

Bennelong Twenty20 Australian Equities Fund

Performance update

As at 31 December 2016

Performance

	1 mth	3 mths	6 mths	1 Year	3 years pa	5 years pa	Since Inception ** pa
Fund	2.62%	2.56%	8.42%	7.41%	na	na	na
Benchmark*	4.34%	4.93%	10.43%	11.79%	na	na	na
Value added	-1.72%	-2.37%	-2.01%	-4.39%	na	na	na

Performance figures are net of fees and expenses. 'Value added' calculation does not use rounded performance figures.

*S&P/ASX 300 Accumulation Index

**Inception date is 2 December 2015

Introduction to the Twenty20 Fund

The Fund has been operating since December 2015. It combines a passive investment in the S&P/ASX 20 Index and an actively managed investment in Australian listed stocks outside this index. The passive investment is one that mimics the performance of the S&P/ASX 20 Index, while the active management seeks to invest in a limited selection of ex-20 stocks that the manager believes will outperform.

The **passive position in the S&P/ASX 20 Index** is achieved by investing individually in each of the index's constituent stocks, including for example Commonwealth Bank, Telstra and CSL. The weighting in each of these 20 stocks approximates the same weight they represent in the S&P/ASX 300. The Fund's overall weight in the S&P/ASX 20 will thus approximate its weight in the S&P/ASX 300. Currently, this weight is approximately 60%.

Given this heavy weight in the S&P/ASX 20, the Fund's largest positions will typically coincide with those of the market, as seen in the table of the Top 10 Holdings.

The **active position in ex-20 stocks** has the goal of allowing the Fund to outperform the broader market. This active investment is managed according to the same strategy adopted in respect of the Bennelong ex-20 Australian Equities Fund. This strategy seeks to identify high quality, strongly growing companies whose earnings prospects are underestimated by the market.

Divergence in the performance of the Bennelong Twenty20 Australian Equities Fund from its benchmark, the S&P/ASX 300, will arise from the relative performance of the Fund's active investment in ex-20 stocks.

The Fund gives broad exposure across the Australian stock market and is available at a low management fee of 0.39% (plus a performance fee where applicable).

Top 10 Holdings

Commonwealth Bank
Westpac Banking
Australia and New Zealand Banking
National Australia Bank
BHP Billiton
Telstra
Aristocrat Leisure
Domino's Pizza
Treasury Wine Estates
Wesfarmers

Source: BAEP

The Fund's sector exposures will deviate from the benchmark to the extent that its actively managed investment in ex-20 stocks results in an over or under-weighting to any particular sector.

Sector	Fund Weight	Benchmark* Weight	Active Weight
Discretionary	18.9%	5.2%	13.7%
Consumer Staples	11.0%	6.8%	4.1%
Liquidity	0.7%	0.0%	0.7%
Telco's	4.9%	4.4%	0.5%
Health Care	6.6%	6.2%	0.4%
Industrials	5.5%	6.7%	-1.3%
IT	0.0%	1.4%	-1.4%
Financials	36.0%	37.7%	-1.7%
Utilities	0.0%	2.5%	-2.5%
Energy	1.5%	4.2%	-2.8%
Materials	12.2%	16.2%	-4.0%
REIT's	2.8%	8.6%	-5.8%

Source: BAEP. *Benchmark is as for the Fund.



Bennelong Twenty20 Australian Equities Fund

Monthly performance update

As at 31 December 2016

Performance review

The stock market had a decent year in 2016, returning 11.79%. The relatively strong returns were achieved despite a hectic year for markets that included Chinese wobbles in January, Brexit in June, a Trump election win in November, and a steep bounce in long term rates in the latter part of the year.

As stated on the previous page, the Fund's performance is dictated largely, although not entirely, by the performance of the S&P/ASX 20 Index. Deviation from the benchmark, the S&P/ASX 300, arises to the extent of the Fund's relative performance in respect of its active management of ex-20 stocks.

The Fund returned 7.41% over the year. This meant the Fund underperformed against the market, which is disappointing. We do believe, however, that the ex-20 companies in the portfolio are currently performing well operationally and that their longer term prospects remain bright. In each case, our investment thesis remains intact. As such, we believe the underperformance portends future outperformance.

