Quarterly Commentary

March 2022

PELLA
RESPONSIBLE INVESTING

Investment Manager

Pella Funds Pty Ltd
ABN 56 650 744 791 AFSL 238198

Level 1, Suite 117, 165 -167 Philip Street, Sydney, NSW 2000, Australia.

Tel +61 9188 1500

www.pellafunds.com

Responsible Entity

The Trust Company (RE Services) Limited.
ABN 86 000 431 827AFSL 235150

Level 18, Angel Place, 123 Pitt Street, NSW 2000, Australia.

Tel +61 9229 9000

www.perpetual.com.au

Message from the CIO

Jordan Cvetanovski
CIO and Portfolio Manager

The absence of inflation allowed central banks to pump huge amounts of liquidity into the market

For over a decade conditions for most asset classes could hardly have been better with low interest rates and benign volatility. This was underpinned and turbo charged by the injection of trillions of dollars, euros and yen into the monetary system by central bankers who had been lulled into a false sense of security by year-upon-year of (almost) non-existent inflation.

The return of inflation is structural

We have now come to the end of this Pollyanna decade and are faced with inflation rates unseen for over 40 years. In February-2022, US CPI was 7.9% and Europe was not far behind with 5.9%.

Perhaps the most worrying element of the current inflation environment is that there are few signs of it abating. It is our belief that many of the inflationary pressures that have emerged in recent times are structural. We estimate that the inflection point occurred during the Trump presidency, when the US initiated a very assertive stance on trade with China. Of particular significance was its decision to cut off commercial access to the US and other western markets for Chinese companies like ZTE and Huawei. The resultant "trade war" created an incentive for countries to unwind, or at least duplicate, some of their long-standing supply chains, with many (including China) recognising the need to become self-sufficient. The effect was and continues to be inflationary. Subsequently, the COVID-19 global pandemic added to this inflationary momentum as supply chains became further strained.

Perhaps unexpectedly, COVID also triggered some seemingly permanent labour dislocations. For decades, the wealth-divide and the extraordinary gains that corporates/shareholders were reaping at the expense of labour endured unabated. However, it is to be expected that it could not continue to expand forever. While the growing wealth-divide remains a challenging and concerning issue, it appears that labour is now able to take a larger share of the corporate profit pool. When combined with an ongoing decline in immigration and a rapidly ageing population, most of the developed world is facing a shrinking labour pool that is demanding higher wages. This will be another significant structural driver of inflation.

Major pricing pressure on raw materials

Looking at the supply side, we have already seen major pricing uptrend on raw materials such as lumber, copper and zinc as global base material production struggled to satisfy a resurgent global economy. While some of the logistics-related bottlenecks that are driving these price increases may unwind, we are still facing a structural shortage of base materials due to chronic under-investment over the past decade. This situation is not going to change any time soon and the resultant pressures will, if anything, only increase.

When it comes to the supply of raw materials, the latest straw on the proverbial camel's back has been the conflict between Russia and Ukraine. This has not only brought forward some glaring imbalances in the supply of base materials and fossil fuels, but it has also put into question the supply of grains and fertilizer. The world hasn't seen a concurrent food and energy crises since the early 1970's and the flow on effects will be prolonged and will show up in unexpected corners of the market. Therefore, in addition to the many geo-political implications of the Russia and Ukraine conflict, it is certain to stoke further inflation.

Market implications

The initial response from central bankers was to raise rates both to curtail near term inflation and to anchor inflationary expectations. They started off timidly, presumably hopeful that the inflationary pressures would simply abate over time. However, for the reasons outlined above, we do not see inflation normalising in the short/medium term and therefore central banks are likely to act with more conviction going forward. This will catalyse a meaningful slowdown in economic activity and is likely to have a negative influence on asset values, particularly in the most expensive high-growth segment of the equity market.

Longer term, however, the US central bank (and many others) will be limited in how far they can raise rates, due to the enormous debt burden that their economies now carry.

All attempts at crystal ball gazing aside, our investment process has been utilised for over 17 years and has successfully navigated through various market conditions. The one constant is that we embrace these variations. We face the challenges head-on, using a mix of high-quality structural growers for consistency, cyclical companies for agility and innovative companies for dynamism. We remain extremely disciplined on valuation and portfolio diversification. When it comes to valuation, our core methodology focuses on one key measure, free cash flow generation.

Fund Commentary

Portfolio Positioning

Global markets experienced a negative quarter to 31 March 2022, with the MSCI ACWI (AUD) down 8.4% as the AUD strengthened against most other major currencies.

