FUND DESCRIPTION AND FEATURES

The Pengana Australian Equities Fund aims to enhance and preserve investor wealth over a 5-year period via a concentrated core portfolio of principally listed Australian 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-stewardled 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.

PORTFOLIO HIGHLIGHTS

The Fund generated a solid return of 4.0% over the June quarter. By way of comparison the Share Market was up 8.0% and the RBA cash rate returned 0.4% for the quarter. For the 12 months to June, the Fund was up 8.1% while the Share Market was up 13.7% and the RBA cash rate returned 1.5%. As at 30 June 2018, the Fund’s cash holdings were 22%.

At 30 June, the Fund passed an important milestone of operating for 10 years. Importantly, we have consistently achieved our objectives of:

1. Capital preservation by completing our 10th consecutive year of positive returns; and
2. Generating at least a 6% return above the risk-free rate – the Fund has achieved 10.8% p.a., implying 7.8% above the average risk-free rate over the decade.

We have also witnessed large changes over the decade (see 10 Year Milestone Report below for more details).

During the quarter, the Fund increased its existing holdings in the banks, mainly CBA. The unusual volatility in several share prices meant disposals made up most of the activity. These included disposing of our Mirvac position, trimming CSL, Z Energy, ResMed, Ryman Healthcare, FlexiGroup and Accent into strength. The Fund’s exposure to non-Australian dollar earning streams stood at 9% at quarter end.

For the year, the Fund’s long tail of positive contributors was led by CSL, ResMed and Accent Group, all longstanding positions held by the Fund. The major detractors were CBL Insurance, Telstra and Clearview.

PERFORMANCE COMMENTARY

The RBA Cash Rate Target plus Australian equity risk premium.

*(including GST, net of RITC) of the increase in net asset value subject to the RBA Cash Rate & High Water Mark.

<table>
<thead>
<tr>
<th>Portfolio Managers</th>
<th>Rhett Kessler and Anton du Preez</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIR code</td>
<td>PCL0005AU</td>
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<tr>
<td>Redemption price</td>
<td>A$1.9848</td>
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<tr>
<td>Fees</td>
<td>Management Fee: 1.025%</td>
</tr>
<tr>
<td></td>
<td>Performance Fee: 10.25%*</td>
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<tr>
<td>Minimum initial</td>
<td>A$20,000</td>
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<tr>
<td>investment</td>
<td></td>
</tr>
<tr>
<td>FUM at month end</td>
<td>A$1,371m ex-distribution</td>
</tr>
<tr>
<td>Fund inception date</td>
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</tr>
</tbody>
</table>

TEN YEARS OF CONSISTENT CAPITAL PRESERVATION AND ROBUST RETURNS
At 30 June, the Fund passed an important milestone of operating for 10 years. Importantly, we have consistently achieved our objectives of:

1. **Capital preservation** by completing our 10th consecutive year of positive returns; and

2. **Generating at least a 6% return above the risk-free rate** – The Fund has achieved 10.8% p.a., implying 7.8% above the average risk-free rate over the decade.

The Fund’s principal fund managers have remained unchanged with Rhett Kessler and Anton du Preez remaining focused on identifying the underlying after-tax cash earnings as the basis for stock selection. Each prospective company’s aggregated business has been separated into discrete earnings streams allowing for an assessment of their value by rating their robustness, sustainability and risks. By building an investment thesis for each investment, we also set out a roadmap of investment milestones which we use to test the resilience of our investment thesis over time.

Several companies have maintained a presence in our portfolio since the early periods of our Fund’s existence and include: ResMed, Credit Corp, NIB Holdings, Woolworths, Accent and CSL. They represent strong business models with excellent management teams. Due to large fluctuations in their share prices, we have actively managed our exposure to these companies, reducing our holdings where higher share prices mean lower anticipated returns and increasing into weakness to benefit from higher returns.

A common question we get from our stakeholders is, “given the current environment is particularly challenging/interesting, how do you see the market performing over the next 12 months?” I have been involved in the funds management industry for over 25 years and cannot remember a time when the market wasn’t challenging or interesting. In our view, that’s what makes a market: the constant dynamic assessment of future risks versus future returns based on estimates of an uncertain future.

Instead of trying to predict what the market is going to do, we choose instead to focus our time and efforts on finding good businesses run by competent management at a price that allows a margin of safety for an uncertain future.

Upon reflection, there are two key components of our investment philosophy that have been key to enabling us to deliver on our objectives – maintaining discipline around our investment process / valuation requirements, and the ability to stay in cash when we cannot find investments that meet our criteria.

