QUARTERLY REPORT

PENGANA INTERNATIONAL EQUITIES LIMITED

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
Founded	19 June 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$1.05
NTA (pre-tax)[1,2]	A$1.2342
NTA (post-tax)[1,2]	A$1.2101
Premium/discount to pre-tax NTA[1]	14.9%
Market Cap	A$266.75m
Net Asset Value	A$307.65m
Ordinary shares on issue[1]	254.05m
Benchmark	MSCI World[3]

[1] At 30 June 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 30 June 2019[4]

	1 mth	3 mths	1 yr	FYTD	Since Inception p.a.[5]
PIA	4.1%	3.9%	7.4%	7.4%	7.9%
Benchmark	5.2%	5.3%	12.0%	12.0%	7.5%

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 June 2004. See footnotes 4 and 5 below for further details.

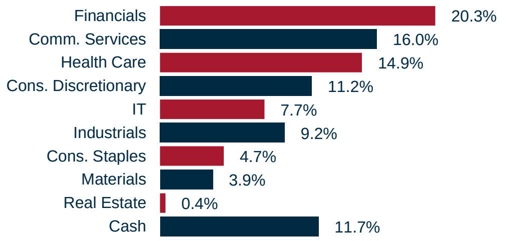
PORTFOLIO INFORMATION

Top 10 stocks

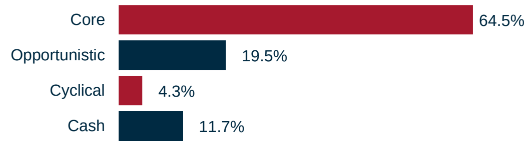
Name	Country	Sector
Aon	United States	Financials
ASML Holding	Netherlands	Information Technology
Bharti Infratel	India	Communication Services
CME Group	United States	Health Care
Charter Communications	United States	Communication Services
Cigna Corp	United States	Financials
Deutsche Boerse	Germany	Financials
Medtronic	United States	Health Care
Rakuten	Japan	Consumer Discretionary
Tencent Holdings	China	Communication Services

Largest 3 contributors (for the quarter)	Largest 3 detractors (for the quarter)
CME Group Inc	Bharti Infratel
KAR Auction Services	Smith (A.O)
Rakuten	Zee Entertainment

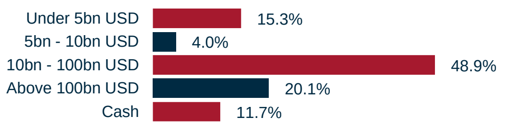
SECTOR BREAKDOWN



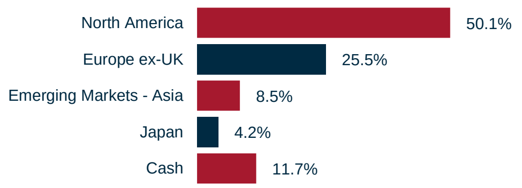
SEGMENT



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 June 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 3.9% in 2Q19.

Key drivers of the performance include:

- Stocks that were the largest positive contributors – Rakuten (Japanese eCommerce), CME (US derivatives exchange) and KAR Auction Services (US used vehicle auctioneer).
- Stocks that were the largest detractors – ZEE Entertainment (India media), Bharti Infratel (India cellular towers), A.O. Smith (US water boiler manufacturer).
- Cash – on average, approximately 9% of the portfolio was held in cash 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.

In summary, the portfolio was invested in the better performing companies within each sector, while its cash holdings and relatively lower exposure to IT has been a relative performance headwind.

MARKET COMMENTARY

In 2Q19, the MSCI World Total Return Index was up 5.3% in AUD-terms. This marked the thirteenth positive quarter in the past 16 quarters, which is a virtually unprecedented period of stock-market prosperity.

A key driver of the strong performance this quarter was essentially the same as in prior ones – expansionary monetary policy during a non-recessionary economic environment.

The sectors making the largest positive contribution to the Benchmark's positive return were Financials, Information Technology (IT) and Industrials. The weakest performing sectors were Energy, Real Estate and Health Care.

Inclusion of IT in the top performing sectors is a continuation of a long played out trend, with that sector being among the top three performing for 13 out of the last 16 quarters.

We believe the performance of IT is largely due to its high concentration of large cap growth/quality stocks. As we explain in the 'Macro Discussion', below, large-cap growth/quality has been the defining theme of the current bull market.

