Harbour ASSET MANAGEMENT

Equity Fund

Harbour Australasian Equity Focus Fund

31 DECEMBER 2023

1 month performance	1 year performance	Fund size	Performance since inception
8.01%	**11.45%**	**$84,740,392**	**11.54%**
Before fees & tax	Before fees & tax	NZD	Annualised, before fees & tax. Inception 10/4/2014

Fund performance was positive and ahead of its benchmark for the month and quarter. Share markets rallied on further signals from central banks (particularly the US Federal Reserve) that they are ending their interest rate increase cycle. Longer term bond yields continued to fall supporting share market valuation metrics and triggering investors to increase investment in shares. Lower rates also triggered a last-minute year-end rush of takeover proposals for several New Zealand and Australian listed companies.

Over the month fund performance was boosted by positive returns from investment in takeover candidate Volpara Healthcare and investments in growth shares Summerset, Goodman Group, CSL and Auckland Airport. Underperformance from IDP Education, Ebos, Kathmandu, Serko and QBE detracted from fund performance. Over the quarter the fund performance was enhanced by investments in growth shares Volpara, Goodman Group, CSL, Auckland Airport and Macquarie Group. Key detractors were investments in underperformers Telix, Ryman, Pilbara, Kathmandu and Serko.

Performance	1 MONTH	3 MONTH	1 YEAR P.A.	2 YEAR P.A.	3 YEAR P.A.	5 YEAR P.A.	10 YEAR P.A.	SINCE INCEPTION P.A.
Return before fees & tax, inc. IC	8.01%	6.64%	11.45%	-6.80%	0.15%	10.06%	-	11.54%
Benchmark return, inc. IC	5.74%	6.53%	8.49%	1.16%	3.53%	9.00%	-	9.29%

Inception: 10 April 2014. IC= imputation credits. Benchmark: 50% S&P/NZX 50 Index & 50% S&P/ASX 200 Index (50% hedged to NZD). Past performance is not indicative of future results.

Key market movements	1 MONTH	3 MONTH	1 YEAR P.A.	3 YEAR P.A.	5 YEAR P.A.	10 YEAR P.A.
S&P/NZX 50 Gross Index with Imputation (NZD)	3.96%	4.30%	3.51%	-2.72%	6.79%	10.64%
S&P/ASX Total Return 200 Index (NZD)	7.67%	8.76%	12.99%	9.45%	10.87%	7.87%
S&P/ASX Total Return 200 Index (AUD)	7.26%	8.40%	12.42%	9.24%	10.28%	7.93%

Source: S&P/NZX, Bloomberg.

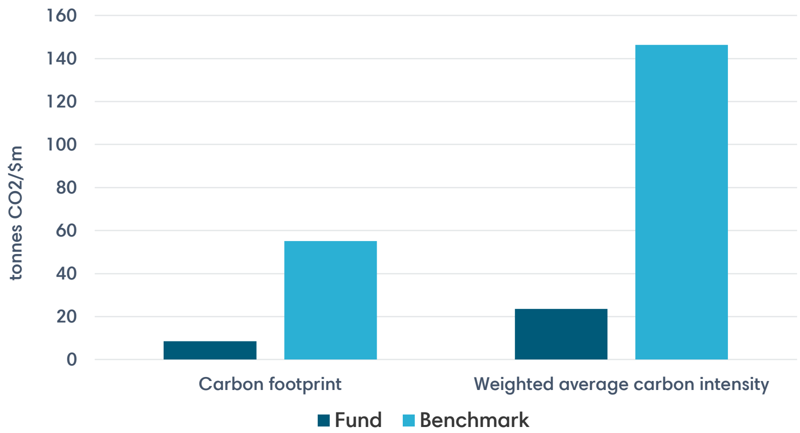
Fund characteristics

	FUND
Return on equity	11.47%
PE ratio forward 12 months	22.6x
Gross yield	1.95%
Expected volatility	15.42%
Hedge on AUD exposure	4.66%

Top 10 holdings

	POSITION
Summerset Group	8.04%
Infratil	7.63%
CSL	7.52%
Mainfreight	7.47%
Auckland International Airport	6.43%
Xero	6.12%
Goodman Group	6.07%
Macquarie Group	5.25%
Ryman Healthcare	4.65%
Volpara Health Technologies	4.37%

Carbon statistics



Carbon Footprint tonnes CO2e emissions per million NZD invested.
Weighted Average Carbon Intensity tonnes CO2e emissions per million NZD revenue.

Metrics are calculated according to the methodology of the Task Force on Climate-Related Financial Disclosures (TCFD) Implementation Guide. Data is the latest available and represents the portion of the fund invested into public equities. Additional information on screening thresholds and processes are outlined in the exclusions section of our ESG Policy
Carbon data source: Harbour Asset Management, ISS ESG, Bloomberg, underlying fund managers

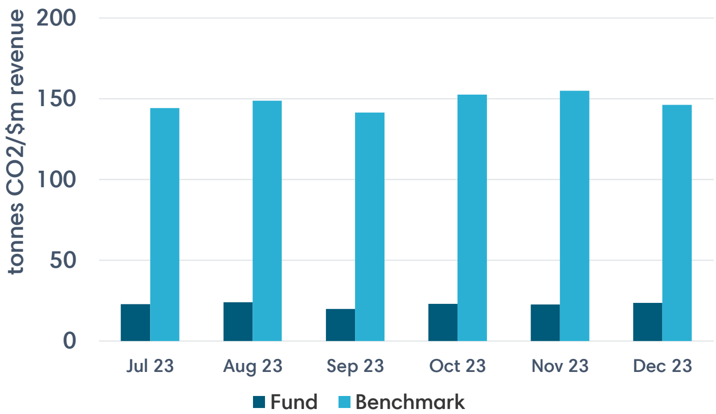
Note: The carbon statistics presented have been adjusted for the extraordinary circumstance of the Channel Infrastructure holding based on data from its latest sustainability report which includes the decommissioning of its refinery operations.

