Bennelong Australian Equities Fund
Quarterly performance update

As at 30 September 2017

Performance

	1 mth	3 mths	6 mths	1 Year	3 years pa	5 years pa	Since Inception** pa
Fund	1.56%	2.49%	5.87%	11.10%	11.19%	13.68%	13.49%
Benchmark*	0.04%	0.80%	-0.78%	9.02%	7.12%	9.94%	10.43%
Value added	+1.52%	+1.69%	+6.66%	+2.08%	+4.07%	+3.73%	+3.07%

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
CSL
Westpac Banking
Aristocrat Leisure
National Australia Bank
Reliance Worldwide
Flight Centre Travel
Treasury Wine Estates
Fisher & Paykel Healthcare

Portfolio Sector Allocation

Sector	Fund Weight	Benchmark* Weight	Active Weight
Discretionary	23.3%	5.0%	18.2%
Health Care	18.8%	7.0%	11.8%
Industrials	12.3%	7.5%	4.8%
Liquidity	1.4%	0.0%	1.4%
Consumer Staples	8.5%	7.2%	1.2%
Utilities	1.5%	2.1%	-0.7%
IT	0.0%	1.6%	-1.6%
Telco's	0.0%	3.1%	-3.1%
Energy	0.0%	4.4%	-4.4%
REIT's	1.3%	8.4%	-7.1%
Financials	27.8%	36.7%	-8.8%
Materials	5.3%	16.9%	-11.7%

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

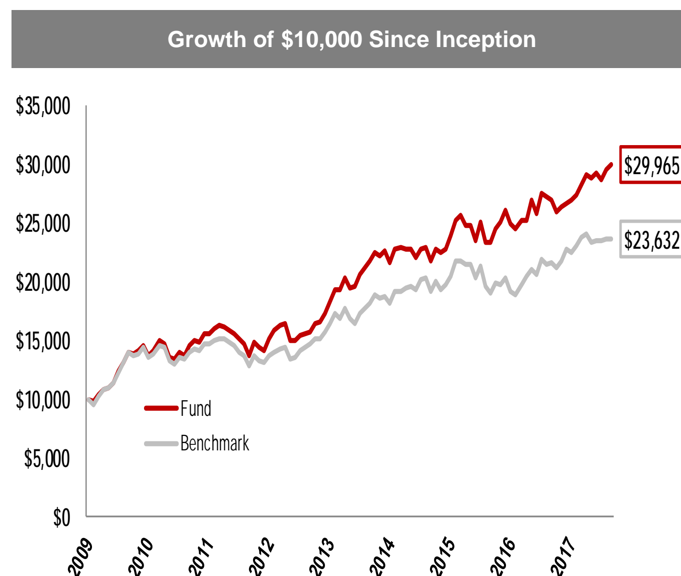
Portfolio characteristics

	Fund	Benchmark*	
Return on Equity	15.7%	11.9%	Premium Quality
Debt/Equity	17.9%	24.0%	
Sales Growth	7.4%	4.2%	Superior Growth
EPS Growth	9.3%	5.3%	
Price/Earnings	19.7x	15.8x	Reasonable Valuation
Dividend Yield	3.4%	4.5%	
Beta	0.90	1	
Active Share	67%	na	Genuinely Active
No. of Stocks	28	299	

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

Long-term performance

Growth of $10,000 Since Inception



Source: BAEP

bennelong

BAEP
Bennelong Australian Equity Partners

A recap of BAEP's investment approach

By way of recap, our investment approach is based on the following.

1. **Focusing on high quality and strongly growing companies.**

   We believe that a focus on quality and growth sets the portfolio up for stronger returns and lower risk over time.

   In many respects, the quality of a company defines the level of risk inherent in its business. This includes in relation to business risks, competitive threats, regulatory risks, macro-economic exposures, other exogenous risks, and ultimately, earnings risk. Reflecting a quality focus, BAEP's portfolio has typically had a heavy concentration in defensible, quite predictable and lower-risk businesses such as those selling everyday consumer and healthcare products and services. Quality also defines the potential to grow profitably, for example via high returns on new investments, pricing power and market share gains. Growth then will allow earnings and therefore shareholder value to build over time, which in turn ultimately makes its way into shareholder returns.

   Our focus on quality and growth is reflected in the characteristics of the portfolio itself. Consistently, the table titled 'Portfolio characteristics' on the front page of these performance reports shows above-average quality metrics (ROE and gearing) and above-average growth rates (sales and earnings).

