

Bennelong Australian Equities Fund

Performance update

As at 31 December 2017

Recap of BAEP's high conviction approach

In the September quarterly performance update, we provided a recap of our investment approach. Here is a quick summary.

We seek to invest in high quality growth companies whose business prospects we believe are underappreciated by the market. Philosophically, we believe that share prices are discounting mechanisms, meaning they factor in or discount the market's expectations of a company's future prospects, most pertinently in relation to earnings. We believe investment outperformance is therefore achievable by investing in companies that outperform those expectations.

These opportunities are not easily found. To do so we perform extensive on-the-ground research that involves a continuous program of countless meetings with the listed companies themselves, as well as their customers, suppliers, competitors, franchisees, regulators and other industry contacts. We are constantly driven to learn more and more about each company, and their near and long-term prospects, risks and opportunities. This learning is focused on facts, figures and whatever other evidence we can find; rather than the stories and prophesying on which many investors base their decisions.

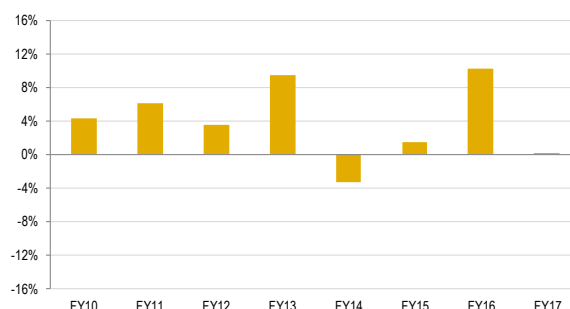
Invariably, our returns will be based on what happens in the future, which is always going to be uncertain. The best we can do is gain sufficient levels of conviction based on our research, importantly in respect of both the upside potential and the downside risks. We include and weight stocks in the portfolio based on these conviction levels. Given this high conviction approach, we tend to have relatively concentrated portfolios that look materially different from the index.

Where relevant, we also marry macroeconomic research and analysis with our predominantly bottom-up stock specific approach. This macro overlay seeks to highlight and manage portfolio-wide risks that may otherwise build up inadvertently, such as an over-concentration to a particular sector or over-sensitivity to interest rates.

The Fund has a strong long-term investment track record and this reflects our robust, effective and proven investment approach. The following graph

shows the relatively consistent extent to which the Fund has outperformed the benchmark over time, being in all but one financial year since inception.

The Fund's gross performance versus the benchmark over each financial year since inception*



Source: BAEP. * Performance figures are relative to the benchmark and are gross (ie, before fees and expenses). Net performance can be found on the front page of this report.

Quarterly performance review

Over the quarter, some of the largest contributors were:

- **Treasury Wine Estates**, the owners of wine brands such as Penfolds, Wynns and Lindemans.

There was no company-specific news that prompted the company's relatively strong performance over the quarter. Rather, it is likely to have been caused by evidence of strength in Chinese liquor consumption, particularly at the premium end of the market. China is an important market for Treasury Wines, with strong demand for its high-end brands such as Penfolds. Accordingly, the company will likely be a beneficiary of these positive trends.

- **Costa Group**, Australia's largest agricultural produce company.

During the quarter, the company announced it was buying further shares in African Blue to increase its shareholding from 49% to 90%. African Blue is a blueberries joint venture that produces in Morocco and sells into Europe. As a result of this acquisition, and due to better than expected trading in its core operations, the company at its AGM revised up its previous full



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year profit guidance from 10% growth to 20% growth. We believe this guidance could yet prove conservative.

For the medium term, the company stated at its full year results in August that it is targeting double-digit growth over a three to five year time horizon. In basic terms, this growth is underpinned by rising consumption – particularly in the fast-growing berry categories in which it is the dominant producer in Australia and its investment in new production capacity. The market is slowing coming around to understanding the quality and strong growth prospects of this company.

- **Aristocrat Leisure**, the slot machine and online social games developer.

During the quarter, the company announced its full year 2017 financial results (it has a September year-end). It reported revenue growth of 15% and earnings growth of 36%, which was actually 40% in constant currency terms. The result was solid and was broadly in line with expectations, with outperformance of Aristocrat's digital business balanced out by underperformance of its US slot machines business.

This digital business develops online games. This was initially online casino games, but with the US\$500 million acquisition of Plarium in August this year, it moved into new market segments that include social, combat and other strategy games such as *Vikings: War of Clans*.

