

Bennelong Australian Equities Fund

Performance update

As at 31 March 2017

Performance

	1 mth	3 mths	6 mths	1 Year	3 years pa	5 years pa	Since Inception** pa
Fund	3.37%	5.84%	4.94%	12.00%	7.18%	11.66%	13.58%
Benchmark*	3.28%	4.71%	9.88%	20.24%	7.51%	10.83%	11.21%
Value added	+0.09%	+1.13%	-4.94%	-8.24%	-0.33%	+0.83%	+2.37%

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 30 January 2009

Portfolio positioning

Top Holdings
Westpac Banking
CSL
National Australia Bank
Aristocrat Leisure
BHP Billiton

Portfolio Sector Allocation			
Sector	Fund Weight	Benchmark* Weight	Active Weight
Discretionary	21.8%	5.0%	16.8%
Health Care	19.4%	6.8%	12.6%
Liquidity	1.0%	0.0%	1.0%
Consumer Staples	7.3%	7.2%	0.1%
Utilities	2.6%	2.7%	0.0%
Industrials	5.9%	6.7%	-0.8%
IT	0.0%	1.2%	-1.2%
Telco's	0.0%	4.0%	-4.0%
Energy	0.0%	4.3%	-4.3%
Materials	10.9%	15.6%	-4.7%
Financials	31.0%	38.2%	-7.2%
REIT's	0.0%	8.4%	-8.4%

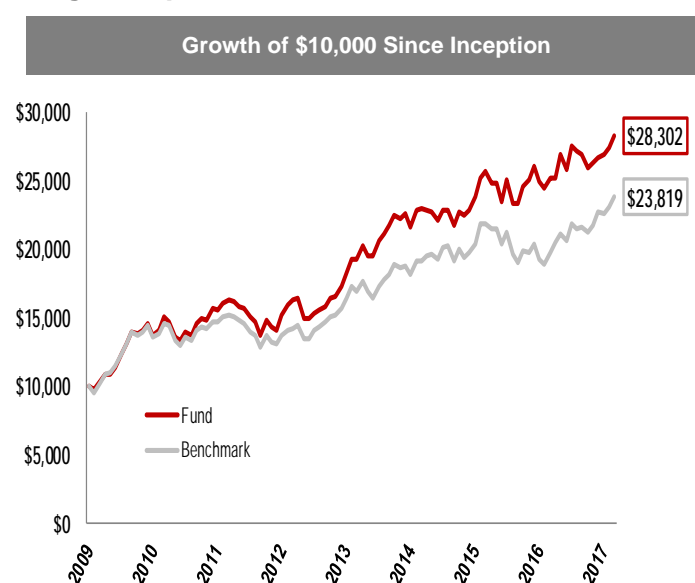
Source: BAEP. *Benchmark is as for the Fund

Portfolio characteristics

	Fund	Benchmark*	
Return on Equity	15.1%	12.0%	Premium Quality
Debt/Equity	17.1%	25.1%	
Sales Growth	7.1%	4.3%	Superior Growth
EPS Growth	14.1%	12.9%	
Price/Earnings	18.4x	16.0x	Reasonable Valuation
Dividend Yield	3.6%	4.4%	
Beta	0.97	1	
Active Share	64%	na	Genuinely Active
No. of Stocks	26	301	

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

Long-term performance



Source: BAEP



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Performance Review

The stock market had a strong month and a strong March quarter. The Fund outperformed the market over the quarter, returning 5.84% compared to the benchmark's return of 4.71%. For the month of March, the Fund returned 3.37% and the benchmark returned 3.28%.

More importantly, the Fund continues to outperform over the long term, delivering strong absolute returns for clients. It has also been able to achieve relative outperformance in a relatively consistent fashion, although not through all time periods. The long-term results reflect what is a robust, effective and proven investment approach.

The strong performance over the quarter owed itself to the large outperformances of CSL, Aristocrat and Treasury Wine Estates. On the other hand, the Fund has a large position in Domino's Pizza Enterprises, which performed poorly.

The Past 12 Months' Performance

You will note from the performance table on the front page that the Fund has underperformed over the last 12 months. Of course, the market was very strong over the last 12 months, and investors in the Fund have likewise enjoyed very attractive returns. It's just that they weren't quite as good as the market. This underperformance warrants some explanation.

Over the back half of 2016, there was a dramatic change within the market, which involved a rotation from quality, defensive, growth and yield stocks; to value, cyclical and deflation beneficiaries. This rotation came about as the macro narrative has turned more upbeat. For example, if the economy is to produce stronger growth, then one can find that in cyclical and value stocks trading at lower valuations rather than in the defensive growth stocks.