2. **Seeking to identify those whose earnings prospects are underappreciated by the market.**

   Ultimately, share prices are discounting mechanisms. This means they largely reflect the market's expectations of each company's future prospects, most pertinently in respect of earnings. In other words, share prices are predominantly based on – and will move with - earnings expectations. For example, a company might report very strong earnings growth but see its share price fall because the market expected more. In this respect, understanding the market's expectations can be an important part of investing successfully, although admittedly it is not always easily done. To the extent that you can identify companies that outperform the market's earnings expectations, you should also achieve investment outperformance.

   Alas, identifying these companies is not easy. We attempt to identify underappreciated earnings strength through our extensive real-world research. Here we are focused on the facts rather than the narrative that often engulfs the market. Our real-world research involves frequent and ongoing meetings with the listed companies themselves, as well as their customers, suppliers, competitors, franchisees and regulators, and other industry contacts. Essentially, the idea is to identify where a company's prospects look brighter than what is widely perceived, including for example where things are quietly changing for the better.

   We believe a focus on earnings strength provides opportunity for upside surprise, which manifests in companies beating earnings expectations, positive trading updates, bullish guidance, and upward consensus earnings revisions. Generally, such events will lead to strong returns. Conversely, we believe it also limits the portfolio's exposure to downside surprises, which comes with poor investor returns.

   Looking for underestimated earnings prospects is akin to looking for undervaluation. Many are familiar with looking at the valuation of a company based on its PE multiple. Generally, the 'E' used in this calculation of the PE is the consensus broker earnings forecasts for the upcoming year. Where we may differ slightly is in focusing much more intensely on the input – the forecast earnings - than the output of the PE multiple itself. While we still believe the multiple is important, stock prices and dividends will ultimately move with actual earnings rather than what is expected. Thus, we are driven to find companies whose earnings will exceed expectations.

3. **Constructing the portfolio with a view to optimising its risk-return dynamics.**

   Fundamentally, we put the portfolio together one stock at a time, based on the individual merits of each particular stock. The size of any specific stock in the portfolio will depend on our conviction levels, both in respect of the upside potential and, just as importantly, the downside risks. These conviction levels develop from our extensive research and analysis, particularly in relation to the company's earnings prospects relative to the market's expectations. Particularly in the case of macro-dependent sectors such as Banking and Resources, we will marry together macroeconomic research and analysis with our predominantly bottom-up stock specific approach.

   The portfolio construction process suffers few of the constraints that might otherwise impact the ability to limit downside risks and optimise upside exposures. Thus, the process gives us the flexibility to completely avoid risky sectors or large benchmark positions, and allows us to take concentrated positions to leverage high conviction

ideas. In addition to the stock-specific risks, the portfolio is also run with a macro and quantitative overlay. This seeks to highlight and manage portfolio-wide risks that may otherwise build up inadvertently, including for example concentration or currency risks.

The outcome is a selective, high conviction and differentiated portfolio. Currently, the portfolio has just 28 stocks and doesn't bother with many of the mega-cap stocks you typically find in an all-cap fund – such as Commonwealth Bank, BHP, Telstra and Woolworths. Indeed, the active share of the Fund's portfolio is 67%, which means that 67% of the portfolio's holdings differ from the benchmark's holdings.

Historical investment outcomes

The historical investment outcomes of this investment approach are as follows:

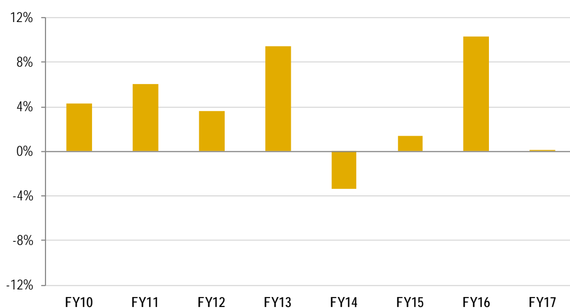
1. **Pleasing long-term returns for our clients, and strong outperformance versus the market**

   Since inception, the Fund has returned 13.49% per annum, which compares to the market's return of 10.43%. Over the past three years, the Fund has returned 11.19% versus the market's return of 7.12%.

2. **Relatively consistent outperformance against the market**

   While the portfolio has not outperformed at all times, it has managed to do so most of the time. The following graph illustrates the performance of the portfolio relative to the market over each financial year since its inception. It shows that the portfolio has outperformed the market in all but one financial year, as denoted by the gold bars extending up.

The Fund's gross performance versus the benchmark*



*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.*

3. **Relative resilience in down-markets**

   The portfolio tends to outperform in down-markets, although not always. This reflects our focus on risk, including both stock-specific and portfolio-wide risks.