During the past 10 years we have seen a number of cycles, including several periods where the market has been particularly strong, with stocks becoming very expensive, and the temptation to be lured into participation has been high (i.e. to chase the momentum). We are pleased to be able to say that we have maintained our discipline – preferring to explain why our steady result may have fallen short of a strong market performance, rather than explain why a breach of our discipline had resulted in a loss of capital. Our track record has shown that consistent reasonable returns have produced a superior result for our investors than the more variable market performance over the 10 years.

A key enabler of this discipline is the ability to hold up to 100% of the portfolio in cash. Our cash holding at any point in time is an outcome of investable opportunities available to us – we come to work each day eager to find and invest in good businesses, but we cannot always do so at the right price. In expensive markets, we find our cash levels are higher, and when market valuations are low we find our cash levels are lower.

Our experience has been that staying out of expensive markets is relatively straightforward. We have our investment criteria, we stick to it, and if we miss out in the short term we have at least held our discipline. The much harder part of the process, we have found, is having the conviction and fortitude to invest when the market comes crashing back to you. We call it the ability to “reach across the abyss”.

Two notable occasions include the trading days of the Brexit Vote, and the most recent US Presidential election. On each occasion markets were relatively expensive, and our cash levels therefore relatively high going into the event. And on each occasion, we noted an indiscriminate, sell off of in equities. We were able to satisfy ourselves that there had not been a change to fundamentals - people in Australia were still going to buy their lottery tickets and put petrol in their cars despite the event. However, “reaching across the abyss” and deploying significant amounts of cash amongst the hysteria of those markets was extremely challenging mentally, though thankfully in hindsight, they proved to be significant opportunities for the fund.

We are sometimes asked “given you have delivered 10.8% p.a. with an average cash holding of approximately 20%, should you not have been fully invested and delivered higher returns” – to which we highlight that our management of cash has been a key enabler of the performance delivered, not a dilutive factor in the process. If we stick to our discipline, we find ourselves – not perfectly – but more often than not, on the right side of market cycles, with a lower exposure to equities at market tipping points, and cash to deploy when the opportunities inevitably present.
IN SPITE OF THE MEDIA’S BEST EFFORTS, THE DOMESTIC ECONOMY REMAINS ROBUST

It is worth noting that over the past 10 years of the Fund’s history, our portfolio has been predominantly populated by what we refer to as “toilet paper and toothpaste” type businesses. More specifically, we refer to those businesses which do not require a particular part of the economic cycle to generate wealth. Instead, our investment thesis is premised on the basis that fundamental value is created by the growth in Australia’s overall wealth or GDP. Two factors underpin this measure: population growth and productivity, namely, more people producing more goods and services underpins fundamental wealth creation in the economy. The following series of charts highlight this.

We are attracted to strong underlying fundamentals. In particular, we like consistent compound annual growth. The past 20 years of domestic statistics paint a robust picture of the “lucky country”. While most short-term commentary tends to focus on annual growth rates we proffer that medium-term to longer-term investing may be better served by focusing on cumulative absolute numbers. Both series have been included in the charts.

Chart 1 shows that the Australian population has grown - through a combination of net migration and robust birth rates – at 2% p.a. from 18.5m to the current 25m people. Employment growth (Chart 2) is even stronger increasing from 8.5m to 12.5m people over the same period (admittedly with a bit more volatility).

Interestingly, wage growth (Chart 3) has also been strong almost doubling over the same period from an average of just $40,000 to almost $80,000 per person in 2018. Chart 4 combines these into a long period of consistent economic growth with GDP growing from $240b to $450b.

Additionally, it is useful to see where consumers have allocated their money with both retail spending (Chart 5) and the more durable measure of residential housing stock (Chart 6) following similar trends.
SEVERAL OTHER IMPORTANT THEMES

Interest rates, otherwise referred to as “the cost of money”, are unlikely to move lower

Existing investors have often heard my description of our “magic bullet” being that if we could liquidate the entire portfolio just before the Reserve Bank of Australia (RBA) increased interest rates back to the early 1990s level of 19%! Imagine sitting out the ensuing carnage in all long duration assets including shares, property and long bonds. After the damage to asset prices, our magic bullet would allow us to deploy the intact wealth into 20 high quality companies before putting up our feet to benefit from the RBA gradually reducing interest rates back to current levels.

In short, we subscribe to the common-sense view that long duration assets increase in value as interest rates come down and decrease as the cost of money goes up. Given that the local interest rates remain at record low levels since the 6 July 2016, we think it is likely the next move will be up. We are fairly confident that an out of cycle rate hike is imminent i.e. the big four banks raise interest rates without any change from the RBA.