This rotation affected the Fund's relative performance in two ways: the market sold down what we owned and bought up what we didn't. On the former, we have consistently favoured and weighted the portfolio towards high quality growth stocks. These are the type of companies that we believe have strong, sustainable and growing businesses that are best positioned to build shareholder wealth over time. These types of stocks typically do best over the long term, but can lag the market from time to time. Often the lag occurs during bull markets. Over the December half, it was the lower quality, cyclical and value stocks that led the charge and outperformed.

Looking through the companies owned within the portfolio, one can observe that their underlying fundamentals remain on track, or in some cases, have improved materially. Together with lower share prices, these now present as very attractive investments relative to the rest of the market. A case in point is Domino's Pizza Enterprises, which has dragged down the Fund's performance over the last nine months, and which we discuss at greater length below.

We believe there are real signs that the rotation has played out, if not gone too far. PE dispersions are low, meaning that relatively little premium need be paid to buy higher quality stocks over low quality ones. Meanwhile, some of the stronger performing sectors over the back-end of last year have more recently started to lag, such as the Resources sector; likewise past underperformers have more recently started to outperform, such as the REITs.

A Case Study: Domino's Pizza Enterprises

We have written before on **Domino's Pizza Enterprises**. It is a large holding in the Fund, and its recent share price underperformance warrants specific comment. BAEP first purchased shares in the company for the Fund in 2014, when they traded at around \$15 per share. The shares hit a peak of just over \$80.33 on 17 August 2016, the day after it reported its 2016 financial year result. At that result, it reported 42% earnings growth for the 2016 financial year. It also guided towards EBITDA growth of 25% for the 2017 financial year. Since then, the company has upgraded both its short and long term prospects. Specifically:

- at its AGM in November, Domino's upgraded this financial year's EBITDA growth to 30%;
- also at its AGM, it brought forward and lifted its guidance for EBITDA margins, to 25% within five years in Europe (from 18% today) and to 45% in Australia and NZ within six years (from 37% today);
- also at its AGM, it lifted its long-term guidance for store numbers in 2025 to 4,650 stores, from guidance of 4,550 stores previously. Currently, it has just over 2,000 stores; and
- in reporting its first half year result in February, it upgraded its current year EBITDA guidance again, to 32.5% (from the 30% guidance at its AGM).



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These disclosures evidence a business with strong momentum and sustainable long-term growth prospects. That longer term growth derives from:

- continuing strong same-store-sales growth, owing to menu improvements and the growth in online ordering and delivery services;
- the addition of new stores, with the company planning to more than double its store numbers by 2025;
- an increase in profit margins, particularly as the scale of the business grows and many of the fixed costs associated with advertising and the like are amortised across a larger base of sales;
- the possible move into new countries beyond the existing seven countries in which it currently operates the Domino's franchise; and
- the possible acquisition of new fast-food chains.

Despite the improved company fundamentals, its shares have fallen since last August, ending the March quarter trading at approximately \$58 per share. With the company more valuable, but its market valuation lower, the investment outlook looks bright. Of course, one must also consider the risks.

Growth slowdown

The first risk is the prospect that the company's stellar growth slows down.

This is best illustrated in considering Domino's most profitable markets of Australia and NZ. Here, the company has for years achieved increasing same-store-sales growth, hitting a record of 17.4% growth at its most recent half year result. This growth is on top of what is achieved through the opening of new stores. It compares very well to other strong performing retailers. For context, Woolworths, another staples retailer, reported same-store-sales growth in the first half year of 1.9%, whilst Bunnings, one of the more successful retailers in Australia and benefiting from a strong housing cycle, achieved 6.5%. The law of large numbers however will ultimately come to bite, meaning that these growth rates will inevitably decline. This is not to say that growth is now constrained. Whilst Australia is the company's most mature market, it has only a small share of the fast food market, at just less than 3%. This shows there is still plenty of future growth potential. Indeed, the company has guided to a target for Australia and NZ of 1,200 stores by 2025, from 738 at the end of the last half year.

The bigger opportunity for longer term growth is in Europe, where it has operations in France, Germany,

Belgium and the Netherlands. Its markets are more than seven times larger in terms of population, and perhaps surprisingly, there is a similar appetite for pizza on a consumption-per-capita basis. Currently, revenues derived from Europe are more than from Australia, but profit margins are less than half. The European opportunity looks similar to that of Australia a decade ago. Only recently has the company started to introduce to Europe some of the innovations, IT, apps and other systems that have allowed the company to grow in Australia so successfully. This may well cause some growing pains, and we should expect slower growth and perhaps some bumps in the road in the near term, but sets the European business up to execute on the tremendous growth opportunity in front of it.