ESG metrics summary

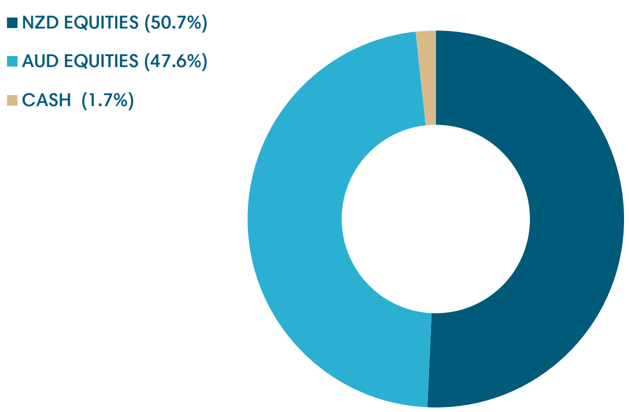
	FUND
Gender diversity (workforce >40% female representation)	56%
Modern Slavery Statement	60%
TCFD Reporting	50%
Majority Independent Board	83%
Science Based Target	22%

Source: Bloomberg, Harbour Asset Management

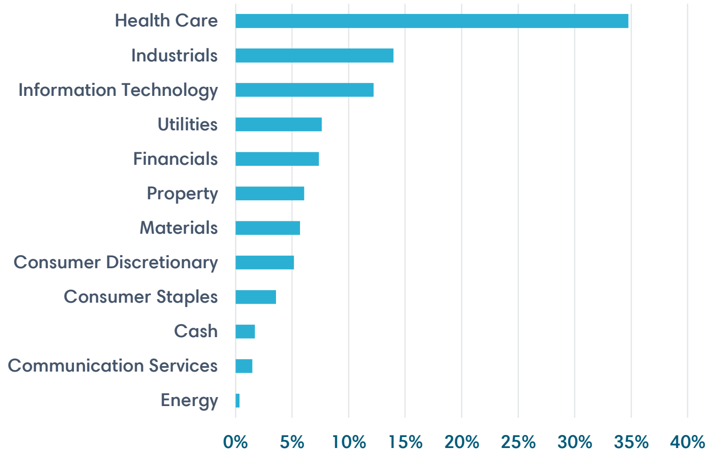
Weighted average carbon intensity



Investment mix



Sector weights



Source: MSCI

Monthly attribution

Largest contributors	AVE. POSITION	TOTAL CONTRIB.	STOCK RETURN
Volpara Health Technologies	3.90%	1.33	38.65%
Summerset Group	8.10%	0.81	10.08%
Goodman Group	6.05%	0.73	12.21%
CSL	7.55%	0.73	9.69%
Auckland International Airport	6.63%	0.73	11.08%

Largest detractors	AVE. POSITION	TOTAL CONTRIB.	STOCK RETURN
IDP Education	3.80%	-0.47	-11.28%
EBOS Group	3.77%	-0.16	-4.12%
KMD Brands	1.88%	-0.05	-2.59%
Serko	3.66%	-0.04	-1.23%
QBE Insurance Group	1.04%	-0.04	-3.17%

Quarterly attribution

Largest contributors	AVE. POSITION	TOTAL CONTRIB.	STOCK RETURN
Volpara Health Technologies	3.42%	1.67	52.86%
Goodman Group	5.87%	1.09	19.05%
CSL	6.88%	1.09	14.77%
Auckland International Airport	7.20%	0.72	11.17%
Macquarie Group	5.11%	0.61	11.59%

Largest detractors	AVE. POSITION	TOTAL CONTRIB.	STOCK RETURN
Telix Pharmaceuticals	2.56%	-0.32	-11.29%
Ryman Healthcare	4.63%	-0.30	-6.28%
Pilbara Minerals	0.81%	-0.26	-17.60%
KMD Brands	2.11%	-0.24	-10.53%
Serko	3.78%	-0.23	-5.86%

Outlook and strategy

The US Federal Reserve (the Fed) signalling an end to its official hiking cycle during the December month opened the gates for a flood of cash into equity markets. The Fed pivot saw capital markets quickly focus on when and by how much the Fed and other central banks would cut official interest rates. After a lower than expected (+3.2% year on year to November) core Personal Consumption Expenditure (PCE) deflator inflation reading (the Fed's preferred measure of inflation) capital markets are now pricing in a 100% chance of a US Fed official interest rate cut in March and six 0.25% rate cuts over the 2024 year, which would see the Fed Funds rate sit at circa 3.75% versus the 5.25-5.5% range at the end of 2023. Institutional and retail investor money came off the sidelines from money-market funds into equity markets on expectations that current high yields offered in money market funds would fall early in the first quarter of 2024. The flood of capital contributed to a broadening in sectors and shares delivering positive returns during the period. The New Zealand and Australian share markets also benefited from the global cost of capital drop from lower government bond yields post the Fed pivot.

The New Zealand share market delivered a solid return over the December month supported by a 0.56% fall in New Zealand 10-year government bond yield over the month to 4.32%. The New Zealand share markets saw the negative impact of earnings downgrades during the period from consumer facing and economic activity sensitive companies (including Air New Zealand, Heartland Group, Kathmandu and Sky City) and a block sell down in Channel Infrastructure offset by lower bond yields and a flurry of merger and acquisition (M&A) proposals (including Arvida) that highlighted valuation anomalies in parts of the share market. The best performing New Zealand share market industry sectors for the month were information technology (+16.5% over the month, led by Vista group), consumer staples (+8.2%, led by Fonterra and Scales), and property (+7.3%, led by Investore and Stride). The worst performing New Zealand sectors over the month were energy (-2.5%. hit by Channel Infrastructure), communications (+0.8%, Spark NZ lower after completing its share buyback) and financials (+0.9%, hit by Heartland) . The main positive contributors to the S&P/NZX50 index over the month were Auckland Airport, Meridian and a2 Milk, with Ebos, Heartland and Air New Zealand providing the largest negative contributions for the month.

