PENGANA AUSTRALIAN EQUITIES FUND

In search of the gifts that keep on giving

October 2014

Recommended
Lonsec Research *

Zenith Investment Partners
HIGHLY RECOMMENDED
Recommended
APPROVED
NOT RATED
REDEEM **

So What Do Investors Really Need?

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1. Capital Preservation, and
2. A Reasonable Real Return

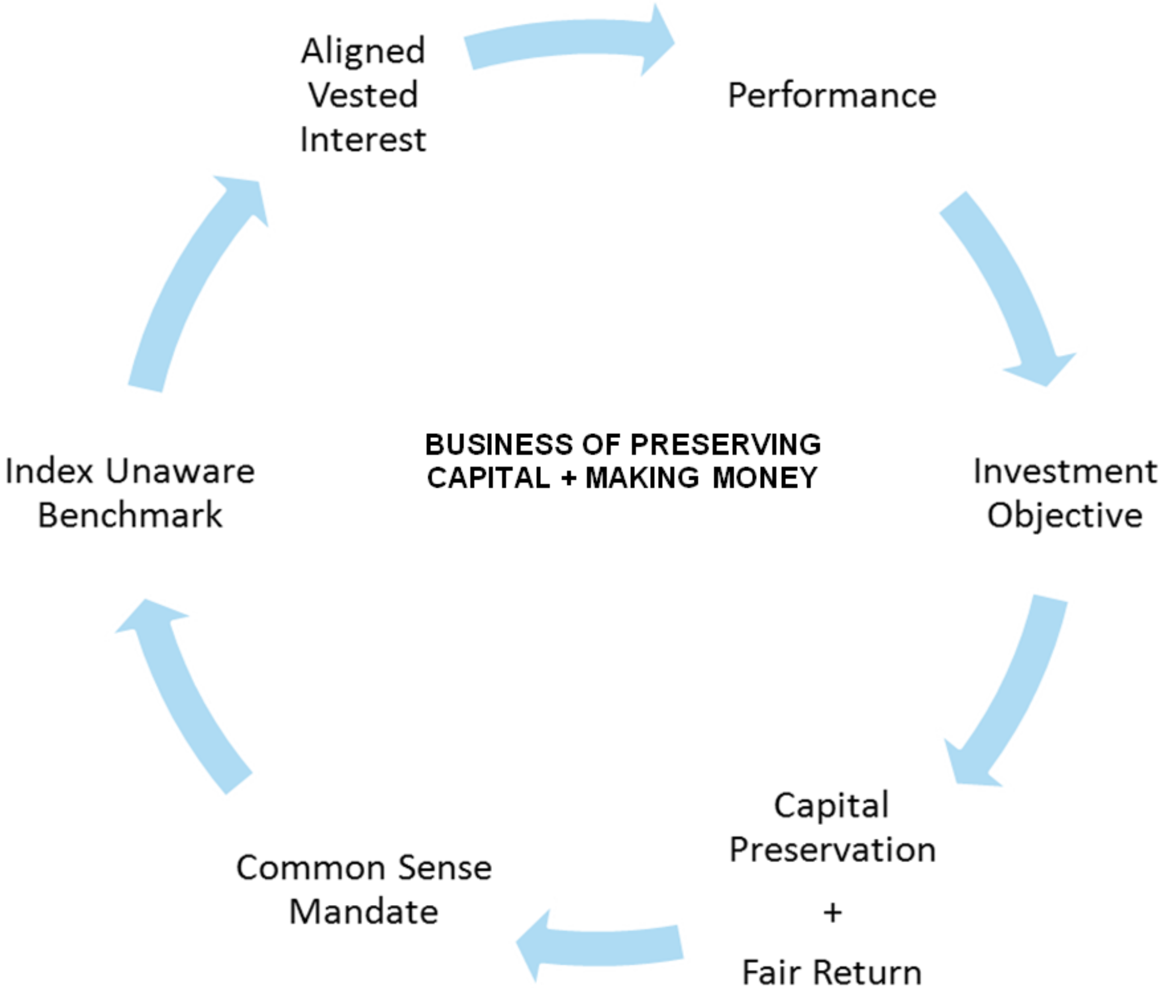
Capital Preservation:

Maintain Real Value of Money in Relevant currency

Reasonable Real Return:

The Risk Free Rate	Currently 2.5%
PLUS	+
an Equity Risk Premium	Approx 6.0%

Our Fundamental Beliefs



Our Fundamental Beliefs

- We are in the business of protecting capital and making money (not in the business of beating the market)
- If we cannot find investments that justify the risk we will stay in cash
- Our clients are co-investors
- We will limit the capacity of our fund to maintain performance
- Binary outcomes (even ten baggers) are not for us
- Information arbitrage happens at a granular level of detail
- We are tax aware

Fund Performance

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Net Returns to 31st October 2014[2]					
	AEF	Cash Rate	All Ords	Std Dev	Sharpe Ratio
1 Month	2.5%	0.2%	4.0%	N/A	N/A
3 Months	1.6%	0.6%	-0.8%	N/A	N/A
6 Months	4.0%	1.3%	2.8%	N/A	N/A
1 Year	4.4%	2.5%	5.9%	5.7%	0.33
2 Years annualised	**13.7%**	**2.7%**	**14.9%**	**7.1%**	**1.56**
3 Years annualised	**14.7%**	**3.1%**	**12.9%**	**7.1%**	**1.64**
5 Years annualised	**11.7%**	**3.6%**	**7.9%**	**7.7%**	**1.04**
Since inception p.a.	**12.1%**	**3.8%**	**5.0%**	**9.8%**	**0.85**

[1] Total return performance figures are derived from Managers' records and are shown after all fees and expenses, and assume reinvestment of distributions. Investments can go up and down. Past performance is not a reliable indicator of future performance. Inception date: 1 July 2008.