   To illustrate, the portfolio's historical downside capture ratio has been 87% since inception. This means the portfolio has on average shared in only 87% of the market's decline in down markets. Over the past three years, the downside capture ratio has been just 75%.

   Where the portfolio has historically underperformed against the market is in strong bull markets. This is particularly so in bull markets led higher by cyclicals, value stocks and other lower quality companies. An example of this was in the last half of calendar 2016. During that half year the market returned 10.4%, while the Fund returned just 3.4% (we have since been able to make up the underperformance and some). The Fund's performance was decent enough, but not in the context of the strong bull market at the time.

Overall, the Fund has a strong long-term investment track record, and this reflects what is a robust, effective and proven investment approach.

Quarterly performance review

The Bennelong Australian Equities Fund returned 2.49% in the September quarter, outperforming the market, which returned 0.80%.

The Fund's performance benefited from strong returns during the quarter from Flight Centre, Reliance Worldwide and Costa Group. Also helping the Fund's relative outperformance, we managed to benefit from the poor performances of Telstra and Commonwealth Bank, which dragged down the benchmark. The largest detractors were the Fund's positions in Ramsay Health Care, Domino's Pizza Enterprises and Aristocrat Leisure, and our underweight exposure to the strong performing Resources sector.

BAEP built up a large stake in **Flight Centre** earlier this year. The company has since been a strong performer for the Fund, and was the largest contributor to its performance in the quarter.

The company is best known for its well-known Flight Centre branded retail stores. Many believe its business to be structurally challenged by online competition. Indeed, for some time it has quite consistently been one of the most heavily shorted stocks on the ASX, as it was earlier this year when we began to build our stake in the company.

However, Flight Centre's business is much broader than its namesake stores. It has:

- other retail formats, including Cruiseabout and Student Flights;
- online-only businesses such as StudentUniverse.com.au, the leading travel booking site for the youth market;
- its own travel product, including ownership of bus tour operator Top Deck;
- travel-related businesses such as the currency exchange business Travel Money; and
- the world's largest corporate travel business.

All up, it has about 40 travel brands, 2,500 retail shops in 14 countries, 19,000 staff, and it arranges more than $20 billion worth of travel bookings per annum.

What is perhaps surprising to some is that the company has quite consistently grown volumes faster than the broader travel market, meaning it has taken market share. This fact hits up against the bearish narrative that questions Flight Centre's competitive position. When one considers whether Flight Centre has a place in today's hi-tech world, one should consider that $20 billion of travel bookings can't be wrong. Of course, these facts have not got in the way of the bearish narrative that underestimates the breadth and overall quality of Flight Centre's business and management team.

What prompted us to take a big stake in Flight Centre earlier this year was signs of a renewed focus on cost discipline, something that has been missing for some years. In prior years, the company was able to grow travel bookings nicely, but was also good at growing costs. With a renewed focus on costs, top line growth should also make its way to the bottom line.

During the quarter, the company reported decent profits for 2017, as indicated in their upgraded guidance earlier in July. More importantly, the company announced a transformation program for the next five years. This program 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.

Reliance Worldwide is a manufacturer of plumbing products and water control valves, including the Sharkbite brand of push-to-connect plumbing fittings. The company posted a strong full year financial result in August. It grew net profit by 26% in 2017, and guided to 20%-24% growth for 2018. Both the result and the guidance exceeded the market's expectations, and its shares gained nicely as a result.

Some investors had been negative on Reliance Worldwide. Indeed, it was one of the most heavily shorted stocks on the ASX prior to its results announcement, with approximately 9% of its free float sold short. This short interest emerged predominantly when Reliance ended its exclusive sales arrangement with Home Depot and started also selling through Lowes (these are the two largest home improvement retailers in the US). The short thesis appears to have been that Home Depot would switch away from selling Sharkbite – it announced a trial of the competing Tectite brand in some regional markets – and the impact from this would more than offset the benefit from also selling through Lowes. More recently, there has also been concern that higher copper prices, a key cost item in the manufacture of brass fittings, would hurt margins.

This negativity was a positive for the Fund. It gave us the opportunity to substantially increase the Fund's stake in the company at very attractive prices.

Positively, the reported results in August showed that Reliance continues to enjoy strong momentum of Sharkbite sales in the US. Home Depot continues to back Sharkbite in the main, and their relationship continues largely as it was, including the development of new product extensions. Meanwhile, Reliance is now also benefiting from strong sales into Lowes. The US is Reliance's largest market by far, and Home Depot had been its most important customer. The move into Lowes, and other wholesale channels such as Amazon, diversifies its customer base and expands its distribution reach. The brand continues to prove popular to end-customers and valuable to retailers. Indeed, its value proposition affords it a degree of pricing power, which has allowed it to historically pass on higher copper costs through higher priced products.