At the same time as announcing its 2017 financial results, Aristocrat also announced the acquisition of Big Fish for US\$990 million. Big Fish is an online gaming company that will merge with Aristocrat's existing business to create the second largest player globally in social casino gaming. The acquisition also expands Aristocrat into new genres, including casual gaming with titles such as *Gummy Drop!* and card games such as *Fairway Solitaire*. Aristocrat has the opportunity to improve the returns from Big Fish's games by leveraging its expertise in both casino game algorithmic models and customer acquisition. Conversely, Aristocrat's existing games and capability will be enhanced by Big Fish's expertise in metagame functionality, which basically socialises games by offering player interaction, chat rooms and gifting.

The market appears sceptical of these acquisitions, as evident from the share price declines on the announcement of both acquisitions. It will likely take some time before the market grows comfortable with the strategy. For us, we believe both acquisitions make financial and strategic sense, but as always, will remain ever-watchful of performance in Aristocrat's hands.

With the addition of Big Fish, Aristocrat's digital business will account for approximately 38% of its total revenues. This underpins an increasing base of recurring revenues, which next year should account for approximately 65% of Aristocrat's total revenues (the other recurring revenues derive from sales of slot machines on a 'participation basis'). This is important because it makes for a more predictable earnings base, which in turn justifies a higher earnings multiple. Currently, the shares trade on approximately 19x next financial year's earnings – which allows for a full year of both acquisitions – and we believe this valuation is undemanding given the improved quality of its business and the growth ahead.

The portfolio is also very underweight in the Banking sector. This positioning benefited the portfolio's relative performance, as the banks underperformed over the quarter. Investor sentiment towards the big banks seems lukewarm at present, particularly with a Royal Commission into the sector starting next year.

Some of the largest detractors were:

- **Reliance Worldwide**, a manufacturer of plumbing products and water control valves, including the Sharkbite brand of push-to-connect plumbing fittings.

There were no material negative developments that caused Reliance's shares to come under pressure during the quarter.

The company did, however, hold an investor day in late October. From this, it can be said that the company currently appears to be trading well. This includes in the US, where the market was concerned that ending its exclusive sales arrangement with Home Depot would cause a greater loss of sales than it would pick up from starting to sell through Lowe's and other retailers and wholesale distributors. It seems the brand remains popular to end-customers and valuable to its retail and other customers.



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The company also laid out a detailed growth strategy which augers well for longer term prospects. In basic terms, this revolves around developing or acquiring new products and markets. Some of the main areas of focus were:

1. the continuing development of new products. For example, this year the company will be launching about 130 new SKUs across its Sharkbite, EvoPEX and Cash ACME brands;
2. a move into the new residential and commercial construction markets in the US, where the company current has very little exposure;
3. the launch of its EvoPEX range in Australia in early 2018; and
4. bolt-on acquisitions, particularly in Europe where it has a relatively small business at present. This follows the acquisition earlier this year of Holdrite, which expanded the company's product suite to include piping support, water heater accessories and firestop systems.

We believe the market seems to be underestimating the strength of Reliance's brands, management team and various longer term growth opportunities. The company has guided towards 20-24% earnings growth for the 2018 financial year, and we think there are decent prospects that they will exceed this guidance.

- **Flight Centre**, the diversified travel company best known for its namesake retail stores.

There were no material negative developments that caused the company's shares to come under pressure over the month. That said, its shares have been a strong performer over the year, with the Fund benefiting handsomely. Rarely do you get stocks going up nicely in a straight line.

In August, the company laid out a transformation program for the next five years. This is focused on maintaining strong growth in travel bookings, cutting out unprofitable businesses, lifting under-performing businesses, and more tightly managing costs. The program comes with ambitious financial targets that, if achieved, imply very strong earnings growth and material upgrades to the market's expectations for earnings over the foreseeable future. A major driver of investor returns from the stock will come

down to its execution on this transformation program, which we will be tracking very closely.

In addition, our underweight position in the Resource and Energy sectors detracted from our relative performance as both sectors outperformed as a result of strength in the price of oil, iron ore and other commodities.

Portfolio positioning

Not a lot has changed over the quarter in terms of the positioning of the portfolio. Attractive new opportunities are not in abundance at present, although we have added a few new ideas to the portfolio.

As discussed above, each stock is added to the portfolio based on our predominantly bottom-up stock specific approach. There are, however, some common themes among our individual stock picks.