Most of the Fund's performance versus the market can be explained at the stock level. In this respect, there was a mix of winners and losers in the portfolio. The largest contributors to the year's relative performance included Fortescue Metals Group, Newcrest (an underperformer which the Fund avoided), Vocus Communications (which the Fund owned on the way up but had exited before its troubles set in) and Flight Centre. The main detractors included TPG Telecom, Domino's Pizza Enterprises, South32 (a strong performer in which the Fund was underweight) and Fisher & Paykel Healthcare.

In more general terms, the Fund benefited from an underweight position in the bond proxies – including the REITs, Infrastructure and Utilities stocks - which suffered alongside bonds; and it benefited from avoiding the Gold sector, which ended up a poor performer over the full year. On the other hand, the Fund's performance was hindered by an overweight exposure to the Healthcare sector, specifically through positions in Ramsay Health Care and Fisher & Paykel Healthcare in particular; and from its exposure to the Retail sector, where a number of names held underperformed.

The sell-down in healthcare stocks reflects a broader market rotation out of the higher quality, higher PE names. These companies tend to own long duration businesses with quite reliable growth. It is therefore understandable that they would sell-off with a lift in longer term interest rates - as a result of which their outer year earnings are more heavily discounted in a present day valuation - and as investors increasingly believe in a return of broad-based growth, as a result of which their growth becomes less rare. However, what is right for the group is not necessarily right at the individual stock level, and this is where our

difference of opinion with the market lies. Over the course of the year, the Fund has trimmed or sold out of a number of high PE names, but maintained positions in companies in which the company fundamentals justified doing so. Some of these experienced quite material share price declines, even without any change in the underlying company fundamentals. Indeed, in a number of cases such as Ramsay Health Care and Domino's Pizza Enterprises, the fundamentals have improved ahead of expectations. Ultimately, these fundamentals will dictate investors' returns over time.

Over the last quarter, the market returned 4.93% and the Fund returned 2.56%; whilst over the December month, the market returned 4.34% and the Fund returned 2.62%.

Outlook

Economic overview

The performance of the various global economies are mixed. The world's largest economies, the US and China, are growing strongly. However, this lies in contrast to the rest of the world and the domestic economy. China continues to grow strongly, indeed off an ever-increasing base. Currently, it is benefiting from fiscal stimulus in the lead up to elections later this year. Chinese strength is best evident in Australia in the strong demand and pricing for iron ore, coking coal and other commodities. The US economy is also lifting, particularly at the consumer level which accounts for approximately 70% of economy. Indeed, the Fed's more hawkish stance over recent months is reflective of this economic strength. The US economy may now also benefit from pro-growth efforts by a Trump Administration.

On the other hand, we see the Australian economy as generally sluggish at present. We base this on our many company meetings and other industry contact, but it is also evident from the generally weak macroeconomic data. Corporate investment and hiring is generally weak, the consumer is highly indebted, wage growth is tight, and state and federal governments seem fiscally constrained. There are however some pockets of growth. These include the tourism, healthcare and construction industries, and geographically, the NSW economy (specifically Sydney). The domestic economy has so far succeeded in its transition away from the resources focus of the decade past, although further signs of softness are coming to light, including for example in NSW. One wonders now what will take up the slack when residential and other construction tapers off? There are a number of hopeful scenarios, but the most likely is for continued slow growth in Australia.



Bennelong Twenty20 Australian Equities Fund

Monthly performance update

As at 31 December 2016

Stock market valuations

Valuations are quite attractive overall. On consensus numbers, the overall stock market trades on a PE multiple of 16x and comes with EPS growth of 14% for the upcoming year. In addition, it offers a dividend yield of 4.5% (grossed up for franking credits it is 6.0%), which compares very favourably to the yield on offer elsewhere. For example, the 10-year Australian Government Bond currently yields less than 3%.

