PENGANA CAPITAL

MONTHLY REPORT
SEPTEMBER 2021

# PENGANA AUSTRALIAN EQUITIES FUND

## DESCRIPTION

The Pengana Australian Equities Fund aims to enhance and preserve investor wealth over a 5- year period via a concentrated core portfolio of principally Australian listed securities. The Fund uses fundamental research to evaluate investments capable of generating the target return over the medium term. Essentially, we are in the business of seeking to preserve capital and make money – we are not in the business of trying to beat the market. We remain focused on acquiring and holding investments that offer predictable, sustainable and well-stewarded after-tax cash earnings yields in excess of 6% that will grow to double digit levels as a percentage of our original entry price in five years. We believe that building a well-diversified portfolio of these "gifts that keep on giving" represents a meaningful way to create and preserve financial independence for our co-investors.

## STATISTICAL DATA

| VOLATILITY[3] | NUMBER OF STOCKS | BETA (USING DAILY RETURNS)[4] | MAXIMUM DRAW DOWN |
|---|---|---|---|
| 11.3% | 31 | 0.63 | -23.1% |

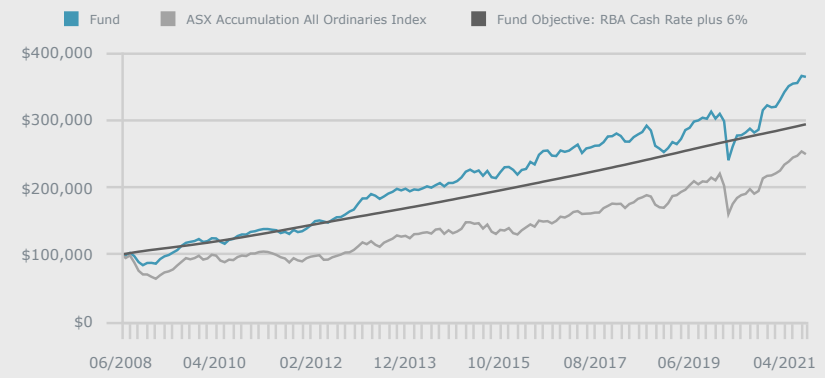
## PERFORMANCE TABLE

NET PERFORMANCE FOR PERIODS ENDING 30 Sep 2021[1]

| | 1 MTH | 1 YEAR | 3 YEARS P.A. | 5 YEARS P.A. | 10 YEARS P.A. | SINCE INCEPTION P.A. |
|---|---|---|---|---|---|---|
| Australian Equities Fund | -0.4% | 29.4% | 8.6% | 7.4% | 10.8% | 10.2% |
| ASX Accumulation All Ordinaries Index | -1.6% | 31.5% | 10.4% | 10.8% | 10.9% | 7.1% |
| Fund Objective: RBA Cash Rate plus 6% | 0.5% | 6.1% | 6.7% | 7% | 7.8% | 8.5% |

## PERFORMANCE CHART

NET PERFORMANCE SINCE INCEPTION[2]




## TOP HOLDINGS (ALPHABETICALLY)

| | |
|---|---|
| Aristocrat Leisure | Consumer Discretionary |
| CBA | Financials |
| Credit Corp | Financials |
| CSL | Health Care |
| Mirvac Group Property Trust | Real Estate |
| NAB | Financials |
| ResMed | Health Care |
| SG Fleet | Industrials |
| Super Retail Group | Consumer Discretionary |
| Telstra | Communication Services |

## SECTOR BREAKDOWN

| | |
|---|---|
| Consumer Discretionary | 12.3% |
| Consumer Staples | 3.2% |
| Energy | 1.5% |
| Financials | 28.4% |
| Health Care | 16.2% |
| Industrials | 9.8% |
| Materials | 9.9% |
| Real Estate | 3.9% |
| Communication Services | 7.1% |
| Utilities | 2% |
| Options | 0.5% |
| Cash | 5.2% |

