Equity Fund

Harbour Australasian Equity Focus Fund

31 OCTOBER 2023

1 month performance	1 year performance	Fund size	Performance since inception
-4.64%	**-1.67%**	**$75,724,978**	**10.45%**
Before fees & tax	Before fees & tax	NZD	Annualised, before fees & tax. Inception 10/4/2014

Fund performance was negative and behind its benchmark for the month. An increase in geopolitical risk, a further increase in long term interest rates and weak updates from several companies combined to push share markets lower. Economic growth sensitive shares led the New Zealand market lower reflecting weaker than expected updates from Freightways, Port of Tauranga and Tourism Holdings, and a negative read through from global peers lowered the share price of Mainfreight which reports earnings in mid-November. Communications was the only New Zealand sector to generate positive returns over the month with a potential takeover of Sky TV and Spark's defensive characteristics supporting returns. Better than expected updates from defensives Fonterra and Ebos also provided a positive offset. The Australian share market also fell in the month with the bond sensitive information technology and healthcare (GLP-1 impacted) sectors detracting, and the utilities (M&A activity), materials (iron ore and gold prices higher) and communication services sectors outperforming.

Within the portfolio negative returns from investments in Mainfreight, Telix, CSL, Auckland Airport, Rymans and Summerset were the main detractors from performance. Positive returns from IDP Education, Volpara, Ebos, BHP and Aroa boosted portfolio returns.

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	-4.64%	-9.44%	-1.67%	-11.12%	0.46%	6.39%	-	10.45%
Benchmark return, inc. IC	-3.92%	-8.59%	-0.55%	-3.35%	3.32%	6.43%	-	8.29%

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)	-4.77%	-10.43%	-4.26%	-3.05%	5.03%	9.26%
S&P/ASX Total Return 200 Index (NZD)	-2.49%	-6.70%	1.81%	9.76%	7.24%	6.07%
S&P/ASX Total Return 200 Index (AUD)	-3.78%	-7.19%	2.95%	8.88%	7.18%	6.60%

Source: S&P/NZX, Bloomberg.

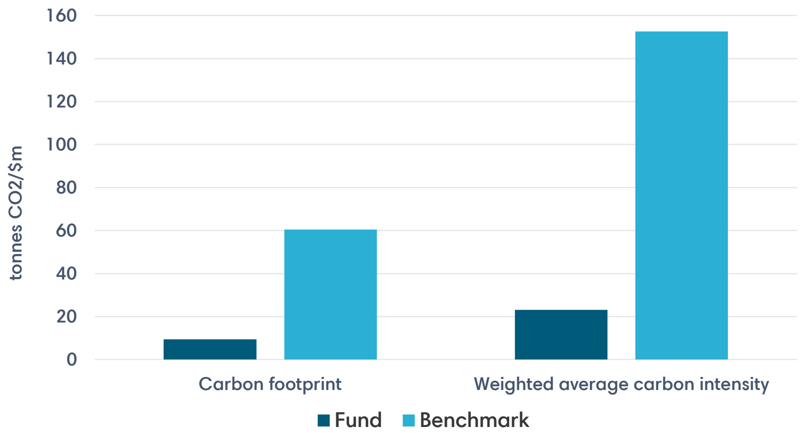
Fund characteristics

	FUND
Return on equity	11.07%
PE ratio forward 12 months	21.6x
Gross yield	2.30%
Expected volatility	15.22%
Hedge on AUD exposure	19.98%

Top 10 holdings

	POSITION
Summerset Group	8.72%
Infratil	8.69%
Auckland International Airport	7.39%
Mainfreight	7.14%
CSL	6.41%
Xero	6.11%
Goodman Group	5.64%
Macquarie Group	5.06%
Ryman Healthcare	4.92%
EBOS Group	4.28%

