Quarterly Commentary

September 2022

PELLA
RESPONSIBLE INVESTING

Investment Manager

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Message from the CIO

Jordan Cvetanovski
CIO and Portfolio Manager

Energy is the lifeblood of the global economy. Wars are waged, economies are restructured, and political campaigns are fought in the name of energy. One of the most enduring themes of our generation is the growing demand for electrical energy and the concurrent migration away from fossil fuels.

There are two primary drivers of this movement. The first relates to sustainability, as it is possible to generate green electricity using renewable sources rather than burning fossil fuels. The second driver is the growing need for electricity to power mobility and a computerised and connected world.

During the September quarter there were several events that point to an acceleration of that theme. Before we describe these events, it is worthwhile providing some historical perspective.

In October 1973, OAPEC (the predecessor to OPEC) proclaimed an oil embargo on many western nations. This led to a 310% increase in the oil price over the six months to March 1974, when the embargo was eased. The dramatic increase had a devastating impact on the global economy, with the US and UK experiencing stagflation (inflation plus a recession). It also led to some lasting outcomes as western countries recognised that energy could be weaponized. For example, the US established its Strategic Petroleum Reserve (SPR), automobile manufacturers commenced investing heavily in fuel efficiency, and oil majors ramped up investment in difficult terrains such as the North Sea and the Arctic.

A similar scenario followed in 1979 in the wake of the Iranian revolution and Iran-Iraq war. While that oil crisis only reduced global oil supply by approximately 4%, it resulted in the oil price spiking by almost 150% to $40/barrel (inflation adjusted = $152/barrel) by January 1980. This contributed to a global recession in 1982 as well as structural changes, including mushrooming consumer demand for compact, fuel-efficient vehicles and Japanese automobile manufacturers surpassing the US' production totals. Electric utilities worldwide switched from oil to other fuels, governments invested billions to develop alternatives to oil, and the White House installed a wood-burning stove in the living quarters.

Fast forward to today and the world is experiencing another energy shock and weaponization of fossil fuels due to the Russian/Ukraine conflict. Concurrently, there are generationally severe droughts in parts of the US, China, and Europe which is curtailing hydro-electricity generation, exacerbating the energy shortage. As with the oil crises of the 1970s, these cyclical factors will create incremental impetus for global energy reform.

Countries are responding as you would expect. During the September quarter, the US passed the Inflation Reduction Act, which (despite its name) is primarily a program to increase investment in sustainably generated electricity and migration away from fossil fuels. Several countries proposed extending the life of old nuclear plants (Belgium, Japan, Germany, USA) or investing in new ones

(France, UK, Czech Republic, Poland). California passed legislation to ban the sale of new internal combustion vehicles from 2035, and China continued the march towards energy independence that was outlined in its most recent five-year plan. The world is at the doorstep of an energy revolution as it faces the reality that fossil fuels aren't a long-term solution despite the need to continue our reliance on them in the short term.

According to the International Energy Agency's (IEA) analysis, under the Stated Policies Scenario (STEPS)[1], electricity demand will grow by almost 30% from 2020 to 2030[2]. Over the same period, the IEA estimates that oil demand will rise by barely 4%[3], natural gas demand will grow by 15%[4], and coal demand will decline by 55%[5]. Different scenarios[6] generate different figures but the same conclusion: **electrification is the growth theme of the energy complex, and a growing portion of that electricity will be generated using sustainable inputs**.

Green energy production is at the epicentre of the electrification revolution, but it is not alone in offering investment opportunities. The networks of the future will require investment in electrical components, wires, and resources.

Pella has invested across that value chain while always emphasising low carbon and high ESG characteristics. The Pella Global Generations Fund (PGGF) has positions in Sunrun (SUN.US) and Orsted (ORSTED.DK), which are leaders in residential solar and offshore wind generation, respectively. The Fund also has an investment in Schneider Electric (SU.FR), one of the world's largest suppliers of components used in electricity networks (Schneider is this quarter's stock in focus, below). The Fund also has positions in Antofagasta (ANTO.GB) and Boliden (BOL.SE), which produce copper, the key commodity necessary in upgrading electricity grids, and in Epiroc (EPI.A-SE), which makes the equipment used by producers such as Antofagasta and Boliden. In-line with the investment theme, Epiroc is also the leader in developing mining equipment that operate using electricity rather than fossil fuels.

