PENGANA CAPITAL GROUP

MONTHLY REPORT
DECEMBER 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
11.5%	25	0.63	-23.1%

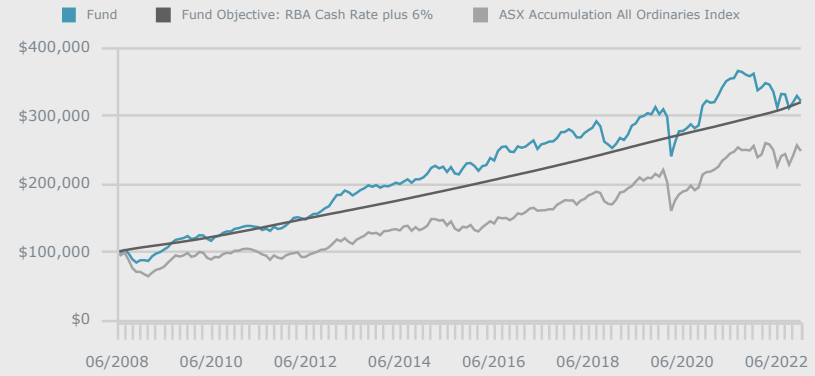
PERFORMANCE TABLE

NET PERFORMANCE FOR PERIODS ENDING 31 Dec 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	-2.3%	-11.1%	2.1%	3.1%	6.8%	8.4%
Fund Objective: RBA Cash Rate plus 6%	0.7%	7.2%	6.6%	6.9%	7.5%	8.3%
ASX Accumulation All Ordinaries Index	-3.3%	-3.0%	5.8%	7.2%	8.8%	6.5%

PERFORMANCE CHART

NET PERFORMANCE SINCE INCEPTION[2]



TOP HOLDINGS (ALPHABETICALLY)

BHP Group Ltd	Materials
CBA	Financials
CSL	Health Care
Evolution Mining	Materials
NAB	Financials
NIB Holdings	Financials
ResMed	Health Care
Super Retail Group	Consumer Discretionary
Telstra	Communication Services
Woolworths	Consumer Staples

SECTOR BREAKDOWN

Consumer Discretionary	10.8%
Consumer Staples	4.4%
Financials	25.6%
Health Care	14.1%
Industrials	3.1%
Materials	13.9%
Real Estate	1.4%
Communication Services	6.9%
Utilities	2.7%
Options	0.7%
Cash	16.3%

CAPITALISATION BREAKDOWN

ASX 1-50	54.5%
ASX 51-100	4.3%
ASX 101-300	14.5%
All Ordinaries	4.8%
Non ASX	5%
Derivatives	0.7%
Cash	16.3%

CUSTOM SECTOR BREAKDOWN

Defensive	43.7%
Financials	21.1%
Consumer Discretionary	9.3%
Resources	8.9%
Options	0.7%
Cash	16.3%

POWDER DRY, AWAITING OPPORTUNITY

COMMENTARY

The Fund generated a -2.3% return in December. By way of comparison, the (annual) return of the RBA cash rate + 6% equated to approximately +0.7% for the month, whilst the Australian stock market declined by -3.3% over the month. For the 6 months ended December 2022, the Fund generated a return of +3.1%, compared to the benchmark of RBA cash rate plus 6% return of +4.1% and the Australian stock market return of 9.7% over the same period.

From the outset we wish to be clear that we are disappointed with the returns from the Fund for the financial year to date which, whilst positive, are below our targeted return for the period, and further lagged a strong, resource driven market.

In terms of positioning going forward, despite the economy remaining stronger for longer than many had anticipated, we continue to retain a level of caution in our outlook for 2023. We have worked hard to improve the liquidity of the Fund, and retained a focus on well managed defensive cash generators. Cash levels have continued to rise and at c15% at December 22, are at their highest levels in the Fund for some time. Furthermore, we continue to have active protection from puts in the portfolio (cost absorbed in the 1H23 performance), and will continue to assess our levels of protection in the near term. Notwithstanding a strong period from energy and resource stocks, we have observed the negative impact of the higher cost of money on valuations of long duration assets, and believe that dynamic will likely continue in the medium term. That said, we remain hungry for opportunities to deploy cash and believe those opportunities may present in coming months, as households reassess their budgets post-Christmas, taking into account the delayed onset of higher monthly mortgage repayments and rising costs of living. Having the cash readily available and protection active in the portfolio gives us both the confidence and ability to move when we assess the time is right.

There were two notable detractors to absolute performance in the period. The largest was a decline in value of our holding in New Zealand aged care operator Ryman Healthcare. Ryman is New Zealand's largest, and broadly recognised as the country's highest quality aged care provider, with an expanding presence in Victoria. Ryman shares have been under pressure for some time given a perceived link between the value of its investment property portfolio and New Zealand house prices. We had been broadly comfortable with this dynamic – believing the link to be overestimated, however we have become increasingly concerned with medium term cash flow generation from the existing portfolio as management pursue an ambitious expansion strategy. We have discussed our concerns with management and the board, and look forward to seeing an improved focus on these areas of concern in the near term.

The second main detractor from performance was the cost of holding put options at varying levels over the 6 month period. As we have regularly communicated, put options are one of a number of tools that we deploy to protect capital when we have broader concerns over market valuations. For much of the past 12 months we have been articulating such concerns, however given the strong (resource led) market performance, the Fund has not recovered the cost of the options in this period. Essentially we insured ourselves for a potential event, and (somewhat thankfully) that event has not occurred.