## CAPITALISATION BREAKDOWN

| | |
|---|---|
| ASX 1-50 | 51% |
| ASX 51-100 | 6% |
| ASX 101-300 | 22% |
| All Ordinaries | 6.2% |
| Non ASX | 9.1% |
| Derivatives | 0.5% |
| Cash | 5.2% |

## CUSTOM SECTOR BREAKDOWN

| | |
|---|---|
| Defensive | 50.1% |
| Financials | 29.5% |
| Consumer Discretionary | 8% |
| Resources | 6.8% |
| Options | 0.5% |
| Cash | 5.2% |

# 3 ISSUES THAT ARE CHALLENGING INVESTORS IN TODAY'S MARKET

## COMMENTARY

The Fund generated a robust 2.8% return for the September 2021 quarter, against a market return of 2.1% (ASX Accumulation All Ordinaries Index) and our targeted return (RBA Cash rate +6% annually) of 1.5% for the quarter. Several of the Fund's larger holdings exhibited strong share price growth including **Telstra, Aristocrat, Resmed**, and **NAB**.

The Fund also benefited from strong contributions from **Smart Group** (takeover offer), **Ryman Healthcare** in NZ, and **Medibank**. The main detractors in the quarter were confined to **Evolution Mining** and **Accent Group** (the latter in particular has rebounded strongly in October), as well as miners **Fortescue** and **Rio Tinto** following the correction in iron ore prices.

We continue to be somewhat surprised that the Fund has performed as well as it has over the quarter. As we have commented previously, we believe protecting capital and generating a sufficient return in this environment is nontrivial. A key element of our capital preservation tool kit has always been the option to remain in cash, however, we find ourselves increasingly drawing on other elements such as put options, exposure to gold/utilities, and an even stronger overall bias towards defensively characterised business models.

With an average after-tax cash earnings yield of approximately 7% across a portfolio of largely toilet paper and toothbrush-type stocks, we think that we can accumulate 7% in value on a fairly reliable basis, with opportunities for management teams to leverage generally under-geared balance sheets to create additional value from accretive M&A or capital returns.

We are pleased with the Fund's performance in the first quarter of FY21 and remain focused on our primary objectives of capital preservation and generating a reasonable real return for our investors.

In our recent investor webinar, we discussed 3 issues that are challenging investors in today's market and how we are managing these issues in the Fund.

## 1) Low-interest rate environment & inflationary risks.

More than a generation of investors in today's market have experienced nothing other than a falling interest rate cycle, which has created a tailwind for long-duration assets. With long term rates now at all-time lows (and near zero), we see limited scope for further downside, suggesting at best an end to The Great Tailwind. Furthermore, with inflation now rising ahead of long term rates (and with further inflationary pressures in the system), real interest rates have turned negative, raising the question of the sustainability of interest rates at these all-time low levels. What happens if interest rates start rising…?

To manage this dynamic, we look to business models that have elements of inflation protection (such as Telstra's NBN income stream), pricing power in their value chain (such as Woolworths) or business models that perform well in a rising rate environment (such as NAB). These businesses do not require an inflationary or rising rate environment to perform well, but in the event that one does materialise, should provide the Fund with, not only protection but hopefully additional upside as well.

## 2) Elevated forecasting error associated with COVID and ongoing lockdowns.

In order to accurately forecast or predict future cash flows, we establish financial models which aim to provide us with a reliable base. As we stand today, the past 2 financial years have been heavily influenced (positively and negatively) by the COVID pandemic and this has continued in the current period with extended lockdowns in Victoria and NSW. The result is that forecast risk remains extremely high as we attempt to accurately distil what a 'normalised' or underlying earnings and cash flow trajectory looks like.