Heavy concentration to 'all weather' businesses

We have a heavy concentration towards 'all weather' businesses selling relatively defensive products or services. This includes:

- bio-pharmaceuticals and other vaccines and medicines (**CSL Limited**);
- wine (**Treasury Wine Estates**);
- pizzas (**Domino's Pizza Enterprises**);
- fruit and vegetable produce (**Costa Group**);
- hospital services (**Ramsay Health Care**);
- breathing support devices (**Fisher & Paykel Healthcare**);
- plumbing fittings (**Reliance Worldwide**); and
- education services (**IDP Education**).

Heavy concentration in global businesses

We also have a heavy concentration towards exporters and global businesses with "exportable competitive advantages". They all have valuable attributes that can be leveraged into profitable growth in offshore markets. These include:

- brands (such as **Treasury Wine Estate's** Penfolds wines);
- intellectual property (**CSL's** extensive R&D-backed IP in plasma-derived medicines); and

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- innovative products (**Reliance Worldwide's** Sharkbite push-to-connect plumbing fittings and **Aristocrat's** market leading slot machine games).

Generally wary of domestic cyclical

We remain generally wary of domestic cyclical such as retailers, media companies, builders and industrials. Ultimately, however, we are stock pickers and we are willing to buy into a company even if the sector looks grim. This year, we built up a position in Flight Centre, a position that is discussed above. Otherwise, we have limited exposure to domestic cyclical.

Unexcited by most of the blue chips

Unlike the typical all-cap Australian equities fund, our investment process allows us the flexibility to avoid large benchmark positions. This is fortunate because we currently consider only a few of these large stocks as attractive. Thus, we do not hold a position in many of the mature 'blue chips' such as Telstra, Woolworths, Wesfarmers, AMP, Suncorp, IAG and Scentre. Most have solid-enough businesses and pay reasonable-enough dividend yields, but offer little if any growth.

Some are also seeing competition starting to restrain sales, pressure margins, and ultimately eat into earnings. For example, **Telstra** is seeing increased competition from NBN resellers in broadband, and Optus, Vodafone and soon TPG in mobile.

Woolworths and **Wesfarmers'** Coles are fighting it out for market share, together with Aldi and possibly Amazon in the future. And **Scentre's** shopping centres are seeing sales stagnate in part due to online competition.

Underweight exposure to the banks

In contrast to these names, the banks have much stronger competitive positions. This is evident in their pricing power, which is easiest seen in their repricing of mortgage rates and their ability to manage net interest margins. Historically at least, this pricing power has allowed the banks to generally deliver on earnings expectations. At present, credit conditions remain benign and bad debts low, costs are getting cut, and their capital positions are strong enough to ensure they are able to meet regulatory requirements to be 'unquestionably strong' by 2020.

Meanwhile, the sector will remain in the headlines over the next year as we see in a Royal Commission. While nothing may come of it, one can be reasonably confident that no positive news will likely flow. Importantly, the scrutiny may also limit the extent to which the banks can rely on their pricing power to make up their profit numbers.

Purchased at the right price, the banks offer decent, albeit unexciting, returns. We are invested in the big four banks, but we are significantly underweight compared to the benchmark, and remain watchful of macroeconomic risks, particularly in relation to consumer strength and the housing market.

Very little exposure to the commodities companies

We have very little exposure to resource and energy companies. Less than 5% of the Fund was invested in these sectors as at the end of the quarter. This compares to about 19% for the benchmark. Given our predilection towards defensible, predictable and lower-risk propositions, we are not naturally given to commodity companies. In general, we lack much conviction in relation to the price of most commodities at present, and thus our small weighting to the sector. Where we are invested, we have stuck with the highest quality operators, including the two big miners.

Selective exposure to the bond proxies

We have no exposure to the pure bond proxies such as the REITs and Utilities sectors. These sectors account for an outsized weighting within the Australian market. We believe many of these stocks have very little going for them other than their dividend, typically with little or no growth that might otherwise augment investors' returns. We are interested in those exceptions that also offer decent growth. For example, we have a position in **Transurban**, which we have managed to buy at attractive prices. In contrast to the pure bond proxies, Transurban is able to grow through increasing traffic, toll rate rises, and by investing into value-accretive road extensions and other projects. This decade, Transurban has grown earnings by an average of 10% a year, as it did again in 2017.

Without growth, bond proxies are very sensitive to interest rates. Should rates rise, their typically heavy debt loads will become more expensive, and valuations will come under pressure via higher discount rates or cap rates (as the case may be).

