Q&A with Nathan Hughes

By Perpetual Asset Management

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The Perpetual Ethical SRI Fund, managed by Portfolio Manager Nathan Hughes, is now more accessible to investors after the 29 November launch of GIVE, the first in a suite of Exchange Traded Managed Funds (ETMFs). Here Nathan discusses how the Fund seeks to meet the needs of investors looking to invest in companies that are consistent with their social, environmental, and ethical preferences.

The Fund has had a good year with performance a little more muted over the second half of 2021. How do you think it's gone?

The fund modestly outperformed the benchmark for the September quarter, which was nice, but is of questionable relevance given it is such a short period of time. My focus is on generating sustainable performance through market cycles, rather than chasing the thematic of the day, or trying to position the portfolio on the right side of every market headline.

Looking forward, the portfolio is full of businesses that I believe have resilient balance sheets, strong market positions, decent cash flows, and sensible management teams. I would argue many durable businesses have gone largely unnoticed by the market with attention squarely focused elsewhere – such as the large number of IPOs, which are often seen as a quick way to bank performance in a buoyant market environment. This means we have been continuing to find good opportunities at attractive valuations, despite the strong performance of the market in aggregate.

Give us a sense of the investment philosophy underpinning the fund's management and how the screening process of an Ethical fund differs from other portfolios?

The fund follows our core philosophy of quality and value and is guided by our four quality filters: recurring earnings, quality of business, sound management and balance sheet strength. We are always wary of investing in companies that are heavily reliant on capital markets to fund their growth, as these companies are beholden to market sentiment. Funding that is taken for granted in buoyant equity markets can quickly disappear. I prefer companies that generate strong cash flows and can fund their own growth internally, or alternatively, have the discipline to return surplus capital to shareholders.

The Ethical SRI fund has additional investment screens pertaining to fossil fuel production, alcohol, tobacco, and weapons manufacturing amongst others. We also look at how companies perform across a range of SRI factors. There is more to the construction of the portfolio than simply accepting the result of this screening process. There may be companies that pass through these filters where we have queries as to the long-run sustainability of the business model, for example, unregulated credit. Over and above this filtering process we try to understand how a business makes money and how they provide value to their customers, whilst also managing a complex group of stakeholders, rather than simply accepting an ethical screen at face value.

Can you take us through a few examples of themes being explored in the fund or sectors that are currently of interest?

We are not thematic investors at Perpetual. We are bottom-up investors, and each stock must make it into the portfolio on its merits. But something that we're mindful of is energy transition and decarbonisation. And somewhat counterintuitively, that is very heavily reliant on resource

extraction – in particular, base metals. The scale of electrification required is likely to create significantly increased demand for copper, yet the supply side response is long dated. We like OZ Minerals, a company with long-life producing assets and potential for production growth.

Something else of interest is the shift in consumer spending to online from physical stores, which has accelerated very quickly over the last 18 months. Part of that was of course necessitated by COVID and being at home. However, we don't believe the pure play online retailers will be longstanding beneficiaries. Rather, our view is gains in share will accrue to some of the more traditional retail players who have worked hard to develop a true omni-channel offering. We have seen a number of companies invest heavily in their online distribution capability. These companies can leverage existing infrastructure and an online footprint to provide great service and choice to customers. COVID was also an opportunity for some to optimise their physical footprint.

In terms of Financials, is it fair to say you prefer insurance companies to banks at the moment?

The insurance and banking sectors have very different drivers. My view on banks is very much stock specific and valuation driven, with the exception of Westpac which is screened out. The sector has retained sensible provisioning and is well capitalised, however the valuation of Commonwealth Bank doesn't look particularly appealing to us when considering the premium to peers (notwithstanding higher returns).

It is right to say that I believe insurance offers greater opportunity at the moment. IAG is a business that is currently enduring some challenges with recent weather events driving increased claims costs and short-term earnings downgrades. However, the company retains a strong market position owing to its quality personal lines franchise, and we believe the market is underestimating the underlying earnings power of the business. We believe it would be naïve to ignore the potential for greater volatility in weather patterns going forward and indeed IAG has published research on this very topic. Equally, we believe it is too pessimistic to capitalise a particularly bad period into perpetuity – volatility in earnings is a feature of insurance businesses and we believe many are now trading at their most attractive valuation in some time.

The Perpetual Australian Equities team has been broadly resistant to the thesis that inflationary pressures are transitory over the past 12 months. How have you positioned the portfolio as a result?

At the outset I would say I don't position my portfolio solely with a view on any particular macroeconomic variable. It is worth reiterating that we are bottom-up investors, and whilst there are good reasons to believe inflationary pressures will persist given the magnitude of fiscal and monetary stimulus, the reality is I just don't know. We are informed, however, by what we are hearing from companies in our discussions and there is no doubt there are cost pressures – be it raw materials, shipping and freight, or pockets of labour.

To date, companies have been able to combat this through price increases given demand has been so strong, however, it remains to be seen how far this can be pushed. As such, if I had to speculate, I'd say there might be some margin pressures beginning to appear in the next six to twelve months. In the event inflation does persist I'd like to think the portfolio will navigate well – given our focus on quality businesses, low gearing and valuation – the latter being relevant both for cost of debt and discount rates used to value equities, which may rise sharply in a persistently inflationary environment.

Take us through a few stocks you currently like the look of?

Some stocks that have driven fund performance over the last twelve months include the cyclical stocks like building materials (Fletcher Building) and discretionary retailers (Nick Scali). Both sectors have benefitted from large fiscal stimulus, buoyant housing markets and reallocation of household spend away from travel and leisure. We were also able to capitalise on REITs like Dexus, where the listed equity was implying a material haircut to reported valuations. This in isolation is not reason enough to buy the stock, however, office assets were clearing in private markets (including some owned by Dexus) at prices at or modestly above book value. Industrial assets were actually trading at a premium – and funds management was effectively being thrown in for free. We believe this valuation gap has now substantially closed.

Looking forward we think Deterra Royalties remains a good opportunity. The company earns royalties on iron ore produced from BHP's Mining Area C. Following a recent expansion at South Flank, Deterra's income stream will grow as volumes ramp to full production run rates over the next few years. They will also receive the benefit of one-off production payments to reflect increased tonnes mined. We believe the stock offers an attractive fully franked yield and a degree of balance sheet optionality should additional royalty opportunities present.

Can you give us a sense of your investment philosophy and what has influenced this view?

I don't think the list of investment books I've read would surprise anyone. It includes the classics from Peter Lynch, Phil Fisher, the Buffett partnership letters, the letters from Nick Sleep, and the compilations from Marathon Asset Management in Capital Account and Capital Returns. I think it is important to keep reading and keep evolving as an investor and so I am always on the lookout for something I have missed or someone with a slightly different perspective. There are always ways to learn and improve my performance over time. In a professional sense, I have been fortunate enough to be given the opportunity to work with a number of talented fund managers at Perpetual over the last decade and each has advice and experience to offer. I have tried to take a little bit from everyone whilst developing my own style. My investment philosophy is simple. Successful performance is a function of strict adherence to a disciplined investment process and is as much about trying to minimise mistakes as it is finding winners. I believe in a relatively concentrated portfolio as truly

outstanding ideas are few and far between, and when they present, it makes little sense to me to dilute those ideas with a long tail of names where conviction is low.

Find out more about the Perpetual Ethical SRI Fund.

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