QUARTERLY REPORT

PENGANA INTERNATIONAL EQUITIES LIMITED

MARCH 2019 PERFORMANCE UPDATE

PENGANA INTERNATIONAL EQUITIES LIMITED (ASX: PIA)

DESCRIPTION AND FEATURES

Pengana International Equities Limited provides access to the benefits of an actively managed core portfolio of 30-50 ethically screened companies across developed and developing global markets via a listed investment company structure.

Investments are made predominantly in companies that deliver stable yet growing free cash flow throughout cycles (which we classify as 'Core' holdings) whilst also taking positions in more cyclical companies ('Cyclical') and those whose valuation has been materially misconstrued by the market ('Opportunistic').

Visit our website for more information on the Company.

Portfolio managers	Jordan Cvetanovski Steven Glass
ASX code shares	PIA
ASX code options	PIAO
Founded	19 March 2004
Mandate inception	1 July 2017
Asset class	International Equities
Fees	Management fee: 1.23% p.a. Performance fee: 15.38% of any return greater than the MSCI World [3]
DRP	Yes
Share price[1]	A$1.12
Option price[1]	A$0.001
NTA (pre-tax)[1,2]	A$1.2230
NTA (post-tax)[1,2]	A$1.2108
Premium/discount to pre-tax NTA[1]	8.42%
Market Cap	A$283.56m
Net Assets	A$306.56m
Ordinary shares on issue[1]	253.00m
Bonus options on issue[1]	237.79m
Benchmark	MSCI World[3]

[1] At 31 March 2019
[2] The figures are unaudited.
[3] MSCI World refers to the MSCI World Total Return Index, Net Dividends Reinvested, in A$.

FOR FURTHER INFORMATION PLEASE VISIT OUR WEBSITE:

PENGANA.COM/PIA

PERFORMANCE

Net performance for periods ending 31 March 2019[4]

	1 mth	3 mths	1 yr	FYTD	Since Inception p.a.[5]
PIA	1.4%	7.0%	4.6%	3.4%	7.8%
Benchmark	1.5%	11.5%	12.3%	6.3%	7.3%

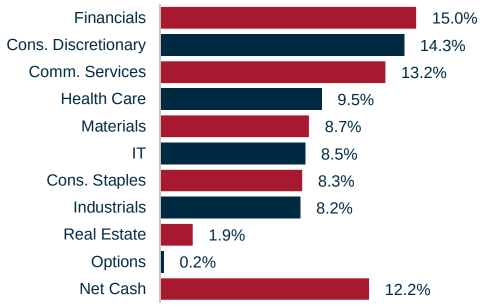
Pengana International Equities Limited has been managed under the new investment mandate by the Pengana investment team since 1 July 2017. The performance since inception in the table above refers to the movement in net assets per share since the inception of PIA in March 2004. See footnotes 4 and 5 below for further details.

PORTFOLIO INFORMATION

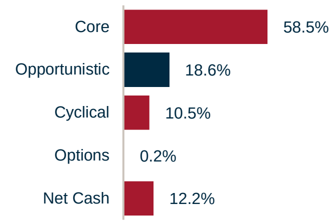
Top 10 stocks		
Name	**Country**	**Sector**
Aon	United States	Financials
ASML Holding	Netherlands	Information Technology
Bharti Infratel	India	Communication Services
CME Group	United States	Health Care
Charter Communications	United States	Communication Services
Cigna Corp	United States	Financials
Deutsche Boerse	Germany	Financials
Heineken	Netherlands	Consumer Staples
Nutrien	Canada	Materials
Rakuten	Japan	Consumer Discretionary

Largest 3 contributors (for the quarter)	Largest 3 detractors (for the quarter)
Bharti Infratel	TomTom
Huazhu Group	Cigna Corp
Worldpay	CME Group