Focusing on copper as an example of the opportunity in electrification. Global copper consumption is approximately 26m tonnes[7] p.a. We calculate that Internal Combustion Engines (ICE) vehicles account for close to 10% of that demand. Depending on the technology used, electric vehicles use 2x-to-3.5x more copper than ICE vehicles[8]. This implies that the transition to EV alone would increase copper demand by more than 10% and possibly by more than 20%. Add to this the need for copper for other areas of electrification, and S&P Global estimates global demand for copper will reach 50m tonnes by 2035.

Meanwhile, copper supply is expected to peak in 2024 at approximately 28m tonnes. Using these types of inputs, BloombergNEF estimates there will be a 14m tonne output

[1] The STEPS provides a more conservative benchmark for the future because it does not take it for granted that governments will reach all announced goals. Instead, it takes a more granular, sector-by-sector look at what has been put in place to reach these and other energy-related objectives, taking account not just of existing policies and measures but also of those that are under development

[2] IEA, World Energy Outlook 2021, pg. 195

[3] IEA, World Energy Outlook 2021, pg. 214

[4] IEA, World Energy Outlook 2021, pg. 226

[5] IEA, World Energy Outlook 2021, pg. 240

[6] The IEA also applies an Announced Pledge Scenario (APS) and Net Zero Emissions by 2050 scenario (NZE)

[7] Australian Department of Industry, Science and Resources, Resource and Energy Quarterly Jun-22

[8] International Copper Association, Jun-17, and Copper Development Association

gap by 2040, S&P Global estimates a 10m tonne deficit in 2035, and Goldman Sachs calculates there will be an 8m tonne deficit within a decade. Based on this analysis, the outlook appears favourable for copper miners (Antofagasta and Boliden) and companies supplying them (Epiroc).

Pella's electrification-theme stocks had mixed performance over the quarter. Sunrun jumped 28% following the US passing the Inflation Reduction Act, Schneider held ground, Orsted declined due to its sensitivity to interest rates, while Antofagasta, Boliden, and Epiroc suffered due to fears of an imminent recession.

History has taught us that the combination of structural forces and short-term shocks creates lasting changes to the energy market. We have no reason to believe that this time will be any different and the events during 3Q22 will add fuel to the ongoing march towards an electrified future. This development will proceed across several interest rate and economic cycles, and Pella believes its Fund's positioning across the electrification value chain will generate attractive long-term returns, while benefiting the planet.

Fund Commentary

Portfolio Positioning

Key market issues during 3Q22 were rising interest rates and the threat of an imminent recession. Much ink has been spilt on those topics and we wrote about them in our articles, *Why elevated inflation will persist* (23 Feb-22), *Why tight monetary policy will not persist* (10 Mar-22), and in the 2Q22 commentary. While these issues are critical for markets, the views that we outlined in those earlier articles are no longer particularly contentious. Therefore, for the sake of brevity, we have chosen not to revisit them in this report.

In a quarter bursting with newsworthy events, some of the most interesting activity occurred in the currency markets, most notably the USD strength and GBP weakness. The former can be largely attributed to a flight to quality as markets brace for a global recession and the latter can be explained by the UK's deteriorating economic situation and conflicting monetary and fiscal policies. Ironically, the US' economic situation is beset by similar issues to the UK (deteriorating economy and conflicting monetary and fiscal policies), but the USD is bestowed with special privileges as the reserve currency. The title to a FT opinion piece expressed the situation succinctly, '*Truss learns the hard way that Britain isn't America*'[9].

While it is open to interpretation whether the USD should have appreciated during the quarter, Pella believes the key message being delivered by its rise is entirely valid and there are several early warning signs that should catalyse a further flight to quality, including:

- Warnings by businesses operating in early cycle industries such as semiconductors (Nvidia, Advanced Micro Devices, Intel, and Qualcomm), companies exposed to digital advertising (Google, Snap, Meta, Gannett, New York Times, Warner Bros. Discovery, Roku), discretionary clothing retailers (GAP, Abercrombie & Fitch, Victoria's Secret, ASOS), and delivery networks (FedEx).
- The US housing market has made a rapid retreat, and the National Association of Realtors described the US market as already in a '*housing recession*'. Meanwhile, Chinese property sales have been declining sequentially for over a year and, according to Citi's research, nearly a third of all property loans in that market should be classified as bad debts.
- Notable declines in the prices of several commodities.
- US yield curve inverted, which is a phenomenon that has preceded most, if not all, recessions in that country.