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

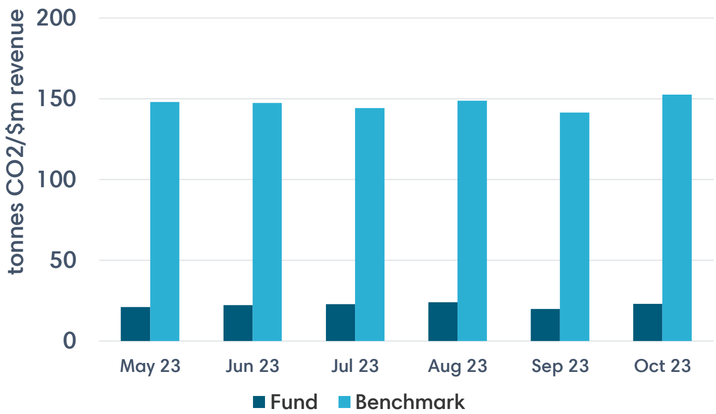
Note: The carbon statistics presented have been adjusted for the extraordinary circumstance of the Channel Infrastructure holding based on data from its latest sustainability report which includes the decommissioning of its refinery operations.

ESG metrics summary

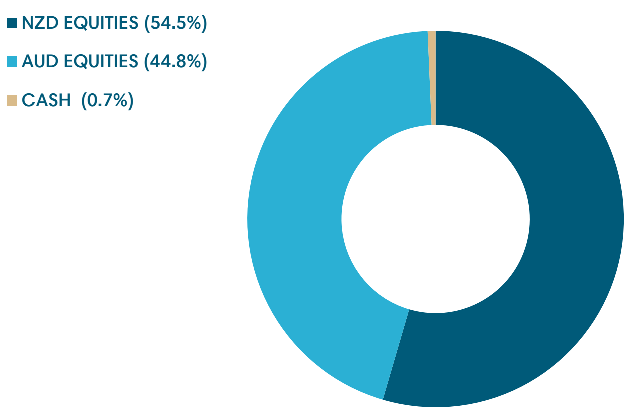
	FUND
Gender diversity (workforce >40% female representation)	54%
Modern Slavery Statement	60%
TCFD Reporting	46%
Majority Independent Board	82%
Science Based Target	25%

Source: Bloomberg, Harbour Asset Management

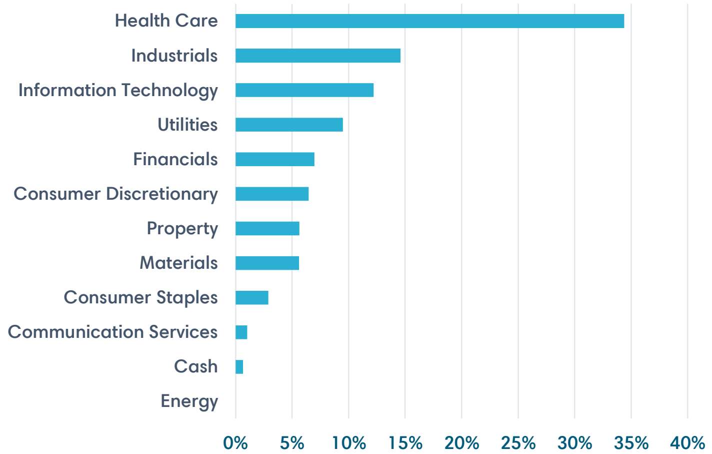
Weighted average carbon intensity



Investment mix



Sector weights



Source: MSCI

Largest contributors	AVE. POSITION	TOTAL CONTRIB.	STOCK RETURN
IDP Education	3.97%	0.10	2.60%
Volpara Health Technologies	3.12%	0.09	2.72%
EBOS Group	4.07%	0.09	2.32%
BHP Group	2.68%	0.04	1.52%
Aroa Biosurgery	2.76%	0.00	0.06%

Largest detractors	AVE. POSITION	TOTAL CONTRIB.	STOCK RETURN
Mainfreight	7.58%	-0.97	-12.14%
Telix Pharmaceuticals	2.63%	-0.62	-21.48%
Auckland International Airport	7.73%	-0.56	-7.22%
Ryman Healthcare	4.55%	-0.46	-9.85%
Summerset Group	8.94%	-0.42	-4.54%

Outlook and strategy

New Zealand and Australian share market returns and valuations continued to be impacted negatively by further sharp increases in long-term government bond yields (New Zealand 10-year Government bond yields up 0.25% to 5.55% and Australian up 0.44% to 4.92%) over the month. Military action in Israel-Palestine drove a flight to safe assets as investors feared the potential for a broadening conflict, with capital moving out of riskier investments, including smaller capitalisation and pre-profitability shares. The combination of higher interest rates and geopolitics triggered wide deleveraging by hedge funds and systematic funds which added to weakness in the broader share market. During the month, the annual general meeting (AGM) and quarterly update season disappointed against market expectations, contributing to further reductions in earnings forecasts.