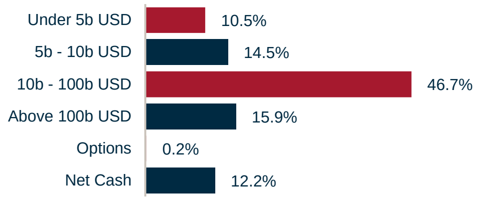
SECTOR BREAKDOWN



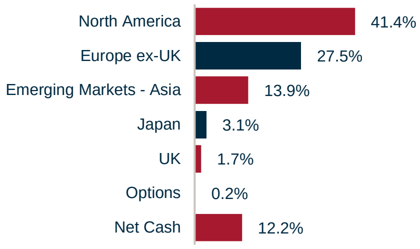
SEGMENT



CAPITALISATION



GEOGRAPHIC



4. Performance figures refer to the movement in net assets per share plus dividends per share paid in the period, reversing out the impact of option exercises, before tax paid or accrued on realised and unrealised gains. Past performance is not a reliable indicator of future performance, the value of investments can go up and down.

5. Inception date of PIA: 19 March 2004, new investment team with new mandate adopted: 1 July 2017

PERFORMANCE COMMENTARY

Aim
We aim to achieve superior AUD-denominated returns with low volatility. The superior returns aim can be disaggregated into (i) capital preservation; (ii) capital appreciation. While these aims make no mention of the benchmark, we believe that fulfilling our aims will result in superior returns to the benchmark over the medium-to-long term.

Quarterly Performance
The portfolio delivered 7.0% in 1Q19. In local currency the portfolio's performance was stronger but currency reduced returns by approximately 1.3%. The portfolio's benchmark, MSCI World (AUD), delivered 11.5%, which is the strongest quarter since 2Q09 and the strongest start to the year in 30-years.

Key drivers of the performance include:

- Stocks that were the largest positive contributors – Bharti Infratel (Indian cellular tower business), Huazhu Group (Chinese hotel operator) and Worldpay (US-listed payment business).
- Stocks that were the largest detractors – TomTom (Dutch map and telematics), Cigna (US health insurer) and CME Group (US derivatives exchange).
- Cash – on average, 16% of the portfolio was held in cash and gold during the quarter. The cash holding was the single largest relative performance headwind during the quarter.
- Sector exposure – the portfolio's underweight exposure to IT was a relative performance headwind.
- Selection within sectors – the portfolio's stock selection within the Consumer Discretionary sector was a notable positive contributor while the portfolio's large exposure to derivative exchanges, was a performance headwind as volatility declined.
- Portfolio insurance (put options) – the put options were a headwind as equity markets rallied.

MARKET COMMENTARY

In 1Q19, the MSCI World was up 13% in local currency and 11.5% in AUD-terms as the AUD appreciated against most major currencies. This marked the best quarterly return since 2Q09 (for the S&P 500) and was a sharp reversal from 4Q18, which was the weakest quarter since 1Q09.

The best performing sectors were Information Technology (IT), Real Estate and Energy. In many of our prior quarterly reports we have commented on the seemingly insatiable market demand for the IT sector and this quarter was no different. IT has now been among the three best performing sectors in 11 of the past 15 quarters. To put some perspective around this, the IT sector has delivered around 80% since Jun-15 while the second strongest sector, Utilities, has delivered less than half of that (according to figures from FactSet). This means that simply being heavily invested in IT would have been sufficient to deliver market beating returns up until now.

The worst performing sectors were Financials, Health Care and Utilities. Weakness in Financials reflects a more benign interest rate environment, which limits the ability for Financials to make a net interest spread. Health Care suffered from the typical pre-election sabre-rattling by politicians. Utilities declined as the market shifted away from lower risk sectors.

The best performing (major) countries during the quarter were China/Hong Kong, Canada, the US and many European markets, most notably Italy, Belgium and Denmark.

The worst performing countries were the peripheral emerging markets including Malaysia, Turkey and Poland.

PORTFOLIO

The portfolio is divided into three segments:

(1) Core (60-80% of the portfolio) – Core is intended to provide a stable base for the portfolio. Companies in this segment are growing, reasonably priced, have low business cyclicality, strong cash generation, dominant presence in their industries, strong management teams and favourable structural tail-winds.

(2) Cyclical (0-30% of the portfolio) – Cyclical contains companies we expect to benefit from shorter duration trends. As these cycles tend to be transitory, timing is more important in our investment decisions than in Core. Cyclical companies offer the potential for materially more substantial short-term gains than Core, however, they are also riskier. Financials, basic materials, and agriculture are examples of industries that may be represented in this segment.