A note of caution is however warranted. The consensus earnings growth forecast of 14% does not reflect the weaker domestic economy. Admittedly, a large part of this growth owes itself to the strong growth in earnings from the Mining and Energy sectors, which are obviously benefiting from the higher commodity prices. Taking these sectors out however still leaves quite bullish growth of approximately 7%.

	Fund	Benchmark*	
Return on Equity	13.2%	11.7%	Premium Quality
Debt/Equity	18.1%	25.2%	
Sales Growth	6.2%	4.2%	Superior Growth
EPS Growth	16.6%	14.4%	
Price/Earnings	16.5x	15.9x	Reasonable Valuation
Dividend Yield	4.1%	4.6%	
Beta	0.99	1	
Active Share	35%	na	Genuinely Active
No. of Stocks	51	300	

Earnings risk

We believe this gives rise to considerable earnings risk, being the risk that companies will disappoint on earnings as against expectations. Stock prices, which implicitly bake in these expectations, tend to falter if companies provide weaker-than-expected guidance or disappointing financial results. And we believe that the generally soft real-world trading conditions across most sectors indicate some disappointment ahead. The stock market appears quite sensitive at present and the stock price reactions to negative news can be quite brutal. We have seen a number of examples of late, including profit warnings from iSentia (down 27% in one day), Healthscope (-24%), Bellamy's (-42%) and Vocus Communications (-25%). In contrast, positive news is gained a more muted response.

The recent profit warnings offer some lessons that investors seem to repeatedly re-learn: be wary of promotional management; be wary of large insider selling; be wary of companies that have been floated by private equity; and be wary of new acquisitions. These lessons are of course not a reason to avoid any

particular stock; they do however require additional due diligence to gain conviction in order to invest.

Fortunately, we have avoided the wrath of these and other disappointments. However, we remain cautious. An important part of our investment process is to go out of our way to gain high levels of conviction around the companies we have invested in, and particularly their prospects for near-term earnings delivery. This involves company meetings, discussions with competitors and customers, and other industry engagement. We aim to build an ever-deeper insight into these companies, their risks and opportunities, and current trading. Based on our research to date, we remain reasonably comfortable with the extent of earnings risk within the portfolio. However, as with all things to do with the future, it is never possible to be absolutely sure. The first half earnings season in February will provide some greater clarity, not just in respect of the companies in our portfolio, but broadly in respect of Corporate Australia.

The risk-reward proposition

We learnt in 2016 that the big-picture macro issues such as elections are not as important in driving equities returns as one would assume from the attention they attract. Instead, it is the company fundamentals that matter. We believe that the Australian stock market offers reasonably attractive returns over the medium term. Given the discussion above, we also believe it will be necessary to remain selective. Importantly, this entails a focus on what the stock market valuation implies in terms of expectations, and whether they are reasonable compared to what the company can deliver. Currently, this is particularly so beyond the more mature, and arguably more dependable, large-cap top 20 stocks.

The Fund's five largest active positions

You will note that most of the Fund's largest positions are top 20 stocks (see page 1). This is the result of the Fund taking a passive position in all of these stocks according to their weight in the index. The Fund employs active management in respect of the ex-20 segment of the market. Here we summarise a number of the Fund's largest ex-20 positions.

Aristocrat Leisure is a manufacturer of slot machines and other gaming products. Some of its hits include *Lightening Link* and *Buffalo Grand*, which are found in pubs, clubs and casinos in 90 countries around the world. Aristocrat is the second largest manufacturer globally, with \$2 billion in annual revenues.

The company's business has incredible momentum at present, allowing it to grow strongly and ahead of expectations.

The company reported its full year 2016 financial results in late November, it having a September year-



Bennelong Twenty20 Australian Equities Fund

Monthly performance update

As at 31 December 2016

end. The company grew earnings by 69%, which was well ahead of expectations. The company guided to continued growth for this upcoming year.

The company is currently out-designing its peers with more popular and successful games and cabinets. This is allowing it to gain market share and thus grow revenues strongly. It is also allowing the company to increasingly sell its product on a revenue-share basis, rather than for a one-off upfront payment. This results in a recurring base of revenues, which in turn adds to greater forward earnings visibility. Units on a revenue-share arrangement grew strongly through the course of the 2016 financial year, and this bodes well for earnings momentum going into the current year.

