSMC is energy (and therefore carbon) intensive. However, in aggregate, these positions lowered the Fund's total carbon intensity.

Cyclical:

The Fund's exposure to the Cyclical segment remained stable and it finished the quarter accounting for 10% of the portfolio. There was no change in positions within this segment, however, we made some minor adjustments to individual company weights. The relatively low exposure to the Cyclical segment reflects concerns that the global economy is heading towards a recession, which would be detrimental to highly economically sensitive companies. The Fund continued to hold positions in cyclical investments in industries where there is an expected tightness in supply, for example fertilizers and copper miners.

Innovation:

Stocks in the Innovation segment are typically 'disruptors' that offer rapid top line growth but low earnings certainty. Exposure to Innovation was taken from a diminutive 3% to a tiny 1% of the Fund at quarter end as the Fund exited RingCentral, which hit stop losses, and reduced exposure to Sunrun. The low exposure to this segment reflects our emphasis on earnings certainty, as explained in the CIO Report.

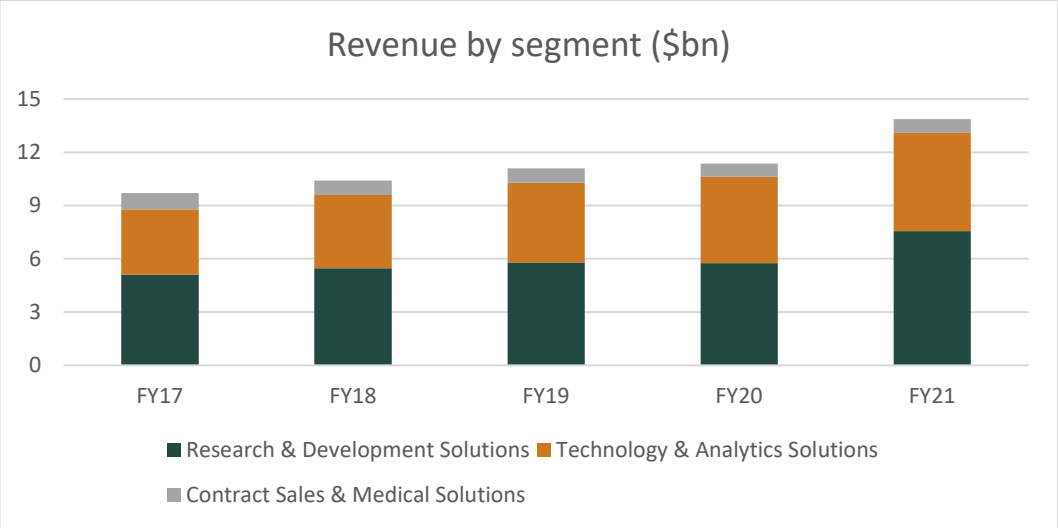
Stock in Focus

Ronald Yu, CFA
Investment Analyst

IQVIA is the largest contract research organisation (CRO) globally, providing clinical trial services to pharmaceutical, biotech and medical device companies. It is also a leading global provider of technology solutions, pharmaceutical sales data and trends, and advanced analytics and consulting services to the health care industry.

The Research & Development Solutions segment accounted for 54% of FY21 revenue and provides a range of clinical trial services including project management (protocol design, patient and investigators recruitment, and site start up), clinical site monitoring, data management, statistical analysis, laboratory services and decentralised clinical trials.

The Technology & Analytics Solutions segment accounted for 40% of revenue in FY21 and provides technology solutions including customer relationship management, performance management, compliance and safety reporting. Through its database of more than 1.2 billion patient records, IQVIA provides real world evidence solutions to inform health care decision making, pharmaceutical sales data and trends to drive marketing and sales decisions, and analytics and consulting services to help improve commercial operations.



Source - IQVIA

Why is the CRO industry attractive?

For a new treatment to be approved by a regulator such as the US Food and Drug Administration, clinical trials must first be performed on volunteers to evaluate the effects of the treatment. These clinical trials are conducted in multiple phases, with the later phases spanning several years, and can be run by in-house by pharmaceutical, biotech and medical device companies, or partially or fully outsourced to CROs.

Pharmaceutical, biotech and medical device companies outsource for a variety of reasons, including lack of expertise, especially as drugs and clinical trials become increasing complex, lack of infrastructure, especially on a global scale, faster development and increased success rate, and risk reduction.