Accordingly, the portfolio has been increasingly focused on companies that have:

a) Very strong balance sheets e.g. Credit Corp, Flight Centre, Caltex and Viva Energy;
b) Long term fixed debt e.g. CSL;
c) Business models that are positively impacted by rising interest rates e.g. Large deposit taking banks: CBA; Westpac; ANZ; Insurance or similar companies with large prepayment balances; Medibank; NIB; Smartgroup; Flight Centre;
d) Pricing power enabling them to increase/hold prices if circumstances require e.g. Woolworths, Viva Energy and ResMed.

Bifurcation of wealth creation between asset owners and salaried employees getting worse

Another theme that we have been considering for some time is the growing bifurcation between two economic classes:

1. Asset owners (of property, equities and businesses) have seen sharp increases in their wealth due to sharp asset price inflation globally. In addition, any debt funding against these assets remains low. In short, this group has generally never felt wealthier. The frequently posed question by this group is “Where do I invest my surplus cash?”.
2. In stark contrast, both blue and white collar workers have generally not had any significant salary/wage increases for several years. Furthermore, their non-discretionary spending has seen high inflation (think healthcare, utilities, private school fees, tolls, overseas holidays) implying their spending power has declined materially for some time. To maintain their standard of living many have supplemented their disposable income by using their houses as ATMs, facilitated by rising house prices. Their challenge is managing the erosion of the equity in their homes, particularly if house prices reverse their recent gains.

It appears this theme is playing out globally and may be responsible for the sharp rise in populism as the electorate become increasingly disaffected with the status quo. Importantly, political/sovereign risks are increasing as politicians are forced to make popular rather than economically rational decisions.
Evolving business models

Our largest investment successes have been in companies representing the trifecta of good businesses run by competent management and acquired at the right price. Defining a good business in an absolute sense (rather than relative) requires a broad and detailed understanding of the business model with particular reference as to who wields the superior “power” position within the various stakeholder relationships.

Examples include:

**CSL** as both the lowest cost producer of Immunoglobulin products and the highest combined revenue generator per litre of fractionated plasma the company enjoys a commanding position for long term shareholder value creation.

**ResMed’s** development of a cloud-based monitoring system, linked to its strong suite of medical devices and combined with an integrated digital administration system linking users and suppliers, creates a superior value proposition to all participants of the industry.

Retailers **Accent** and **Super Retail Group** have invested in their inventory management systems to provide a platform for efficient access by both in-store and online customers. This is the latest evolution in retail from store based to online, to omni-channel, and now to a combined model.

Perhaps the most ubiquitous trend has been the digitalisation trend and the remarkable benefits companies are achieving. Importantly, we have noticed that the traditional trade-off between “cost to serve” and “quality of service” has been substantially altered. The successful digitalisation of a process can result in improved stakeholder benefits at a lower ongoing cost to the company. Substantial examples include online banking and its impact on high cost branches, online payments reducing debtors days, stock reorder algorithms facilitating efficient maintenance of shelf stocks, and online change of customer details reducing call centre requirements.

The ability to harness this trend is something we have increasingly been using to assess management competence. We often include specific key performance indicators associated with digitalisation as part of the milestones that validate our investment thesis. Specifically, we monitor company stakeholder take up of digital processes, e.g. percentage of monthly statements by email versus paper based for ANZ retail customers; reduction in call centre operators in Telstra; online purchases as a percentage of total sales by Accent.

A key shareholder accretive factor is the ability to generate operating leverage as the volume of digital transactions increase, particularly, if no additional resources are required to service the customers, suppliers or other stakeholders.

We remain cautious in an environment where “momentum investing” has created a large group of fully priced market darlings with Price to Earnings (PE) multiples in excess of 25 times.

In contrast, the 15 times average PE multiple of the Fund’s holdings is further underpinned by the average after tax cash earnings yield of 7.5%. We remain committed to our disciplined and fundamental approach to managing the Fund retaining our absolute return objectives. Importantly, we expect the return of volatility to equity markets to create additional opportunities for the deployment of our significant cash reserves.

**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-stewardied 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.
PERFORMANCE SUMMARY

PERFORMANCE (%)

Net performance for the periods ending 30 June 2018¹

<table>
<thead>
<tr>
<th></th>
<th>1 mth</th>
<th>3 mths</th>
<th>1 yr</th>
<th>3 yrs p.a.</th>
<th>5 yrs p.a.</th>
<th>10 yrs p.a.</th>
<th>Since Inception p.a.²</th>
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</thead>
<tbody>
<tr>
<td>Fund</td>
<td>1.5</td>
<td>4.0</td>
<td>8.1</td>
<td>8.7</td>
<td>8.8</td>
<td>10.8</td>
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<tr>
<td>RBA Cash Rate</td>
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<td>0.4</td>
<td>1.5</td>
<td>1.7</td>
<td>2.0</td>
<td>3.0</td>
<td>3.0</td>
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<tr>
<td>ASX All Ords</td>
<td>3.0</td>
<td>8.0</td>
<td>13.7</td>
<td>9.5</td>
<td>10.3</td>
<td>6.2</td>
<td>6.2</td>
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</table>

