Bennelong Twenty20 Australian Equities Fund
Performance update

As at 30 June 2017

Performance

	1 mth	3 mths	6 mths	1 Year	3 years pa	5 years pa	Since Inception** pa
Fund	1.07%	0.06%	5.08%	13.93%	na	na	9.28%
Benchmark*	0.22%	-1.57%	3.07%	13.82%	na	na	9.96%
Value added	+0.85%	+1.63%	+2.01%	+0.11%	na	na	-0.68%

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
Aristocrat Leisure
CSL
Telstra
Domino's Pizza
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	20.0%	5.2%	14.8%
Consumer Staples	12.4%	7.1%	5.4%
Liquidity	0.9%	0.0%	0.9%
Health Care	8.1%	7.5%	0.6%
Utilities	1.9%	2.3%	-0.4%
Telco's	3.2%	3.8%	-0.5%
Financials	36.2%	36.9%	-0.7%
Industrials	6.1%	7.4%	-1.3%
IT	0.0%	1.5%	-1.5%
Energy	1.4%	4.1%	-2.7%
REIT's	3.3%	8.3%	-5.0%
Materials	6.4%	16.0%	-9.6%

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

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Bennelong Australian Equity Partners

Performance review

The market was weak over the June quarter, returning -1.57%. The market's weak showing owed itself to material declines in the Big Banks and other top 20 stocks. The S&P/ASX 20 Index actually returned -4.09%. Pleasingly, the Fund still managed a positive return, albeit only +0.06%.

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. That is, the relative performance of the ex-20 sleeve of the portfolio will determine the Fund's out or underperformance versus the market.

<u>Contributors/detractors over the quarter</u>

The Fund's outperformance over the quarter is largely explained by a number of its larger positions in ex-20 stocks. Some of these had positive news-flow during the quarter; others did not but performed well regardless.

By far the largest contributor to the Fund's quarterly performance was **Aristocrat Leisure**. Aristocrat develops slot machines and games for casinos, pubs and clubs. It also develops online social casino games for play on networks such as Facebook and Apple's iOS. Its business is global, although the US accounts for a majority of revenues.

More than five years ago now, Aristocrat started a journey to re-energise the business. The focus was on developing successful gaming product, the key success driver for its business. The company targeted top industry talent and invested considerably behind design and development (D&D). The company was able to develop some very successful games, including *Buffalo Grand*, licensed titles such as *Game of Thrones*, as well as *Lightening Link*. Today, the company has an attractive pipeline of new products to come. This includes *Dragon Link*, perhaps the most anticipated game release in the US this year.

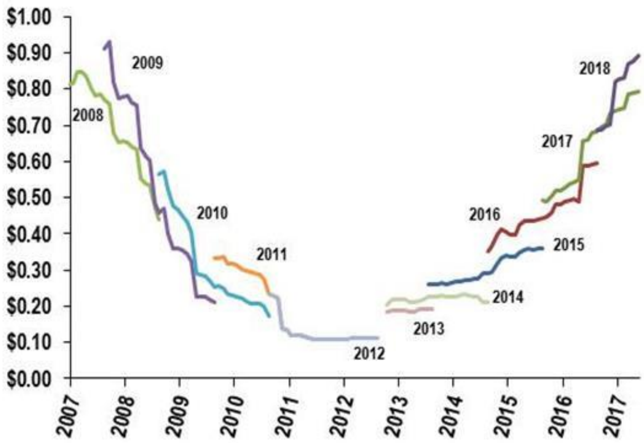
In addition to developing a slew of successful new games, the company also made the following strategic acquisitions:

- Product Madness, which is an online social gaming business and which Aristocrat acquired in late 2012. The acquisition was important in augmenting the company's then nascent online business. This online business now represents approximately 15% of the company's earnings.

- Video Gaming Technologies, which was acquired in mid-2014. VGT is a developer of Class II gaming machines (Class II games are bingo-style games, as opposed to the standard Class III games such as *Buffalo Grand* which are based on random number generators). VGT sells its games largely on a 'participation basis' in which it participates in the revenues made from the machine over time. As a result, revenues are more of a recurring nature, which in turn ensures a more predictable earnings profile.