Why are we cautious?

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- Cost of Money impact already in the prices
- Developed economies have thrown the “Kitchen sink” yet the Velocity of money remains low
- General Valuations are high
- Currency war implications still to play out

It's All About the Cost of Money (Risk Free Rate)

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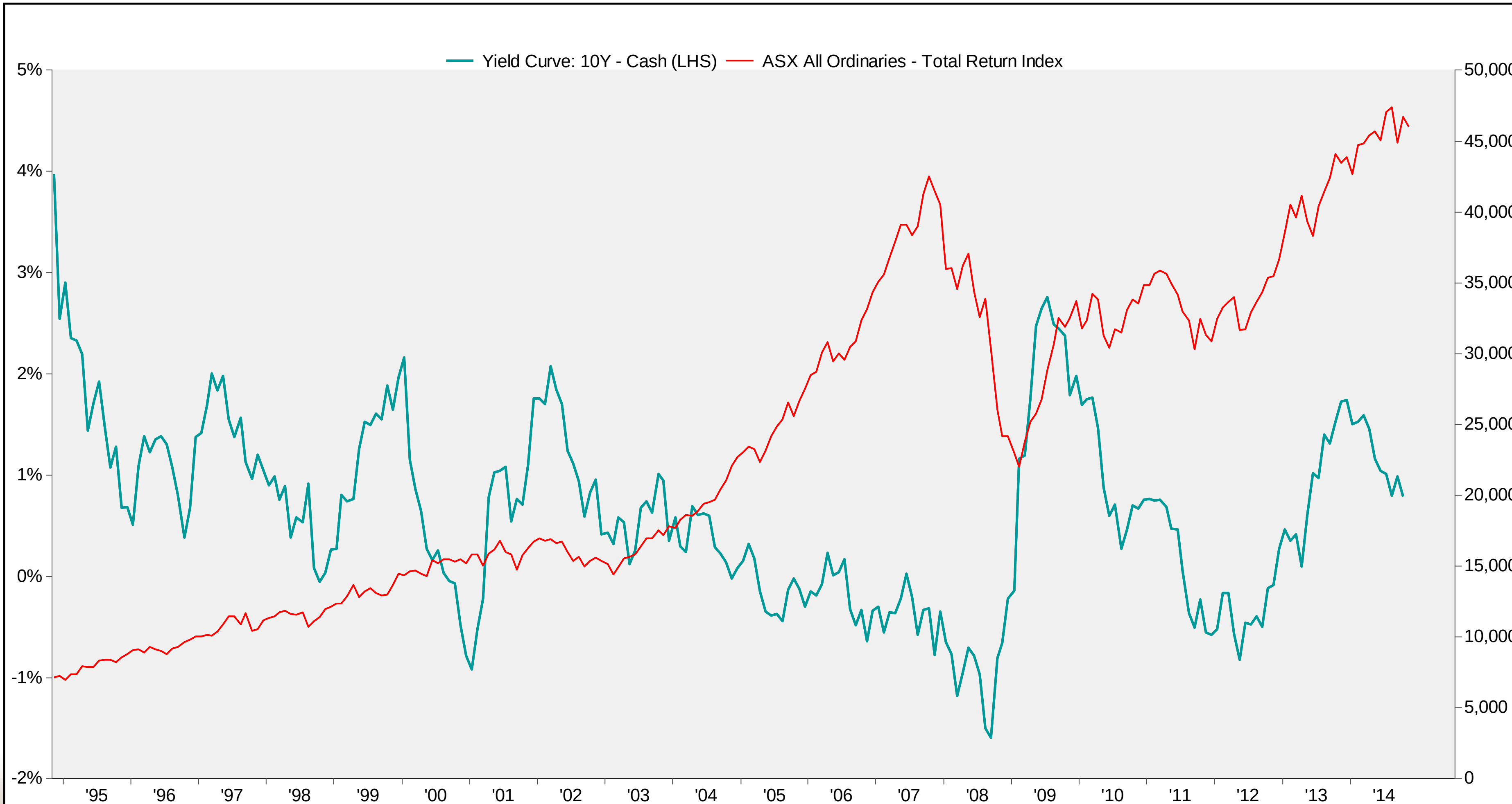
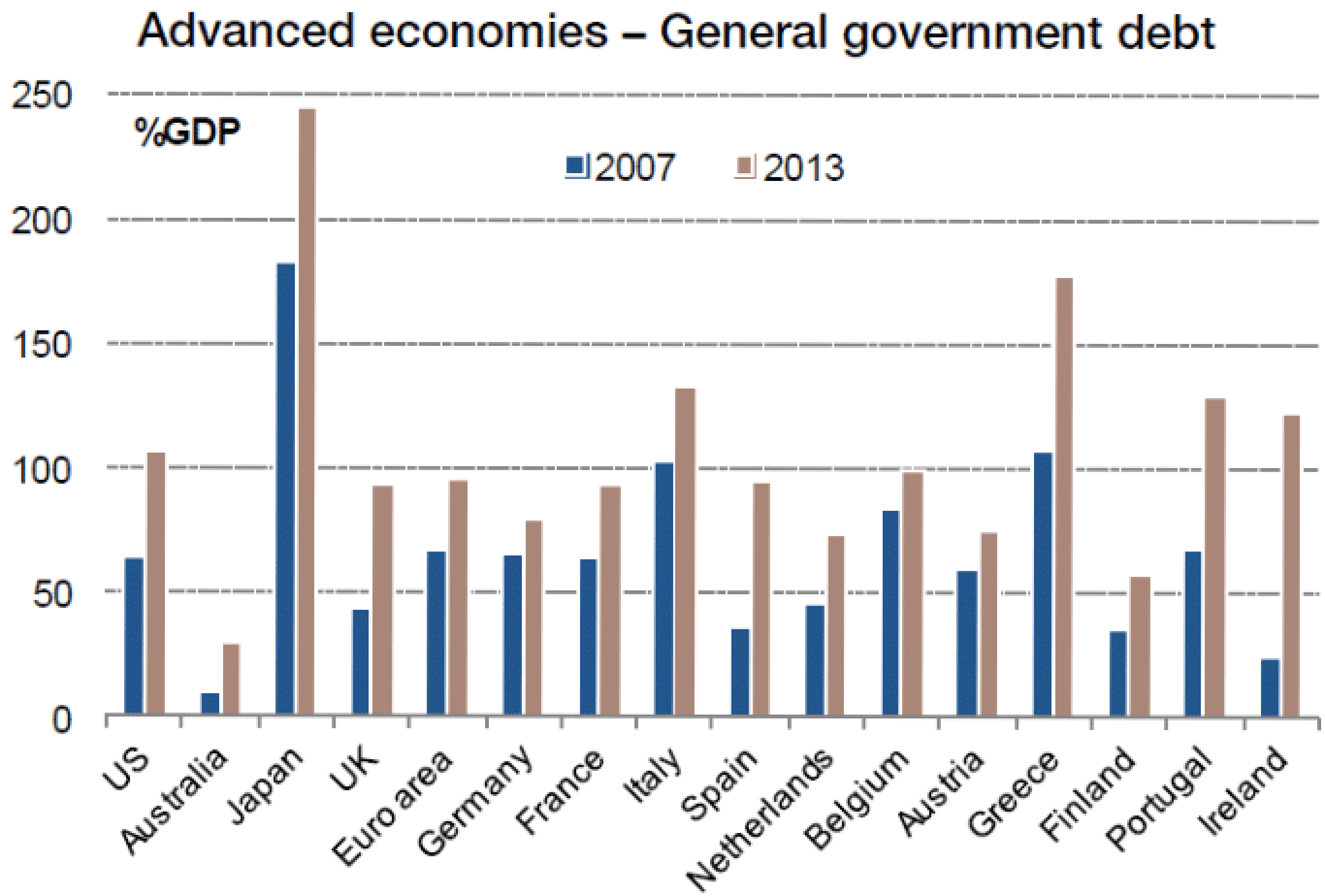