Only five shares included in the S&P/NZX50 index generated positive returns over the month. Given the increase in market uncertainty, a flight to safety supported the Spark NZ share price. Investors continue to be attracted to a rational mobile phone market and Spark's share buyback programme supported the share price during the month. Medical supplies company, Ebos, provided an upbeat trading update at its AGM which highlighted continued strength in its underlying business conditions (i.e., ex-Chemist Warehouse and COVID/anti-viral revenues), with revenue growth of 8.6% year on year (YoY) translating to circa 10% YoY earnings before interest tax, depreciation and amortisation (EBITDA) growth. This gives us greater confidence in the outlook for pharmacy sales despite the challenging conditions facing Ebos today (i.e., lower COVID/anti-viral revenues and changes to 60-day dispensing). Sky Network Television announced that it had received a highly conditional, non-binding preliminary expression of interest to acquire all the shares in Sky TV, with no price or identity of the bidder at this stage. And the Fonterra share price responded to a better-than-expected update from the co-operative reflecting better efficiency and cost outcomes.

Updates from the transport and logistics sector were particularly weak with firms reducing inventory levels and restructuring supply lines impacting on activity. Listed global transport companies noted slowing activity and falling unit prices, contributing to falling share prices. Anticipation of slower activity and weakness in peer share prices impacted negatively on the **Mainfreight** share price. **Port of Tauranga** provided a weak first quarter trading update at its AGM, with first-time financial year 2024 profit guidance well below consensus expectations. Port of Tauranga's soft guidance follows a tough first quarter - the volatility in freight flows has increased in recent periods as inventory levels across the supply chain normalise post COVID, reflecting reduced end consumer demand, increased competitive pressure from Ports of Auckland and KiwiRail costs increasing significantly. Transport company **Freightways** also provided a weak update at its AGM held during the month, with management noting weaker first quarter trading and a more subdued near-term outlook than previously anticipated, reflecting rocky economic conditions on both sides of the Tasman.

Auckland Airport shares also tracked lower as higher long-term interest rates impacted negatively on the valuation of its future cashflows. Auckland Airport's traffic recovery is slower than some had expected (international passengers still 10% below 2019) and the mix of international travellers remains less profitable with Chinese arrival numbers remaining well below 2019 (pre-COVID) levels. North American air connectivity is strong, with capacity +26% versus 2019. Chinese air connectivity is steadily rebuilding with airlines reporting strong load factors and profitability on the Auckland to China city routes. **Air New Zealand** provided first half profit guidance that was below market expectations, with Air New Zealand management noting the negative impact of higher jet fuel prices and softening domestic New Zealand travel.

Medical technology (MedTech) share prices continued to fall over the month reflecting the negative impact of higher long-term interest rates on the valuation of future cashflows, ongoing speculation around the disruptive impact of GLP-1 for weight loss (branded as Wegovy) and the treatment of type-2 diabetes (branded as Ozempic), and negative earnings revisions across the industry. The announcement by Novo Nordisk, the manufacturer of GLP-1 drugs, that its FLOW research trial had been stopped early on positive efficacy grounds put pressure on the share prices of companies exposed to obstructive sleep apnea including **Fisher & Paykel Healthcar**e and Resmed, and kidney disease treatment including **CSL**. Diabetes and obstructive sleep apnea are progressive diseases where obesity may contribute to the progression. While a reduction in the population with obesity is positive, reversing a progressed state of disease is challenging. Capital markets are struggling with what the broader use and funding of GLP-1 drugs might mean for the longer-term total addressable market for existing treatments. GLP-1 drugs, while helpful, are not a cure-all, and patients may still need other treatments. In early November the CEO of Novo Nordisk, the manufacturer of Wegovy, noted that he thought that market participants were overly eager in their expectations for GLP-1 drugs to displace current therapeutics. CSL held an upbeat capital markets day during the month with the company outlining growth plans that support double digit earnings growth.