Aristocrat's journey so far has resulted in a turnaround in the company's earnings. Importantly, earnings have surprised the market on the upside. To give some sense of this, the graph below presents brokers' average EPS estimates over the last decade. Since around 2014, those EPS estimates have been continuously revised upwards. This reflects an underappreciation by the market of the company's earnings power.

"Snail Trail" of Consensus EPS Estimates for Aristocrat



Source: BAEP, BAML, as at 30 June 2017

In May, the company reported a strong set of first half financial results, which were again ahead of market expectations and to which the market reacted positively. The company achieved first half-year earnings growth of 49% and reconfirmed guidance for full year earnings growth of 20%-30%. In the context of a strong earnings result and the strong momentum within the business, this guidance looks conservative.

For the next few years, there is opportunity for upside owing to the following factors:

- continued strong momentum of current hits, especially *Lightening Link* and follow-up title *Dragon Link*. In *Dragon Link's* case, this is underpinned by improving game performance, and evidenced by recent customer surveys;

- the momentum, sustainability and longer term growth prospects of the digital gaming business. In the near term, the strength of this business derives from the continued success of the *Heart of Vegas* app and from new release *Cashman Casino* (which has *Lightening Link*). Longer term, it derives from Aristocrat being able to continue leveraging its game library into new apps, and to scale up this business globally;

- there is potential upside from the roll-out of new products such as a stepper (a mechanical reel product) and Class II video content (which VGT does not currently offer); and

- continued cost discipline, which allows for increased leverage of strong revenue growth into even stronger earnings growth.

Based on consensus numbers, Aristocrat trades on a PE multiple of 23x its 2018 financial years earnings. We believe that company could exceed consensus numbers, which implies a lower PE multiple. Regardless, the multiple appears to us to underestimate the quality of the business, its future growth prospects and earnings power.

Other large ex-20 holdings in the Fund that contributed to its quarterly outperformance were as follows.

- **Fisher & Paykel Healthcare**, the manufacturer of breathing-support devices that assist with breathing difficulties, including humidified ventilation systems and CPAP devices. During the quarter, the company reported a strong financial year result, with profits up 18% over the prior year. The company also guided to another strong year coming. The company is currently involved in patent litigation with competitor Resmed. In a positive development during the quarter, Resmed dropped its complaint with the US International Trade Commission against Fisher & Paykel Healthcare for patent infringement, which is one part of series of litigation between the two companies.

- **BWX**, the manufacturer of the Sukin brand of skincare creams and other products, which are sold in Australia as well as the UK, Canada, China and elsewhere. There was no specific news that explained BWX's strong gains during the quarter. The market is, however, coming to understand the growth opportunity before BWX. This includes through the development of new products, expansion into the UK and other international markets, and now, the potential acquisition of similar-type businesses. Early in July, BWX announced the acquisition of Mineral Fusion, a natural cosmetics company based in the US.

- **Reliance Worldwide**, the manufacturer of plumbing products and water control valves, including the Sharkbite brand of push-to-connect plumbing fittings. During the quarter, Reliance Worldwide announced the acquisition of Holdrite for US$92.5 million, a business that bolts on neatly into its existing business. Holdrite manufactures engineered products for plumbers and contractors in the housing construction market. Its products are largely patented and include secondary pipe support solutions, water heater accessories and firestop systems. The acquisition boosts the breadth of Reliance Worldwide's product offering.

The largest detractor to performance during the quarter was **Domino's Pizza Enterprises**. Its impact was, however, relatively limited.

We continue to like Domino's longer term prospects and believe the stock offers attractive longer term returns. We have previously written at length on our investment thesis, including an assessment of the investment risks. The stock price has fallen quite significantly since hitting a high in August 2016. This appears to have been caused by a derating of its earnings multiple. Since August, the company has upgraded its earnings guidance for the 2017 financial year. Guidance is for earnings growth of 32.5%, which is in line with consensus expectations. We believe that the company can grow consistently over the forseeable future at a rate of 20%-30%. Whilst this is a step-down from the rates of recent years, it is still impressive growth.