The highest probability conclusion one could draw from the above is that a global recession is inevitable. However, the stock market's quarterly sectoral performance provided mixed signals.

During the quarter, the MSCI ACWI declined 0.3% with the best performing sectors being Consumer Discretionary, Energy, and Financials; and the worse performing sectors being Communication Services, Real Estate,

[9] FT, Truss learns the hard way that Britain isn't America, 27 Sep-22

and Information Technology. Three companies (Apple, Tesla, and Amazon) contributed a combined +1% to the Benchmark's performance and excluding those three stocks the Benchmark would have declined 1.3% and the Fund would have been approximately in-line with the Benchmark.

The best performing regions were North America, Central Asia, and South & Central America, and the worst performing regions where Asia Pacific, and Europe. As with the sectoral performance, North America's strong performance is explained by just three stocks (Apple, Tesla, Amazon), which accounted for **slightly over 70%** of that region's positive performance.

Asian stocks (and currencies) were broadly down with only 18 stocks (1.3% of the Benchmark) having a positive impact on the Benchmark. One of the key drivers of this was the slowing Chinese economy. European stocks (and currencies) were also weak owing to a cocktail of issues including spiking energy prices, slowing global economy, and high inflation, while that region has few 'hero' stocks like Apple, Tesla, and Amazon.

Bringing the above together, the Fund's underperformance can be almost entirely explained by the absence of Apple, Tesla, and Amazon in its portfolio and its underweight exposure to the USD. Our decision not to own those stocks is due to none of them complying with our price-for-growth valuation framework.

Portfolio Segments

Core:

The Fund increased its exposure to the Core segment to 75%, the highest allocation the Fund has had to that segment since inception. During the quarter, the Fund exited two positions and added two new positions. The positions exited were Visa, on ESG grounds (explained in the Responsible Investing section, below) and Vulcan Materials on valuation grounds and due to the deteriorating US housing market.

Cyclical:

During the quarter the Fund's exposure to the Cyclical segment was reduced to 9% from 17% at the end of the June quarter. The Fund exited several Cyclical positions including Flow Traders, Samsung Electronics, Stora Enso, STMicroelectronics, and Weyerhaeuser. These exits largely reflected 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 (discussed in the CIO Message, above).

Innovation:

As communicated in the 1Q22 and 2Q22 quarterly reports, we have been scouring the market but remain underwhelmed by the valuations of many companies, particularly in the innovation space. The Fund's exposure to Innovation remained essentially unchanged in 3Q22 with two stocks that comprise 2% of the portfolio.

Stock in Focus

Ryan Fisher
Investment Analyst

As outlined in the CIO Message, Pella considers electrification as an attractive long term growth opportunity. We have invested across that electrification value chain, with a focus on best-in-class businesses with strong ESG characteristics. One of those businesses is AAA-rated[10] Schneider Electric (SU.FR), one of the world's largest suppliers of the components used in electricity networks and buildings/data centres to boost electrical efficiency.

Schneider is a French company that was founded in 1836. Following a major acquisition in 1975, it moved from a focus on steel and industrial products to electricity and energy. Since then, it has developed a global footprint, with both North America and Asia Pacific now contributing more revenue for the group than Western Europe. The group's share of the global electrification market is roughly 20%, which is more than 1.5x larger than the #2 player (ABB). Schneider's leadership position is a function of its comprehensive product and service offerings, and diverse distribution network.

Schneider divides its operations into two segments:

1. Energy Management (77% of revenue)
2. Industrial Automation (23% of revenue).

The Energy Management business services homes, buildings, data centres, grids and infrastructure, and industrial companies. It provides an end-to-end range of products, systems, software, and services that aim to boost customers' energy efficiency and reliability.

The Industrial Automation business provides products and solutions for the automation and control of machines, manufacturing plants and industrial sites.

The company also has a rapidly growing software offering which features full integration of its energy management and automation services and covers the customer's entire process (from design to build to operate & maintain).

Sustainability is at the core of Schneider's strategy and operations. The company estimates that more than 70% of its revenue is derived from climate or resource-efficiency solutions and its targets include 80% green revenue and >800M tons of C02 saved and avoided by customers by 2025 (vs 2018). This means Schneider is well placed to help solve, and benefit from, the escalating global energy crisis.

The recent surge in energy prices is likely to create a sense of urgency amongst customers (particularly in Europe) to accelerate their investments in electrification. On the back of the surge in power prices, the payback period for the company's solutions has shortened considerably.