The best performing New Zealand share market industry sectors for the December quarter were information technology (+18.1% over the quarter), communications (+6.9%) and property (+6.6%). The worst performing New Zealand sectors over the quarter were energy (-5.4%), financials (-3.7%) and consumer staples 0%). The main positive contributors to the S&P/NZX50 index over the quarter were Fisher and Paykel Healthcare, Auckland Airport and Spark NZ, while Ryman, Heartland and Air New Zealand provided the largest negative contributions for the quarter.

The Australian share market was one of the best performing global share markets over the month supported by a 0.46% fall in Australian 10-year government bond yields over the month to 3.96%, a flurry of M&A proposals which highlighted valuation gaps, and a slight increase in consensus earnings revisions for the broader Australian share market during the month. The best performing Australian share market industry sectors for the month were property (+11.5% over the month), healthcare (+9.1%) and materials (+8.8%). The worst performing Australian sectors over the month were utilities (+2.5%), energy (+3.4%) and consumer staples (+5.1%). The best performing Australian share market industry sectors for the December quarter were property (+16.6%), materials (+13.4%) and healthcare (+13.1%). The worst performing Australian sectors over the quarter were energy (-9.1%), utilities (-2.1%) and consumer staples (+0.2%).

Merger and acquisition (M&A) activity heated up over the month with several transactions being announced across both New Zealand and Australia. With a plateauing in the cost of capital companies are looking to grow through acquisitions. This maybe a theme which continues to play out over the next year. Wellington based and long-term holding in Harbour portfolios **Volpara Health Technologie**s received a bid from Korean based Lunit Inc at $1.15 per share, a 47% premium to Volpara's closing price on 13th December. Volpara provides software for the detection of breast cancer and the transaction it is expected to accelerate Volpara's ability to serve its purpose.

Aged care operator **Arvida Group** provided an update to the market in December that it had been approached in September this year with a proposed non-binding indicative offer of $1.70 per share. Despite the offer being at a healthy premium to Arvida's share price at the end of September of $1.22 per share, the company has dismissed the approach on the basis that it isn't in the best interest of shareholders.

In the week prior to Christmas there was also a flurry of activity in the Australian share market with takeover offers for financial administration services company Link Administration (from Japanese listed company Mitsubishi UFJ), construction materials company Adbri (from competitors Irish listed CRH and private company Barro), and dental centre operator Pacific Smiles (from Genesis Capital). Globally we also saw a takeover offer for US Steel by Nippon Steel to create the world second largest steel company.

Shares in pharmaceutical company **CSL** continued to outperform the market over December with a bounce back in sentiment towards healthcare stocks following the fall in longer term interest rates and snippets of re-enforcing data from the company highlighting the benefits of their products. CSL updated that their Behrings Hemgenix product for the treatment of haemophilia b is the first and only gene therapy approved by the US Food and Drug Administration (FDA) to show sustained efficacy and safety at three years post treatment. The CSL share price also received a boost after biotechnology competitor Argenx announced the failure of another trial for the use of its Vyvgart treatment this time investigating the use of the treatment of pemphigus. Pemphigus is a rare disease and is only responsible for 1-2% of the global demand for immunoglobulin (also known as IG, the most type of antibody found in blood circulation). Argenx is now reconsidering its other trials into new indications, prioritising clinical development of Vyvgart in its ongoing severe autoimmune indications. This raises question marks around therapies competing with CSL IG not being as successful as previously assumed. 2024 may also be a watershed year for CSL with outcomes from their CSL112 phase 3 trial expected in the first quarter 2024. This new potential product is described as a chemical vacuum cleaner for plaque and cholesterol in the heart with the market not yet ascribing any value or earnings in forecasts.

Shares in retirement village operator **Summerset** and other listed retirement/aged care companies moved higher reflecting potential sector M&A (Arvida) and the steady improvement in New Zealand residential property turnover. A steady fall in the average number of days sell a residential property is helpful for improving the cashflow for listed retirement/aged care companies that has put financial pressure on some operators. Real Estate Institute of NZ (REINZ) data for November showed house prices increased on unchanged sales and a slight lengthening in days to sell. New Zealand house prices increased 0.4% in the November month and are 14% below the November 2021 peak. Days to sell increased to 42.5 in November up from 40.6 days in October (versus a long-term average of 39.3 days). This increase may have reflected an increase in stock to sell with real estate agents reporting a surge in new listings as the New Zealand residential market 're-opened'. The new National-led government may encourage a reacceleration in house prices over the summer, as they plan to reintroduce interest cost deductibility for landlords and change the "bright-line" property rule for capital gains on investment properties to 2 years (from 5 years for new builds and 10 years for other properties). Late in December in a further boost to residential property markets several banks began cutting their 2-year mortgage rates reflecting, but still lagging, a fall in 2-year forward swap rates.

