PENGANA CAPITAL GROUP

MONTHLY REPORT
JUNE 2022

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[4]	MAXIMUM DRAW DOWN
11.4%	28	0.63	-23.1%

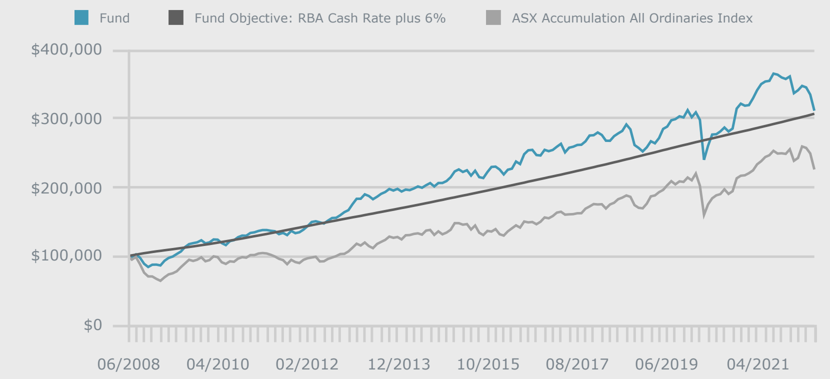
PERFORMANCE TABLE

NET PERFORMANCE FOR PERIODS ENDING 30 Jun 2022[1]

	1 MTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.	10 YEARS P.A.	SINCE INCEPTION P.A.
Australian Equities Fund	-7.0%	-12.0%	2.6%	3.9%	7.8%	8.5%
Fund Objective: RBA Cash Rate plus 6%	0.5%	6.2%	6.3%	6.8%	7.5%	8.3%
ASX Accumulation All Ordinaries Index	-9.4%	-7.4%	3.8%	7.2%	9.4%	6.0%

PERFORMANCE CHART

NET PERFORMANCE SINCE INCEPTION[2]



TOP HOLDINGS (ALPHABETICALLY)

Amcor PLC	Materials
Aristocrat Leisure	Consumer Discretionary
BHP Group Ltd	Materials
CBA	Financials
Credit Corp	Financials
CSL	Health Care
NAB	Financials
ResMed	Health Care
Telstra	Communication Services
Woolworths	Consumer Staples

SECTOR BREAKDOWN

Consumer Discretionary	9.8%
Consumer Staples	4.3%
Energy	0.6%
Financials	26.2%
Health Care	15.1%
Industrials	6.2%
Materials	12.9%
Real Estate	3%
Communication Services	7.7%
Utilities	2.3%
Options	1.1%
Cash	10.9%

CAPITALISATION BREAKDOWN

ASX 1-50	58.1%
ASX 51-100	2.8%
ASX 101-300	15.7%
All Ordinaries	5.4%
Non ASX	6.1%
Derivatives	1.1%
Cash	10.9%

CUSTOM SECTOR BREAKDOWN

Defensive	48.8%
Financials	24.7%
Consumer Discretionary	7%
Resources	7.6%
Options	1.1%
Cash	10.9%

VALUATIONS REBASED ACROSS MOST ASSET CLASSES - OPPORTUNITIES STARTING TO PRESENT WITH QUALITY EXPECTED TO SHINE GOING FORWARD

COMMENTARY

The Fund generated a -7% return in the month of June and -10.4% for the June quarter. By way of comparison, the (annual) return of the RBA cash rate +6% equated to approximately +0.5% for the month (+1.6% quarter), whilst the Australian stock market declined by -9.4% in June and -12.9% for the quarter. For the 2022 financial year, the Fund's total return equated to -12%, compared to the market return of -7.4%, and a cash rate +6% of +6.2%.

The Fund enjoyed a relatively strong start to the financial year in the September quarter however, as we wrote at the time, we were somewhat surprised given our observations of an increasingly difficult environment to protect capital whilst generating a sufficient return. By December our concerns were already coming to fruition and the new calendar year brought with it the ultimate inflection point… the final emergence of inflation and the end of an extended downward cycle in global interest rates, compounded by the unexpected war in Eastern Europe and subsequent imbalances to the global economic order.

As we entered the new calendar year, the Fund was positioned strategically to manage our assessment of risks associated with inflation and rising rates. Whilst a number of these strategies paid off, they were not enough to offset the broader market weakness, and we discuss below some reflections from this difficult period in equity markets.

Looking forward, we continue to plan for an environment where the cost of money is once again going up whilst the availability of money is going down, a troubling formula for investing in long duration assets.

We remain as focused as ever 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.

We have discussed for some time now the 40 year deflationary rate cycle that began in 1981 after the US 10yr bond yield peaked at almost 16% and troughed in the depths of COVID in 2020 when the yield reached almost zero. This cycle created a tailwind for long duration asset prices for more than a generation of investors, culminating in the unsustainable valuations, particularly of 'tech' or 'growth' stocks, in recent years.