[10] MSCI ESG rating

Schneider is also well positioned to benefit from the ongoing digitalization of society. These forces are creating growing demand for data centre capacity, which is an area where Schneider has a particularly strong integrated offering (currently generating around 16% of its revenue) and has been gaining market share. Furthermore, growth in wireless data traffic and the rise of big data is driving the need for increasingly sophisticated electrical and digital infrastructures within buildings. More recently, we have also seen the emergence of labour shortages and wage inflation in most parts of the world. This is likely to drive accelerated investment in the group's automation and industrial software applications.

These developments have a beneficial "knock-on" effect for the group. For example: the installation of solar panels and EV chargers in buildings will require the renovation and upgrade of their existing electrical systems, all the way from circuit breakers and panel boards to cable and load management. Meanwhile, the rapid rise in renewables and the growing demand for fast-charging stations for EVs will put pressure on existing electrical grids, creating the need for more sophisticated distribution solutions.

Schneider's financial characteristics complement the above themes. Its margins have improved significantly in recent years and now stand well above the peer average. It has a relatively flexible cost base (70% variable) and its focus on assembly results in a low energy-intensive and low capital-intensive operating model. Furthermore, it operates with an agile supply chain, with a multi-hub model that enables it to leverage global scale effects while maintaining a strong local presence (with products adapted to local specificity and standards). In 2022, Schneider was ranked second in the Gartner Supply Chain Top 25 study, which identifies companies demonstrating excellence in supply chain management. This has enabled Schneider to manage the challenges of the post-COVID period (including recent lockdowns in China) without the same difficulties as many other companies.

The company has demonstrated pricing power in recent periods. We attribute this to a combination of a high barriers-to-entry industry, a fragmented customer base, proven innovation capabilities and the industry's largest distribution network. Furthermore, its product prices represent a small portion of total electrical installation costs (vs labour at around 70% of total costs) and the cost of electrical installation is only a mid-single-digit portion of the total cost of a new building. Therefore, electricians tend to have very strong brand loyalty and are generally able to pass any electrical product price increases on to the final customer relatively easily. These factors have enabled Schneider to continue to meet or beat analyst expectations over the last few quarters.

We see Schneider Electric as a high-quality way to gain exposure to the attractive, long-dated theme of electrification. In addition to its strong market position, the company has appealing operational, financial and ESG characteristics. It also satisfies Pella's price-for-growth valuation criteria, offering a 2023E free cash flow yield of over 5.5% and mid-to-high single digit through-cycle revenue growth.

As we enter a challenging period for the global economy, we would not expect the company to be immune to the effects of any major slowdown in activity, but we do believe that its leadership in a structurally expanding space, along with its diversified profile across geographies and end-markets, should stand it in relatively good stead.

Responsible Investing

One of the highlights of the quarter was the release of Pella's inaugural [Responsible Investing Report](), for the financial year ending June 2022. The Report provides an overview and assessment of Pella's responsible investing activities and performance over the preceding financial year. Our self-assessment is that Pella met and often exceeded its targets across all metrics (transparency, excluded activities, norms-based requirements, ESG, carbon intensity, positive impact, voting and initiatives).

Two issues mentioned in the Report that were addressed during the September quarter relate to submitting votes for Swedish companies and preparing a shareholder resolution for Marsh & McLennan's (MMC.US) next AGM.

During the 2022 AGM voting season Pella was unable to submit votes for its Swedish positions. The issue relates to needing to execute certain documents that must be delivered to Broadridge, the Fund's ballot provider. Pella is well progressed with resolving this issue, and it should not reoccur.

The MMC initiative involves submitting a Shareholder Proposal at the company's next AGM to improve its disclosure of its involvement in the fossil fuel industry. Pella has engaged with its proxy advisor for direction relating to the submission of the proposal. This must be submitted by 2 Dec-22 for inclusion at the next AGM.

The Fund's UK-domiciled listings held their AGMs during the September quarter.

Table 1 summarises Pella's voting at those AGMs. Pella voted against two Board Recommendations at the Ashtead AGM, namely: (i) Approve Remuneration Report – Pella believes Ashtead has not taken sufficient steps to address the remuneration concerns recorded at the 2021 AGM; (ii) Re-election of Lucinda Riches as Director – as the Chair of the Remuneration Committee, she is ultimately responsible for Ashtead's remuneration practices.