We believe these rates of growth are underpinned by the long runway of growth ahead for the European business. In many ways, the European business is just starting out, with recent acquisitions expanding the business in France and into Germany. Only recently has the company started to introduce to Europe some of the innovations, apps and systems that have allowed the company to grow in Australia so successfully. We expect some growing pains in the short term, but are excited by the longer term opportunity.

On consensus numbers, the stock trades on a PE of 29x this financial year's earnings, and 23x next year's. Domino's PE multiple should continue to amortise down thereafter as strong growth works to compound earnings materially higher over time. We believe that Domino's current valuation underestimates the long term growth prospects of the company.

Outlook

Sentiment towards equities is quite interesting. Very few investors seem bullish, some seem complacent, and many seem quite cautious. On the latter, we note many other fund managers are holding relatively high levels of cash within their equity funds. Market levels will reflect investor sentiment, and so this point is a positive.

Currently, the Australian market trades on reasonable valuation metrics. As at 30 June 2017, it trades on:

- a PE multiple of 15.8x the next 12 months consensus earnings, which equates to an earnings yield of approximately 6.3%;

- a dividend yield of 4.5%. This implies that only about 70% of earnings are paid out as dividends on average, leaving the remaining 30% to be reinvested back into businesses for future growth. This dividend yield of 4.5% also comes with a level of franking credits. On a grossed up basis, which is the best measure when comparing the yields available on bonds and like assets, this yield equates to 5.9%; and

- EPS growth of approximately 8% for over the next 12 months. As discussed below, there is significant earnings risk within the Australian market, meaning that this growth forecast is likely to be revised down. That said, there is likely to be at least some level of growth that augments the dividend yield. This earnings growth partly results from the reinvestment of retained earnings.

A major risk in the Australian stock market is earnings risk. This is the risk that companies miss the market's expectations of earnings. Based on our many company meetings and extensive industry contact, we believe many corporates are doing it tougher than appreciated by the market. This might well play out during earnings season in August. If we are right, it means the E assumed in the P/E ratio is currently too high, and that in reality the PE is actually higher.

Even allowing for this risk, Australian equities continue to look relatively attractive, especially in the context of low prospective returns for other asset classes. For example, cash, which as before is attracting a number of fund managers, pays less than 3%.

The attraction of equities very much depends on where interest rates go from here. Current valuations can afford some moderate rise in rates, but probably nothing too dramatic. On this, we are quite calm. The recent uncertainty around rates has however introduced some volatility to the market. It is resulting in something of a tug-o-war between the reflation trade (supporting cyclicals, value stocks and inflationary beneficiaries such as banks) and the duration trade (supporting yield plays and long-duration growth stories). These macro issues tend to work themselves out over time, with stock returns ultimately determined by company fundamentals.

Portfolio Positioning

In terms of the ex-20 sleeve of the portfolio, and consistent with our investment style, we continue to hold high quality, strongly growing companies. This is reflected in the Fund's portfolio characteristics, as set out in the table below.

	Fund	Benchmark*	
Return on Equity	8.8%	11.2%	Premium Quality
Debt/Equity	11.5%	22.7%	
Sales Growth	6.3%	4.0%	Superior Growth
EPS Growth	8.8%	8.0%	
Price/Earnings	17.0x	15.8x	Reasonable Valuation
Dividend Yield	4.1%	4.5%	
Beta	0.95	1	
Active Share	37%	na	Genuinely Active
No. of Stocks	51	297	

Two other important themes flow out of the positioning of the ex-20 sleeve of the portfolio. They are as follows.

- We have a heavy concentration in "all weather" businesses selling relatively defensive products or services such as wine, pizzas, electricity, hospital services, skincare creams and medical products.

- We also have a heavy concentration to global businesses with "exportable competitive advantages". These companies are all finding growth through expansion in offshore markets. Examples include Treasury and BWX, both with valuable brands that are proving to travel profitably offshore; as well as Fisher & Paykel Healthcare, Aristocrat and Reliance Worldwide, which have out-innovated their international competition.

Bennelong Twenty20 Australian Equities Fund

Monthly performance update

As at 30 June 2017

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 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

- AMP Personalised Portfolio
- CFS First Wrap
- Federation Managed Accounts
- Macquarie Wrap

Contact details

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