Supporting Aristocrat's future product pipeline is a significant investment in innovation. Specifically, the company invests over 10% of its revenue base each year in design and development (D&D), and this year it may be as high as 12% in 2017. Based on our research, including extensive contact with customers and attendance at various industry conferences, we believe that Aristocrat's current range of products will continue to gain traction and that its pipeline of new releases looks attractive. This includes, for example, extensions of existing successful titles such as *Buffalo Gold* and *Dragon Link*.

The company is also growing its offering of online 'social' casino-style games such as *Heart of Vegas*. These are available to play through Facebook and mobile apps. This digital business saw profits more than double in the 2016 financial year. The business now has 1.27 million active users who each spend on average 42 cents per day.

The company's strong operating performance has led to strong cash flows and much reduced debt. This positions the company well to continue investing in D&D and to potentially consider acquisitions, with which it has had material success in recent years.

Treasury Wine Estates is a wine maker with 70-odd brands, selling 34 million cartons of wine globally and generating annual revenues of approximately \$2 billion.

Its business has been structurally challenged for decades, operating in an oversupplied market and unable to extract value from its brands that include Penfolds, Beringer and Wolf Blass. However, under new CEO Mike Clark, the company is undergoing a turnaround that moves it away from its role as a price-taking wine producer and towards a price-making marketing-led brand business. It is cutting down production and supply chain costs; it investing in a very targeted way in its 15 'power brands' in the luxury and 'masstige' segments of the market; it is growing demand especially through new markets like China;

and it is taking a disciplined approach to pricing product to ensure decent prices and margins. The results of this were evident in the 2016 financial result reported in August, when it announced a doubling of profits from the prior year.

From our research, we believe the company is continuing to execute on its strategy. Business costs are coming out, volumes are strong, and price rises are holding. The high-margin Asian business in particular appears to be performing very strongly, as demand continues to build. The company will be affected by currency headwinds for the first half of the 2017 financial year, over which time the Australian dollar was elevated, but the company should be able to trade itself through the headwind.

We initiated a position in **Fortescue Metals Group** this year. Fortescue is an iron ore miner with its mines and associated infrastructure such as rail lines and port facilities located in the Pilbara in Western Australia. Its mines have 5.4 billion tonnes of hematite resource and together allow annual production of approximately 160 million tonnes of iron ore.

The investment in Fortescue reflected our view in the company's improving quality. This improvement has come about as the company has dramatically reduced its operating costs, to an extent that has materially surprised the market. The company has reduced its C1 unit production costs from US\$48/wmt five years ago to now below US\$13/wmt. Indeed, a very recent industry-produced cost curve shows that Fortescue is the lowest cost iron ore producer in the world. In the resources game, the quality of an operation is largely about its position on the cost curve. A lower unit production cost allows the company to withstand much lower iron ore prices, and to make considerably larger profits at higher prices. Most investors have been overly focused on the iron ore price in judging Fortescue, whereas its profits depend more on the dollar margin per tonne of ore mined, that is, the iron ore price minus the cost to produce. As that margin grew last year, the company was able to earn much higher profits. And with its hefty capex done for now, this translated into very significant free cash flow generation.

The strong cash flows were used mostly to pay down what was a once considerable debt load. Indeed, the company's net debt reduced from \$10.5 billion in 2013 to now just \$4 billion. This has meant that the considerable investment of debt holders in Fortescue's business has shifted across to equity holders, a fact that manifested in greater value attributed to that equity through a higher share price. Alongside paying back debt, the company has also managed to lift its dividend. Reflecting the tripling of earnings in the 2016 financial year, the company also tripled the annual dividend. Investors have reappraised the company's quality, with that quality