The CRO industry provides diversified exposure to the growing biopharmaceutical industry without the binary risk and medical complexity often associated with investing in biopharmaceutical companies. Large CROs typically have relationships with many biopharmaceutical companies and are not dependent on the success of a single clinical trial, drug or company and given the multiple phases and length of clinical trials, CROs typically have multiyear backlogs, providing high earnings visibility. Although backlogs can be cancelled, IQVIA's analysis shows that CRO industry revenue has grown every year since 2001, including during the GFC and COVID-19, suggesting a reduction in drug development spend during weak economic environments has been a last resort as there would be no future without new drugs.

Why invest in IQVIA?

IQVIA is a core position in the Fund as it provides diversified exposure to the health care industry at an attractive growth rate, has an unrivalled collection of health care data, differentiated CRO capabilities, and high earnings visibility. IQVIA also generates significant free cash flow and is trading on an attractive valuation given the defensiveness.

IQVIA has grown at an average of 5% per year historically but this has been accelerating, with growth expected to increase to more than 8% per year through 2025. With over 10,000 customers in over 100 countries, including pharmaceutical companies such as Pfizer and AstraZeneca, medical device companies such as Medtronic and Stryker and consumer health companies such as L'Oreal and 3M, IQVIA provides diversified exposure to the health care industry at an attractive growth rate.

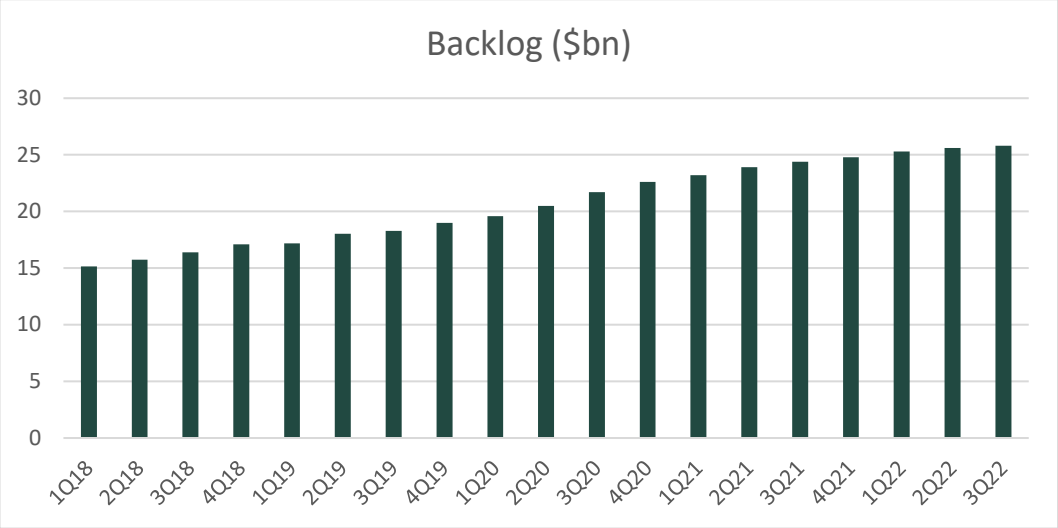
Figure 5 - Sample of IQVIA's customer base

Source - IQVIA

IQVIA has an unrivalled and growing collection of health care data with a database of more than 1.2 billion comprehensive and longitudinal patient records spanning sales, prescription and promotional data, medical claims, and electronic medical records. This data set contains approximately 56 petabytes of proprietary data sourced from approximately 150,000 data suppliers and covering over one million data feeds globally, making it practically impossible for a competitor to replicate.

In the Research & Development Solutions segment, IQVIA's data, expertise and global scale provides differentiation through decentralised clinical trials, where IQVIA brings the clinical trial to the patient, and better protocol design, faster site start up and faster patient recruitment which result in faster clinical trials that save time and money.

IQVIA has high earnings visibility, an important quality that was discussed in the Message from the CIO, due to its subscription revenue and solid multiyear backlog. In the Technology & Analytics Solutions segment, an estimated 40% of revenue comes from recurring subscriptions and in the Research & Development Solutions segment, IQVIA has a growing backlog of $25.8 billion, the largest in the industry and more than three times the expected segment revenue in FY22.



Source - IQVIA

IQVIA has negative working capital requirements, allowing it to generate strong operating cash flows which are used to make acquisitions and repurchase shares. On a free cash flow yield of nearly 5% in FY23, IQVIA is attractively valued as it has defensive characteristics and can grow by at least 8% per year.