As a result, we lean more towards our core investment methodology of focusing on defensively characterised transparent business models. That's not to say that such businesses have not experienced a variation in their earnings through COVID, but more so that the underlying drivers are clearer, less volatile and more predictable, such that we can more accurately predict a new trajectory of earnings post-COVID. Examples again include the likes of Woolworths, CSL, Ryman, Ramsay Health, and Mirvac Group.

## 3) Supply Chain / Inventory Disruptions.

One of the enduring impacts of COVID is the substantial pressure it has put on global supply chains. In the first instance, the availability of raw materials or components has been severely impacted (eg computer chips). Second, manufacturing and assembly lines have in many cases ground to a halt given lockdowns and staff shortages. If an importer has been able to secure inventory, freight and logistic availability have also become scarce and costs have skyrocketed. As a result, aside from the inflationary element, lead times have blown out making inventory management very difficult and, in many cases, resulting in a supply limitation to revenue growth.

The key to managing this dynamic is twofold. First, a company needs to have a balance of power, not just domestically but globally, in their value chain to elevate themselves up the pecking order when scarce inventory is allocated globally. A good example of this is Rebel Sport within Super Retail Group – Rebel is a leading customer of Nike (and other sporting brands) globally such that, during the pandemic, the global brand manufacturers were re-allocating stock from lower-tiered customers/regions to Rebel in Australia. The second key factor is to have the balance sheet strength and integrated supply chain infrastructure to be able to 'go long' on inventory. Again using Super Retail Group as an example, the company was able to make use of its debt-free balance sheet as an enabler for management to build elevated levels of inventory well in advance of key sales periods. Furthermore, global manufacturers who typically rely on 3rd party logistic providers increasingly used Super Retail Group's substantial distribution centres and supply chain network in order to get their goods into and throughout Australia. Other examples of businesses that are well-positioned in this respect include Aristocrat, Accent Group and JB Hi-Fi.

To be clear, managing these (and other) issues has not required a change in our investment approach, rather adhering to it has focused our attention on what we characterise as 'hard assets'. We think of hard assets as business models with long-term contractual arrangements at favourable terms with strong counterparties; owning unique or scarce assets; being the lowest-cost producer, or owning superior non-trivial intellectual property.

With an average after-tax cash earnings yield of approximately 7% across a portfolio of largely toilet paper and toothbrush-type stocks, we think that we can accumulate 7% in value on a fairly reliable basis, with opportunities for management teams to leverage generally under-geared balance sheets to create additional value from accretive M&A or capital returns.

We are pleased with the Fund's performance in the first quarter of FY21 and remain focused on our primary objectives of capital preservation and generating a reasonable real return for our investors. We continue to believe this is best served by a disciplined approach and consistent investment methodology. A variety of good businesses run by honest and competent management teams at the right price will create a well-diversified portfolio of ever-growing cash earnings streams.

## FEATURES

| | |
|---|---|
| APIR CODE | PCL0005AU |
| REDEMPTION PRICE | A$ 2.0635 |
| FEES * | Management Fee: 1.025%<br>Performance Fee: 10.25% |
| MINIMUM INITIAL INVESTMENT | A$10,000 |
| FUM AT MONTH END | A$ 986.66m |
| STRATEGY INCEPTION DATE | 1 July 2008 |
| BENCHMARK | The RBA Cash Rate Target plus Australian equity risk premium. |

## FUND MANAGERS

**Rhett Kessler**
**CIO and Senior Fund Manager**

**Anton du Preez**
**Deputy CIO and Fund Manager**

1. Net performance figures are shown after all fees and expenses, and assume reinvestment of distributions. No allowance has been made for buy/sell spreads. Past performance is not a reliable indicator of future performance, the value of investments can go up and down.
2. Inception 1st July 2008.
3. Annualised standard deviation since inception.
4. Relative to ASX All Ordinaries Index. Using daily returns.

*(including GST, net of RITC) of the increase in net asset value subject to the RBA Cash Rate & High Water Mark. For further information regarding fees please see the PDS available on our website.

# PENGANA AUSTRALIAN EQUITIES FUND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