The share price for industrial property owner and developer **Goodman Group** continued to track higher through the period reflecting value adding acquisitions, a positive peer update and increasing investor understanding of the opportunity for Goodman to add value with additional data centre developments. Goodman management announced the purchase of 50% of the M7 Hub (three multi-unit industrial properties in Sydney) from Brickworks for A$117m, which gives Goodman 100% control of the property post-acquisition. Goodman's US listed peer Prologis provided an upbeat update at its annual investor day held in December including tenant demand remaining high for productivity enhancing warehouse and logistics facilities with many retailers trying to catch up with Amazon, low levels of new development supply with speculative developers unable to get funding, and detail on property related energy and data centre investment opportunities – all of which Goodman may also be able to benefit from. Our research indicates Goodman Groups data centre growth sleeve remains undervalued by the share market.

Accounting software as a service provider **Xero** saw a share price recovery over the month after Xero announced price increases and the UK Government reiterating timing for the next stage of Making Tax Digital (April 2026, applying to 1.75m small businesses) which may support UK subscriber growth for Xero. Xero announced global price increases to entry level Partner edition products, namely its ledger and cashbook products, ranging between 1% to 27% which was higher than expected and relative to historical increases, albeit the increase is for a smaller, lower dollar value entry level subset of customers. The impact from these changes to overall group average revenue per user (ARPU) will be in the low single digits (an estimated +2-4%). While modest this increase supports market consensus ARPU growth expectations of 5-10% in financial year 2024 and 2025.The price increases are consistent with Xero's strategy to optimise growth and profitability through balancing subscriber growth with price to ensure adequate value is extracted from its customers – something that our research suggests the share market is yet to fully reflect in the Xero share price.

The share price of building material producer **James Hardie** also continued to move up reflecting positive customer updates and the potential for demand for its products to increase as US mortgage rates fell, particularly in its core repair and remodelling market. Several of James Hardies listed US home building customers reported better than expected demand for new homes as interest rates have begun to fall in the US. Repair and remodelling product demand has the potential to increase as turnover of existing homes may increase with lower mortgage rates (homeowners tend to renovate prior to or post purchases).

Horticulture, protein and primary produce logistics company **Scales** provided a positive trading update which reassuringly highlighted a bounce back in momentum for the company following the impact of cyclone Gabrielle, with apple production volumes now forecast to be better than initially though post cyclone. Whilst financial 2023 guidance was unchanged the company provided for the first-time financial year 2024 guidance which is at the higher end of market expectations. The key driver to the 2024 improvement is the expected recovery in the horticulture division with a solid forward order book for premium apple varieties in Asian markets, a promising 2024 crop and a benefit from foreign exchange and shipping tailwinds.

Film industry software company **Vista Group** provided several positive updates over the month highlighting the conversion of clients to their cloud platform including European exhibitor Pathe Cinemas, Southeast Major Cineplex and the world's largest exhibitor Cinepolis. Vista also confirmed the completion of the business transformation project streamlining go to market practices and reshaping of the global workforce by 8% and removing $10m of annualised costs.

Shares in **Auckland Airpor**t were stronger reflecting lower bond yields and a better-than-expected outcome from the New Zealand Commerce Commission final report on the Input Methodology review which reduces the risk around Auckland Airports aeronautical prices to be charged from 1 July 2027 (prices setting event 5, PSE5). The main changes to inputs announced were an asset beta of 0.67, which is up from 0.55 in the Commerce Commissions draft report released in June. While this is positive the Commission is currently working on a separate review into Auckland Airport's prices for the current PSE4 period after revised aeronautical prices for that period were announced in June and applied from 1 July 2023, with the draft decisions from the PSE4 review due in May. There is some risk that the Commerce Commission lands on a lower return for PSE4 than reflected in Auckland Airports PSE4 aeronautical charges. Recent passenger volumes continue to show a positive pace of international arrivals but a slowing pace of domestic passenger volumes. Importantly retail income has the potential to beat expectations with passenger spend rates improving.

During December Exxon Mobil sold its entire stake (14.2%) in pipeline and storage operator **Channel Infrastructure** at $1.35 per share, a 10% discount to Channels $1.50 closing price for the preceding day. The need for Exxon Mobil to be an equity holder in Channel diminished with the Channel operation turning from a refinery to a tolling storage and pipeline transport operation. 2024 may see further opportunities to invest further in infrastructure assets with the possibility of other major sell downs in Channel. During the month Bay of Plenty council also announced the review of its 54% shareholding investment in the Port of Tauranga. Wellington council has also announced a similar review with regards to its holding in Wellington Airport.

On the negative front we saw profit guidance downgrades from cyclically facing companies which we have been avoiding and remain wary of. **Air New Zealand** downgraded earnings forecasts with continued softness in domestic corporate and government travel, and more recently a greater price sensitivity in domestic and trans-Tasman leisure travel. Pent up short haul (domestic and trans-Tasman) travel demand following Covid may have waned, and cost of living pressure may be impacting on some travellers. Increased competition on North American routes is providing consumers with choice and holding back yields on Air New Zealand's US and Canadian operations. Ongoing engine issues are also limiting Air New Zealand's ability to grow its available capacity profitably in the near term.

Sky City also provided a trading update which also highlighted the pressure on the domestic economy. Weakness in electronic gaming machine revenues across all properties was cited as the key driver with shrinking consumer discretionary expenditure a headwind.

Lifestyle brand owner and retailer **KMD Brands**, the owner of Kathmandu, Rip Curl, and Oboz, provided a disappointing update for the four months to November 2023 which was below consensus market expectations. Year-to-date KMD Brands group sales through the first four months is down -12.5% versus the prior year. Weaker Kathmandu trading (-21.6% on the prior year) was primarily driven by rainwear and insulation in Australia, while Rip Curl (-5.7%) and Oboz (-18.2%) were affected by inventory destocking in wholesale channels. Positively, KMD noted group gross margin has improved year on year (first half 2023 circa 59%) and operating costs appear to be well controlled, mitigating some of the impact from operating deleverage from lower sales. Despite a gross margin recovery, and cost out measures taken, operating deleverage contributed to a circa -NZ$16m decline in earnings before interest tax depreciation and amortisation (EBITDA) for the four months against the prior year. Positively KMD noted a -10% reduction in group working capital on the prior year, and it expects its continued focus on balance sheet management to drive strong cash flow generation in the second half of financial year 2024. The KMD Brands share price has been aggressively sold down by the market on what may be conservative company guidance given opportunities to improve margins (e.g. freight rate improvements and lower price discounting).