Responsible Investing

The 3Q22 quarterly report listed two issues that Pella was addressing. The first related to rectifying an issue submitting votes for Swedish companies and the second related to submitting a Shareholder Proposal at Marsh & McLennan's (MMC) next AGM to improve that company's disclosure of its involvement in the fossil fuel industry. Pella is pleased to share that it resolved the Swedish voting issue and materially progressed the MMC initiative, although not in the manner first intended.

Pella's goal was to improve MMC's fossil fuel disclosure. We initially believed that the AGM would be the most effective forum, however, we learned that Pella had not held a sufficiently large position in that company for long enough to submit the proposal at MMC's next AGM, in 2023. While that issue would be resolved for the 2024 AGM, Pella believed it was important to act sooner given MMC's recent involvement in organising insurance for the East African Crude Oil Pipeline.

Pella prepared a letter for MMC's Board's ESG Committee requesting that MMC "*makes additional disclosures regarding its exposure to the fossil fuel sector. Specifically, Pella is requesting that MMC issue a report, at reasonable cost and omitting proprietary information, addressing whether and how it intends to measure, disclose, and reduce the GHG emissions associated with its underwriting, insuring, and investment activities in alignment with the Paris Agreement's 1.5°C goal.*" Pella is pleased to share that MMC agreed to present the proposal at its January 2023 Board Meeting.

We will follow up with the company to track the outcome of our request and share the details with you. If the targeted outcome is not delivered with fair justification, Pella currently intends to escalate the issue and is now able to submit a resolution at MMC's 2024 AGM.

Pella participated in all its shareholder votes during the quarter and the voting track-record is in Table 3. There were two resolutions where Pella voted differently to the investee companies directors' recommendations.

- Microsoft - Pella voted 'For' the company to 'Assess and Report on the Company's [Microsoft] Retirement Funds' Management of Systemic Climate Risk', as Pella's policy is for its votes to aligned with improved environmental, social, or governance proposals.
- RingCentral – Pella voted 'Against' RingCentral 'Amend[ing] Omnibus Stock Plan' for the following reasons: (i) the plan permits repricing and exchange of grants without shareholder approval and cash buyout of awards without shareholder approval; (ii) the plan contains an evergreen feature; (iii) the estimated duration of available and proposed shares exceeds six years; (iv) the plan allows broad discretion to accelerate vesting.

Table 3 – Pella's 4Q22 voting track-record

Company Name	Meeting Type	Voting String
JD Sports Fashion	Special	FFF
Microsoft	Annual	FFFFFFFFFFFFFFAAFAAA
RingCentral	Annual	FFFFFFFFFFFA1A
Samsung Electronics	Special	FF

In addition to its investing activities, during the quarter Pella employees volunteered at Thread Together, a charity that solves the problem of too much new clothing heading to the dump, by diverting it to people in need. Pella believes in investing globally and acting locally, and we welcome suggestions of organisations we can volunteer at. If you have volunteer ideas to share with us, please email them to enquiries@pellafunds.com.

Finally, the Fund complied with all its Responsible Investment guidelines during the quarter. As illustrated in the Fund Analytics on the second last page of this document, more than 30% of the Fund is invested in companies rated AAA by MSCI and 100% of the Fund is invested in companies with a higher rating than BBB. In addition, the Fund's carbon intensity is significantly less than its target, 30% below the benchmark, and the Fund did not invest in any companies involved in activities included in our exclusion list.

Pella's Responsible Investing performance was recognised by Zenith Investment Partners who ranked the Pella Global Generations Fund – Class B second out of the 35 funds it rates in the International Sustainable/Ethical class. This is an outstanding achievement for any fund, and more so given the Fund achieved this within its first year since inception.