(3) Opportunistic (0-20% of the portfolio) – Opportunistic includes companies we believe are materially undervalued or whose growth has been under-appreciated. These companies offer potentially more attractive shorter-term gains than Core, however, they also tend to be riskier. Examples of Opportunistic investments include companies in the midst of a takeover, earlier stage internet/health/retail companies and companies whose share prices have markedly declined.

The portfolio's positioning at 31 March 2019 is summarised as:

- 88% of the portfolio is invested in equities, 2% of the equities exposure is in gold-linked shares, and 12% is held in cash.
- Segment exposure is 58.5% in "Core", 10.5% in "Cyclical" and 18.6% in "Opportunistic".
- Geographic exposure – 41% of the portfolio is invested in the US, and while this is the portfolio's largest geographic exposure, it is 19% lower than the portfolio's benchmark. The portfolio has relatively high exposure to Europe ex-UK (28%) and Asia (17%).
- Sector exposure – the portfolio is notably underweight IT, Energy and Utilities while having a relatively large exposure to Materials.
- 25% of the portfolio is invested in small or mid-cap companies, 47% is in large-caps, and 16% is in mega-caps.

MACRO DISCUSSION

The biggest macro event that occurred during 1Q19 was the Federal Reserve's pivot to a more accommodative monetary policy. This was the cue for money to flood back into the equity markets, resulting in the S&P 500 delivering its best quarterly return for almost 10 years.

We concur with the broader market that lower interest rates should be supportive of equity markets and during 4Q18 we were relatively active at entering new positions. However, our focus has been different to many others and rather than invest in the in-vogue US growth stocks we have increased our exposure to Emerging Markets (EMs) both directly and via companies listed in Developed Markets that have large EM exposure.

Our attraction to EMs is twofold. Firstly, the EMs have been, and we think will continue to be, the primary source of global economic growth. Secondly, valuations are attractive.

According to the IMF, in recent years, EMs generated approximately 75% of global economic growth. This is likely to persist as Citi forecasts that over the next five years industrial countries will grow less than 2% while EMs will deliver almost 5% growth. We believe it is always helpful investing with a strong tailwind and that tailwind is blowing from EMs.

This relative stronger growth expected to come from EMs is not reflected in valuations. According to Minack Advisors the EMs' cyclically adjusted PE ratio is less than 15x while the US market is trading on almost 30x and developed markets (ex-US) are trading on around 16x. The valuation gap between the US market and EMs is close to a record. In other words, EMs have never been cheaper relative to the US market than they are right now.

US interest rates have a material impact on EMs. Rising US interest rates have historically resulted in capital outflows from EMs and make it more difficult for overseas borrowers to service their debt. The converse is true with lower US interest rates. This means a more accommodative Federal Reserve, makes it easier for EMs to fund their growth.

We believe EMs' economic growth outlook, especially with a supportive US interest rate environment, and valuations are a supportive foundation for investing in those markets.

STOCK FOCUS

Huazhu Group is the second largest hotel operator in China, with more than 4,000 hotels and 400,000 hotel rooms in its hotel network. Huazhu owns over 10 hotel brands and its agreement with Accor provides it with the rights to the Mercure, Ibis, Ibis Styles, Grand Mercure and Novotel brands in China. Some of the hotels are owned or leased by Huazhu but the majority of the hotels are operated under a managed franchise model, whereby Huazhu provides the franchisee with a hotel manager and receives ongoing franchising fees while the franchisee is responsible for all the hotel operating costs (rent, employee expenses, capital expenditures).

Our attraction to Huazhu includes its long, sustainable and visible runway for growth, expanding margins, asset light business model, sustainable competitive advantages, good management team with a strong track record of execution, and a relatively low level of regulatory risk.

Huazhu has increased its hotel network from five hotels at the end of 2005 to more than 4,000 hotels at the end of 2018, with about 500 hotels opened in each of the last three years and 600-700 hotels expected in 2019. There are insufficient branded hotels in China compared to the US, especially in the midscale segment and this will continue to drive new hotel openings in the foreseeable future. Huazhu has a strong and increasing hotel pipeline and this provides a long and visible runway for growth, with management targeting 10,000 hotels in the longer term.