Student placement and English language test provider **IDP Education** shares fell as student visa data across Australia, Canada and the UK has been mixed, and on concerns potential changes to UK and Australian Government migration rules may reduce future student placement volumes. Our research suggests that tightening in migration rules is likely to lead to a reshaping of the student placement industry favouring businesses with strong relationships with the best education institutes and technology advantages, with IDP Education better positioned through its investment in technology than its competitors in this reshape.

Shares in medical supplies distributor **Ebos** continued to underperform the market following its failed M&A attempt at the Greencross assets. Perhaps the bigger influence in December was the announcement of a reverse takeover of Sigma Healthcare by Chemist Warehouse, which will see a stronger competitor to Ebos in the distribution market and for the first time the opening to listed capital markets for Chemist Warehouse. However, Ebos may see upside from independent pharmacies who may not be enamoured with being distributed from a major competitor.

Shares in insurance company **QBE** fell as the market allowed for the potential for lower interest rates. QBE's reserves boost its earnings when interest rates are higher. The QBE share price may also have been impacted by expectations of large losses associated cyclonic activity in Queensland over December.

Australian health insurance provider **nib Holdings** shares finished the month down after investors sold the share after the details of the Australian National Disability Insurance Scheme (NDIS) review released during the month were considered to be below expectations. Investors were concerned with the review recommending a consolidation of the NDIS ecosystem and the proposition of a 'digital payment system' that would erode nib's role in the value chain. While the 'digital payment system presents minor earnings risk, we believe nib has established itself to win in the new consolidated ecosystem.

Training and professional services company **APM Human Services** was also impacted by the NDIS review release. APM currently serves more than 35,000 NDIS participants and is expected to gain advantages from government efforts included in the NDIS review aimed at stricter compliance and removing unnecessary intermediaries and non-compliant small providers. APM's operational efficiency, scale advantages, market size, extensive social service experience, and high star rating puts it in a favourable position to benefit from these initiatives. APM's NDIS and Allied health business are estimated to have made up 5% of financial year 2023 revenue but it is the fast-growing segment for APM (estimated growth of 20% for financial year 2024).The APM share price continue to track lower over the period with the market continuing to reflect APM's lower earnings guidance provided at its November annual shareholder meeting. APM's business mix tends to benefit from an increase in unemployment, with current low levels of unemployment limiting earnings growth near term.

Outlook – Melt up?

The US Federal Reserve signaling the end of its interest rate hiking cycle, with Fed Chair Powell suggesting that the risk of over-tightening triggering a recession meant rate cuts were a possibility, contributed to a 'melt up' in share markets globally over the period with hot cash being put to work in share markets driving returns. Over the past two years, most investor interest has been on how to navigate a hawkish, rate increase biased, central bank policy. A more balanced monetary policy setting (official rates not being increased rapidly) and earning expectations basing locally provide a more constructive framework for local share market returns, with the local New Zealand and Australian share markets starting to offer a useful alternative for income focused investors after the sharp drop in long-term Government bond yields over the last few months.

Capital markets may have gotten ahead of themselves in assuming an aggressive official interest rate cutting (monetary policy easing) environment. While we are of the view interest rates should have fallen and the trend in interest rates is lower, we continue to focus on the link between interest rates and earnings expectations. After a strong 'everything melt-up' recovery in share markets we expect the reemergence of volatility as capital markets establish where interest rates are likely to range in a more balanced central bank framework and where earnings expectations land in a slower economic growth environment. Research highlights that shares in the structural growth sectors of healthcare and technology which the fund favours have historically outperformed on average following central bank rate cuts, but we also know the term 'average' can be misleading when considering capital markets.

Central bank monetary policy official cash rates may be too high if central bankers want to avoid a recession. Disinflation (falling inflation) has continued into year-end as supply chains have normalised (including new shipping capacity growth offsetting recent Red Sea vessel diversion) and as the cumulative impact of interest rate increases on over the last two years have the desired effect for central banks in slowing demand. At a +1.9% annualised basis for the 6 months the November US PCE reading supports cuts to US Fed official interest rates – whether there should be the 6 or more cuts in 2024 starting potentially in January that are priced into forward rate expectations is yet to be proven.

If there are official interest rate cuts what does history teach us for share markets? Research by Morgan Stanley shows us that assuming an 'average' response can be misleading for the US share market (and for local share markets). Looking at historical rate cutting events on 'average' the benchmark US S&P 500 share market index gains +10% in the year following the first Fed cut. However, data back to the 1970s shows that setups into a first-rate cut vary, as do eventual outcomes. Cuts in response to significant macro weakness are often associated with weaker returns. Policy normalisation against a more sanguine economic backdrop can lead to strong market returns, with this being the setup markets are currently assuming.

Our economic central case remains for an orderly slowing in global economic activity (resilient but including a potential technical recessions), rather than a full-blown recession. If the next step lower in inflation proves stickier and inflation rates remain above central bank targets, then the move in bond yields may have overshot near term. In contrast recession risks may be being underappreciated by share market investors. We would not be surprised to see bond yields oscillate around current levels reflecting economic data points and expect share market volatility will increase as bond markets land on how far and how fast interest rates need to fall – just as the ride up in interest rates was volatile for share markets so too will be the ride down in interest rates.