Pella Global Generations Fund

Performance

Net of all fees	PGGF Class B	MSCI ACWI (AUD, net)	Relative
1 month	-2.9%	-5.1%	2.2%
3 months	9.6%	4.1%	5.6%
6 months	7.9%	3.7%	4.2%
1 Year	-9.7%	-12.5%	2.8%
Inception to date [1]	-9.7%	-12.5%	2.8%

(1) 1 January 2022

Past performance is not indicative of future performance. Performance returns are net of fees and assume reinvestment of distributions. Actual investor performance may differ due to the investment date, date of reinvestment of income distributions, and withholding tax applied to income distributions. Past performance is not indicative of future performance

Fund Holdings

As of 30 November 2022

Holdings Name	Sector	Country
3i Group	Financials	United Kingdom
Adobe	Information Technology	United States
AIA Group	Financials	China
Alphabet	Communication Services	United States
Antofagasta	Materials	Chile
Ashtead Group	Industrials	United Kingdom
ASML	Information Technology	Netherlands
Atlas Copco	Industrials	Sweden
B&M European Value Retail SA	Consumer Discretionary	United Kingdom
Bayerische Motoren Werke	Consumer Discretionary	Germany
Boliden	Materials	Sweden
Cigna Corp.	Health Care	United States
CME Group	Financials	United States
Deutsche Börse	Financials	Germany
Dollar General	Consumer Discretionary	United States
Epiroc	Industrials	Sweden
Intuitive Surgical	Health Care	United States
IQVIA	Health Care	United States
JD Sports Fashion	Consumer Discretionary	United Kingdom
Marsh & McLennan	Financials	United States
Microsoft	Information Technology	United States

Mosaic	Materials	United States
Novo Nordisk	Health Care	Denmark
Nutrien Ltd.	Materials	Canada
Ørsted	Utilities	Denmark
Ping An Insurance	Financials	China
RingCentral	Information Technology	United States
Schneider Electric	Industrials	France
Sunrun	Industrials	United States
Texas Instruments	Information Technology	United States
Thermo Fisher Scientific	Health Care	United States
TSMC	Information Technology	Taiwan
UnitedHealth Group	Health Care	United States
VINCI	Industrials	France

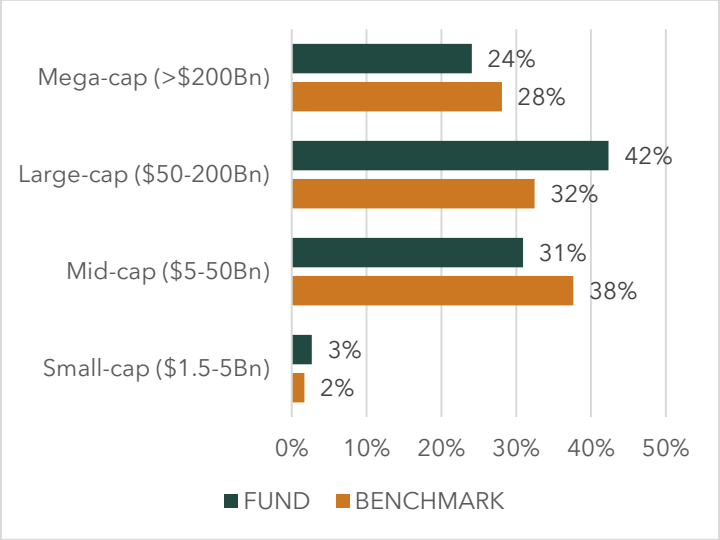
Fund Analytics

As of 31 December 2022

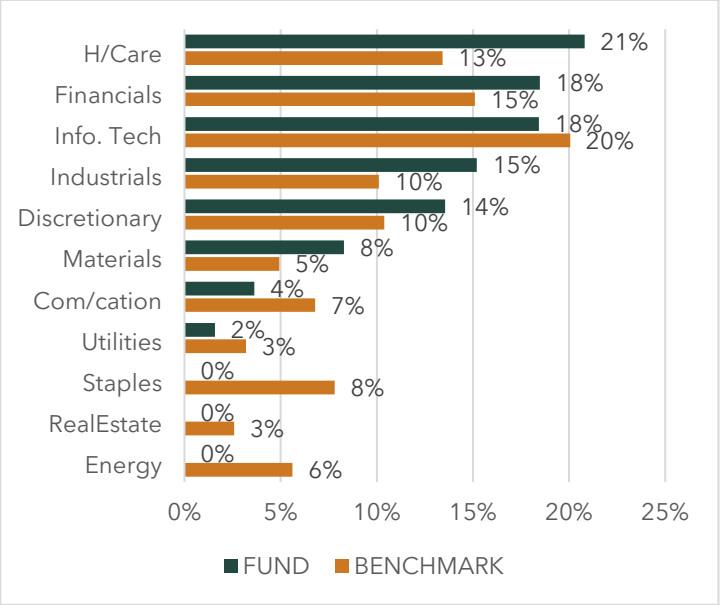
Asset Allocation

Equities	91%
Developed Markets	81%
United States	43%
Europe	38%
Japan & Korea	0%
Emerging Markets	10%
Asia (ex-Japan & Korea)	8%
Latin America	2%
Cash	9%