Table 1 – Company voting disclosure

Company Name	Meeting Type	Voting String
B&M European Value Retail	Annual	FFFFFFFFFFFFFFFFFFFF
JD Sports Fashion	Annual	FFFFFFFFFFFFFFFF
Ashtead Group	Annual	FAFFFFFAFFFFFFFFFF

Pella pursued two stewardship initiatives during the September quarter. The first was engaging with large prosthetic limb manufacturers (Enovis, Globus Medical, Integra Lifesciences, Johnson & Johnson, Medtronic, NuVasive, Ossur, Smith & Nephew, Stryker, Zimmer Biomet) to request prosthetic donations to the [United Ukraine Appeal]() for civilian victims of the Russia/Ukraine conflict.

Some of the companies (Medtronic, Ossur) are already providing support, Stryker responded that it would consider the initiative, and the rest have not responded yet. Pella has, and will continue to, follow up with the laggards.

Pella also continued with its initiative to encourage all its Fund's positions to become signatories to the United Nations Global

Compact (UNGC). Over the year we have had some success with Samsung Electronics, Flow Traders, and Sunrun becoming signatories. However, there remains work to be done with 16 of the Fund's current positions that are not UNGC signatories. This is an ongoing initiative for Pella.

During the September quarter Pella exited its position in Visa due to our belief that the company violated Norms-Based Requirements[11], following its alleged complicity in the monetisation of child pornography. For a detailed overview of our thinking, please refer to the article, *Visa, Porn, and our Red Line* (29 August 2022).

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.

[11] Norms-Based Policy involves identifying and excluding companies that do not meet minimum standards of business practices based on international norms and conventions

Pella Global Generations Fund

Performance

Net of all fees	PGGF Class B	MSCI ACWI (AUD, net)	Relative
Since Public Launch (1)	-17.6%	-15.9%	-1.7%
Latest Quarter	-1.6%	-0.3%	-1.2%
1 Month	-2.8%	-3.6%	+0.8%

(1) 1 January 2022

Past performance is not indicative of future performance

Fund Holdings

As of 31 August 2022

Holdings Name	Sector	Country
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
Fiserv	Information Technology	United States
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
Samsung Electronics	Information Technology	Korea
Schneider Electric	Industrials	United States
Stora Enso	Materials	Finland
Sunrun	Industrials	United States
Texas Instruments	Information Technology	United States
Thermo Fisher Scientific	Health Care	United States
UnitedHealth Group	Health Care	United States
VINCI	Industrials	France
Weyerhaeuser	Real Estate	United States