Tight monetary policy settings from the Reserve Bank of New Zealand (RBNZ) may begin to be challenged by slowing economic data points. ANZ's truckometer activity index for November showed a 1.7% month on month increase for light traffic (following two months of falls) while the heavy traffic lifted 1.0% month on month. While the trends are positive, they are pretty flat when considering strong population growth, consistent with an economy that is slowing in per capita terms. The New Zealand Consumer Confidence index for December showed an improvement to 88.9 from 80.2. While this is the highest reading since quarter 1 2022 it is still at a depressed level consistent with sluggish consumer spending continuing, well below the long-term average around 110, and not much above the GFC low. Importantly the consumer confidence index reading included a big fall in inflation expectations from 4.6% to 3.9%. New Zealand capital markets are starting to anticipate more balanced policy statements from the RBNZ – at December month end the market priced five-year swap rate at 4.09% is 1.3% below the 13-year high of 5.39% we saw just two months ago.

The Reserve Bank of Australian (RBA) is likely to be slower to move official interest rates lower just as it has been slow to increase rates. While accelerating migration is beneficial overall, it may make containing inflation a tougher task for the RBA in the near term and sustain rate pressure on the domestic Australian economy. Potential changes to migration policies may reduce this pressure. While both the RBNZ and RBA may be at the end of their interest rate hiking cycle they may choose to stay 'higher for longer,' until the potential market/consumer weakness forces them to reconsider.

Current inverted yield curves (near term rates higher than longer-term rates) have historically been an ominous sign for economic activity (with a lag of typically 12-18 months). But the prospect of less aggressive central bank monetary policy may allow investors to focus on what drives long term share market returns – earnings growth.

Earnings growth expectations for the New Zealand and Australian share markets remain conservative, with single digit three-year annualised compound annual growth forecasts below long run average levels that have been delivered across both markets. But as the earnings downgrade from earnings downgrades during the period from consumer facing and economic activity sensitive companies (including Air New Zealand, Kathmandu and Sky City) there is a tail risk from the rapid increase in interest rates we have seen over the last year. The consumer sensitive retail and tourism sectors are exposed to the faster pass though of the more immediate impact of mortgage increases on household budgets due to short term variable mortgages in New Zealand and Australia versus the long-term fixed mortgage terms in the US. Consensus earnings revisions for the broader Australian share market turned marginally positive (+0.1%) during the month mainly driven by the materials and information technology sectors. However, revisions over the past three months remained negative (-0.2%). Consensus expectations are for Australian share market earnings to fall by -4.2% in financial year 2024 and to bounce back by +2.4% in financial year 2025.

The risk for broader New Zealand equity market earnings expectations remains the emergence of an economic recession, but we would expect official interest rates to be cut aggressively to offset the emergence of an economic recession. Local economic lead indicators are mixed but don't point to a recession. What they do point to is a period of time when some industry sectors will continue to do well while others face tough times. We would not be surprised to see further downgrades to profit guidance from local cyclical companies in the new year, but this may represent a low point in earnings after a reset in economic activity.

In our view it is important to be selective and focus on those business able to benefit from long term secular tail winds, particularly when competitors have been destabilised by the cost of capital reset over the last year. Secular trends are long-term, deep-rooted changes that are external to the markets – trends like demographics, digitisation (including generative artificial intelligence, GenAI), industry disruption and decarbonisation. We continue to seek invest in companies with the management factor to convert secular tail winds into compound growth for investors. The management factor is about people, their industry awareness and their understanding of capital management. Historically periods of increased focus on company fundamentals, like the emerging environment, have contributed to better returns for investors.

While capital markets may have moved too fast to price in the timing and degree of rate cuts the trend in official interest rates is lower. The combination of lower long term Government bond yields post the Fed pivot and low credit spreads have eased financial conditions globally, reducing the cost of capital for companies, boosting the valuation of long duration assets including parts of the share market, and restarting parts of the capital market that have been dormant over the last year. A flurry of merger and acquisition (M&A) proposals over December 2023 month across parts of the New Zealand and Australian share markets highlights the sometimes large gap between the private market and public market valuation of entities. There are several factors that may have influenced the timing of outbreak of New Zealand and Australian M&A including the fall in interest rates in the fourth quarter of 2023, expectations of USD currency weakness (non-USD asset hedge) and listed Japanese companies under pressure to close price to book discounts (as directed by the Tokyo Stock Exchange).

But ultimately the M&A flurry may just be about providing 'cheap' growth for acquirers where public markets are mispricing potential cashflow growth, cashflow quality and cashflow timing. Public market investors have in some cases struggled with the rapid increase in interest rates over the last two years and what a higher cost of capital means for how to value companies listed on share markets. With markets now pricing in an interest rate easing cycle and with organic growth harder to come by as economic activity slows, companies are back exploring growth through acquisitions including merging with or taking private listed companies.

Generally New Zealand and Australian listed company balance sheets remain under geared relative to history providing the financial ability to actively engage in M&A activity. Research by Goldman Sachs indicates that over 80% of the companies included in the Australian ASX 200 (ex-financials) benchmark index has forecast Net Debt to EBITDA multiple of less than 2x, while a third of ASX 200 (ex-financials) firms are in a net cash position. We would not be surprised to see a further round of M&A breakout in parts of the New Zealand and Australian share markets as interest rates stabilise highlighting valuation mispricing in parts of the publicly listed market.