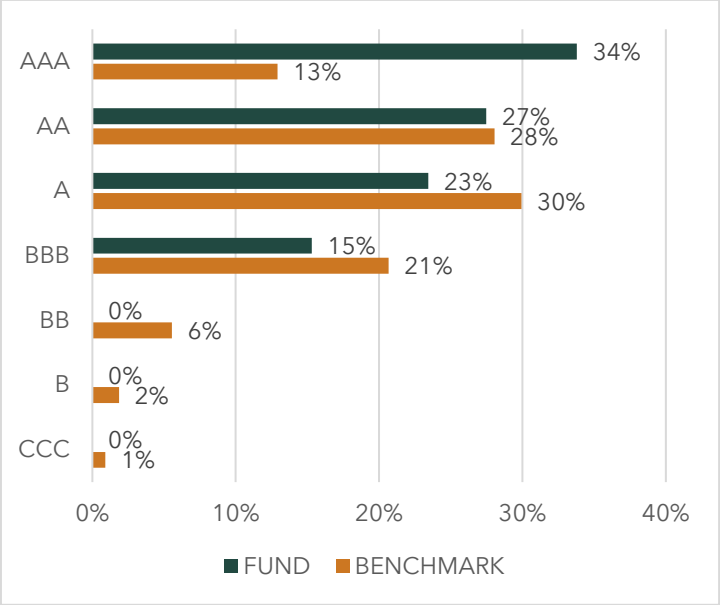
Market-Cap Allocation



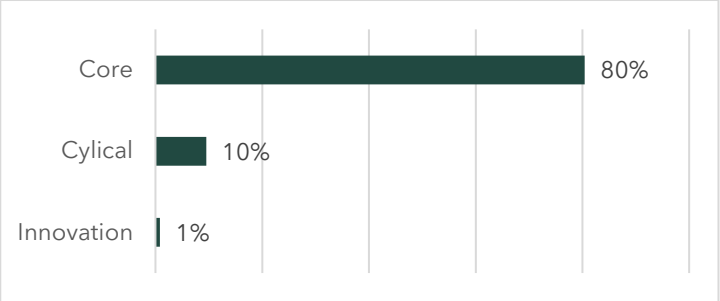
Sector (GICS) Allocation



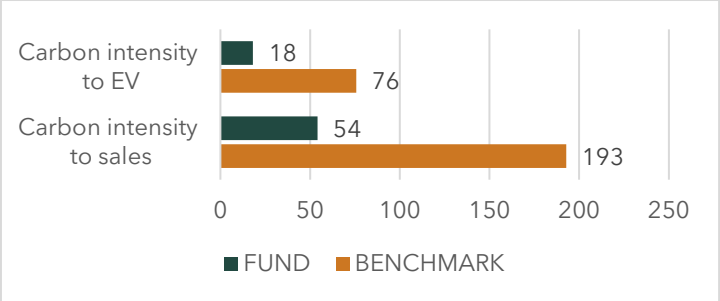
MSCI ESG Rating Distribution



Segment Allocation



Carbon Intensity



Key Information

Portfolio Manager	Jordan Cvetanovski
Inception date	1-January-2022
Price Class B (NAV)	$1.081 (31 December 2022)
Buy/Sell spread	+0.25% /-0.25%
Minimum	$25,000
Additional Investment	$1,000/ $1,000 per month on a regular savings plan.
Pricing frequency	Daily
Distribution frequency	Annual
Base fee	0.65%
Performance fee	15% above benchmark
Benchmark	MSCI All Country World Index ("MSCI ACWI") (A$, net) *
APIR code	PIM5678AU
ISIN	AU60PIM56781

* The fund's investable universe differs to its benchmark. The fund's negative screen excludes several activities that are included in the benchmark such as fossil fuel mining, transportation, or electricity generation; weapons; alcohol; and casinos. The fund also excludes companies that are rated CCC by MSCI. In addition, the fund can invest in companies that are not included in the benchmark, provided those companies satisfy the fund's liquidity requirements. Thus, the fund may be of a different return and risk profile then the benchmark.

Contact Us

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