We believe Reliance is a high-quality company with strong growth ahead. It has a strong brand, product leadership, and ongoing customer-focused product innovation. It is the dominant player in the brass push-to-connect plumbing fittings category. This category is presently a relatively small part of the broader fittings market but is taking market share, largely because push-to-connect fittings are easier and quicker to install. Through market share gains, the release of new products and price rises, Reliance should continue to enjoy strong revenue growth in the future. Over the past decade, Reliance has grown constant-currency revenues each year at an average

compound growth rate of 12%. In the 2017 financial year, it achieved revenue growth of 13%, which (with margin expansion) translated into profit growth of 26%.

The company has a longer-term opportunity to expand globally into other markets, including Europe where it has only a very small business. In addition, the company can continue to make acquisitions in order to build out its product suite. Earlier this year, Reliance made the acquisition of Holdrite for US$92.5 million, a nice bolt-on to its existing business. Holdrite manufactures engineered products for plumbers and contractors in the housing construction market, including piping support, water heater accessories and firestop systems.

The market seems to be underestimating the quality of its business, the strength of its management team, and the various growth options available to it.

Costa Group, Australia's largest agricultural produce company, saw its shares rise strongly over the quarter. This was largely due to an upbeat results announcement in August. The company reported a rise in profits in the 2017 financial year of 37%, which was well ahead of previous guidance for 25% growth, and also ahead of the market's expectations. Costa also guided to 10% growth in 2018, which appears conservative, and stated that it is targeting double-digit growth over a three to five year time horizon.

We believe Costa is a quality company. It has leading market positions in high growth categories, underpinned by valuable intellectual property. In the fast-growing blueberries segment, for example, Costa is the dominant producer in Australia, and the only one with the ability to supply all year round. It has developed varieties through collaborated research and development that it is licensing worldwide in exchange for royalties. The company has also mitigated a lot of its exposure to agricultural risks through geographic diversification and weather-protected cropping.

Growth has been underpinned by rising consumption and Costa's investment in new production capacity. It has also expanded berry production offshore, through joint ventures in China and Morocco, and is building out avocado production, largely through acquisitions.

Ramsay Health Care, the largest private hospital operator in Australia, was the largest detractor from performance over the quarter. The company's shares came under pressure as its future growth rates look to be slowing down.

In August, the company reported its financial year results. It grew earnings by 13% in 2017, which was in line with guidance and the market's expectations. More importantly however, it issued guidance for 2018 of 8-10% earnings growth, which underwhelmed the market.

Ramsay's Australian hospitals continue to see strong and steady demand, despite a slowdown in broader industry trends. Historically, Ramsay has achieved quite material margin accretion, which has translated strong revenue growth into very strong earnings growth. With less opportunity now for margin improvement, earnings growth should remain strong but slightly slower than previous years. This is despite the benefit of further 'brownfield' hospital expansions, additional procurement cost-out savings, and the acquisition-led growth of its pharmacy business. Meanwhile, the French and UK hospital businesses are finding growth a struggle. Both businesses face regulatory pricing headwinds, with sizeable tariff cuts in both countries again in 2018. Ramsay is cutting costs to offset these cuts, but they will unlikely be enough.

We believe Ramsay is a high quality company. In its core Australian business, it owns hospitals that have strategic value as essential social infrastructure, and significant financial value as tangible assets. They are well located, well run and offer opportunity for high returning investment through 'brownfield' expansions. Ramsay's hospitals are set to benefit over the long term from the steady growth in patient demand that results from a growing and ageing population, clinical innovation and other quite dependable factors. Similar drivers, together with acquisitions, should support growth in its offshore businesses over time.

Overall, we believe Ramsay can continue to achieve earnings growth in the high single-digits for the foreseeable future. This is slower than historic rates, but still well above the market average. Trading on a PE multiple of approximately 22x this year's earnings, we believe the market underestimates the quality of the assets it owns, the strength of its culture and operations, and the consistency and reliability of strong earnings growth.

Domino's Pizza Enterprises was another significant detractor from performance over the quarter, as it has been over the past year. In August, the company reported results and guidance that disappointed the market, and its stock price reacted accordingly.

The company has a history of exceeding expectations. For 2017, it gave initial guidance of 25% growth, which it upgraded to 30% at its AGM in November, and then to 32.5% at its half year result in February. As it turns out, the company grew net profit by 29% in 2017, which was obviously strong but fell short of its upgraded guidance, as well as the

market's expectations for slightly more. It was the first time in a decade that the company missed guidance.