The share price of cancer radiopharmaceutical company **Telix** fell after the company provided a solid quarterly update including early data for its emerging prostate cancer therapeutic (TLX 591) that disappointed some. Some interpreted the data for TLX 591 as proving marginal efficacy, and therefore proving higher efficacy would require additional investment. Our research suggests that the share price may have overreacted to the data. The **Pacific Edge** share price reacted negatively to the US Federal Drug Administration announcement of proposed rule changes that laboratory determined tests, including Pacific Edge's Cxbladder, would need to be approved as medical devices, requiring compliance with additional efficacy/safety requirements. Pacific Edge management warned in its October investor update that the risk of a non-coverage decision from Medicare for its Cxbladder product is now 'more elevated than we assessed for much of the last year'. In response, Pacific Edge has restructured its business to reduce cash burn, ride out a non-coverage determination period and regain Medicare coverage relying on its existing capital reserves. This contrasts with Pacific Edge's prior focus on top-line revenue growth.

The share price for retirement village operator **Ryman** fell during the month reflecting wariness around management resetting the targets set at its recent capital raise at its pending half-year profit result announcement. Evidence of trading conditions within the industry suggest retirement unit sales volumes remain strong but the settlement of sales has been patchy, with signs of improvement in settlements in recent weeks in line with an improvement in broader residential property transaction activity. While the pending Ryman update may not provide the evidence some may need that its business model has reverted to its lower-risk, higher cash-generative model, we expect to see evidence that the business is moving in the right direction. The **Summerset** share price was also weak reflecting potential for a downweighting in a global index.

New Zealand electricity generator/retailers (gentailers) share prices also fell during the month, reflecting the negative impact of higher long-term interest rates on the valuation of future cashflows. Weakness in the sector may also reflect research that highlights the potential for significant new generating capacity that is likely to be commissioned over the next decade to limit, or even reduce, wholesale electricity prices. A further fall in the US and UK listed iClean iShares Global Clean Energy Exchange Traded Fund (ETF) may also have weighed on returns for **Meridian** and **Mercury** which are included in the ETF. Both **Contact Energy** and Meridian provided positive quarterly updates, while Merdian's AGM was constructive and included the announcement of a small investment in the redevelopment of the Te Rere Hau wind farm near Palmerston North.

The **Fletcher Building** share price came under pressure reflecting further news regarding their potential liability for plumbing failures in Australia. Fletcher also delivered a mixed AGM update. A presentation by Western Australian building firm BGC on the cause of Fletcher Building Iplex bursting pipes focused on manufacturing faults, but Fletcher Building subsequently provided a comprehensive rebuttal focused on installation faults. These combative presentations contributed to shares in Fletcher Building falling 13% to $4.25 at one stage during the month (after an extended trading halt). The Fletcher building share price now reflects a relatively conservative estimate of Fletcher's potential liability for bursting pipes and plumbing remediation costs but this issue seems unlikely to be resolved in the near term.

Infant formula company **a2 Milk** and milk production company **Synlait** saw their share prices track lower over the month with the two parties entering arbitration associated with a2's cancellation notice of the exclusive production of nutritional powder by Synlait for a2. This notice has not been accompanied by any management commentary and has driven further uncertainty as to potential returns from a more capital intensive manufacturing investment. Evidence that China's new infant birth rates remain weak, continues to suggest downside risk for a2's infant formula products.

Lithium producer **Pilbara**'s share price fell with weakness in the lithium price. The lithium price has fallen with uncertainty around electric vehicle (EV) production rates. Our research suggests that lithium prices may stabilise with inventories at relatively low levels.

The share price of Australian listed **APM Human Services** saw a strong recovery over the month from recent lows. The announcement of management changes that are expected to improve returns at this very purposeful company, and the acquisition of share on market by company management, combined to reignite investor interest in the company. Weakness in the APM share price has been driven by concerns its value adding M&A strategy would stretch the company. In our view, APM's business is well capitalised and has a proven track record of successfully bolting on complimentary businesses. Upside optionality exists from a rise in unemployment and synergies from prior acquisitions.

