SOLARIS
investment management

Solaris Core Australian Equity Fund

(APIR: WHT0012AU)

Quarterly Investment Report

as at 30 June 2022

Market and Fund Performance

The S&P/ASX200 Accumulation Index fell -8.8% during the month, finishing -11.9% lower for the quarter ending 30 June 2022. The start of 2022 has witnessed some of the worst year-to-date returns on record as investors grapple with inflation, higher interest rates, geopolitical tensions, and an economic slowdown. Despite a sea of red, there has been a clear divergence in global equity returns. US indices have led the decline for the half (S&P500 -20.6%, NASDAQ Composite -29.5%), resulting in Emerging markets outperforming Developed markets. Japan (Nikkei 225 -8.3%) and Australia (S&P/ASX 200 Accumulation -9.9%) were exceptions and acted somewhat as safe havens for investors.

The sell-off in bond markets continued during the quarter amid stubborn inflation and higher than anticipated interest rate hikes from global central banks. The US 10-year yield moved from 2.34% to 3.01%, with 2-year yields rising from 2.33% to 2.95% and the 10/2-year spread inverted multiple times throughout the period, which has stoked fears of a US recession. The Australian 10-year yield moved from 2.83% to 3.66%, the highest level since 2014. At a sector level Energy was the standout winner during the quarter, supported by higher energy prices and intensified supply constraints resulting from the conflict in Ukraine. Defensives such as Utilities, Health Care and Consumer Staples also outperformed. Information Technology, REITs and Consumer Discretionary sectors underperformed as long-duration assets continue to face headwinds in this higher interest rate environment and as consumer sentiment deteriorates.

The top three moves in the Index over the quarter were Atlas Arteria Group (+23.1%) after a 15% stake was acquired by IFM Investors, Viva Energy Group (+23.0%) which continued to perform strongly due to higher energy prices and refining margins and Polynovo Ltd (+21.9%) which appreciated after reporting strong earnings in March. The bottom three moves within the Index were impacted by the broader sell-off in high growth technology focused companies during the month combined with company specific news. Zip Co (-70.4%) underperformed following Apple's announcement that the next iPhone would include a buy-now-pay-later function, Novonix (-63.2%) declined with growing concerns that a global recession would slow demand for electric vehicles and batteries and Megaport Ltd (-60.8%) fell after management reported weak earnings in its quarterly update.

A portfolio holding in focus over the month is Atlas Arteria, after the IFM Global Infrastructure Fund obtained an economic interest in approximately 15% of the company. While a takeover proposal may or may not be made, Atlas Arteria is a core portfolio holding where we see unrealised value and the approach by IFM validates the opportunity we see in Atlas. The company holds stakes in a portfolio of high-quality toll road assets with revenues linked to inflation, the balance sheet is strong and under-geared, the company's revenues are continuing to recover from COVID-19 travel impacts and we believe the company is well placed to outperform the market. The approach highlights the willingness for longer term capital to take advantage of mis-pricings in the listed market, in many cases by simply looking through the short-term noise and taking an investment view over a longer-term investment horizon.

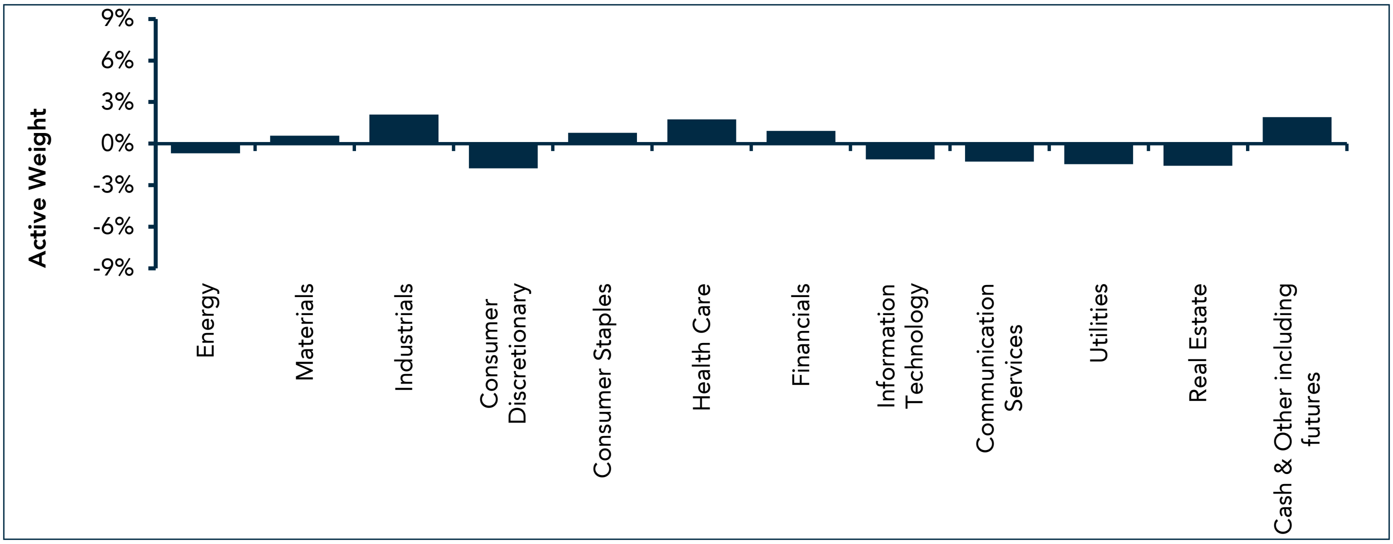
Returns	Month	Rolling Quarter	FYTD	1 Year	3 Years p.a.	5 Years p.a.	7 Years p.a.	10 Years p.a.	Inception p.a. (17/09/2008)
Fund Gross Return^	-8.69%	-11.70%	-4.13%	-4.13%	2.21%	6.78%	7.42%	10.43%	7.92%
Benchmark Return*	-8.77%	-11.90%	-6.47%	-6.47%	3.34%	6.83%	6.91%	9.29%	6.85%
Active Return	**0.08%**	**0.20%**	**2.34%**	**2.34%**	**-1.13%**	**-0.05%**	**0.51%**	**1.14%**	**1.07%**
Fund Net Return^	-8.76%	-11.92%	-5.05%	-5.05%	1.23%	5.76%	6.39%	9.37%	6.90%
Benchmark Return*	-8.77%	-11.90%	-6.47%	-6.47%	3.34%	6.83%	6.91%	9.29%	6.85%
Active Return (After fees)	**0.01%**	**-0.02%**	**1.42%**	**1.42%**	**-2.11%**	**-1.07%**	**-0.52%**	**0.08%**	**0.05%**