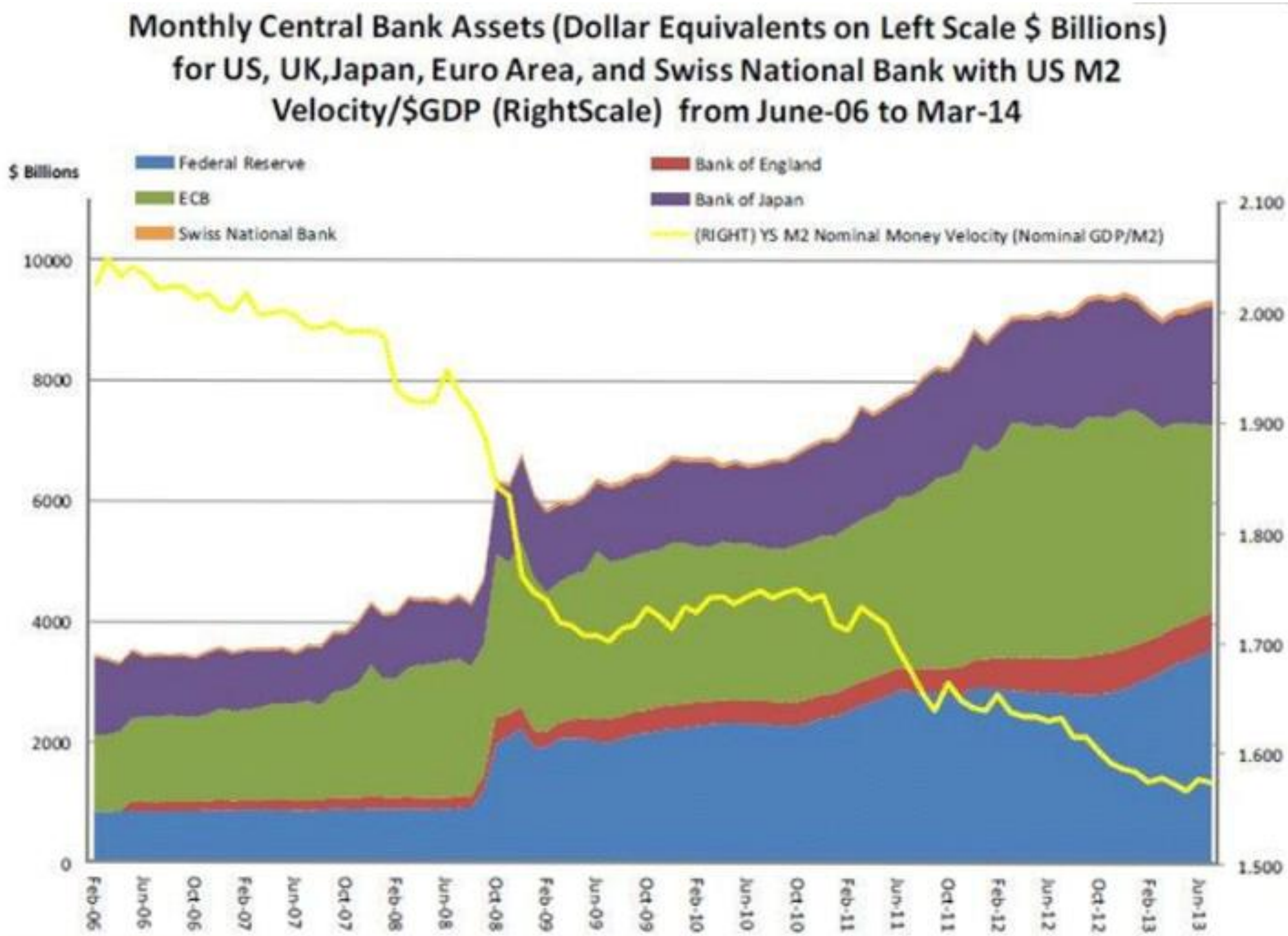
Source: FactSet

Government Debt Growth Since GFC

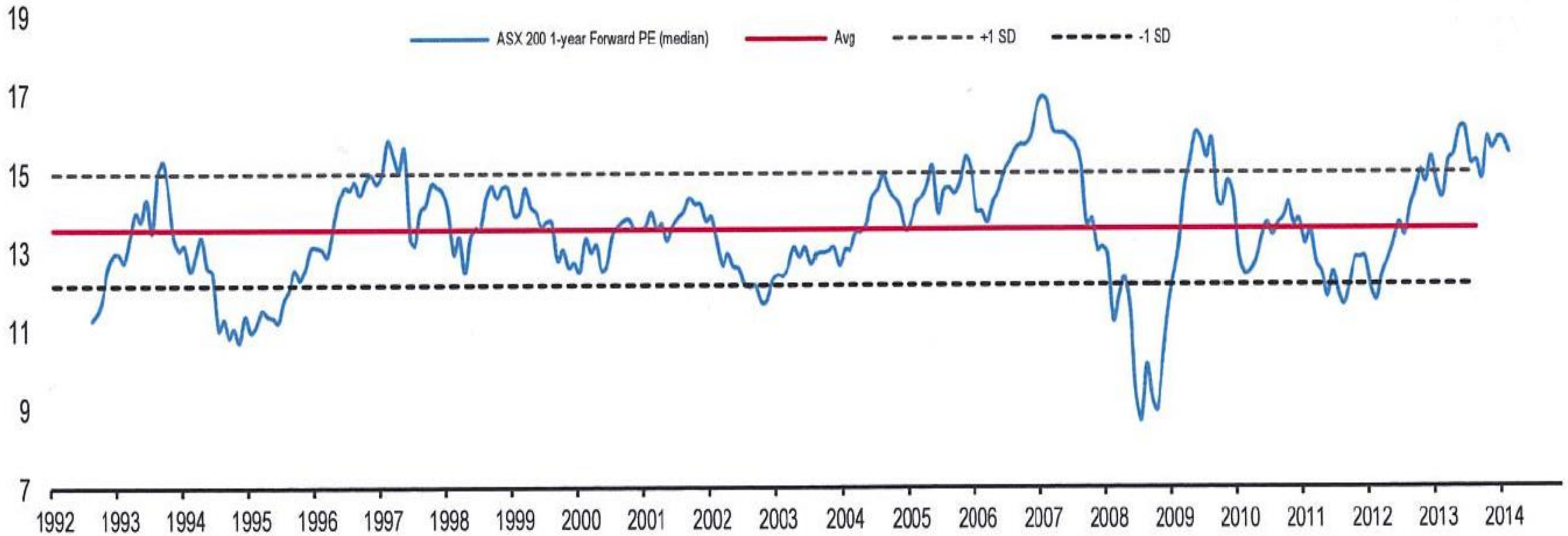


Source: European Commission, IMF, SG Cross Asset Research/Economics

Velocity of Money



General Valuations Are High



Source: Credit Suisse

How We Think About Risk

Investment Risk ≠ **Tracking Error vs The Index**

- Capital Preservation Risk
  - **Company Specific Risk**
  - **Market Risk**
  - **Currency Risk**
- Sufficient Reward Risk