Outlook

Our last quarterly performance report addressed a number of positive signs for the market, including a lack of general public enthusiasm for stocks. The idea was to provide some balance for the many investors who seem circumspect about valuations and market levels. Investor sentiment seems to have since shifted up a notch, aided by and abetting the decent run over the past quarter. This should give investors poise for some caution.

Investors are in a believing mood these days, especially at the more speculative end of the market. Investors are back chasing IPOs for what



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they believe to be an inevitable 20%-plus first-day pop, even if of suspect quality. What is new and lacks much historical track-record allows an enthusiastic view of the future and entails little by way of disproof. Witness the recent demand for lithium stocks, disruptive technology names, pre-revenue concept stocks and bitcoin. In these cases, value seems to be largely in the eye of the beholder rather than any observable fundamentals. One should note, however, that at this stage, enthusiasm for the unproven is not widespread. Similar enthusiasm has not made its way up to the large end of the market.

The more bullish tone in equity markets is understandable. The present set of conditions is ideal for stocks. Economic growth, at least globally, is strong and mostly strengthening, causing similar growth in corporate earnings. Meanwhile, it has not been strong enough for long enough to meaningfully lift inflation and thus also interest rates, which still remain extremely accommodative.

In this environment, equities continue to look attractive relative to most other asset classes such as cash, bonds and property. In aggregate, the Australian stock market trades on an earnings yield of approximately 6%, a grossed-up dividend yield of just under 6%, and offers expected earnings growth for this upcoming 12 months of 5-6%. For comparison purposes, the benchmark 10-year Government Bond yields just 2.6%.

The market's good run of late, together with low levels of volatility, seems to be encouraging investors. This is important as many have been reluctant stock investors, scarred by the GFC and ever fearful of another collapse just around the corner. As we have seen in past cycles, the effect can become self-fulfilling. Whether this optimism continues into a full-blown bull market is difficult to predict.

Since the GFC, bad economic news has been good news for stocks, most particularly because it resulted in further monetary easing. In these present Goldilocks-like conditions, good news is good news.

However, there will be a point when good news becomes bad news. This could be when the good news starts to not be as good as expected, perhaps portending a recession. Or more pertinently, it might be when interest rates start to rise materially higher and liquidity starts to tighten. This appears to be the greatest risk for equities at present, at least at the broader market level. Just as equities benefited from low rates, they will also suffer as they rise. The Australian market in particular is very sensitive to interest rates. It is one of the highest-yielding markets in the world, replete with bond proxies and bond-like blue chips.

For what it's worth, our view is that rates may lift, but not dramatically so. Inflation remains benign, and there are good reasons why this might persist for some time yet, including factors relating to innovation, demographics and under-employment. That said, our views on interest rates do not really influence our stock picking or portfolio construction, although we do manage around the risk of higher (or lower) interest rates where we consider it sensible.

In light of the above, we believe it makes sense to take a constructive view of markets at present, being neither closed-minded bearish nor ever-believing bullish. This at least opens you up to take advantage of opportunities when and as they arise. As before, opportunities are not abundant at present, but they are out there. In this respect, and as always, we focus on high quality growth stocks whose earnings prospects appear to us to be underappreciated by the market.



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About BAEP

Bennelong Australian Equity Partners (BAEP) is a boutique fund manager focused on Australian equities. It was founded in 2008 in partnership with Bennelong Funds Management. BAEP is a genuinely active fund manager with a consistent and disciplined investment approach.

BAEP's investment philosophy is to selectively invest:

- in high quality companies;
- with strong growth outlooks; and
- underestimated earnings momentum and prospects.

BAEP's investment process is research-intensive with a focus on proprietary field research and is supported by economic and quantitative insights.

About the Fund

The Bennelong Australian Equities Fund typically holds 25-60 stocks across the entire spectrum of the Australian share market. It primarily holds stocks from the S&P/ASX300 Index, although it is not limited to holding stocks in this index.

Benefits of the Fund

- BAEP is an award winning and highly rated equities fund manager with an experienced and performance-orientated team.
- BAEP is a genuinely active and high conviction fund manager, meaning potentially significant deviation from the benchmark and with prudently concentrated portfolios.
- The Fund has a track record of adding value by outperforming the market over the long term.
- The Fund is managed in accordance with BAEP's robust, disciplined and proven investment philosophy and process.

The Fund is managed by Bennelong Australian Equity Partners, a Bennelong Funds Management boutique.

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