^ Performance is for the Solaris Core Australian Equity Fund (APIR: WHT0012AU), also referred to as Class B units, and is based on month end prices before tax. Net performance is calculated after management fees and operating costs, excluding taxation. Gross performance is stated excluding all fees, costs and taxation. This is historical performance data. It should be noted the value of an investment can rise and fall and past performance is not indicative of future performance. All p.a. returns are annualised. * Benchmark refers to the S&P/ASX 200 Accumulation Index.

Top 10 Stocks (Alphabetical Order)

Name	Sector
BHP Group Limited	Materials
Coles Group Limited	Consumer Staples
Commonwealth Bank of Australia	Financials
CSL Limited	Health Care
Goodman Group	Real Estate
Macquarie Group Limited	Financials
National Australia Bank Limited	Financials
Westpac Banking Corporation	Financials
Woodside Energy Group Limited	Energy
Woolworths Group Limited	Consumer Staples

Sector Allocation



Market Valuation & Earnings Estimates:

	Market & Sector EPS Growth			Market & Sector PEs			Market & Sector Dividend Yield		
Pro-rated to June	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
All Companies	20.0%	6.0%	-5.1%	13.7x	12.8x	13.5x	4.8%	5.0%	4.8%
Banks	10.7%	3.9%	8.4%	13.3x	12.8x	11.8x	5.3%	5.7%	6.0%
Listed Property Trusts	9.7%	3.9%	6.8%	14.6x	14.0x	13.1x	4.9%	5.2%	5.4%
Resources	31.4%	1.5%	-23.3%	7.1x	7.0x	9.1x	8.8%	8.7%	6.5%
Industrials ex-Banks	13.7%	12.8%	8.9%	22.2x	19.8x	18.1x	3.0%	3.3%	3.6%

Estimate only, which may not be realised in the future.

The securities presented on this slide are for illustrative purposes only and are not the complete holdings of the fund.

Market Outlook

Inflation is running red hot in major economies, and central banks are now poised to do "whatever it takes" to counter inflation, a backflip on the policies of the past decade. The US Fed Reserve and most other global central banks now find themselves in a challenging position in that they are tightening and raising interest rates into an economic slowdown while at the same time equity markets are collapsing. Given the economy's observed sensitivity to rising rates, how will the economy function as rates continue to normalise? Can the central banks pull off a soft landing? Are we heading for a recession? Will the Fed Reserve pivot once again like the end of 2018? These are all important questions that not even the central banks can answer. Macroeconomic forecasting is perilous at the best of times; recall that only six months ago, the Reserve Bank of Australia expected to hold interest rates near zero until at least 2024.

As we highlighted above, the market moves over the past few months have been ruthless, so the critical question then becomes how much further do equity markets fall before they find a bottom? Valuation multiples have de-rated by more than 25% since the beginning of this year, factoring in plenty of negative sentiment (1yr forward P/E multiple of the ASX 200). However, forward consensus earnings expectations remain near all-time highs, and there are early signs of the earnings pulse turning weaker, with earnings revisions turning negative in June. In our experience, sell-side analysts can be slow in updating earnings numbers, particularly in a rapidly changing macro-environment. This suggests further downside risk to company fundamentals. Our investment process is well suited to this environment, with our detailed fundamental bottom-up approach a key advantage in identifying inefficiencies, including analysing where earnings expectations are unrealistic. Solaris aims, as much as possible, to ensure the risk in the fund is generated from bottom-up stock decisions rather than allowing macroeconomic events to dictate risk and performance.