With the rise of the middle class in China, there is increasing demand for midscale hotels, which have much higher prices and margins compared to economy hotels. Furthermore, the majority of new hotel openings are asset light for Huazhu as the franchisee is responsible for all the upfront costs and this is also margin accretive. The asset light model also protects Huazhu in a cyclical downturn as Huazhu receives a percentage of the franchisees' revenue but none of the costs.

Huazhu's competitive advantage stems from its loyalty program with 122 million members, which continues to grow every quarter. The loyalty program reduces reliance on referrals from online travel agencies while making the hotel network more attractive to potential franchisees as being part of Huazhu's network would immediately provide the franchisee with a potential customer base of 122 million.

Huazhu's founder was the ex-founder of Ctrip (largest online travel agency in China) and Home Inns (third largest hotel chain in China) and under his leadership, Huazhu was able to grow from five hotels to more than 4,000 hotels over 13 years as well as outperform peers in terms of both hotel occupancy and average daily prices.

We met with Huazhu in Hong Kong in late 2017 and the company remained on our watchlist but became too expensive as the fundamental story continued to improve in early to mid-2018. However, the sell-off in China in the second half of 2018 provided us with the opportunity to initiate a position as Huazhu's share price halved. Although a slowdown in China would be negative for Huazhu, we were impressed with the quality of the company as well as its long-term prospects and we believed that the share price reaction was excessive. Since we invested Huazhu's share price has recovered more than 70% and we recently fully exited our position as the valuation has become stretched once again. Nonetheless, it remains firmly in our sights should the share price again inexplicitly materially decline.

ETHICAL FOCUS: AXON ENTERPRISES

We have always maintained that ethics are as important as investment returns. Commencing this quarter, in conjunction with a report we provide on an investment held by the portfolio, we will include an ethical study we have faced. The inaugural ethical study is on Axon Enterprises.

With unmatched market dominance, a compound annual growth rate of 16% over the last seven years and a mission statement to "obsolete the bullet", Axon Enterprises appeared on our potential investment opportunity radar recently.

The manufacturer of TASER, a conducted energy weapon, Axon recognised a gap in law enforcement for 'non-lethal' weapons back in 1993. Today, 17,000 out of 18,000 US police agencies procure TASER devices, and the company is quickly expanding globally, with

TASERs deployed as far afield as Mexico, the UK and Australia.

Not content with global product expansion, Axon has been developing an end to end integrated law enforcement solution. Axon already offers digital evidence management and the ability for officers to capture public safety videos through Axon's body cameras. In the near future, Axon will be expanding its product range to include police agency records management systems and computer-aided dispatch software.

While Axon boasts impressive financial fundamentals, the ethics of investing in such a business aren't as clear.

Axon describes TASER as "an alternative far superior to using firearms in many contexts". According to the company, TASERs have saved nearly 200,000 lives, with over 3.7 million uses in the field worldwide.

But research to back up such claims is, at best, inconclusive. Described by the United Nations Committee Against Torture as "a form of torture…that in certain cases could also cause death", labelling TASER a 'non-lethal weapon' is a misnomer. In the US alone, reportedly over 1,000 deaths have occurred following the police use of TASERS, and there is growing evidence of the risk of cardiac failure from TASER use.

Research by the University of Chicago found that the Chicago Police Department's adoption of TASERs resulted in a reduction in officer injury but no effect on firearm use by law enforcement. The study found that "police injuries fell, but neither injury rates nor the number of injuries to civilians were affected."

Further ethical and privacy issues present themselves from Axon's shift to data capture, management and retention. Live-streaming of incidents and real time facial recognition, tracking and matching technology is less of a technology challenge than an ethical one.

Although Axon has established an Artificial Intelligence Ethics Board to help guide the development of Axon's AI-powered devices and services, its members include law enforcement representatives, the very sector that faces growing scrutiny over how it uses Axon products.

Ultimately, these unresolved ethical issues surrounding Axon led us to the decision not to add the company to the portfolio.

PENGANA CAPITAL

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