Bennelong Twenty20 Australian Equities Fund

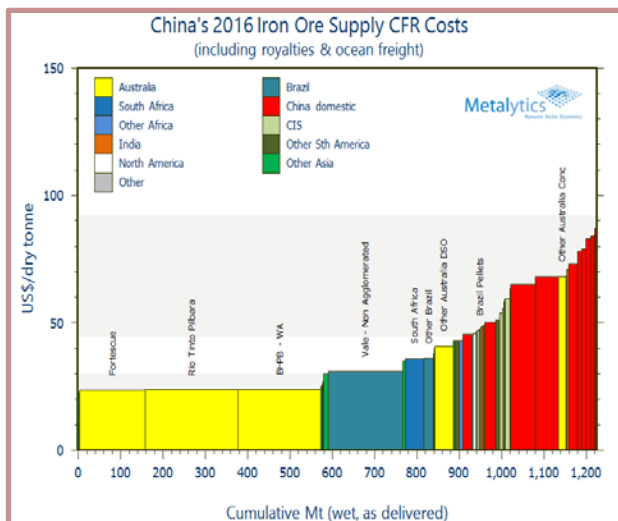
Monthly performance update

As at 31 December 2016

characterised by a low cost position and a strong balance sheet.

The initiation of a position in Fortescue and a select few other miners in 2016 was a break from the last few years in which the portfolio avoided the sector entirely. We have always been conscious of the sector's considerable sensitivity to commodity prices, which at least over the short term can be volatile. We believe however from our research that the price for iron ore and certain other commodities will likely hold up around current levels over the near term at least. Even if they do not, Fortescue is positioned as well as any other in the industry.

Iron Ore Cost Curve



Source: Metalystics Resource Sector Economics, November 2016 review

From here, Fortescue's share price still factors in quite conservative estimates for the iron ore price, well below current iron ore prices. This means that its share price is justified even if the iron ore were to retreat somewhat, and presents upside to the extent that the iron ore price holds at these levels. This is something we observe right across the Resources sector. In contrast to most of the Australian stock market, earnings for mining stocks continue to revise upwards as investors catch up to the strong and sustained recovery in commodity prices. That is to say that there appears to be less earnings risk associated with this sector presently.

Some investors will shy away from the sector's exposure to commodity price volatility. As a result, they miss out on the potentially attractive returns and diversification that this important sector in Australia can offer. A company like Fortescue has assets with very long lives. The value of its assets often depend little on the iron ore price of the day, despite what its share prices might imply. This can provide opportunities for long term investors who are willing to wear the share price volatility. The recent opportunity has been to buy when sector valuations were very

depressed and were heading higher as commodity prices recovered and continued trending higher.

Domino's Pizza Enterprises owns the Domino's franchise in Australia, New Zealand, Japan, France, Belgium, the Netherlands and Germany. All up, it has over 2,000 stores under its control, and together, these stores sell approximately \$2 billion worth of pizzas and other food items.

The company is also performing very well currently.

At its AGM in early November, the company was able to upgrade its outlook for the 2017 financial year and beyond. The company upgraded its EBITDA growth guidance to be in the region of 30% (previously 25%). Sales in all regions are at or above previously guided levels of growth. Remarkably, the most mature of Domino's operations, stores in Australia and New Zealand, achieved same store sales growth of an extremely strong 17.7% for the first 16 weeks of the financial year. This prompted management to upgrade its same store sales guidance for the full year in these countries to 12-14% (from 10-12% previously). The new menu extensions recently introduced - including the remarkably popular thickshakes - are really resonating with customers.

Europe has been a big effort for the company over the last year. It has rolled out some of the technology currently in use in Australia, and it has had to integrate two meaningful acquisitions made in 2016, being Sprint Pizza in France and Joey's Pizza in Germany. Remarkably they have been able to convert the acquired stores across to the Domino's brand retail model well ahead of what it originally planned. One would expect that the technology rollout and acquisition integrations will have resulted in some disruption to trading. The shorter term impact is inconsequential however to the longer term opportunity.

Moving to the longer term view, the company's prospects have never looked so bright, both in terms of profitability and growth potential. At the AGM, the company brought forward EBITDA margin targets, to 25% within five years in Europe (from 16% currently), and to 45% in Australia and New Zealand within six years (from 34% currently). It also upgraded the 2025 target store numbers in Europe, which had the effect of increasing the Group target to 4,650 stores (from approximately 2,000 currently). As store economics continue to improve, there is likely to be further upgrades to this long-range store target.