Recent negative news flow

Recent media has raised a number of alleged problems with the Domino's franchise network. Two broad problems were raised: firstly, that the Domino's franchise system is unsustainable because of poor franchisee profitability; and secondly, recalcitrant franchisee business practices, specifically the underpayment of staff wages.

Whilst the negative news flow has died down somewhat in recent weeks, it has been something offered as a reason for the sell down in Domino's shares (on top of a re-rating associated with the market rotation).

Without going too far into the details, we believe the claims are unjustified. On the first issue, the Domino's franchise system is typically one of the most profitable for franchisees, with reported investment pay-backs of up to three years, and potential earnings per store roughly double the average Australian salary. A Domino's franchise represents a potentially highly profitable and low-risk option for those Australians wanting to go into their own business. On the second issue, we believe it is overblown. Franchisees operate effectively as small business owners and run their shops largely as they wish. Conceivably, some will take it upon themselves to cut corners, which relevantly could include underpaying staff. For Domino's, the number of recalcitrant franchisees is relatively small, especially in the context of a network of 400 or so franchisees. More importantly as investors in Domino's, we believe the company has in place adequate policies, procedures and systems to prescribe compliance requirements, audit and detect non-compliance, appropriately deal with recalcitrant franchisees, and rectify incursions.

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Overall, we believe that neither of the issues raised in recent media will affect the long-term prospects for Domino's.

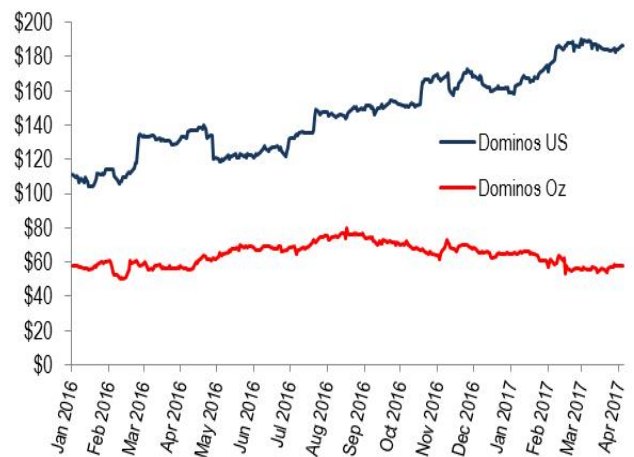
Valuation risk

For some time, Domino's shares have traded at a high PE multiples. Many investors have assumed from this that the shares are overvalued. One must remember here that a PE multiple is a valuation measure that is based only on next year's expected earnings; it therefore does not take into account the growth beyond that next year's estimate. This growth is very important to the valuation of a company like Domino's. Valuation methodologies that account for this outer-year growth, such as a DCF valuation, are far more relevant. And on this count, the valuation looks attractive.

For those obsessed with PEs though, it is worth noting that very fast compound earnings growth will act to amortise down a PE multiple very quickly. For example, if Domino's earnings double over two years, as it will likely have almost done as at the end of this financial year, its PE multiple effectively halves. Based on consensus numbers for the 2017 financial year, the current PE multiple is 42 times, but it falls to 33 times for 2018, and then 26 times for 2019. Soon enough the company's PE multiple will fall to below what is then the average market multiple, which we believe could well happen within the next four or so years. And at that time, investors will still likely be left to look forward to continued strong growth ahead. Whilst the market is predominantly short-term focused, we aim to buy longer term earnings on the cheap. This is what is called time arbitrage. The long-term numbers should ultimately make their way into the short-term view of the market, and when they do, they will be appropriately valued.

Interestingly, whilst Domino's shares have been sold down since August last year, shares in Domino's Pizza Inc., which is the US-listed and based master franchisor, have continued to perform strongly since then. Despite materially lower forecast earnings growth, the US company trades on a higher PE multiple than the local company. Interestingly, the US company has been subject to the same scrutiny over underpayment of staff wages by a certain number of Domino's franchisees, only worse given that it was found culpable and has been ordered to find millions of dollars in fines and restitution over the last year¹.

Share price Chart of Domino's Pizza Enterprises (Dominos Oz) and Domino's Pizza, Inc. (Dominos US)



Source: IRESS, from 1 January 2016 through to 5 April 2017

Portfolio Positioning

Resources

The most significant change to the portfolio in recent months has been a reduction in our exposure to the Resources sector.

