Touchstone Index Unaware Fund

Performance update

As at 31 December 2016

Performance

	1 month	3 months	6 months	Since Inception**
Fund	+4.42%	+5.53%	+12.53%	+14.24%
Benchmark*	+4.34%	+4.93%	+10.43%	+16.80%
Value added	+0.08%	+0.60%	+2.09%	-2.57%

Performance figures are net of fees and expenses.
*S&P/ASX 300 Accumulation Index
**Inception date is 4 April 2016.

Market Review

The Australian equity market, as measured by the S&P/ASX300 Accumulation Index, continued its strong rally from the prior month, advancing by 4.3% in December and posting a gain of 4.9% for the quarter. The main influences on the domestic market for the month, and indeed the quarter, were the rising interest rate policy setting of the US Federal Reserve and the promised stimulatory policies of President-elect Donald Trump.

Despite a turbulent start to the calendar year, the market ended the year significantly higher with a gain of 11.8%, easily surpassing the market return of 2.8% in calendar year 2015. Strong gains in commodity prices aided by increased fixed asset investment in China led to a significant rally in Resources from their lows in February. The sector was the best performer over the year, advancing by more than 42%. The only sector to post a negative return over the year was Telecommunications which fell -7.1%.

At the sector level, December saw a recovery in those sectors which had previously lagged over the quarter. To this end, Property Trusts (+6.8% mom, -0.7% qoq) and Technology sectors (+5.2% mom, -0.3% qoq) rose strongly, reducing their losses for the quarter. Financials (+5.5% mom, +12.7% qoq) saw a continuation of prior months' strength as the domestic banks and insurers were buoyed by the strong rebound in US Financials, which are seen to be beneficiaries of rising bond yields and a less onerous regulatory regime. The Energy sector (+6.1% mom, +7.5% qoq) performed strongly both in the month and quarter following further production agreements by OPEC members in December. Utilities (+8.7% mom, +9.2% qoq) posted a strong gain in the month and quarter as the sector came into focus following a takeover announcement for DUET Group at a 27% premium to its previous closing share price.

Conversely, Telecommunications (+0.4% mom, -4.3% qoq) and Healthcare (+0.9% mom, -8.8% qoq) remained weak both in the month and quarter. Resources (+3.8% mom, +8.7% qoq) also lagged in the month following declines across some key commodities but were very strong over the quarter and calendar year as outlined above.

The main company news over the month came from the merger announcement between by APN Outdoor (+10.7%) and oOh! Media Group (+8.3%). Both companies rallied strongly following the announcement. In other takeover news, DUET Group (+15.3%) received a $3.00 per share all cash takeover from Cheung Kong Infrastructure, and Cover-More Group (+47.3%) received a takeover offer from Zurich Insurance. Tatts Group (+6.9%) received a second takeover proposal from a consortium of bidders including Macquarie Group and KKR & Co. Conversely, Sirtex (-48.7%) and Bellamys (-45.7%) were punished following respective downgrades to their earnings outlook. Santos (+2.3%) announced it would raise approximately $1.5bn to both reduce debt and provide flexibility to take advantage of growth opportunities.

Top 5 Shareholdings

Company
National Australia Bank
Wesfarmers
Westpac Banking Corp
Telstra
Star Entertainment Group

Performance Review

Over the month, the Fund advanced by +4.4% net of fees and expenses, broadly slightly ahead of the market rise of 4.3%. Over the December quarter, the Fund posted a solid return of 5.3%, exceeding the market return by 0.6%.

Pleasingly the outperformance in the quarter was achieved notwithstanding the Fund's large holding of cash. Although cash was a drag in the quarter we are comfortable that our stock selection, coupled with our cash holdings will provide investors with attractive returns over the long term. We have maintained an average cash position in the quarter of circa 12.0%.

At the stock level, the Fund benefited from its positions in select financial stocks such as QBE Insurance (+11.2% mom, +33.7% qoq), IAG (+7.2% mom, +9.5% qoq) and National Australia Bank (+6.0% mom, +14.3% qoq). The Financial sector rallied strongly over the month and

quarter as both insurers and banks are beneficiaries of rising bond yields. While the Fund has a large exposure within the Financial sector, its main overweighting is to the insurers. We remain cautious on banks due to on-going regulatory risk, headwinds from low revenue growth and the historically lows levels of loan losses currently being incurred. As such we believe that the insurers, namely QBE and IAG offer more upside from current levels. Management of both companies have implemented premium rate rises and cost efficiencies which will drive earnings from current cyclical lows. In addition, IAG management outlined plans to drive down costs and deliver through the cycle EPS growth of 10% pa at its Investor Day in December. The confidence in the outlook from management, combined with some early signs of an industry recovery, added to the stocks appeal in the month.

Conversely, our position in Star Entertainment Group (SGR) traded lower over the month and quarter (-2.1% mom, -14.1% qoq), as it was negatively impacted by the arrests of Crown employees by the Chinese Government in early October 2016. After a partial recovery in November following positive AGM comments, the stock was again softer in December due to selling by a substantial shareholder. We remain comfortable with our position in SGR given its strong growth outlook, solid balance sheet and very attractive valuation.

We have maintained a high level of cash in the Fund over the period in order to protect our unitholders in times of market uncertainly and market overvaluation. We will deploy cash at times of market pullback and/or when we see specific opportunities emerging. However, we believe the Fund is well positioned in light of extended financial asset valuations in general and given the heightened geo-political and economic uncertainty going forward.

Market Outlook

The Australian equity market has recovered strongly from its February 2016 lows and has been supported in recent months by the election of Donald Trump whose pro-growth policy stance has been welcomed by the equity market. However, we remain cautious on the sustainability of the market's advance as valuations appear full and the forecast reduction in the unprecedented monetary support from global central banks will weigh on markets in the year ahead. While corporate profitability is anticipated to increase over FY2017, the majority of recent upgrades have been limited to resource and energy companies, which are rebounding from cyclical lows. For banks and industrials the outlook for earnings growth appears modest. The broader company earnings cycle needs to improve in order to justify current valuations.

In addition to the above, we continue to remain cautious on the global political environment. The significant move in global financial markets over the past six months reinforces our stance that political risks will remain a focus for markets in the year ahead. Markets must now grapple with significantly increased uncertainty. Continued strength in the market will require favourable policy measures to be implemented over the year ahead. We also remain cautious as to the flow on implications for forthcoming European elections in 2017.

Touchstone's takeaways:

- Revenue growth remains difficult – tight cost management takes on added significance
- Highly geared capital structures are riskier in this environment, even with low interest rates
- Heightened geopolitical uncertainty.

Contact details

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

The Fund is managed by Touchstone Asset Management, a Bennelong Funds Management boutique.