- Owning appropriate stocks rather than owning stocks because they are in the index
- Stocks with high index weight can reflect peak valuations e.g. “REIT bubble”

Cash holdings are an outcome of available investment opportunities

- Our cash holdings are a bottom up outcome not a top down target.
- In a market where valuations are high, we find our cash balance rises as a result of fewer opportunities that fit within our valuation requirements.
- Periods where valuations are lower present more acceptable opportunities to deploy cash typically resulting in lower cash holdings within the portfolio.
- Over the past 5 years cash has represented as much as 35% and as little as 10% within the portfolio.

Outlook

- US economy is improving although data has been patchy, European monetary policy and Chinese fiscal policies continue to kick the can down the road.
- Ever lower deposit rates continue to force investors into the equity market due to TINA and FOMO
- Discretionary retail hit low point due to extended April holidays, warm start to winter, federal budget. However AB income group consumers are in good shape
- Interesting signs of East Coast economic recovery – ANZ Small Business credit growth, Western Sydney Gaming machine activity, Sandpaper sales by Workmate

Market Themes

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- Caution required around several potential time bombs.
  - Property prices, Discretionary spending, Housing activity, Healthcare over servicing, Interest rate sensitive valuations
- Tradeoff between defensive/resilient businesses and price
- IPO fever continues. Investment banks are very good at stuffing distribution pipes.
  - Several examples of inherent risk in IPO’s (VET)
  - The herds are following early ‘successful’ transactions (education, aged care, roll ups)
- Impact of correction in Australian Dollar
- Aged care demand continues to build

How We Pick Stocks

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Research and Analysis | **Portfolio Construction**

IDEA GENERATION

Should be able to say "no" 5-10 times a day

ASSESSING VALUATION

"Can this company generate an after tax cash earnings yield of 6-8%, with growth, at this price?"

OWNING ASSETS

Maybe say "yes" once a month

≈ 25 stocks

Assessment of qualitative and quantitative factors:

- Good businesses
- Competent management
- At the right price

What is a good business model?

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Transparency: what am I buying for every $ I put into company?

Predictability: can we predict the key drivers?

Who has the **POWER** in each stakeholder relationship?

Woolworths **vs.** amcor

Tattersall's **vs.** Goodman Fielder

21st Century Fox **vs.** ten

How do we assess management?

- Core competency required by our process

It's what we do all day

- Build track record of trust
- Regular access (both group and one on one)
- Cross check with info from customers, suppliers, competitors
- Focus on business dynamics rather than next year's earnings
- Sophisticated interview techniques

How do we make money from it?

- Never confuse a Good Business run by Competent Management with a Good Investment

- Our investment thesis focuses on:
  - Margin of safety
  - Quantum and Certainty of After Tax Cash Earnings Yield
  - Regular milestones to test our Investment thesis

- Definition of After Tax Cash Earnings Yield
  - True Free Cash Flow to shareholders / Cost of buying company
  - EBIT + DA – Working Capital – Maintenance Capex – Interest - Tax

DUET Group

What are we buying:

• Dampier Bunbury Pipeline:	50c	$1.2b of value
• Multinet:	26c	$0.6b of value
• United Energy Distribution:	24c	$0.5b of value

Is the regulated asset utility business a good business?

- Economically resilient industry
- Long term monopoly type assets
- No stock and secure debtors
- Very high EBITDA margins with minimal maintenance capex
- Regulated returns based on fair WACC

Is management competent?

- Demonstrated track record of success in required core competencies – particularly achieving good regulatory outcomes
- Demonstrated good capital management skills

Can we acquire it at the right price?

- Current pre-tax cash earnings yield of 9%, paying 7.2% with growth

CSL Limited

What are we buying:

Plasma Fractionation	92c	$27B of Value
Royalties, R&D, Vaccines	8c	$ 3 of Value

Is the Plasma Fractionation business a good business?

- Economically insensitive business
- Large Scale barriers to entry (CSL is lowest cost producer globally)
- “Last Litre Economics” make FDA Approved Suite of Products a necessity
- Very efficient raw materials source – US Collection centre network

Is management competent?

- Consistently under promised and over delivered
- Conservative accounting with good disclosure
- Consistently invested ahead of the curve in long term strategic projects
- Quality sensitive product has reputation of reliability

Can we acquire it at the right price?

- Current sustainable after tax cash earnings yield of 6%, growing at 10%+

Caltex

What we are buying?

- National Import, Distribution & Marketing (IDM) of Transport fuels : 90c $5.4b of value
- Refinery business (Kurnell in Sydney and Lytton in Brisbane): 10c $0.6b of value

Is the IDM business a good business?

- Demand is predictable and non-cyclical, low working capital requirements
- Scale required to procure, store and distribute environmentally sensitive product is important – Caltex has 30% of Australian market
- Reliability brand and Infrastructure required is in situ for Caltex – stable customer base
- Structural growth provides significant margin enhancement shift to high octane fuel and diesel

Is the refinery business a good business?