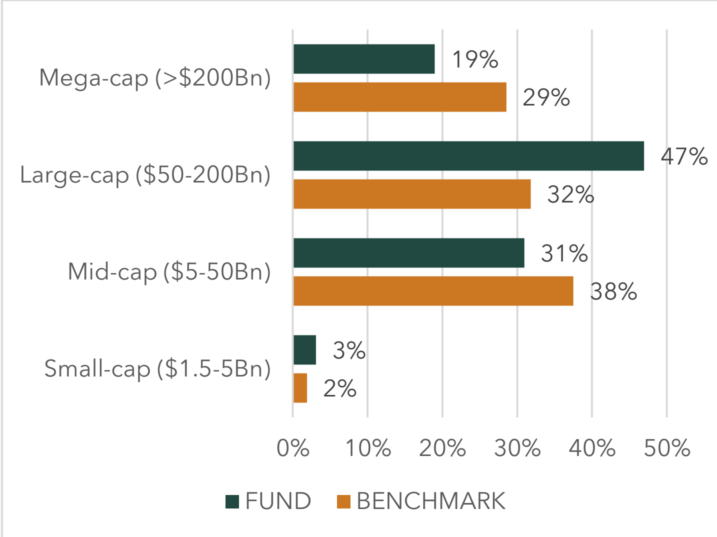
Fund Analytics

As of 30 September 2022

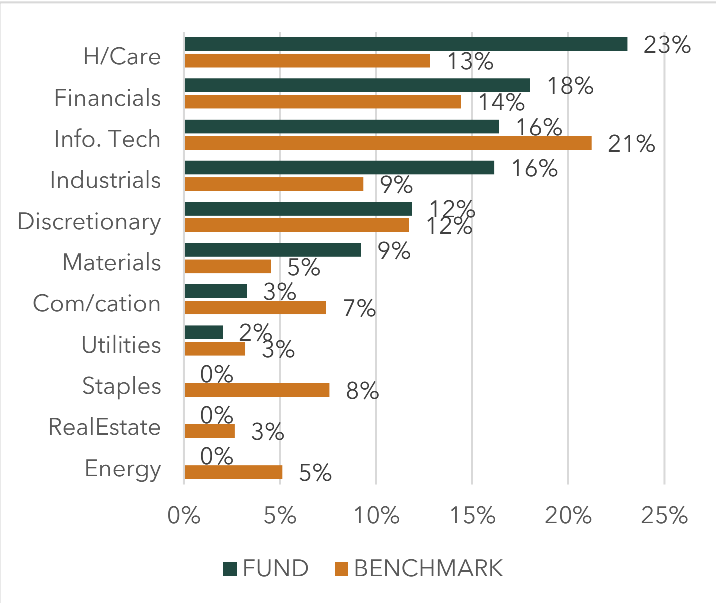
Asset Allocation

Equities	86%
Developed Markets	79%
United States	48%
Europe	31%
Japan & Korea	0%
Emerging Markets	7%
Asia ex-Japan	5%
Latin America	2%
Cash	14%

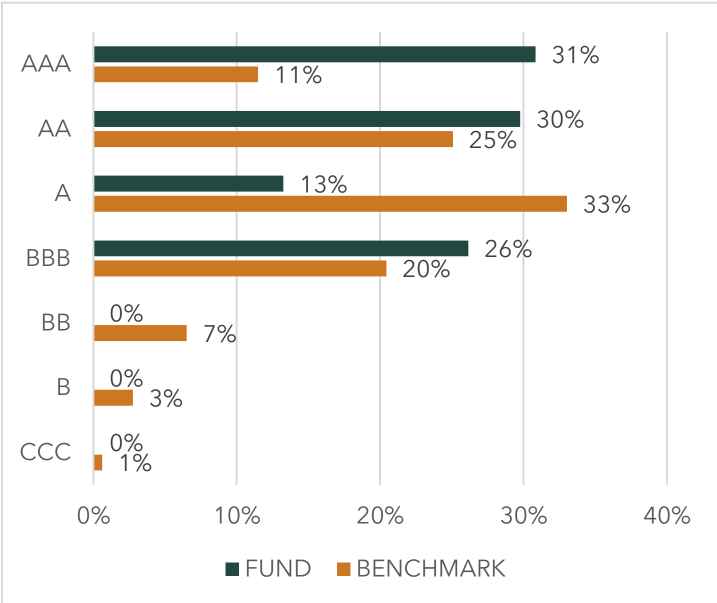
Market-Cap Allocation



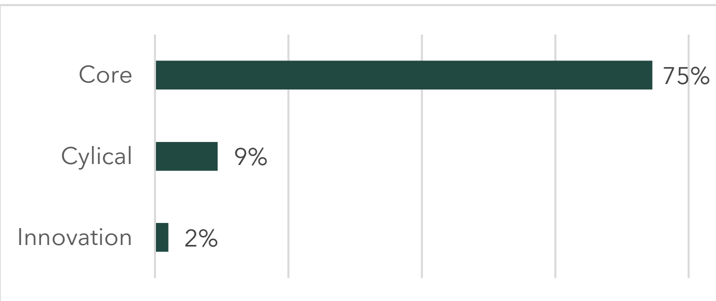
Sector (GICS) Allocation



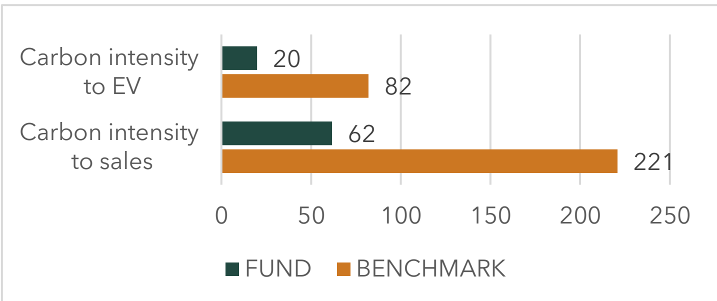
MSCI ESG Rating Distribution



Segment Allocation



Carbon Intensity



Key Information

Portfolio Manager	Jordan Cvetanovski
Inception date	1-January-2022
Price Class B (NAV)	$0.986 (30 September 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

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