One of the main culprits for the miss was softer than expected sales in France. The softness came as the company experienced technical glitches in rolling out digital technologies and some poor promotional planning. These appear to be temporary issues, with French sales now looking strong and momentum starting to build.

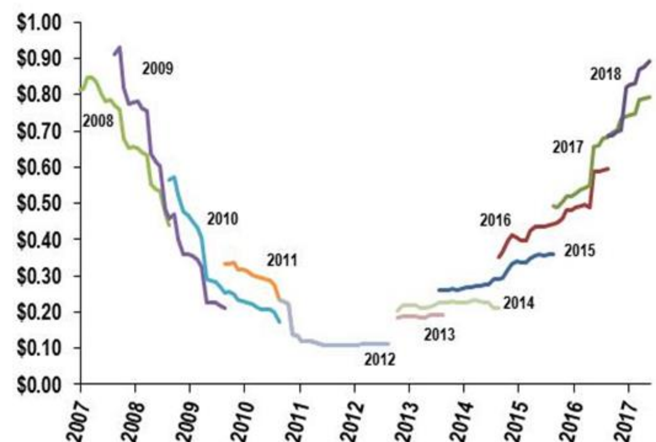
Given the phenomenal growth that it has achieved in recent years, it is likely that Domino's Australian business will slow down. For us, it is the European business that provides the upside for investors. In many ways, the European business is just starting out, particularly as it integrates sizeable acquisitions made last year. Only recently has the company started to introduce to Europe some of the innovations, apps and systems that have allowed the company to grow so successfully in Australia. We gain comfort in the prospects for Domino's in Europe given the potential to rollout a very large number of new stores, the likely take-up of digital ordering, the benefits of gaining scale, and a weak and fragmented competitor set. We expect some growing pains in the short term, as evidenced in the recent results, but we are guided by the longer-term opportunity.

The market has de-rated Domino's shares over the past year, despite its operations remaining on track and its earnings continuing to grow strongly. At BAEP, it is these fundamentals that guide us, particularly as they align with investor expectations and sentiment. There is plenty of investor negativity around Domino's stock at present, and indeed it is one of the most heavily shorted stocks on the ASX, with short interest now at 20% of the company's free float of shares. With growth of 29% in the past year and a guided 20% for this year, Domino's business is clearly a strong one. 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 quickly thereafter, as strong growth works to compound earnings materially higher over time. We believe the market underestimates the longer-term growth prospects of the company, particularly in respect of the European business.

Aristocrat Leisure also detracted from the Fund's performance over the quarter.

Aristocrat is a gaming company that makes slot machines and digital games. We believe it has transformed itself into a high-quality company with a strong suite of successful products and proven strength in new game design and development. The company has been able to leverage its product strength into strong earnings growth, the extent of which has surprised the market. To give some sense of this, the following graph presents brokers' average earnings per share estimates over the past decade. Since around 2014, the consensus earnings estimates have been continuously revised upwards. Reflecting as much, Aristocrat's stock price has also had a strong run. Over the past quarter, however, its stock drifted lower and was one of the largest detractors to the Fund's performance.

"Snail Trail" of consensus EPS estimates for Aristocrat



Source: BAEP, BAML, as at 30 June 2017

During the quarter, the company announced its acquisition of Plarium for US$500 million. The acquisition will be accretive to earnings per share, and has strategic value in increasing and expanding Aristocrat's exposure to the fast-growing digital space. Aristocrat's existing digital business is focused on online casino games, but Plarium moves it into new market segments that include combat and other strategy games such as *Vikings: War of Clans*. With the addition of Plarium, Aristocrat's digital business will account for approximately 22% of its total revenues. This underpins an increasing base of recurring revenues, which next year should account for more than half 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.

Aristocrat did not report full year results in August. The company has a September financial year-end and so will report in late November. However, at its most recent trading update at its half year result, the company guided to full year earnings growth of 20%-30%. Like the market, we believe the company will be able to do better still. Further out, we see opportunity for further upside owing to the following factors:

- continued strong momentum of current hits, especially Lightening Link and follow-up title Dragon Link. In Dragon Links' case, this is

underpinned by improving game performance, and also evidenced by recent customer surveys;

- the strong momentum, sustainability and longer-term growth prospects of the digital gaming business. This should come from the potential successes of recent launches, such as *Cashman Casino*; leveraging its existing slot machine games library into the digital space; and the development of new games, including in the new segments in which Plarium is focused;

- potential upside from the roll-out of new products such as a stepper (a mechanical reel product) and Class II video content (which Aristocrat 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 approximately 21x its 2018 financial year's earnings. We believe the company could well exceed consensus numbers, which implies stronger than expected earnings growth and a lower PE multiple. At any rate, we believe the multiple of 21x does not give full credit to the improvement in the quality of the business, most particularly because of greater earnings predictability.

