PENGANA CAPITAL GROUP

January 2022

HOW A 32-YEAR LONG INVESTMENT STRATEGY SUSTAINS PROFITABLE GROWTH INTO AN UNCERTAIN FUTURE

Investors are keenly focused on how policymakers will react to current levels of inflation. Will it subside without robust intervention (as supply chains overcome logistical bottlenecks and new capacity comes on), or will persistent price pressures force central bankers' hands to tighten monetary policy significantly, in order to avoid inflation becoming embedded in consumer and business expectations? When investing in long-duration stocks, valuation methodologies typically entail discounting earnings from far in the future back to the present stock price. These future earnings are then subjected to significant influences such as inflation and interest rates.

These external influences pose a real challenge to valuation methodologies given an investor's inability to predict or control them.

As an investment manager, Harding Loevner has no process for, nor professed skill at, predicting either inflation or its policy responses. They are not practitioners of the (futile, in their opinion) arts of interest rate prognostication, or stock market timing – nor even market-style timing. As hard as they work to value companies, they are cognizant of the imprecise nature of that art.

So how does the investment team deal with prospective inflation?

Rather than trying to predict inflation, Harding Loevner analyse industry and company-specific vulnerabilities to inflation through the lens of Michael Porter's "Five Forces", especially through the relative bargaining power of buyers and suppliers.

That is, they aim to identify **which businesses will be resilient in an inflationary environment due to their ability to pass on whatever higher costs or supply chain frictions they experience.**

More broadly, Harding Loevner looks to evaluate all the forces that shape and define industry profitability and assess the efficacy of the capital allocation decisions that underpin each of the company's long-term growth trajectories.

With inflation merely one variable in, or facet of, that analysis. This bottom-up analysis has kept Harding Loevner optimistic about the potential for continued strong earnings growth from their investee companies, especially considering what they see as high, and sustained, levels of innovation and secular growth in their target markets.

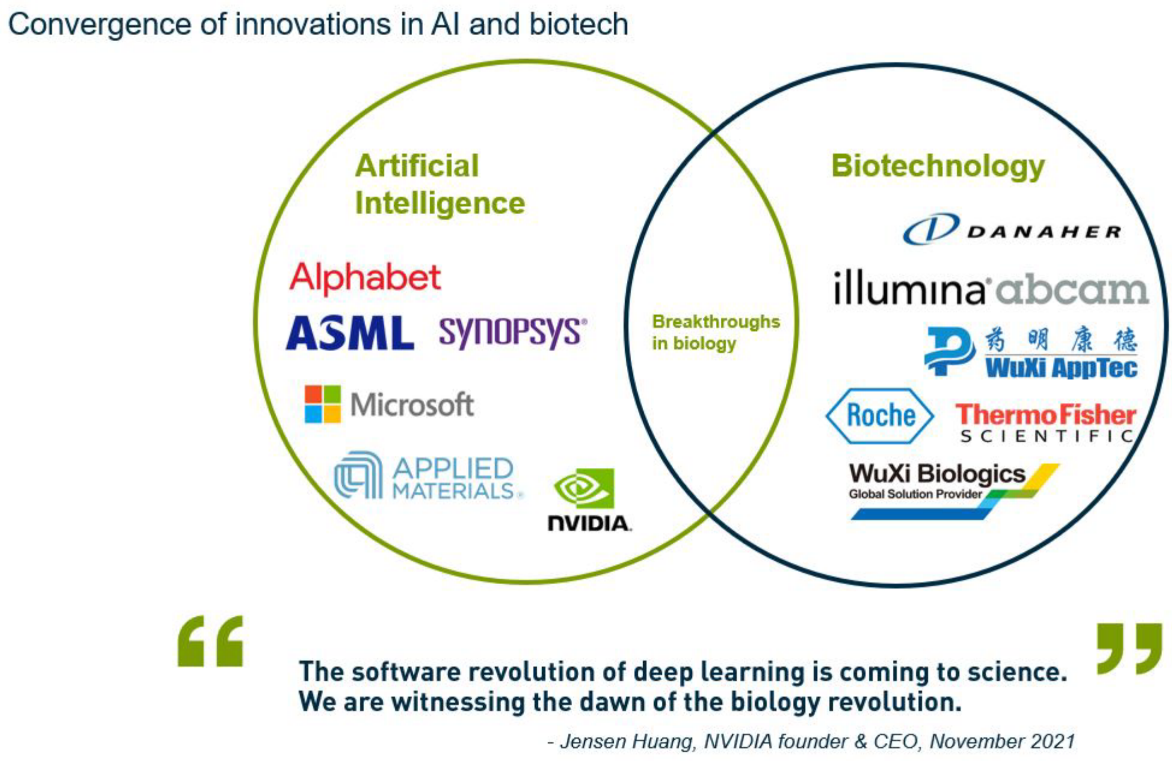
However, that optimism is tempered by the knowledge that, when it comes to precisely assessing stock prices, they are still vulnerable to significant and persistent changes in inflation or interest rates.

The dual existence of a business and its share price underpins why Harding Loevner is always careful to distinguish companies from stocks, both when they consider the investment merits as well as when they write about them. They see their valuation efforts as a quest to detect unsupportable optimism or unwarranted pessimism embedded in share prices, rather than arraying companies precisely along an orderly spectrum of expensiveness with a finely tuned financial model.

The investment challenge boils down to identifying which companies can sustain profitable growth into an uncertain future.