- Highly capital intensive with volatile earnings pattern, mainly due to variability of crude oil. Its main input cost
- Caltex has announced the closure of the Kurnell refinery (oldest, most capital intensive) from FY14 – will be converted to an import and storage facility

Is management competent?

- Management team has good track record – operationally and integrity
- Prior management was poor, leaving lots of low hanging fruit

Can we acquire it at the right price?

- Sustainable after tax cash earnings yield of 8%, growing at 6-7%
- $1 billion of surplus franking credits

Tatts Group

What are we buying:

• National Lottery business:	63c	$3.0B of Value
• Wagering:	34c	$1.4B of Value
• Other:	6c	$tiny
• Vic Gaming license claim	10c	$0.5b not included

Is the Lottery business a good business?

- Long dated Government regulated monopolies
- No debtors or inventory risk
- No global precedents for dilution barriers created by local brands

Is the Wagering business a good business?

- Lowest cost producer
- No debtors or stock
- Now has a long term contract with protection on supply costs (race fields)

Can we acquire it at the right price?

- Current sustainable after tax cash earnings yield of 6%, growing at 10%+

What Sets Pengana Australian Equities Fund Apart From Other Australian Share Managers

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- We're in the business of **Protecting Capital** & **Making Money**
  (We are not in the business of "Beating the Market")
- Fund structure is set up to accommodate this investment philosophy
    - Ability to go to cash (0-100%)
    - Index agnostic
    - Asset class indifferent
- Capacity limited to maintain performance
- Our clients are our co-investors
- Our definition of risk is different to the general one

Pengana Australian Equities Fund Team

Rhett Kessler
(Fund Manager)

- CA
- CFA

Anton du Preez
(Fund Manager)

- CA
- CFA
- CMA

Mark Christensen
(Investment Analyst)

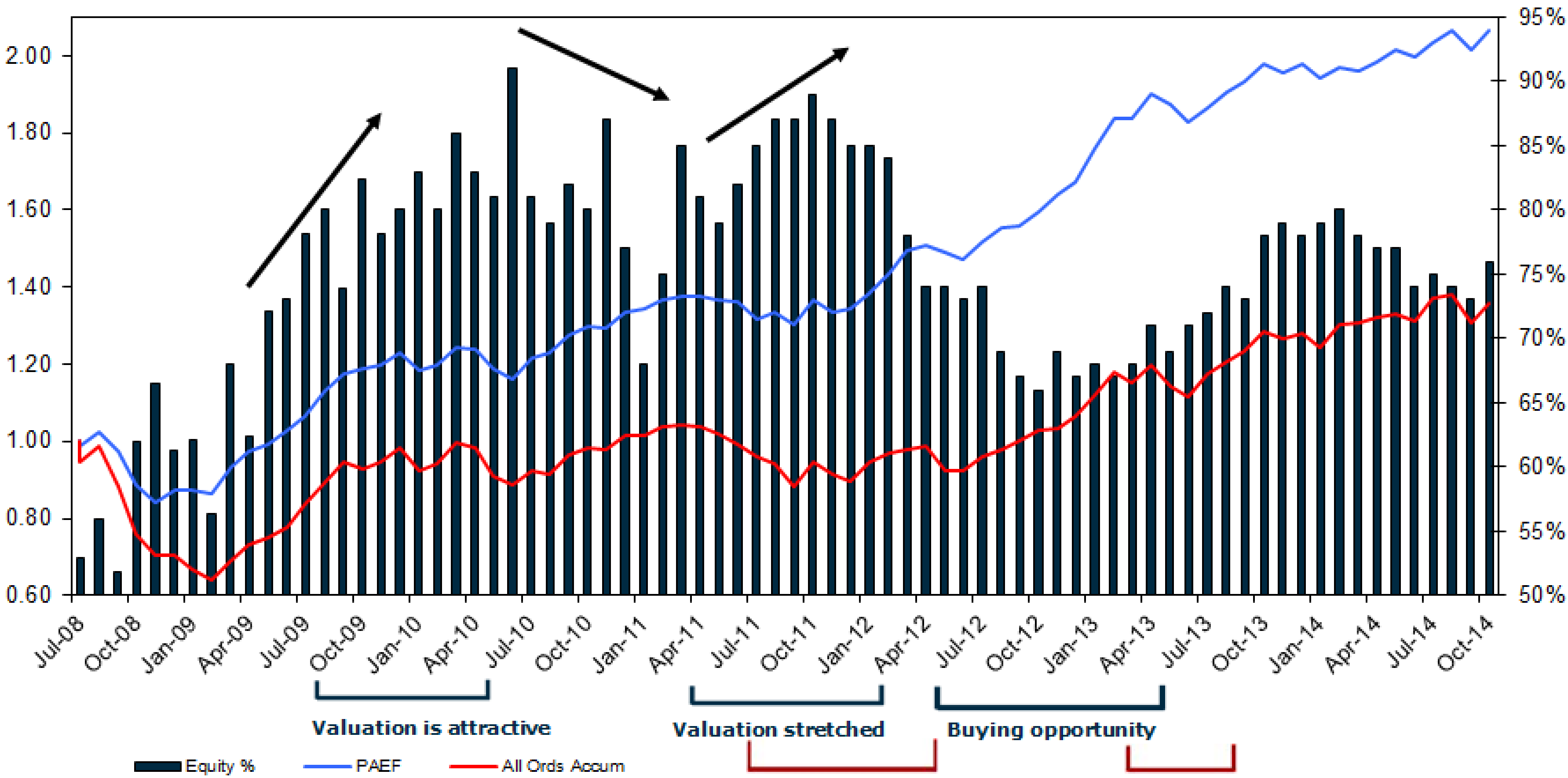
- CA

Steven Glass
(Investment Analyst)