Also detracting from the Fund's relative performance was an underweight exposure to the **Resources** sector. The sector rose on the strength of commodity prices and a solid reporting season in August. Resource companies have been generating healthy profits and they have largely dealt with once-stretched balance sheets. In prior times, they would have reinvested the excess profits back into the ground, but they are increasingly becoming shareholder-friendly. This is probably due to shareholder pressure, the like of which we have seen in the activist campaign targeting BHP. Quite rightly, investors have taken kindly to the sector's increased generosity, and some are even starting to see them as yield stocks. These investors should remember their generosity relies on commodity prices, which are inevitably unreliable.

Portfolio positioning

As discussed above, we put the portfolio together one stock at a time. Each stock's place in the portfolio rests on its individual investment merits, albeit with some broader portfolio-wide oversight. There are, however, some general comments that can be made about the current positioning of the portfolio.

Heavy concentration in 'all weather' businesses

We have a heavy concentration towards 'all weather' businesses selling relatively defensive products or services such as pharmaceuticals, skincare creams, wine, pizzas, hospital services, and fruit and vegetables.

Being defensive, however, doesn't mean they can't grow. Over reporting season we saw:

- **CSL**, the global biopharmaceutical company that is the Fund's largest position, grew earnings by 24% in 2017 and guided towards double-digit growth in 2018;

- **Treasury Wine Estates**, the company behind wine brands such as Penfolds Grange and Wynns Coonawarra, grew earnings by 55% in 2017 and gave guidance that it was comfortable with the consensus' expectations for double-digit growth;

- **Fisher & Paykel Healthcare**, which manufactures humidified ventilation and other breathing support medical devices, reported earnings growth of 18% for 2017, with guidance of strong growth again in 2018;

- **Domino's Pizza Enterprises** grew earnings by 29% in 2017 and guided to 20% growth in 2018;

- **Costa Group** grew earnings by 17% in 2017 and guided to 10% growth for 2018;

- **Ramsay Health Care** grew earnings by 13% in 2017 and guided to 8-10% growth in 2018; and

- **Transurban**, the toll road operator, grew EBITDA by 10% and its distribution by 13% in 2017, and guided to a 9% increase in its distribution in 2018.

Heavy concentration in global businesses

We also have a heavy concentration towards global businesses with "exportable competitive advantages". They all have niche businesses with brands, intellectual property or other attributes that can be leveraged towards profitable growth through expansion into offshore markets. They include some of those companies listed above selling defensive products or services.

Examples include **Treasury Wine Estates**, whose wine brands are resonating with consumers offshore; **Reliance Worldwide**, whose innovative plumbing products are disrupting the plumbing fittings market and in the process taking market share in the US and other offshore markets; and **CSL**, which continually

leverages its R&D capabilities to develop new life-saving bio-medicines.

Unexcited by mature blue chips

We remain unexcited by many of the mature 'blue chips' such as Telstra, Woolworths, Wesfarmers, AMP and Scentre. Most have solid businesses and pay reasonable dividend yields, but offer little if any growth and some are seeing increasingly intense competition. In many respects, they have become bond proxies, but with some business risk. To give a flavour through some examples:

- **Woolworths** and Coles (owned by **Wesfarmers**) are both competing fiercely against one another and Aldi, with the additional prospect of Amazon entering the space in time. This is resulting in lower shelf prices, weak revenue growth and margin pressure. For the 2017 financial year, earnings in their core supermarkets businesses declined by 2.4% and 13.5% respectively;

- **Telstra** faces increasing competition in its core markets. In mobile, competitors Optus and Vodafone are spending big to reign in Telstra's network superiority, and TPG Telecom is building its own network and will add to competition when it starts up in a few years' time. In broadband, the NBN has largely levelled the playing field, allowing numerous resellers into the market. In both cases, it means lower margins and more investment is required. In the 2017 financial year, the company's operating earnings declined 3.2%, with earnings at its prized mobile division declining 1.5%. More importantly, the company was forced to cut its dividend – from 31 cents per share in 2017 to 22 cents this year – in order to realign its dividend policy to the reality of its future operations; and

- **Scentre**'s operating earnings grew just 2.6% for the first half of 2017, with comparable sales growth of 1.1% in the prior 12 months. Its Westfield shopping centres are clearly dealing with softer consumer spending. They also need to deal with online competition, including the entry of Amazon into Australia. With growth constrained, Scentre has guided to more than $900 million in investment to spruce up centres and new developments. In part to finance this spend, it is slowing its dividend growth with the aim of reducing its payout ratio from 100% of earnings to 85%. It is illustrative of a theme from the recent reporting season – particularly among large caps that had not been reinvesting back into their business, preferring instead to maximise dividends. Some are now finding they under-invested and paid out too much of their earnings in dividends. Telstra and Scentre illustrate the perils of investing in a dividend rather than a business.