The valuation metrics for New Zealand and Australian share markets remain reasonable given the potential for an earnings recovery and given they now offer an income option that is competitive versus yields offered by Government bond yields for income focused investors. We expect decelerating inflation and central bank easing will keep real yields low and support price to earnings (PE) valuation multiples. Post December's earnings forecast downgrades the New Zealand share market is currently being priced at a 21.5x price to one year forward earnings per share forecast multiple (PE), a 6% premium to its 5-year average (excluding the January 2020 to January 2022 impacted covid period) of 20.3x. The New Zealand share market currently offers a gross dividend yield of 4.7% post recent forecast cuts which is becoming more attractive for income focused investors relative to 10-year New Zealand government bond yields trading at 4.32%. The Australian share market is currently being priced at a 15.4x PE, a 4% premium to its 23-year average of 14.8x. The Australian share market currently offers a dividend yield of 3.95% which is more attractive than it has been recently relative to 10-year Australian government bond yields trading at 3.96%.

A goldilocks 'not too hot, not too cold' scenario seems to have become consensus in US capital markets with a range of equity positioning measures showing all key investor groups have increased investment to full levels versus historic averages over the last quarter. US equity market sentiment has turned positive, but longer-term indicators imply we still are not at euphoric levels. Typically, from this current level forward 1-year US equity market returns are more modest than long-run historical averages. Locally investor position remains below long run averages with New Zealand and Australian investors at best full weight versus long run targets. While markets have moved quickly to capture the improved conditions there is risk of retracement /pullbacks on economic data points and on elevated geopolitical concerns. Equity market volatility tends to rise when central bank easing begins and market positioning is now more bullish, implying potential near-term vulnerabilities.

Such 'speed bumps' may offer opportunities to invest into a more conducive macroeconomic mix at better levels. The broader picture of slowing inflation and the eventual pivot by central bank rate-cuts may see investors move money out of cash and term deposits into bonds and shares.

Looking at what historically works in share markets after a pause in central bank hiking cycles past pauses have favoured defensives, bond proxies, and reasonably priced secular growth shares. The New Zealand markets mix of defensive and growth at a reasonable price, offering lower volatility, steady returns may become interesting to investors in this environment. While strong migration may be providing a near term increase to New Zealand and Australian inflation it will provide a boost to medium term growth that other economies may not have. The New Zealand and Australian share market may not have the 'magnificent seven' US tech shares but it does have some great compound growth companies that have the potential to grow investor wealth over time.

Harbour portfolio positioning

Harbour's strategy remains to position for a range of scenarios and to be selective. The potential to return to a pre covid lower growth, lower inflation environment supports our continued favouring of investments with secular tailwinds that are less dependent on strong economic activity. We continue to see digitisation, disruption, de-carbonisation, and demographic changes as supporting company earnings. Within the portfolio we are selectively overweight growth at a reasonable price (GARP) shares in the healthcare, information technology and financial services sectors given they offer the potential for compound growth. While the healthcare sector may remain dynamic and face further disruption from innovative technology the reset in investor expectations and valuation multiples, provides us with the confidence to sustain a relatively large but share specific investment in this proven compound growth, wealth creating investment sector. The information technology (IT) sector's secular growth potential is underscored by the runway remaining in GenAI, improving IT budgets, and expectations for improving margins.

We also favour selected Defensive at a reasonable price (DARP) shares, preferring non-cyclical growth channels and or income streams that are tied to inflation and positive secular trends. We remain wary on cyclicals that are dependent on a recovery in consumer and corporate confidence. We favour businesses with productivity and efficiency 'self-help' programmes, particularly where business reengineering introduces technology that improve both revenue and cost structures. We continue to have a bias to quality, well-capitalised businesses that are well positioned to fund value adding growth opportunities.

Disclaimer

Data sources:

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COMPLIANCE CERTIFICATE

Harbour Australasian Equity Focus Fund (the "Fund") (Wholesale Unit Trust)

For month ended 31 December 2023

Harbour Asset Management Limited certifies that, to the best of our knowledge, after having made reasonable enquiries and except as specified in this certificate, the Fund has been managed in accordance with the investment mandate parameters defined in the Conditions of Establishment for the Fund.

Tim Morrison
Head of Compliance
Harbour Asset Management Limited

Dated 04 January 2024

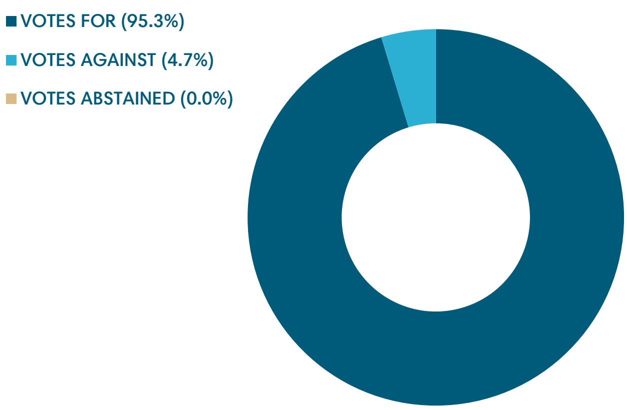
Harbour Environmental, Social and Governance Initiatives

FOR THE QUARTER ENDING 31 DECEMBER 2023

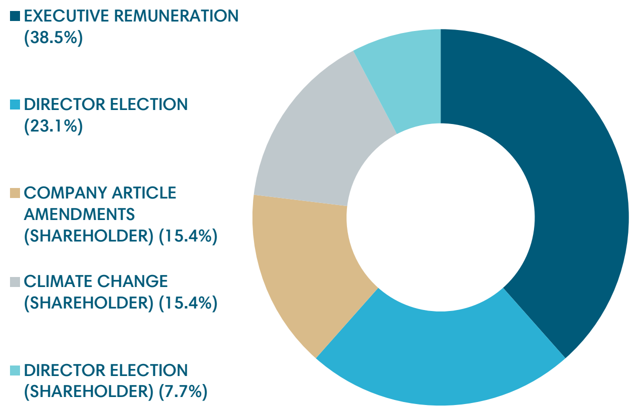
Voting statistics

The number of shareholder meeting proposals (278) peaked during the December quarter as it covered the AGM (annual general meeting) season for Australasian companies. Voting decisions were largely in line with both company management and proxy adviser (ISS) recommendations. The majority of the votes against related to either director elections or executive remuneration proposals while the remainder were all shareholder resolutions on issues such as climate change or nominating an alternative director.