- CFA

	Years in Industry	Experience	Locations	Qualifications
Rhett Kessler	18	IAG Asset Management, UBS, Liberty Asset Management	Sydney (Australia), South Africa	B. Comm. (Accounting)
Anton du Preez	15	Rand Merchant Bank, PSG Asset Management, ABN Amro	Sydney (Australia), London (UK), South Africa	B. Comm. Hons. (Accounting)
Mark Christensen	9	PriceWaterhouseCoopers, Morgan Stanley	London (UK), Sydney (Australia)	B. Comm., B. Business Management, Dip. Applied Finance and Investment
Steven Glass	13	Hunter Hall International, Tricom Securities, Platinum Funds Management	Sydney (Australia)	B. Comm. Merit (Accounting/Finance), Masters Comm. (Advanced Finance)

Cash holdings are an outcome of available investment opportunities



A period where put protection was in place: Oct 2010 – March 2011 ; Dec 2010 – June 2011 ; March 2012 – July 2012
Source: FactSet and Pengana

Portfolio Exposures
(as at 31st October 2014)

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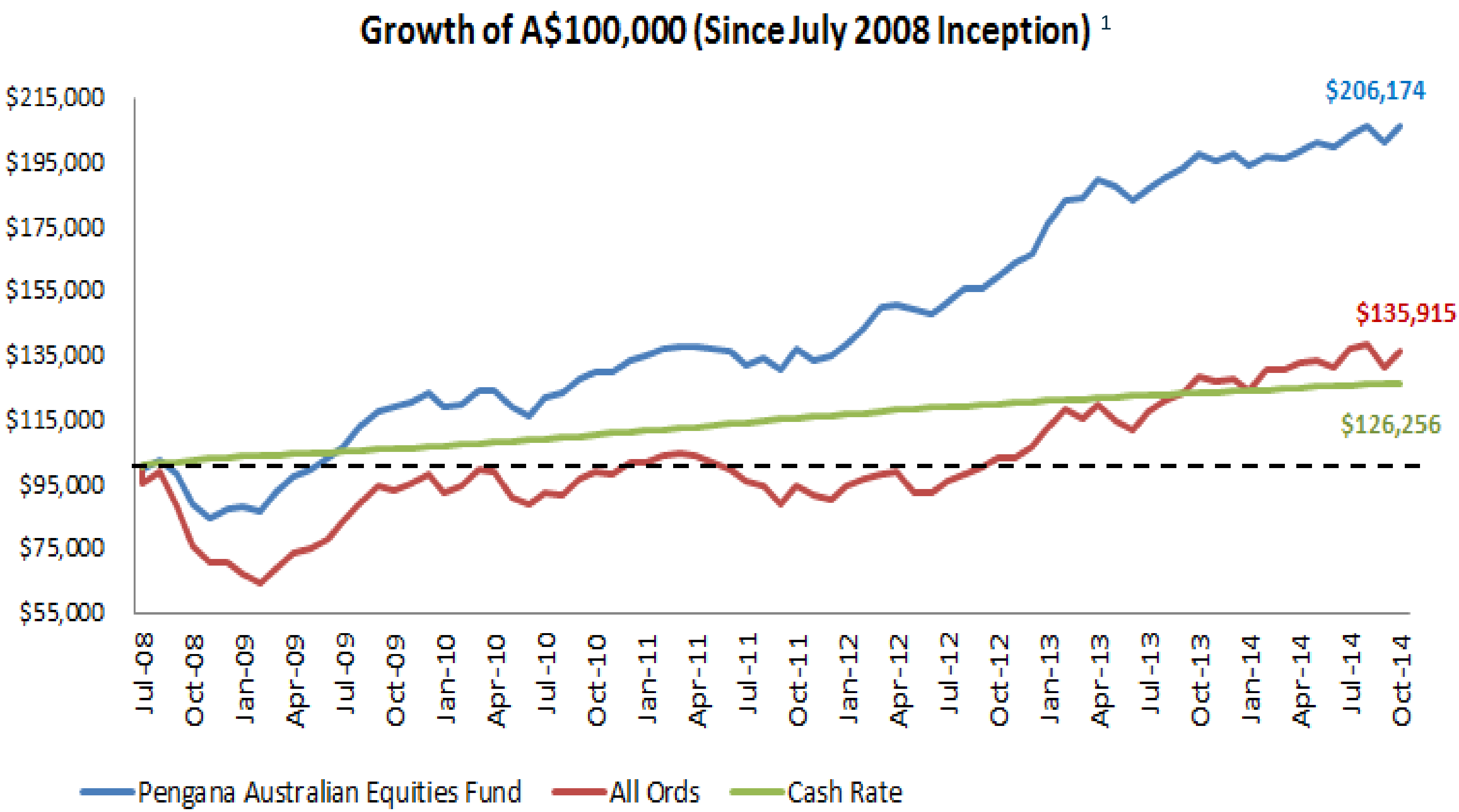
Top 10 Holdings