GROWTH OF A$100,000 INVESTED AT INCEPTION²

PORTFOLIO INFORMATION

Top 10 stocks

<table>
<thead>
<tr>
<th>Name</th>
<th>Country</th>
<th>Name</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANZ</td>
<td>Australia</td>
<td>SG Fleet Group</td>
<td>Australia</td>
</tr>
<tr>
<td>Credit Corp</td>
<td>Australia</td>
<td>Telstra</td>
<td>Australia</td>
</tr>
<tr>
<td>CSL</td>
<td>Australia</td>
<td>Westpac</td>
<td>Australia</td>
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<tr>
<td>Medibank Private</td>
<td>Australia</td>
<td>Woolworths</td>
<td>Australia</td>
</tr>
<tr>
<td>ResMed</td>
<td>Australia</td>
<td>Z Energy</td>
<td>New Zealand</td>
</tr>
</tbody>
</table>

QUARTERLY CONTRIBUTORS

Largest 3 contributors

- CSL
- Telstra
- Accent
- Clearview
- Woolworths
- Credit Corp

SECTOR BREAKDOWN

- Financials: 30.7%
- Health Care: 10.9%
- Consumer Disc: 10.5%
- Industrials: 8.4%
- Energy: 6.3%
- Consumer Staples: 4.3%
- Telecomm. Services: 3.4%
- Real Estate: 2.8%
- Utilities: 0.9%
- Cash: 21.9%

CAPITALISATION

- ASX 1 -50: 32.5%
- ASX 51-100: 8.3%
- ASX 101-200: 11.4%
- ASX 201-300: 17.6%
- All Ordinaries: 2.3%
- ASX Ex All Ords: 0.1%
- Non ASX: 5.7%
- Cash: 21.9%

GEOGRAPHIC

- Australia: 72.4%
- New Zealand: 5.7%
- Cash: 21.9%

STATISTICAL DATA

Fund portfolio summary

- Volatility³: 9.28%
- Beta (using daily returns)⁴: 0.58
- Number of stocks: 29
- Maximum draw down: -17.88%

¹ Net performance figures are shown after all fees and expenses and assume reinvestment of distributions. 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.
### PERFORMANCE TABLE

**Fund Performance (A$, net of fees)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
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<tbody>
<tr>
<td>2017/18</td>
<td>0.6%</td>
<td>1.0%</td>
<td>0.1%</td>
<td>1.9%</td>
<td>3.2%</td>
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<td>1.5%</td>
<td>-1.3%</td>
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<td>-0.1%</td>
<td>2.5%</td>
<td>1.5%</td>
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<td>2016/17</td>
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<td>3.4%</td>
<td>-0.8%</td>
<td>0.7%</td>
<td>1.8%</td>
<td>1.7%</td>
<td>-4.7%</td>
<td>2.7%</td>
<td>10.2%</td>
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<tr>
<td>2015/16</td>
<td>3.3%</td>
<td>-4.2%</td>
<td>-0.6%</td>
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<td>3.4%</td>
<td>0.2%</td>
<td>-1.8%</td>
<td>-3.2%</td>
<td>3.1%</td>
<td>0.7%</td>
<td>4.6%</td>
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<tr>
<td>2014/15</td>
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<td>-2.4%</td>
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<td>1.4%</td>
<td>2.6%</td>
<td>4.0%</td>
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<td>-3.5%</td>
<td>8.9%</td>
</tr>
<tr>
<td>2013/14</td>
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<td>1.3%</td>
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<td>1.4%</td>
<td>-0.4%</td>
<td>1.2%</td>
<td>1.5%</td>
<td>-1.0%</td>
<td>9.1%</td>
</tr>
<tr>
<td>2012/13</td>
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<td>2.4%</td>
<td>2.8%</td>
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<td>4.4%</td>
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<td>2011/12</td>
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<td>4.7%</td>
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<td>1.0%</td>
<td>2.9%</td>
<td>3.6%</td>
<td>4.2%</td>
<td>0.7%</td>
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<td>-1.1%</td>
<td>8.3%</td>
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<td>2010/11</td>
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<td>3.0%</td>
<td>0.7%</td>
<td>1.5%</td>
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<td>2009/10</td>
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<td>12.5%</td>
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<td>-5.3%</td>
<td>3.9%</td>
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<td>-1.4%</td>
<td>7.9%</td>
<td>4.4%</td>
<td>2.1%</td>
<td>3.8%</td>
<td>3.0%</td>
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For further information please visit our website: Pengana.com