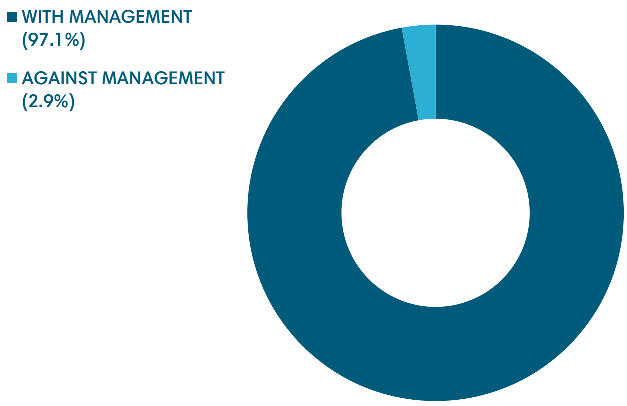
Total proposals



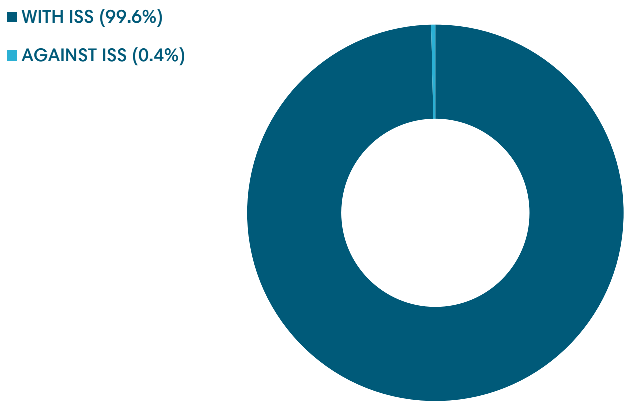
Breakdown of votes against



Management recommendations



ISS recommendations



Corporate engagement & proxy voting

Engagements with companies over the quarter were largely governance oriented given the prevalence of AGMs during the period with some boards proactively conducting investor roadshows to field concerns and provide updates. Despite the governance emphasis, these discussions often involved other sustainability issues as well such as climate change.

One of the common governance topics discussed was board composition, specifically avoiding directors having excessive tenures that could impair independence. Company chairpersons were particularly aware of the views of proxy advisers and investors on this issue and have been carefully considering succession planning. Our feedback acknowledged the importance of having an adequate level of independence but also recognised the need to balance this with the retention of valuable skills and experience on the board. Conversations relating to climate change focused on the preparedness for new reporting regulation with many companies comfortable given the solid foundation of voluntary disclosure already in place.

Other sustainability issues covered during engagements included community impact and indigenous relations. In one of these engagements, the company provided an overview of the early outcomes from its education programme for young women in India which has been successful thus far with a significant number of students already supported by the programme, many of which are considered financially challenged. In another case, we discussed the company's progress in improving iwi/hapu relationships in areas of the country where they are operating or have projects in the pipeline.

Proxy voting activity peaked in the quarter given the AGM season for Australasian companies. Contentious resolutions related to remuneration (both executives and directors), the re-appointment of directors, and climate proposals raised by shareholders. Regarding executive remuneration, a common issue was the lack of transparency on performance hurdles for bonus schemes and in one case we voted against the remuneration related resolutions, especially with the high level of board discretion involved in awarding the bonuses. In terms of director appointments, one example involved a company Chair that was considered 'over-boarded' i.e. having too many other directorships, as well as having an excessive tenure. Given these concerns and the general lack of independence on the board, we elected to vote against the Chair's re-election.

Shareholder proposals relating to climate change were not considered justified given these companies had already made significant progress in establishing emissions reduction targets and developing an appropriate climate transition plan that would see fossil fuel exposure reduced over time. We therefore voted against these resolutions, in line with the view of our proxy adviser ISS.

Industry engagement

Modern slavery policy

We participated in a collaborative engagement with other investors, meeting with a human rights non-governmental organisation (Walk Free) that gave a useful update on the development of modern slavery legislation here in NZ given its involvement in the leadership advisory group that was set up by government. Key points to summarise:

- MBIE conducted a comprehensive public consultation last year on what the intended modern slavery legislation would look like here in NZ.
- The government weren't able to draft up the legislation before the election, but its latest update involved dropping the due diligence aspect so that it only requires reporting from entities within scope.
- The forming of the new government provides an opportunity to lobby for due diligence requirements to be added back in through engaging with the new minister responsible for this work stream. A joint letter has been written up by our industry (via the Boutique Investment Group) to advocate this and to establish a working relationship going forward.

Genesis Energy Investor Day

We attended the company's investor day in Huntly, that included the unveiling of its new Gen35 strategy, a series of updates from the management team as well as a site tour of the Huntly power plant. Some of the key messages from the day in our view are summarised below:

- The new renewable spend programme highlights a growth story driven by electricity gross margin improvement through a combination of a grid scale battery, power purchase agreements (PPAs), and retail business growth.
- Removing the ESG discount – Genesis is focusing on being perceived as an 'improver' by redirecting cash flows from its share of the Kupe gas field to new renewables and having flexibility to displace coal use at Huntly with biomass.
- Cost reduction – primarily through a reduction of 200 staff over the next few years in its retail business.

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