Wary of the pure bond proxies

Similarly, we have no exposure to pure bond proxies such as the REITs and Utilities. Our stance is not predicated on a view of interest rates moving higher, which of course would be a headwind to these stocks. Indeed, we actually believe that we could be in for quite a lengthy period of low interest rates. Instead, our stance is that these bond proxies generally have very little going for them other than their dividend, typically with little or no growth that might otherwise augment investors' return. Where they do offer growth, we are happy to invest. For example, we have a position in **Transurban**, which we acquired at an attractive price when it sold off earlier this year. However, 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.

Some exposure to the banks

We view the banks in a similar vein to the 'blue chips' discussed above. However, we believe they have much stronger competitive positions and better prospects for earnings growth.

The banks' competitive strength is best evidenced by their pricing power, which has most recently been seen in the repricing up of rates on certain types of mortgages. This has supported net interest margins, which has in turn allowed them to grow revenues faster than sluggish credit demand. Meanwhile, 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. This should all see the banks able to deliver on the admittedly slow earnings growth expectations of the market. 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.

Very little exposure to commodities companies

We have very little exposure to resource and energy companies. Less than 3% of the Fund was invested in these sectors as at the end of the quarter. This compares to about 17% for the benchmark. Given our predilection towards defensible, predictable and lower-risk propositions, we are not naturally given to commodity companies. Of course, there are times when we can get comfortable around the downside

case for commodity prices and will be happy to invest in commodity companies. Now is not one of those times. On most commodity prices, we believe there is as much downside risk as there is upside, with little conviction around the former. This is not least because of the potential for a pullback in Chinese fiscal stimulus, weaker than expected demand, and signs of new supply.

Wary of domestic cyclicals

We remain largely devoid of domestic cyclicals, especially consumer discretionary companies. Many of these companies look like they might struggle with likely Australian consumer weakness. This weakness owes itself to little wages growth, worrying debt levels and a real rise in living costs such as electricity prices, mortgage outlays and healthcare costs. The issue is most obviously seen in weak sales growth, as seen in Scentre's lacklustre comparable sales growth.

Ultimately, however, we are stock pickers and we are willing to buy into a company even if the sector looks difficult. An example here is **Flight Centre**, a position discussed earlier. While seemingly at the pointy end of discretionary spending, the travel category appears to be holding strong, and internal dynamics at this high-quality company suggest it should grow strongly and ahead of the market's earnings expectations.

Outlook

Sentiment towards equities is quite interesting at present. Very few investors seem bullish, some seem complacent, many seem cautious, and a few seem worried. In our view, this seems like a good time to be constructive.

While the more bearish narratives typically gain most of the attention, it is worth keeping a balanced view of the market, including to note the following points.

- Recent stock market returns have been decent but unexciting.

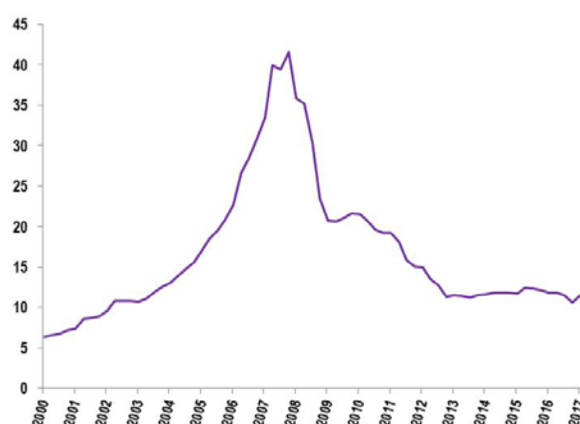
  Over the past three years, the S&P/ASX 300 Accumulation Index has returned just over 7%. For the calendar year to date, it has been just 4%. Indeed, the S&P/ASX 300 Index still sits almost 20% below its highs of about 10 years ago.

- Equity market valuations appear reasonable.

  Currently, the market trades on a PE multiple of 15.8x the next 12 months consensus earnings. This is around the average PE multiple over time, and if for a given time period it is high, it is not by much. The dividend yield of the market is 4.5%, which again is around average, and equates to 5.9% when grossed up for franking credits. Particularly given low interest rates and poor prospective returns elsewhere, these metrics even look attractive.