We had avoided the sector for a number of years up until 2016. However, in early 2016, we started an investment in a select number of miners, those with the low cost operations, long-life assets and strong financials. Because of their low cost operations, they are well placed to survive the lows in commodity prices, as they did in late 2015. They are also well placed to make out handsomely at higher prices, which is what they have done since.

We built up positions in our favoured miners over the course of 2016 and our exposure to the Resources sector actually became quite large. Leaving aside our stock-specific views, our move into the sector was premised on a belief that the market was behind the curve in factoring in the extent of prior years' cost-out efforts and commodity price strength. With the market having now largely caught up, and share prices markedly higher, the upside has diminished and the downside risks have increased.

¹ See for example: <https://ag.ny.gov/press-release/ag-schneiderman-announces-lawsuit-seeking-hold-dominos-and-its-franchisees-liable>



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Banks

We have a reasonable weighting to the big banks in our portfolio, although not nearly as big as their weight in the benchmark.

The banking sector has had a strong run since Trump's election win in November, with share prices up in the order of 20%. Even after this however, the banks offer some of the highest yields in the market. For example, as at the end of March, and after grossing up for franking credits, Westpac yields 7.6% and NAB yields 8.1%.

On the other hand, there are a number of risks that worry the market, not least in respect of the banks ever-growing exposure to residential mortgages. To be sure, these risks are real and warrant close attention.

However, there are a number of positives that arguably don't get as much attention. Given the generally negative tone that makes up consensus forecasts, these positives could give rise to upward revisions to market expectations.

A recent one is that the banks have begun to put up mortgage rates, particularly in respect of higher risk loans such as those for property investment, with high loan-to-value ratios, or that are interest-only. This reflects limited real competition among the cosy banking oligopoly and is supportive of industry margins. Importantly, politicians and others are also quietly supportive, in contrast to yester-year when such moves were met with criticism and outcry. Indeed, the big banks are performing a helpful role in raising mortgage rates. The RBA is stuck between a rock and a hard place: wanting to cut rates to support a lackluster economy with low inflation; but wanting to raise them to restrain the run-away house prices in Sydney and Melbourne. The big banks can specifically target their rates rises to the housing market, without causing any deleterious effect on the rest of the economy. Macro prudential regulation, which acts to restrain the extent to which the banks can write certain riskier mortgages, is providing the cover for the banks' once-criticised out of cycle rate rises.

Other Important Positions

We have taken the opportunity to selectively add to existing positions, especially where share prices have retreated and fundamentals have improved, and to add a few new ones.

The Fund holds a portfolio of high quality and strongly growing companies. Many of their products or services should continue to sell well regardless of the

economic environment, including pizzas, wine, plumbing products, and hospital services. They should also be selling more and more of their products or services over time, which should augur well for longer growth in earnings, value, and ultimately shareholder returns.

There are 26 stocks all up in the portfolio, including the following larger positions.

- **Aristocrat** manufactures slot machines for casinos, pubs and clubs, and develops online social casino games for play on networks such as Facebook. Momentum within the business is strong. At its AGM in February, the company guided towards earnings growth for this financial year of 20%-30%, which was above market expectations. The company has developed a popular range of products, and has an attractive pipeline of new games to follow. Increasingly, the company is selling on a participation basis, in which it shares in the revenues its casino customers make from the machines it sells. This improves the visibility and predictability of earnings, which warrants a high valuation multiple.
- **CSL Limited** is a global biopharmaceutical company and the sixth largest stock on the ASX. In January this year, it upgraded earnings guidance for this financial year from 11% to 18%-20%, and backed that up in February with a solid first-half result. The company has and invests significantly in innovation to improve existing medicines and discover new ones. The company has had a long track-record of strong growth, and we believe this will continue for the foreseeable future.
- **Fisher & Paykel Healthcare** manufactures breathing-support devices that assist with breathing difficulties, including humidified ventilation systems and CPAP devices. At its half-year result in November, it reported profit growth of 26%. The company has very large markets that remain underpenetrated, particularly for its humidified ventilation products. With a strong track-record and a large opportunity in front of it, the company looks likely to grow earnings and shareholder value over the long term. Indeed, the company has recently provided longer term targets to double revenues every five to six years and achieve EBIT margins of 30% (from approximately 25% today).
- **Ramsay Health Care** is the largest private hospital operator in Australia, the largest private operator in France, and has smaller operations in



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the UK and Asia. At its recent half year result, it upgraded its earnings guidance range for the full year from 10%-12% to 12%-14%. Over the next few years, the company has outlined a significant opportunity to reduce procurement costs, which could be quite substantial. Over the long term, it should continue to benefit from the strong growth in demand for hospital services, not least because of an ageing population.