Global English language testing and student placement company **IDP Education** saw its share price recover from recent weakness as a thawing in Canada-India political tensions reduces risk around IDP's Indian student placement into Canada business.

Breast cancer detection and diagnosis company **Volpara Health Technologies** provided a positive second quarter financial year 2024 update during the month, reporting its fourth consecutive quarter of positive net operating cashflow, which is a full year and a half ahead of previous company guidance. During the quarter, Volpara added US$1.2m in contracted annual recurring revenue largely through upselling into existing clients and focused efforts on 'elephant' and 'calf' customers (contracts over $100-$250k). Volpara now has two customers contributing over $1m in annualised recurring revenue (Veteran's Affairs and Radnet).

Shares in diversified base metals producer **BHP** rose with news of a Chinese central government stimulus package which may underpin demand for iron ore and coper. While steel demand, a key use of iron ore, remains muted given slower economic activity inventories of iron ore in China appear to be a lower-than-normal levels at a time when domestic Chinese production of iron ore is low. Copper demand is holding up despite slow economic activity perhaps reflecting the push to decarbonise economies globally via increased electrification.

Outlook – Are we there yet?

With the southern hemisphere summer driving season set to begin, the chorus of 'are we there yet' is set to starting chiming out from the back seat of cars during a long and sometimes winding journey. Capital markets are asking the same thing. In short, the answer is maybe – interest rates may have peaked, and equity market valuations have fallen back to more reasonable valuation levels. But as with many journeys, the last mile is often the longest and sometimes the most challenging – in the case of share markets we may have to navigate the risk of a further round of earnings forecast downgrades, particularly for cyclically exposed companies.

The move up in long-term bond yields has contributed to a pullback in share market valuation multiples. The unwind of Covid ultralow interest rates may have some residual impact for capital markets but valuations and earnings expectations are now more in line with long run "normal ranges". The US has exported higher long term bond yields to global capital markets. A higher cost of capital hurdle has impacted equity market valuations everywhere. The sharp increase in US long term interest rates, driven by higher real rates, reflects a range of factors including upside growth surprise in the US economy, a narrative shift to 'higher for longer', and US federal Government fiscal position/funding requirements. The persistent pressure of climbing yields has weighed heavily on equity markets, with all major indices in correction territory. Capital markets are moving from considering how high interest rate need to go to how long interest rates need to stay in restrictive territory to offset sticky inflation. With share markets now allowing for interest rates staying restrictive for longer a pause in Central Bank official interest rate increases, even if the pause includes 'hawkish' conservative framing, may see a positive response from share markets.

Local share markets are now priced more appropriately for a higher interest rate environment. The S&P/NZSE50FG benchmark index for the New Zealand share market is priced at 20.8x price to market consensus forecast earnings per share (PE). This is a discount to the 10-year historical average multiple of 22x, but still at the upper end of the 17-to-22x PE the New Zealand share market range in the five years leading up to and including 2019. The S&P/ASX 200 benchmark index for the Australian share market is priced at a 14.4x PE. This is a discount to the Australian 10-year historical average multiple of 15.7x, which is at the lower end of the 14-to-16x PE the Australian share market range in the five years leading up to and including 2019. While the valuation multiples for both markets have fallen back to more reasonable levels, the earnings yield offered may not yet be compelling relative to bond yields, and bond yields may need to fall to support significant asset allocation moves by investors. Given many investors currently have a below average allocation to share markets, even a modest move down in bond yields may trigger positive asset allocation moves.

After a sustained period of earnings forecasts downgrades across the aggregate New Zealand and Australian share markets investors may also be waiting for a period of earnings stability to emerge before allocating increased capital to local shares. The high concentration of defensive yield exposures in the New Zealand equity market may reduce the impact on the earnings volatility of the market should the local economy experience a weaker 2024 growth outcome.

In the last three months, higher bond yields have done a lot of heavy lifting for Central banks. Tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring and inflation. But the sharpness of the tightening in financial conditions leaves us wary of a recession. Probabilities vary as to the potential for a meaningful economic slowdown, but looking back at history it would be unusual to avoid an economic recession after the recent degree of aggressive global monetary policy tightening. Signs of stress are starting to appear with less well capitalised companies struggling to generate enough cash flow to meet higher interest payments, capital investment intentions being reset lower and loan delinquencies starting to creep up in some sectors.