We are living in a time of profound technological innovation enabled by rapid advances in semiconductors and their information processing applications. Companies that substantially contribute to, or benefit from, these innovations enjoy enormous growth tailwinds.

One such example of technology-enabled innovation is the application of artificial intelligence (AI) to drug discovery.



In December, Science magazine designated the use of AI to predict the three-dimensional structure of proteins as its 2021 Breakthrough of the Year. Alphabet's AlphaFold2 program and another, a non-profit effort is known as RoseTTAfold (supported in part by Microsoft) are now able to simulate the 3D structures of proteins rapidly, allowing scientists to model proteins binding and inhibitory functions in the pathway of disease.

The significance to Harding Loevner managing Pengana International Equities Ltd (trading on the ASX as PIA) and the Pengana Harding Loevner International Fund is two-fold.

First, are the direct applications to the holdings. In Health Care these include the state-of-the-art providers of drug development services Wuxi Biologics and Wuxi Apptec, as well as life sciences services and consumables companies Illumina, Thermo Fisher, Danaher, and Abcam – the "picks and shovels" suppliers to the AI-wielding scientists and biotech firms on the frontlines of this golden age of drug discovery. The life sciences breakthroughs are but one example of the remarkable impact AI is having across autonomous transport, logistics, automation, climate science, and many other fields.

The second significance to the portfolio is through the companies helping to make AI possible. Alphabet is one company helping to drive these breakthroughs, as well as NVIDIA, the chip designer whose signature graphic processing units and complementary software are at the forefront of providing the tools to unlock the potential oceans of data involved in AI development. Another key enabler is Synopsys – one of few key providers of software to design chips for the AI age – as are ASML and Applied Materials who provide the critical equipment needed to turn sophisticated chip design into real products.

Companies owned in PIA and the Pengana Harding Loevner International Fund aren't just drivers of change and innovation, they are also subject to its consequences. The disruption that many of these enterprises have unleashed has upended whole industries, creating waves that reverberate back to shake the companies themselves. Paypal, the online payments company that helped eBay disrupt e-commerce, has evolved to become a frenemy of banks and credit cards, as it pursues its goal to become the default digital wallet and singular medium of commerce for consumers worldwide. Harding Loevner has been long-time owners of the company because they recognized how ripe the world's fragmented, byzantine payments systems are for disruption. Paypal has lived up to Harding Loevner's expectations as these trends they identified have unfolded. The company has received an added boost from the acceleration of online payments during the pandemic, the rising popularity of cryptocurrencies, and the positive reception of its Buy Now, Pay Later plan (consumer credit updated for the digital age). Unsurprisingly, the success has caught the attention of venture capitalists and entrepreneurs, who are bringing forth innovative payment technologies from new entrants (Bakkt), older players (Stripe, Chime) and newly renamed ones (Block, nee Square) alike. These incursions have slowed PayPal's growth and given its high valuation; investors have reacted negatively.

However, there is more to the PayPal story. As digital payment services become commoditized, it takes a company of vast scale to be able to cater to the evolving expectations of users at a low marginal cost. CEO Dan Schuman makes this point. “When something becomes commoditized, then distribution, like massive distribution, is important because your margins are low, so you want the maximum amount of distribution.” At this point, PayPal is operating with a base of over 400 million consumers, eleven times it’s next largest competitor, Cash App – and is interacting with some 30 million merchants worldwide. Harding Loevner is watching how PayPal grapples with its competition as it attempts to navigate the next stage of its quest to become the financial super app for consumers globally.

Now, as always, part of the challenge of assessing the sustainability of a company’s growth at rates that are sufficient to justify their elevated valuations comes from the ready availability of less-rapidly growing companies trading at more modest valuations. Time will tell how well these assessments have been made, in the meantime, the shifting views of other investors and changes in the discount rates they employ will have an equal or greater impact on the relative performance than the verifiable progress of the companies themselves.

Pengana International Equities Limited (trading on the ASX as ‘PIA’) is a Listed Investment Company (“LIC”) that exists to provide shareholders with continued capital growth as well as regular, reliable, and fully franked dividends.

The strategy aims to generate superior risk-adjusted returns, through investing in an actively managed portfolio of global companies that meet the team’s high quality and durable growth criteria at reasonable prices. A robust responsible investment framework provides an added layer of risk mitigation.

These companies are identified through the conduct of fundamental research, with a long-term, global perspective, and must exhibit the following four key investment criteria: competitive advantages, quality management, financial strength, and sustainable growth potential.

PENGANA CAPITAL GROUP

Harding Loevner was appointed the investment manager for the Pengana Harding Loevner International Fund, as well as Pengana International Equities Limited (ASX: PIA), on 10th May 2021. Harding Loevner is a New Jersey-based global equity fund manager formed in 1989 with over US$86billion in Assets under Management.

The strategy aims to generate superior risk-adjusted returns, through investing in an actively managed portfolio of global companies that meet the team's high quality and durable growth criteria at reasonable prices. A robust responsible investment framework provides an added layer of risk mitigation.

These companies are identified through the conduct of fundamental research, with a long-term, global perspective, and must exhibit the following four key investment criteria: competitive advantages, quality management, financial strength, and sustainable growth potential.

Pengana International Equities Limited (trading on the ASX as 'PIA') is a Listed Investment Company ("LIC") that exists to provide shareholders with continue capital growth as well as regular, reliable, and fully franked dividends.

More info on PIA can be found at: **Pengana.com/PIA**
More info on the Pengana Harding Loevner International Fund can be found at: **Pengana.com/internationalfund**