Relative to the market's performance, our primary observation is that the Fund's ongoing 'underweight' position in the energy and resources space has continued to result in a performance gap given the outsized positive contribution that those sectors have made to the ASX total return, not just in the last 6 months, but over the past 12-18 months as well (Materials & Energy contributed +4.3% within a total market decline of -1.1% in Calendar 22). Materials and energy combined comprise approximately 29% of the ASX 200 and rose c+15% in the six months to December 22. The Fund's exposure to these stocks has approximated 5% over the same period, largely attributable to its relatively smaller holding in BHP. The Fund has benefited from its holding in Evolution Mining, although the investment thesis and drivers of its performance (low cost gold factory helped by stronger copper price and innovative energy projects) differ to those of the broader resource space.

Our long standing position on investing in resources and energy has been that there are too many volatile variables that drive cash flow forecasts for us to hold a 'market weight' position in the space, and so we would expect that a disproportionate weighting, and associated relative performance variances between the Fund and the market, to continue in the medium term. We continue to resist using our investor's funds to manage our business risk of under performance by taking on large market weight related positions in companies that have very difficult to predict future cashflows.

On the positive side, the Fund has been rewarded in the period for its conviction in a pair of high quality discretionary names, the strategy of maintaining exposure to quality financials and by ongoing solid contributions from steady large cap earners.

Super Retail Group was the largest positive contributor in the period, and together with Accent Group, the Funds discretionary exposure provided the largest positive sector contribution to performance in the period. We have gone to great lengths over the past 12 months and more to disaggregate 1) the *underlying earnings* trajectory of these high quality retail companies from the *reported numbers* over the Covid period; and 2) valuation of our underlying earnings vs the markets focus on valuing the more volatile earnings momentum. Put simply, our strategy was to look through the noise of recent trading volatility and take a position on what we think the shares are worth post a return to 'normal' cash flows. We have overlayed this with an assessment of structural improvements realised by the respective management teams during COVID – specifically recapitalisation, improved OMNI Channel capability, improved customer analytics and inventory management etc. Not all discretionary names performed well in the half, with the sector in fact underperforming the ASX 200 overall, however our stock specific process has allowed us to identify the winners in this period. There is no doubt that these names have benefited from the consumer staying stronger for longer. And it is unlikely that current levels of trading are sustainable. However it is our view that the share price performance over the past 6 months reflects the increasing transparency and value of these underlying earnings, and that both remain attractive investments for the Fund.

Our strategy of gaining exposure to the major banks in a rising rate environment, focusing specifically on the quality franchises of CBA and NAB also contributed strongly to performance in the period. The banks earnings outlook benefited in the period from a translation of rising interest rates to expanding Net Interest Margins, and with a relatively benign movement in bad debt provisions to date, share prices have performed well as a result. We maintain a close focus on this space as the prevailing theme evolves from a tailwind associated with rising rates, to one that considers rising costs of funding and competition for new business.

Finally, core holdings in large cap defensive names Telstra and CSL rounded out the major positive contributors for the financial year to date. Telstra has been a top 2 holding for some time, delivering on the key facets of our investment thesis being a defensive earnings stream, stronger than appreciated links to CPI yet to flow through, and a stable / improving dividend outlook. We believe it continues to offer the Fund resilient performance in potentially volatile periods ahead. Similarly CSL represents an investment in a geographically diversified and recession proof healthcare company with several important growth options. Importantly its scale and lowest cost of production status in several of its core operations provide additional support for underlying cashflows.

In terms of positioning going forward, despite the economy remaining stronger for longer than many had anticipated we continue to retain a level of caution in our outlook for 2023. We have worked hard to improve the liquidity of the Fund, and retained a focus on well managed defensive cash generators. Cash levels have continued to rise and at c15% at December 22, are at their highest levels in the Fund for some time. Furthermore, we continue to have active protection from puts in the portfolio (cost absorbed in the 1H23 performance), and will continue to assess our levels of protection in the near term. Notwithstanding a strong period from energy and resource stocks, we have observed the negative impact of the higher cost of money on valuations of long duration assets, and believe that dynamic will likely continue in the medium term. That said, we remain hungry for opportunities to deploy cash and believe those opportunities may present in coming months, as households reassess their budgets post-Christmas, taking into account the delayed onset of higher monthly mortgage repayments and rising costs of living. Having the cash readily available and protection active in the portfolio gives us both the confidence and ability to move when we assess the time is right.

As we enter 2023, we have observed a wide range in outlook commentary – from those who believe the worst is now behind us, to those that believe the pain is only just beginning. Since the inception of the Fund we have heard it said on countless occasions that "we are operating in exceptional times", and it continues to feel that way in the current environment too. 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$ 1.7244
FEES *	Management Fee: 1.025% Performance Fee: 10.25%
MINIMUM INITIAL INVESTMENT	A$10,000
FUM AT MONTH END	A$ 719.92m
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. The benchmark of cash rate plus 6% p.a. is included in the chart as it relates to the Fund's investment objective and performance fee. The Fund may invest up to 100% of its assets in equity securities. The greater risk of investing in equities is reflected in the addition of a margin above the cash rate. No allowance has been made for buy/sell spreads. Please refer to the PDS for information regarding risks. 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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