The Pella Global Generations Fund (Class B) returned -8.6%, net of fees, over the same period, underperforming the MSCI ACWI (AUD) by 0.2%.

The largest index declines were the long-term darling sectors of Information Technology (-10%), Communication Services (-10%), and Consumer Discretionary (-11%) with meaningful declines in stocks such as Meta Platforms (-34%), Netflix (-38%) and PayPal (-39%). Meanwhile, on the back of surging commodity prices the Energy (+23%) and Material (+3%) sectors performed strongly with gains in companies such as Chevron (+40%), Exxon Mobile (+36%), and Shell (+31%).

The shift in market performance from Information Tech and its cousins and towards commodity-related sectors resulted in a rare quarter of value outperforming growth as the MSCI ACWI Value index was flat while the MSCI ACWI Growth index declined 9%. This was also reflected in country market returns with commodity-heavy markets, such as Brazil (+16%) and Australia (+4%) performing better than less commodity markets such as Korea (-8%), Europe (-5%), and USA (-5%).

Debt markets had among their weakest quarters in at least 20 years, while commodity markets had their strongest quarter in living memory. The key impetus for these outcomes were tightening monetary policy (central banks increasing interest rates and ceasing to buy bonds) and the Russian-Ukraine war.

During the quarter the Fund performed broadly in line with its benchmark. The Fund's investments in the Materials sector made a meaningfully positive contribution with Boliden, Nutrien, and Stora Enso being the standouts. Relatively low exposure to Information Technology and related industries also made a positive contribution to performance. The Fund's investments into European industrials were detractors to the relative performance as was the absence of exposure to oil and gas with Energy being the benchmark's best performing sub-sector. Regionally, investments in the Asia Pacific region made the largest positive impact on the Fund's relative performance, and investments in Western Europe were the largest detractors.

The Pella Global Generations Fund has a high allocation to quality companies with strong financial and ESG attributes that have diversified revenue streams. These companies are not reliant on a particular cycle and enjoy various long-term structural growth trends such as ageing population, emerging market consumption and the transition to a green economy. The Fund holds approximately 23% in cyclical companies that benefit from inflationary pressure. We always keep an eye out for quality fast paced opportunities when their valuations become attractive. In our view, the portfolio on aggregate has higher growth potential than the market, is cheaper on a FCF yield basis and has superior ESG and quality attributes than the market. We believe these factors have the potential to produce meaningful outperformance over the long term.

Portfolio Segments

Core:

We took the opportunity during the weakest period of the quarter to add new positions in companies that were previously too expensive according to our valuation methodology, examples include ASML and JD Sports Fashion. To address the potential risks of heightened volatility in markets we have investments in companies like CME and Deutsche Bourse which benefit from market dislocations and may act to cushion losses in weak market environments.

Cyclical:

Cyclical investments are concentrated on industries where there is an expected tightness in supply of the material or service. Within these industries we focus on companies with superior ESG that seek to increase supply in a responsible way. Examples in the Fund include Boliden, a Swedish supplier of copper and zinc and Stora Enso, a Finish wood products business. Over the quarter, in the wake of the conflict in Ukraine, we initiated a position in Nutrien, a supplier of potash and fertilizer. Both Russia and Ukraine command a large share of global grain production and Russia and Belarus are key suppliers of potash which is a key ingredient for complex fertilisers.

Innovation:

On the fast-growing technology Innovation front, we have seen some opportunities appear and have taken advantage of the significant sell-off in the early part of the quarter. We have been scouring the market and remain underwhelmed by the valuations in many companies, particularly when considering the looming potential for significant interest rate increases and the expected volatility that follows.

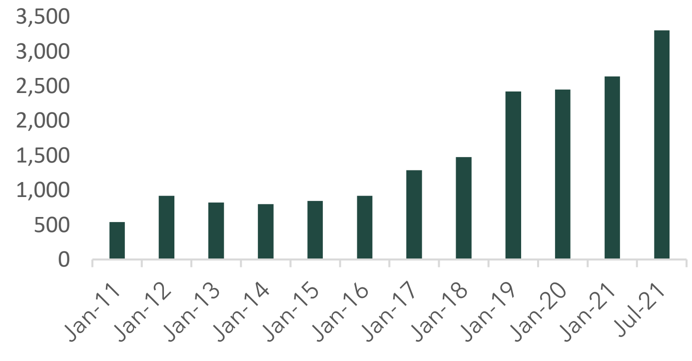
Stock in Focus

Ronald Yu, CFA
Investment Analyst

JD Sports Fashion – Pella Global Generations Fund
JD Sports Fashion is a leading international multichannel retailer of sports, fashion and outdoor brands operating over 3,300 stores globally under multiple banners, including JD, Size?, Chausport, Sprinter, Sport Zone, Perry Sport, Aktiesport, Finish Line, Shoe Palace, DTLR Villa, Millets and Blacks.