ANZ	6%
DUET Group	6%
Tattersalls	5%
Resmed	5%
Telstra	5%
CSL	4%
Fox Group	4%
Crown	4%
Credit Corp	3%
Seven West Media	3%

Sector Exposures

Defensive	40%
Financials	17%
Consumer Disc	15%
Commodity Services	2%
Resources	2%
Cash	24%
Non-AUD	25%

Fund Performance



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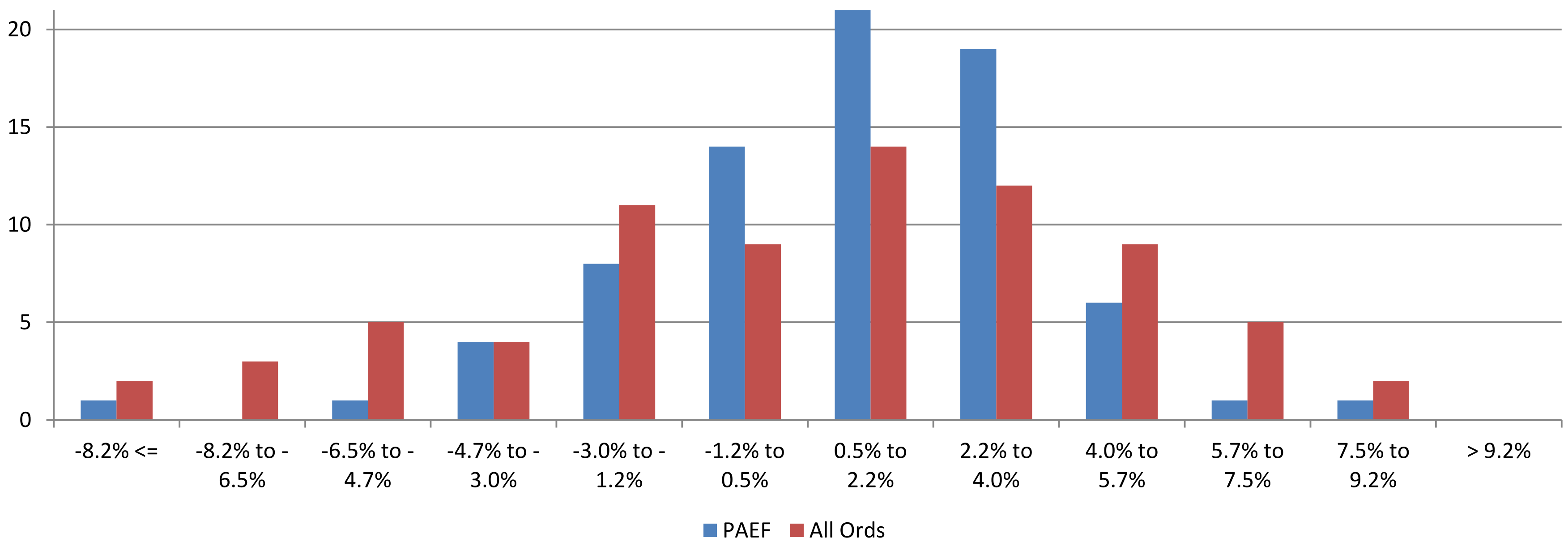
Source: FactSet and Pengana

Fund Performance



Source: FactSet and Pengana

Fund Income and Growth Since Inception (July 2008)

	Pengana Australian Equities Fund			RBA Cash Rate	S&P ASX All Ordinaries Index
As Of Date:	31/10/2014				
	Income Return	Growth Return	Total Return	Total Return	Total Return
1 Mth	0.00%	2.50%	2.50%	0.2%	4.0%
3 Mth	0.00%	1.58%	1.58%	0.6%	-0.8%
6 Mth	6.07%	-2.05%	4.01%	1.3%	2.8%
CYTD	14.36%	9.31%	23.67%	4.9%	27.4%
FYTD	8.48%	4.45%	12.92%	3.4%	21.9%
1 Yr	7.84%	-3.44%	4.40%	2.5%	5.9%
2 Yr p.a.	6.99%	6.75%	13.74%	2.7%	14.9%
3 Yr p.a.	5.94%	8.77%	14.71%	3.1%	12.9%
4 Yr p.a.	5.22%	7.05%	12.27%	3.5%	8.4%
Inception p.a.	4.13%	7.98%	12.10%	3.8%	5.0%

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Source: FactSet and Pengana

Fund Ratings

Research House	Fund rating	Comment
Recommended Lonsec Research *	**Recommended**	Second highest rating
vanEyk	**Rated**	Please refer to Research House for full rating
Zenith Investment Partners – Recommended **	**Recommended**	Second highest rating

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