Economic cross currents, with both inflation and economic growth (gross domestic product) slowing creates a mixed backdrop for earnings in the near term. Economic activity by region remains desynchronised – the US has been strong, the Chinese economy has been weak but is showing signs of stabilising, Europe has been weak, and New Zealand and Australia have been slowing. The US economy has been supported by Federal Government policy favouring increased renewable energy generation and onshoring/reshoring of manufacturing and production. But after a very strong third quarter, US lead indicators, including the Institute of Supply Management (ISM) manufacturing new orders index, have slipped into contraction territory recently, consistent with weakness in world industrial production (IP). Given the tightness in financial conditions there is potential for leading indicators to continue to slow.

Across New Zealand and Australia these cross currents are having some significant impacts for companies and sectors. Fading consumer confidence is being offset by higher migration, contributing to falling consumption per head of population. Public sector investment and works remain elevated, supporting activity but crowding out private sector activity. Business confidence is mixed. The latest Financial Stability Report from the Reserve Bank of New Zealand (RBNZ) highlights that the five major NZ banks see risk that non-performing loans will rise to around 1% by early-2025 – more than double current levels. The risk that tightness in financial conditions causes something to crack or break means we remain wary about more cyclical exposures. We remain watchful for earnings downgrades as negative operating leverage and normalisation/reversal of pricing power emerges as the last inefficiencies of Covid stimulus rolls out of the economic system.

Earnings results for New Zealand and Australian companies with a September balance date will start to be reported in the second week of November. Earnings forecasts have continued to be cut in the lead up the results season and expectations are low relative to history. For the New Zealand share market median normalised earnings per share (EPS) expectations are for a -10% year-on-year decline, just surpassing the 2009 GFC earnings season. The drop in earnings expectations reflect cost inflation, higher interest expense, and slowing economic activity. More than 20 companies will report in November earnings season, with the majority reporting first half 2024 results with the season dominated by REITs (six companies) and aged care (three companies). We would not be surprised to see a repeat of the past few reporting season with actual results beating low expectations, but subdued outlook statements contribute to negative share price reactions.

Maintaining a defensive bias

Given this framework we continue to favour quality at a reasonable price. Defensive at a reasonable price (DARP) shares may do better in this environment, particularly given the pricing of some DARP shares has improved in reaction to interest rates moving back to levels consistent with historic long-term averages. Within DARP we remain defensive, preferring non-cyclical growth channels and or income streams that are tied to inflation. Pricing power/resilience, cost control and positive (but not heroic) operating leverage will remain key to support the increasing dividend track record of more attractive DARP shares.

But we fundamentally continue to favour growth at a reasonable price (GARP) shares medium term given they offer the potential for compound growth. The healthcare sector, as a historically value adding GARP sector, is showing signs of stabilising after the disruption of GLP-1's broader application on demand for existing treatments and the headwinds of higher bond yields combined to drive one of the sharpest deratings in the sector over the past 20 years. If the selloff in bond yields is overdone and the downside risk form GLP-1's has been overcapitalised the recent sell-off in healthcare shares may be providing one of the better points to increase investment in a proven wealth compounding sector in a long time. But investors need to be selective with not all healthcare share prices capturing the risks.

While we may still be on the long and winding road, and the earnings season may throw up the odd pothole, we are getting closer to being 'there'. With capital market settings having moved back to being in line with long run settings investors are now being rewarded with a more appropriate return for risk.

Harbour portfolio positioning

Harbour's strategy remains to position for a range of scenarios and to be selective. We continue to favour investments with structural tailwinds that are less dependent on strong economic activity. We continue to see technology disruption, de-carbonisation, and demographic changes as supporting company earnings. Two trends stand out as potential sources of near-term positive earnings risk - demographics, particularly positive migration, and generative artificial intelligence. Businesses exposed to energy transition and the onshoring/nearshoring of manufacturing and storage of goods may face opportunities and threats. We are also favouring 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 less vulnerable to a tightening in financial conditions.

Disclaimer

GICS

COMPLIANCE CERTIFICATE

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

For month ended 31 October 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 November 2023