JD Sports Fashion generates two-thirds of its revenue from Europe, with the UK and Republic of Ireland accounting for 45% of revenue and the rest of Europe accounting for 22% of revenue. JD Sports Fashion's primary banner is JD, a sports fashion, multichannel retailer of branded sports and casual wear with 893 stores in twenty countries.

Graph 1: Number of stores

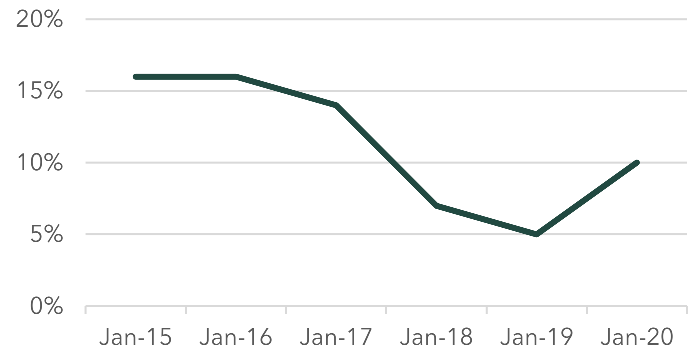


Source: Company Reports

Why the sports fashion market is attractive?
The sports fashion market is attractive due to the trend towards sportswear/athleisure, with global brands including NIKE, adidas and PUMA enjoying high-single digit revenue growth historically. This trend is expected to continue, with the sports fashion market expected to grow by at least mid-single digits until 2025. Although global brands have continued their channel shift from wholesale to direct-to-consumer, wholesale revenue continues to grow, with larger differentiated retailers benefitting from the exit of smaller undifferentiated retailers.

Why invest in JD Sports Fashion?
JD Sports Fashion is a core position in the Pella Global Generations Fund as it has a strong track record of winning, significant white space opportunities, further acquisition opportunities and potential for profit margin expansion. JD Sports Fashion also generates significant free cash flow and is trading on an extremely attractive valuation. JD Sports Fashion has increased like-for-like sales (including online) in the 6 years prior to COVID-19 by an average of more than 10% per year, significantly ahead of the market, and it would not be a surprise if JD Sports Fashion continued growing like-for-like sales by mid-single digit, given the strong market growth and JD Sports Fashion's shift towards more apparel.

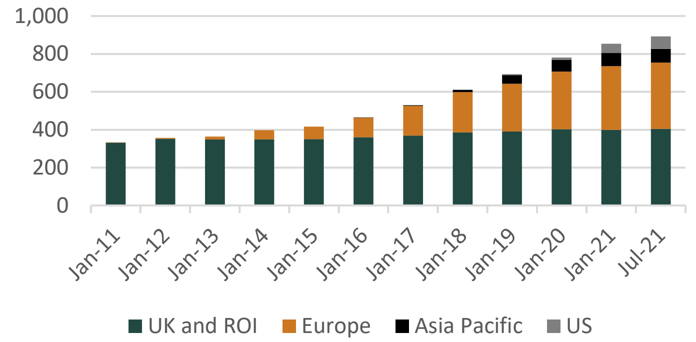
Graph 2: Like-for-like sales including online



Source: Company Reports

With only 893 JD stores globally, of which 405 are in the UK and Republic of Ireland, there is significant potential to increase the JD store footprint globally. The number of JD stores has increased at a CAGR of 10% in the last ten years and management expects to open more than 50 JD stores in Europe per year and an unspecified number of new JD stores in both the US and Asia-Pacific. In addition, management expects to open 5% new stores per year in both of its Shoe Palace and DTLR Villa banners in the US.

Graph 3: Number of JD stores



Source: Company Reports

JD Sports Fashion has spent more than £1bn in cash on acquisitions in the past, with the three most notable acquisitions being Finish Line, Shoe Palace and DTLR Villa, which provided an entry and a platform into the US market. With retail continued to be pressured by online and potentially weakening because of inflation, JD Sports Fashion could benefit from an increase in distressed retailers looking for an exit, both in the US and in Europe.

JD Sports Fashion's gross profit margin and profit before tax and exceptional items margin have declined due to various factors including COVID-19, Brexit and margin dilutive acquisitions. However, these factors will normalise over time with stores being reopened, a new distribution centre being built in Europe and the acquisitions being successfully integrated. In addition to an ongoing shift towards apparels which have higher profit margins, the gross profit margin and the profit before tax and exceptional items margin should both increase over time.