It is prudent to act cautiously in this environment but remain vigilant in monitoring the market landscape for opportunities to pick up high-quality assets at discounted prices. These can be volatile and complex environments; however, they also often coincide with providing outstanding opportunities for patient long-term investors.

Areas that warrant caution:

➢ *Discretionary retail*

We are cautious areas of the market exposed to a weaker consumer, as we can see a range of factors compounding into significant headwinds for earnings. Firstly, a decisive shift in spending from 'goods' to 'services' is occurring as consumers return to normal patterns of living and is impacting sales, margins and profits of many companies that benefitted during the peak COVID lockdown periods. Secondly, we expect the rising cost of living (food, energy bills, petrol costs, mortgage interest payments) to pressure the household budget, restricting discretionary spending. According to JP Morgan analysis, the average Australian households with a mortgage will see a drop of at least $6,000 to their disposable income by the middle of 2023, possibly as much as $10,000 as interest rates increase. Thirdly, we believe consensus earnings estimates in many companies have been irrationally anchored to the peak revenue and profit margins experienced through 2021-22. The current elevated inventories, labour costs and logistics challenges are important catalysts over the second half of 2022, which we believe will drive a normalisation in margins.

➢ *Highly indebted corporates*

As interest rates normalise from record low levels, areas of the market that employ high levels of debt, including highly leveraged corporates and real estate investment trusts are subject to higher interest costs. Rising base rates (variable funding costs), rising fixed swap rates (fixed funding costs) and rising corporate credit spreads are a potent combination that leads to higher interest costs and has a disproportionately large impact on the earnings of heavily indebted corporates. Whether this impact is immediate or experienced over time depends on the level of the hedging, with corporates that have a low level of hedging the most exposed in the short term. As the famous saying goes, it's only when the tide goes out that you see who has been swimming naked.

➢ *Speculative loss-making firms*

Areas of the high-growth segment of the market, in particular, several loss-making and concept companies, look particularly vulnerable when viewed through the rational lens of an 'investor' rather than the lens of a 'speculator'. We have been cautious and underweight this area of the market for some time. While valuations have re-traced, they remain elevated versus their long-term history. Notably, the cost of capital for the speculative segment of the market has increased significantly, with both the cost of equity and the cost of debt materially higher.

Areas we favour:

➢ *Firms with strong pricing power*

In this environment, pricing power and the ability to pass through rising costs have never been more important. We have analysed both quantitative and qualitative measures of pricing power across our portfolio positions. In this environment where rising energy costs, wage inflation, input cost inflation and supply chain issues can impact corporate margins, firms with pricing power and the ability to protect or grow margins are paramount. We are invested in a range of firms that we believe are well placed to navigate this period and are underweight a range of companies we think are exposed to these challenges.

➢ *Quality*

The core elements of Solaris's investment framework focus on companies with stable or improving industry structures, competent and trustworthy management teams, accounting quality, positive trends in return on equity, a high level of importance on ESG factors and avoiding excessively geared balance sheets. Many high-quality firms across the portfolio exemplify the characteristics above and are well placed to navigate this environment. As an example, the healthcare sector currently has a range of high-quality companies that we see offering extremely attractive value.

➢ *Scarce resources*

We see value in a range of companies that control of scarce resources (e.g. critical minerals, energy and food commodities) and see the potential for a continued supply/demand imbalance supporting higher commodity prices through the cycle. In many cases, the higher price environment has led to much more robust balance sheets, the return of material amounts of surplus cash flows via dividends and off-market buybacks and the ability for management teams to re-invest in projects that enable a green transition.

➢ *Growth at reasonable prices*

While we remain cautious of the more speculative end of the growth spectrum, we believe a range of quality growth companies are now presenting higher relative returns, with many being caught up in the indiscriminate growth unwind. We are seeing more value in this area of the market for the first time in recent years and have been increasing positions in profitable companies with superior cash flow growth profiles. We are yet to see distress or wholesale 'bargains' in the higher-quality companies and believe it pays to be selective.

We believe it is imperative to keep an open mind, listen to what the investment landscape tells us, and stay nimble. We are in a rapidly evolving uncharted economic environment and expect significant volatility as central banks move to control inflation. Investors need to consider investment managers with experience investing capital in these challenging environments.

Solaris aims to ensure that the majority of the risk in the fund is generated from bottom-up stock decisions rather than allowing macro events to dictate risk and performance. Through our portfolio construction and robust risk management, which is embedded in our +20-year process, we are confident in our objective and seek to offer higher potential returns across all market conditions. We are seeing clear investment opportunities across many areas of the market and believe this elevated volatility is well suited to the Solaris investment process.

As always, thank you for your support and for allowing us the privilege of managing your investments.

Solaris Team.

Source: Solaris Investment Management, June 2022

Contact Details

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Link to the Product Disclosure Statement

Link to the Target Market Determination

For historic TMD's please contact Pinnacle client service Phone 1300 010 311 or Email service@pinnacleinvestment.com