In addition, the company may look to make further acquisitions. These could include other pizza businesses (then converting stores across to its Domino's network), a Domino's franchise in other countries, or other non-pizza fast-food franchises.

Management is clearly executing very well right across the company. As it does, the future growth



Bennelong Twenty20 Australian Equities Fund
Monthly performance update
As at 31 December 2016

opportunities and profitability is continually improving.

Ramsay Health Care is a large private hospital operator, with its core business in Australia, but with operations also in France, the UK and Asia.

Ramsay's shares have fallen approximately 20% since highs reached in early September. Its shares sold off in sympathy with a weak trading update from peer hospital operator Healthscope announced in October. Healthscope disclosed to the market that it was experiencing soft hospital volumes and extrapolated flat earnings. This surprised the market, which sold Healthscope's shares down approximately 25% on the day of the announcement. Ramsay's shares also sold off on the day, presumably because investors also assumed soft trading at its hospitals. In contrast, our own research indicated that Ramsay's operations continued to perform strongly, that previous expansions and other investments are paying off, and that cost-out programs are supporting profits. Indeed, the company soon afterwards made an announcement to the market that reflected our research. Specifically, it said that hospital volumes were in line with historical trends, and reaffirmed previous guidance of earnings growth of 10%-12% for the 2017 financial year.

Adding to our confidence in our investment in the company is that management has a long history of providing conservative guidance and ultimately outperforming expectations. Specifically, it has raised its profit guidance, and ultimately beat the raised guidance, in each year since 2009. Ramsay's share price however has continued to come under pressure, notwithstanding the clarification it gave to the market on its own trading.

As suggested earlier, it is possible that the market has started to question the relatively high PE multiple at which its shares trade. We believe that the company is deserving of its PE multiple, given its extremely high quality and the long-term growth prospects. Hospital demand is growing steadily as a result of an ageing population and the innovation of new medical procedures and the like. And importantly, Ramsay is very well positioned to take advantage of the industry growth, specifically by expanding its hospitals to take up the growing demand.

In the near term, we believe it will deliver against its current year financial guidance and the market's expectations.

The contrasting operating performances of Healthscope and Ramsay show that it is necessary to be selective when it comes to stock-picking, and that just buying into an advantaged industry, does not always work.



Bennelong Twenty20 Australian Equities Fund

Monthly performance update

As at 31 December 2016

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 Twenty20 Australian Equities Fund combines an indexed investment in the S&P/ASX 20 Index and an actively managed investment in Australian listed stocks outside of this index. It typically holds 40-55 stocks.

Benefits of the Fund

- BAEP is an award winning and highly rated equities fund manager with an experienced and performance-orientated team.
- The Fund provides a broad exposure to the Australian market via a combination of passive investment (in respect of the S&P/ASX20) and an actively managed investment (in respect of stocks outside of the S&P/ASX20).
- The Fund's ex-20 exposure is managed in accordance with the strategy adopted in the Bennelong ex-20 Australian Equities Fund. This fund is of high conviction and it 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.

The Fund at a glance

Feature	Fund fact
APIR code	BFL0017AU
Benchmark	S&P/ASX 300 Accumulation Index
Investment objective	2% p.a. above benchmark measured over rolling 3-year periods
Investment manager	Bennelong Australian Equity Partners (BAEP)
Active stock limit	± 10%
Cash limit	0-10%
Inception date	2 December 2015
Recommended investment period	Long term (five years plus)
Buy/sell spread	+/-0.30%
Entry/exit fees	Nil
Management Fee	0.39% p.a. of Net Asset Value of the Fund
Performance Fee	15% of any amount by which the Fund's return is greater than the return generated by the S&P/ASX 300 Accumulation Index

How to invest

The Fund is open to investors directly via the PDS, available on our website.

Platforms

CFS First Wrap
Federation Managed Accounts
Macquarie Wrap

Contact details

For more information, call 1800 895 388 or visit baep.com.au

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