Apart from the fact that rates were approaching zero, the ultimate end of the cycle was in this case brought about by the final onset of inflation, and the unsustainable ballooning of 'real' negative interest rates globally. An extended period of 'money printing' by central banks, handouts by governments to manage the impact of COVID on domestic economies, and broad based global supply shortages following COVID and the war in Eastern Europe all combined to form a perfect storm ***where significantly more amounts of money in the system were chasing significantly fewer amounts of goods and services*** – the ultimate definition for the onset of inflation.

As we entered the new calendar year, the Fund was positioned strategically to manage our assessment of these risks. As always, there was a large bias towards defensive business models. We held notable positions in financial stocks (including banks), which we had identified as beneficiaries of a rising rate environment, a larger than usual exposure to Resources – primarily Evolution Mining for its gold linked inflation hedging characteristics, and a modest protection from PUT options.

On the stock specific front, our largest holding in Telstra offered a defensive cash flow supported by an unappreciated inflation hedge via its NBN revenue stream (not to mention the recent announcement of inflation linked pricing in the mobile division). Our exposure to the Health Insurers (NIB and MPL) offered us an improving industry structure post COVID and our holdings were beneficiaries of a higher rate environment via their investment floats. A new position in Amcor offered us highly defensive and diversified global cash flows at an attractive entry point, and BHP was trading at very attractive cash yields, offering a substantial (larger than usual) margin of safety to potential movements in the iron ore price. Each of these stocks and strategies ultimately proved to be successful in their resilience to the market correction and were amongst the main positive contributors to performance in the full year.

Unfortunately, their contribution was not enough to offset the broader and almost indiscriminate sell off that impacted the market, and the Fund, as a whole. Generating a negative performance figure first and foremost is a disappointing outcome. However what disappoints us more is that, in these market conditions, we would normally expect a better performance from the Fund relative to the market. We have reflected upon many lessons learnt in the past 12 months, but to summarise, we would make the following observations:

1. Compared to previous cycles, our cash holdings were relatively low prior to the market correction. In what is perhaps evidence of our bottom-up approach to management of our cash holdings, we had simply been able to identify what we considered to be attractive opportunities to deploy cash into the end of the 2021 calendar year, and were by and large comfortable with the valuations of existing holdings. Our cash holdings were further depleted by the early January distribution to unit holders. The result was a higher than usual exposure to the subsequent equity market correction.
2. Put options in place in the New Year had an unfortunate expiry date days before the onset of the January market correction. We had assessed pricing for new positions to replace them however by that point volatility had already spiked and the cost of new premiums were at a level we considered too expensive. The result was a lack of protection from the market downturn in January/February. We would note that subsequent put options have proven extremely profitable and were a key driver of the Fund's 'outperformance' in the June quarter.
3. We experienced elevated levels of volatility from a number of our less liquid small cap positions. Whilst not a significant weighting in the portfolio individually, we did experience a disproportionate negative impact from a number of our less liquid holdings. We remain comfortable with the underlying business models and cash flows of these holdings, which we continue to believe will prevail in the medium to long term, notwithstanding their recent volatility.
4. Finally, the Fund's performance relative to the market suffered materially due to its significant 'underweight' positions in the materials and energy sectors. Since inception, the Fund has had a minimal exposure to the resources sector on the basis of too many variables and hence higher forecast risk associated with their business models. The energy sector generated a return of +30% in FY22, whilst materials declined by -1.5%, both meaningfully outperforming the market. Combined, these sectors comprise >25% of the ASX300 index, compared to a mid to high single digit total exposure for the fund (mostly Evolution Mining). As such, these sectors provided a substantially greater positive offset to the market correction than they did for the Fund in the period. Of course the opposite is true in times where these sectors are out of favour, which to a certain extent has been the case in the opening week of the new financial year.

Looking forward, we continue to plan for an environment where economies globally will be facing the double whammy of having to digest the removal of unprecedented levels of quantitative easing and other stimulus support, whilst at the same time adjusting to the inflection point of a 40 yr downward interest rate cycle, with interest rates globally now rising again at pace. The cost of money is once again going up whilst the availability of money is going down, a troubling formula (to say the least) for investing in long duration assets.

We continue to position the portfolio with a view to navigate these challenges, ensuring exposure to business models with pricing power and low levels of price elasticity (to combat inflation) as well as those who benefit from a rising interest rate environment. In addition, our cash balance has risen from a low point earlier in the year – predominantly due to high geopolitical risk and uncertainty – and we continue to benefit from our put position in the portfolio, the value of which has risen considerably given recent market movements.

Despite an elevated level of volatility in markets, we remain as focused as ever 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$ 1.7274
FEES *	Management Fee: 1.025% Performance Fee: 10.25%
MINIMUM INITIAL INVESTMENT	A$10,000
FUM AT MONTH END	A$ 778.53m
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.

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PENGANA CAPITAL LIMITED

ABN 30 103 800 568

AFSL 226566

CLIENT SERVICE

T: +61 2 8524 9900

F: +61 2 8524 9901

E: clientservice@pengana.com

PENGANA CAPITAL GROUP

PENGANA.COM