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 30 June 2019 is summarised as:

- 88% of the portfolio is invested in equities, and 12% is held in cash.

- Segment exposure is 60-70% in "Core", 0-5% in "Cyclical" and 15-20% in "Opportunistic".
- Geographic exposure – 50% of the portfolio is invested in the US. The portfolio has relatively high exposure to Europe ex-UK (25%) and Emerging Asia (9%). 4% of the Portfolio is invested in Japan.
- Sector exposure – the portfolio is notably underweight IT and Energy while having a relatively large exposure to Materials and Communication Services.
- 19% of the portfolio is invested in small or mid-cap companies, 49% is in large-caps, and 20% is in mega-caps.

MACRO DISCUSSION

Markets are defined by themes. In recent times the key theme is US large-cap growth. This has been driven by weak economic growth coupled with low interest rates.

Without the support of a strong economy, investors are seeking companies that can grow on their own. These companies have rapidly growing customer bases or revenues and are often labelled 'disruptors' or 'quality' or 'growth' stocks.

Small caps are more economically sensitive than larger companies. During periods where corporate earnings are getting less help from the economy it makes sense to seek growth from larger companies. Therefore, insipid economic growth drives the market towards large cap growth companies.

There are always large cap growth stocks, even in the most moribund economies. All that really ever changes is how much people are willing to pay for those stocks.

Discussing price brings us to interest rates. Lower interest rates increase the value of future earnings relative to current earnings. Since valuations are the present value of future earnings, lower interest rates have a bigger impact on the valuations of growth stocks than other types of stocks. Therefore, people are prepared to pay more for growth when interest rates are low.

Combining the above factors, it is clear that insipid economic growth coupled with low interest rates is the perfect environment for large cap growth stocks.

Strong performance of large cap growth stocks is a global phenomenon. However, there is a much greater number of this type of stock listed in the US than elsewhere. By sheer weight of numbers, large cap US growth stocks have been the dominant theme for the current buoyant market environment.

Investing in US large cap growth has been the road to riches in recent times. To illustrate, we created a basket of ten commonly held US large-cap growth stocks: Alphabet (Google), Amazon, Apple, Facebook, Mastercard, Microsoft, Netflix, Salesforce.com, Starbucks and Visa. We will refer to these stocks as the "*Terrific Ten*".

Simply investing in the Terrific Ten would have resulted in material outperformance. An equally-weighted portfolio of these stocks would have generated a return of 26% (AUD) for the year ending June 19, which is more than *double* the Benchmark's 12% return. Any portfolio manager who focused their attention on these stocks, or other similar large cap growth stocks, would have beaten the market handsomely over the last year.

While having a portfolio that is *highly concentrated* in large cap growth has clearly been the place to be, we do not believe that it is necessarily the right thing to do. As this piece started, '*Markets are defined by themes'*, and themes are subject to change. The current theme could ironically be up-ended by accelerating economic growth, which would push the market into more cyclical companies, or an increase in interest rates (due to the re-emergence of inflation), which would result in a devaluation of growth stocks.

The ethereal nature of market themes is part of the reason this portfolio is always well diversified. We continue to seek companies of all sizes, located in a variety of industries and countries that provide the optimal diversification for our clients and the best risk/return characteristics. Our performance attribution since inception demonstrates that we have made returns over a wide range of sectors and geographies. This gives us the confidence that, when the current market theme shifts away from the narrow focus on large cap growth, we are well placed to continue delivering good returns.

We are currently seeing great value in many sectors and are very excited about the variety of holdings in our portfolio.

STOCK FOCUS

Charter Communications is the USA's second largest cable company, providing subscription-TV, internet connectivity ('Connectivity') and fixed voice services to 27m households and 2m small businesses. Cable companies are often described as pay-

TV businesses; however, the truth is that they generate far more profit from Connectivity. It is more appropriate to think of Charter as a Connectivity business than a subscription-TV business.

It is no secret that households are dropping their incumbent TV subscriptions in preference for internet-delivered services like Netflix. With their history rooted in subscription-TV and roughly 40% of their current revenue coming from that market, it is easy to automatically jump to the conclusion that the outlook for cable companies is bleak (at best). However, we have a different perspective.

The decay of traditional subscription-TV is closely entwined with the growth of broadband connectivity as a household cannot consume internet-delivered video without Connectivity. As households become less dependent on subscription-TV, they are becoming more dependent on Connectivity. This is exceedingly positive for cable companies.