Although JD Sports Fashion only has a BBB rating from MSCI, we believe this is an anomaly as its two largest suppliers, NIKE and adidas, have ratings of A and AAA respectively. We have engaged with JD Sports Fashion and MSCI to identify the key issues and to further increase disclosures and anticipate improvements at the next review.

JD Sports Fashion has no working capital requirement, allowing it to generate strong free cash flows. JD Sports Fashion has net cash of about £1bn and is currently trading on a free cash flow yield of 7%, which is extremely attractive given its multiple avenues for growth.

Responsible Investing

Pella's key Responsible Investing initiative during 1Q22 was to become a signatory of key Responsible Investment organisations and to encourage companies in the Pella Global Generation's Fund to become signatories of the United Nations Global Compact (UNGC).

During the quarter Pella become a signatory to the UNGC, United Nations Principles for Responsible Investing (UNPRI), and Responsible Investing Association Australasia (RIAA).

Pella's Responsible Investment efforts were reflected with the fund being awarded an AA ESG-rating by MSCI and Evergreen Consultants placing the Pella Global Generations Fund in the top quartile of its Evergreen Responsible Investment Grading (ERIG) index.

Pella wrote letters to the CEOs of 24 companies that are not currently signatories to the UNGC to encourage them to do so. Their responses were broadly positive, and several companies committed to become signatories.

During the quarter three of Pella Global Generation Fund's investments had a shareholder vote:

Table 1: Company voting disclosure

Company	Vote
Stora Enso	Pella voted against management recommendations on two votes. 1. Vote against the reappointment of a director because the re-election of that Director would result in insufficient independence of the Remuneration Committee. 2. Vote against the issuance of 2M shares without pre-emptive rights. Pella does not believe the company requires the additional capital.
Novo Nordisk	Pella voted against management recommendations on a single vote. Pella abstained for the re-election of a single Director, who Pella believes is involved in too many boards.
Orsted	Pella voted in-line with management recommendations on all matters.

Pella Global Generations Fund

Performance

Net of all fees	Pella Global Generations Fund (Class B)	MSCI ACWI (net, AUD)	Relative Performance
Since Public Launch (1 Jan 22)	-8.6%	-8.4%	**-0.2%**
Latest Quarter	-8.6%	-8.4%	**-0.2%**
1 Month	-0.4%	-1.3%	**0.9%**

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 at 28 February 2022

Holdings Name	Sector	Country
AIA	Financials	Hong Kong
Alphabet	Communication Services	United States
Amedisys	Health Care	United States
Antofagasta	Materials	Chile
Ashtead	Industrials	United Kingdom
ASML	Information Technology	Netherlands
Atlas Copco	Industrials	Sweden
BMW	Consumer Discretionary	Germany
Boliden	Materials	Sweden
Cigna	Health Care	United States
CME	Financials	United States
Coinbase	Financials	United States
Credit Agricole	Financials	France
Deutsche Boerse	Financials	Germany
Dollar General	Consumer Discretionary	United States
Epiroc	Industrials	Sweden
Fiserv	Information Technology	United States
Flow Traders	Financials	Netherlands
ING	Financials	Netherlands
Lumentum	Information Technology	United States
Marsh & McLennan	Financials	United States
Medtronic	Health Care	United States
Microsoft	Information Technology	United States
Novo Nordisk	Health Care	Denmark
Orsted	Utilities	Denmark
Ping An	Financials	China
RingCentral	Information Technology	United States
Samsung Electronics	Information Technology	South Korea
Schneider Electric	Industrials	France
STMicroelectronics	Information Technology	Switzerland
Stora Enso	Materials	Finland
Sunrun	Industrials	United States
Texas Instruments	Information Technology	United States
Thermo Fisher	Health Care	United States
UnitedHealth	Health Care	United States
Vinci	Industrials	France
Visa	Information Technology	United States
Vulcan Materials	Materials	United States
Weyerhaeuser	Real Estate	United States