- **Reliance Worldwide** manufactures plumbing products and water control valves. These include the Sharkbite brand of push-to-connect plumbing fittings that are growing in popularity among plumbers. The company listed in early 2016 but has a long track record of through-the-cycle revenue growth. At its recent half year result, it reported earnings growth of 19%, and guided to full year earnings slightly ahead of its Prospectus forecast. Over the longer term, the company should be able to grow nicely through market share gains, especially with Sharkbite in the US, and expand into other markets.
- **Treasury Wine Estates** produces and distributes wines, focusing on luxury and 'masstige' brands that include Penfolds, Wynns and Wolf Blass. It is part way through a transformation that essentially involves reorientating from a price-taking production company and more towards a price-making brand company. The transformation is allowing to the company to arrest pricing power back to itself, which is in turn allowing to price up its wine. This is resulting in higher revenues, margins and profits. At its recent half year result, the company reported a more than doubling of earnings over the prior period. Over the longer term, the company looks set to continue the transformation and build out its Chinese and US businesses.

Outlook

Some investors are concerned that the market has run too hard in recent months, that market valuations are too high, that the macro picture remains troubled, and/or that there is potential for a market downturn, or worse. These concerns always seem sensible. As Joseph Schumpeter once said, 'Pessimistic visions about anything usually strike the public as more erudite than optimistic ones.' It is true that there is some justification for the market's caution, and given we are talking about the future, anything is possible.

However, valuations are still quite reasonable, particularly in the context of the lowly yields and prospective returns available elsewhere. The stock

market trades on a PE multiple of just 16 times the consensus earnings for the next 12 months, offers some (albeit sluggish) growth longer term, and is set to pay a dividend yield of 4.4%. In fact, this dividend yield rises to 5.8% when grossed up for the value of franking credits, which one doesn't get on other assets. This appears reasonably attractive compared to other asset classes. To take the most commonly used reference rate, the Australian 10-year government bond yielded just 2.69% as at the end of March (and less at the time of writing). For so long as long-dated yields remain low, the equity markets are likely to remain well supported.

It seems many equity investors have assumed that long-dated interest rates are on the way up. Most seem to have considered this inevitable based on the consensus thinking that the Fed would hike rates three times this year, with more to go next year. Other things being equal, rising long-term rates should act to pressure equity market valuations. However, since the Fed hiked rates in mid-March, long-dated bonds yields have in fact fallen, indeed quite materially. Immediately before the Fed's hike, the Australian 10-year yielded 2.98%, which means it has fallen approximately 30bps since. Similarly, the US 10-year yield also fell, albeit slightly less.

Interestingly, in the last Fed rate tightening cycle starting in 2004, which lasted two years and involved a total of 17 rate hikes that increased the funding rate from 1.00% to 5.25%, the US 10-year bond actually fell by almost 100bps, from 4.87% to 3.88%. This might seem counterintuitive, but it just goes to show how hard it is to forecast long-term bond yields. Inherently, long-dated bond yields price in the market's expectations for rate hikes or cuts over the following 10 years. More recently, the long-term yields had already factored in the consensus rates hikes for 2017 and the prospect for more next year. Few have considered the possibility that the Fed would look to contract its balance sheet, which has the effect of and replaces some of the need for actual rate hikes. Where they go from here is of course difficult to predict. The reality however is that interest rates are low and could well remain low for some time. Coming out of the Depression in the early 1930's, the yield on the US 10-year Government Bond remained below 3% for two decades.

As always, there are some pockets of the market that look vulnerable; some that look quite attractive. It will increasingly pay to be selective.

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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 at a glance

Feature	Fund facts
APIR code	BFL0001AU
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	± 6%
Cash limit	0-10%
Inception date	30 January 2009
Recommended investment period	Medium to longer term (five years plus)
Buy/sell spread	+/-0.30%
Entry/exit fees	Nil
Management Fee	0.95% p.a. of Net Asset Value of the Fund

How to invest

The Fund is open to investors directly via the PDS, available on our website, or via a range of platforms.

Platforms

AMP (Elements Investment, Elements Pension, eWrap Investment Arc, eWrap Pension, iAccess, Investment Service, MyNorth, North, Pension Service, Summit, Super Service, Term Pension, Wealthview eWrap)

ANZ grow IOOF AET

BT: Wrap, Panorama Macquarie Wrap
CFS: First Wrap IDPS

One Answer, OnePath, Netwealth: Super
PortfolioOne Service, Wrap
Service

Hub24 Wealthtrac

IOOF AET HUB24

Contact details

For more information, call 1800 895 388 (AU) or 0800 442 304 (NZ) or visit baep.com.au

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

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