Connectivity is a meaningfully better business than subscription-TV. It offers vastly superior profit margins, is far less capital intensive and the sustainability of the improved economics is more dependable.

In the subscription-TV business, cable companies have to buy expensive content from dominant media companies, resulting in gross margins of <50%. This market is also highly competitive with the cable companies' competitors including two satellite providers, one local incumbent telco and a slew of new internet-delivered video services. Further, subscription-TV is a highly capital intensive business as the cable companies have to portfolio the set top boxes and their installation. Cable companies actually make very little profit and low returns on capital from subscription-TV.

In Connectivity, the cable companies don't have to buy content from anyone, meaning they generate >90% gross margins. Capital expenditure is low as Connectivity requires cheap modems that can be installed by the customer rather than the cable company. Further, the Connectivity market is not overly competitive as the cable companies' only competitor is the local telco, which generally has an inferior product (DSL) to the cable company. The upshot is that cable companies are either monopolies or duopolies.

We have long held the views expressed above and they were a cornerstone of a prior meaningful position in Comcast. So this begs the question, why invest in Charter now?

Charter has been in the midst of a major restructuring program following its acquisition of a large peer (Time Warner Cable). We chose to sit on the sidelines during this restructure as it was fraught with risk. Charter's 4Q18 result demonstrated that the bulk of the transition was behind the company, which gave us the green light to invest.

We expect to do handsomely from the investment, provided Charter continues to grow its Connectivity subscribers, its margins expand and capital intensity declines (owing to the shift away from subscription-TV and towards Connectivity).

ETHICAL FOCUS: FAST-FASHION

Fast-fashion refers to clothing that closely matches the current fashion trend. These trends are fast changing, which means the clothes need to be as well. Therefore, the key to fast fashion riches is the ability to quickly and cheaply manufacture clothing. In business terms this makes total sense. However, in ESG terms, it makes less sense.

Inditex, owner of Zara, was the pioneer of fast fashion. As a demonstration of the success of the model, Inditex is now the world's largest clothing retailer. This created a number of copy-cat businesses, including H&M, 'Misguided' and 'Fashion Nova', that reportedly grew 600% in 2017 and was the most-searched for fashion brand on Google in 2018.

Fast fashion has changed consumer behaviour. Today, the average person buys 60% more clothing but keeps it for about half as long as they did in 2002 and nearly 60% of all clothing is discarded within a year of being made. This increase in consumption has had negative environmental and social impacts.

Today, fashion is the second highest user of water worldwide (producing 20% of global water waste). It accounts for 8% of the world's greenhouse gas emissions and cotton farming uses 24% of all insecticides and 11% of all pesticides despite using only 3% of the world's arable land. Incredibly, it takes about 2,700 litres of water to produce one cotton shirt, the amount an average person drinks over 3 years.

The social impact is just as devastating with the industry's supply chain beset by labour, gender and poverty concerns. According to United Nations Economic Commission for Europe (UNECE), 1 in 6 people in the world works in a fashion related job, and 80 percent of the labour force throughout the supply chain are women. This could support the social and empowerment of women, however a large portion of workers in the sector are paid well below minimum wage, with non-compliance rates as high at 53% in countries like the

Philippines. A study by the International Labour Organization (ILO) of seven garment exporting countries in Asia found that women are more likely to be paid below minimum wage and a significant number of workers are paid less than 80% of the minimum wage.

Increased awareness of the damaging environmental and social impacts of fast-fashion is leading to changes in consumer behaviour. According to a 2018 report by UK based not-for-profit consultancy Ethical Consumer, UK sales of ethical and second-hand clothing grew by 20% and 23% respectively in 2017 while ThredUp's 2019 Resale Report estimates the US market for second hand apparel will double in the next five years.

Inditex itself has taken heed, taking action on circularity by starting its repair and reuse program called Closing the Loop which encourages customers to return clothes to Zara so that they can have a second life. Zara has also deliberately clustered its suppliers geographically to enable increased visibility and transparency throughout its supply chain, with the 2019 Ethical Fashion Report giving Zara an overall A for the strength of its risks mitigation systems around forced labour, child labour and general exploitation in its supply chain.

Despite the improvements, we are wary of investing in in fast-fashion on ethical grounds.

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