Fund Analytics

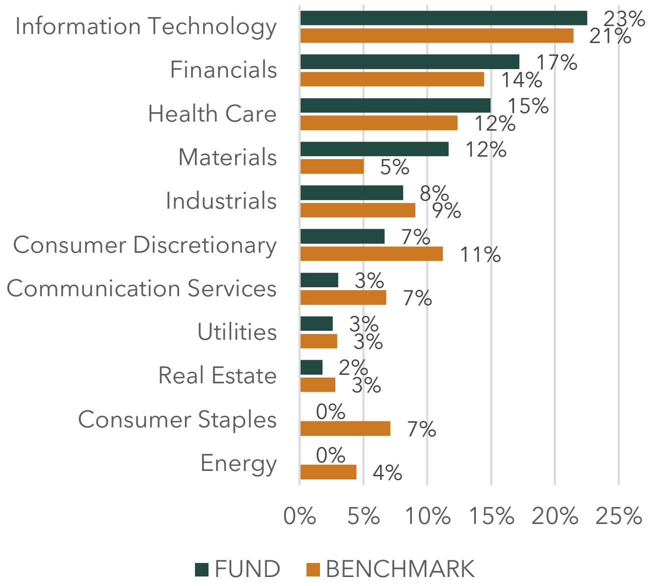
As at 31 March 2022

Fund Asset Allocation

Equities	89%
Developed Markets	83%
United States	47%
Europe	31%
Japan & Korea	2%
Emerging Markets	5%
Asia ex-Japan	3%
Latin America	2%
Cash	11%

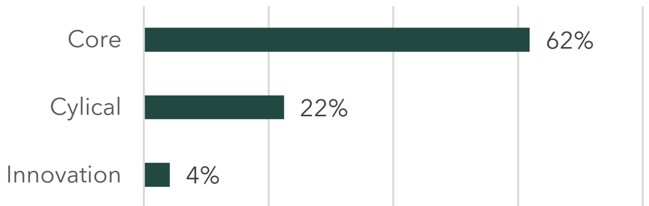
Source: Pella Funds Management

Sector (GICS) Allocation



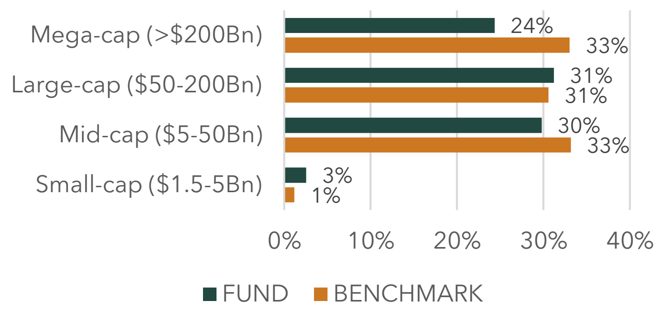
Source: Pella Funds Management

Fund Segment Allocation



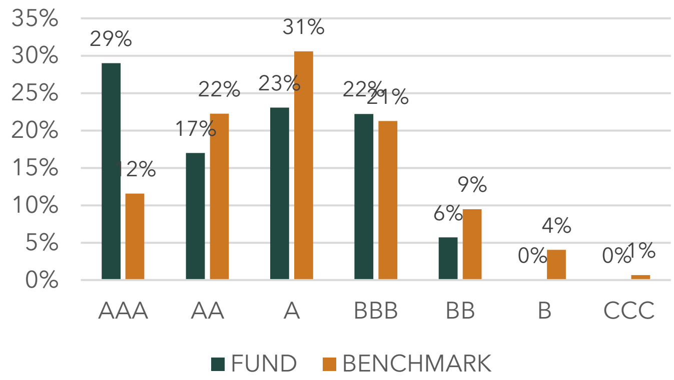
Source: Pella Funds Management

Market-Cap Allocation



Source: Pella Funds Management

MSCI ESG Distribution



Source: Pella Funds Management

Carbon Intensity

	FUND	BENCHMARK
CO_2 to sales (1)	54	157
CO_2 to EV (2)	14	56

Source: Pella Funds Management
(1) Tonnes (mils) of CO2 (scope 1 and 2) per US$m of sales.
(2) Tonnes (mils) of CO2 (scope 1 and 2) per US$m of EV

MSCI ESG Rating

MSCI ESG Rating of the Pella Global Generations Fund

Key Information

Portfolio Manager	Jordan Cvetanovski
Inception date	1-January-2022
Price Class B (NAV)	$1.0972 (31 March 2022)
Buy/Sell spread	+0.25% /-0.25%
Minimum	$25,000
Additional Investment	$1,000/ $1,000 per month on a regular savings plan.
Pricing frequency	Daily
Distribution frequency	Annual
Base fee	0.65%
Performance fee	15% above Benchmark
Benchmark	MSCI ACWI (A$, net)
APIR code	PIM5678AU
ISIN	AU60PIM56781
ARSN	653 919 478

Contact Us

Joy Yacoub
Head of Distribution

M: 0414 226 007
E: joy.yacoub@pellafunds.com