- There are few signs of investor froth.

  For example, as seen in the following graph, margin lending has plateaued at reasonably low levels. Margin lending levels approximate the levels seen before the 2005-2007 bull market.



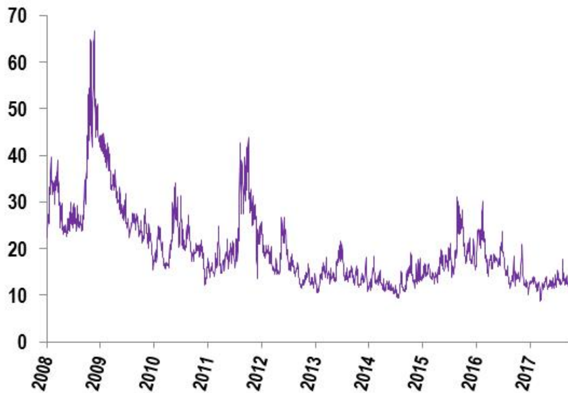
Source: RBA, to 30 June 2017

  In addition, there is little talk of the stock market at BBQs, cabbies haven't any good stock tips to give, and few are giving up their real jobs to take up day-trading.

- Likewise, the IPO market, usually hot when investors are exuberant, is in a balanced state. Indeed, many IPOs are falling away to trade sales, meaning that public markets are not valuing these companies as much as trade buyers. Corporates themselves are fairly cautious in the main. M&A activity is quite muted, business investment is weak, gearing levels are very conservative, and there are few other real signs of animal spirits.

- There is, however, a degree of complacency.

  For example, the S&P/ASX 200 VIX Index, which reflects investor sentiment in the Australian stock market, is low (albeit above lows set in 2014).



Source: S&P Dow Jones Indices, to 6 October 2017

- Most importantly, there are still investors talking about the ominous long bull-run in stocks, over-valuations, and even market crashes and calamity. And a number of institutional and other investors hold relatively high levels of cash, which itself reflects quite negative sentiment. Historically, such negative sentiment has rarely come at market peaks.

The point of the above is not to present a bullish case for equities. Instead, it is to provide some balance. While the short term is virtually impossible to pick, it seems we could well be in a muddle-through environment, with decent-enough but unexciting returns. Regardless of what is happening at the broader market level, we will always look to manage a portfolio of stocks that we believe are each individually attractive. Risk is ever-present in the stock market, even when not front of mind for investors. However, rather than run from risk, we seek to manage it.

In Australia, one of the problems is that large blue chip stocks account for such a large part of the market and, as discussed before, they likely offer muddle-through like returns. The Banks and Resource sectors in particular are important in determining the direction of the market, and both entail significant macro-economic risks around the consumer, housing and Chinese economic strength. Another area of concern is the potential for consumer weakness in Australia, affecting consumer discretionary companies such as retailers. That said, while we are predominantly a consumer economy, our stock market is far less exposed. Fortunately, investing is a game of pick-and-choose, and being as selective as we are at BAEP means we can avoid stocks we think might struggle, and focus on those where the prospects are bright.

Another major risk to the Australian stock market is the possibility that interest rates rise meaningfully. Unarguably, higher rates mean lower equity valuations, at least all other things being equal. The Australian market is very sensitive to interest rates. It is one of the highest yielding markets in the world, replete with bond proxies and bond proxy-like blue chips. For what it is worth, our view is that rates may lift, but not dramatically so. Inflation remains benign, and there are good reasons why this might persist, including factors relating to innovation, demographics and under-employment. To the extent that we see higher rates, it is likely because inflation has built up, which is likely to result from economic strength. To this extent, some offset could then be presumed to come from earnings growth. Our views on interest rates do not really influence our stock picking or portfolio construction, although we do manage around the risk of higher (and lower) interest rates where we consider it sensible. Nevertheless, it remains a risk for equities, as it does for most asset classes.

In short, we believe it is not a time to be bullish, nor to be pessimistic, but to be constructive. In having a constructive view, we continue to open ourselves up to a number of attractive investment opportunities we see at present. In this respect, and as always, we are focused on being selective in our stock picking, targeting high quality and strongly growing companies whose earnings prospects appear underappreciated by the market.

Bennelong Australian Equities Fund
Quarterly performance update
As at 30 September 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 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	+/-0.25%
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
BT Wrap
CFS: First Wrap
Hub24
IOOF AET
Macquarie Wrap IDPS
Netwealth: Super Service, Wrap Service
Wealthtrac
One Answer, OnePath, PortfolioOne

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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