Bennelong Twenty20 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	1.06%	1.74%	1.80%	9.64%	na	na	8.97%
Benchmark*	0.04%	0.80%	-0.78%	9.02%	na	na	9.00%
Value added	+1.03%	+0.94%	+2.58%	+0.63%	na	na	-0.03%

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 mirrors 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 by 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
Flight Centre Travel
CSL
Reliance Worldwide
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	19.6%	5.0%	14.5%
Consumer Staples	12.1%	7.2%	4.9%
Liquidity	2.5%	0.0%	2.5%
Health Care	7.5%	7.0%	0.5%
Industrials	7.4%	7.5%	-0.1%
Telco's	2.7%	3.1%	-0.4%
Financials	36.2%	36.7%	-0.4%
IT	0.0%	1.6%	-1.6%
Utilities	0.0%	2.1%	-2.1%
Energy	1.4%	4.4%	-3.0%
REIT's	2.3%	8.4%	-6.1%
Materials	8.3%	16.9%	-8.6%

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

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BAEP
Bennelong Australian Equity Partners

Performance review

The market was relatively flat over the September quarter, returning +0.80%. Pleasingly, the Fund managed to outperform, with a return of +1.74%.

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.

Contributors/detractors over the quarter

The Fund's outperformance over the quarter is largely explained by a number of its larger positions in ex-20 stocks, including Reliance Worldwide, Flight Centre and Costa Group. Holding back the extent of this outperformance were positions in Domino's Pizza and Aristocrat Leisure, both of which underperformed, and an underweight stance in the Resources sector, which performed strongly.

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 by 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 for example in 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.

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 one of the largest contributors 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.

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.

Domino's Pizza Enterprises was the largest 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 for 2017 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.

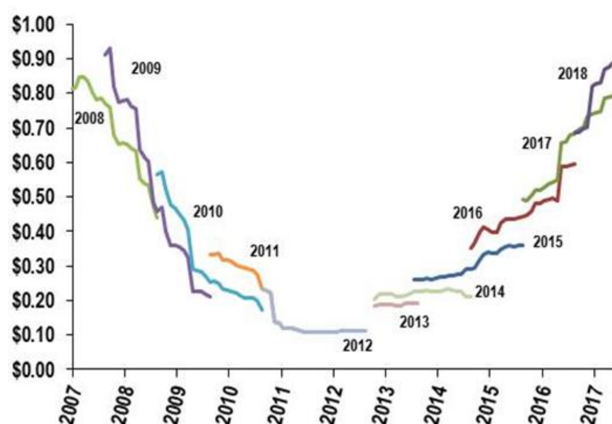
Given the phenomenal growth that it has achieved in recent years, it is likely that Domino's Australian business will slow down. For us, it is the European business that provides the upside for investors. In many ways, the European business is just starting out, particularly as it integrates sizeable 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 will inevitably remain unreliable.

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 following table.

	Fund	Benchmark*	
Return on Equity	14.4%	11.9%	Premium Quality
Debt/Equity	17.9%	24.0%	
Sales Growth	7.3%	4.2%	Superior Growth
EPS Growth	7.0%	5.3%	
Price/Earnings	16.8x	15.8x	Reasonable Valuation
Dividend Yield	4.1%	4.5%	
Beta	0.95	1	
Active Share	38%	na	Genuinely Active
No. of Stocks	46	299	

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

Two other important themes flow out of the positioning of the ex-20 sleeve of the portfolio.

<u>Heavy concentration in 'all weather' businesses</u>

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

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

- **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;
- **Domino's Pizza Enterprises** grew earnings by 29% in 2017 and guided to 20% growth in 2018;
- **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;
- **Ramsay Health Care** grew earnings by 13% in 2017 and guided to 8-10% growth in 2018;
- **Costa Group** grew earnings by 17% in 2017 and guided to 10% growth for 2018; and
- **BWX**, the owner of Sukin skincare creams, grew earnings by 31% in 2017 and guided to at least that again in 2018.

<u>Heavy concentration in global businesses</u>

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.

Some examples include **Treasury Wine Estates** and **BWX**, both with valuable consumer brands that are resonating with consumers offshore; and **Fisher & Paykel Healthcare**, **Aristocrat** and **Reliance Worldwide**, which have out-innovated their international competition with strong IP-protected products.

Market 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.

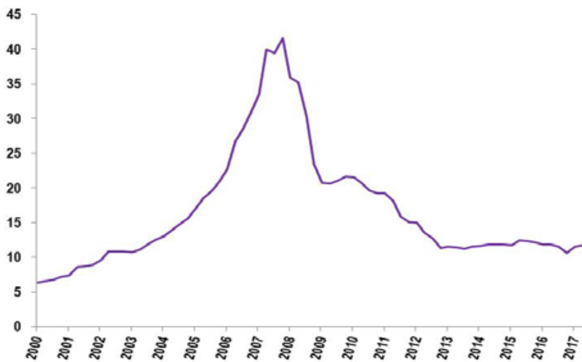
  Currently, the market trades on a PE multiple of 15.8x the next 12 months consensus earnings. This is around the average PE multiple over time, and if for a given time period it is high, it is not by much. The dividend yield of the market is 4.5%, which again is around average, and equates to 5.9% when 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.

  Total margin lending in Australia ($ billions)



Source: RBA, to 30 June 2017

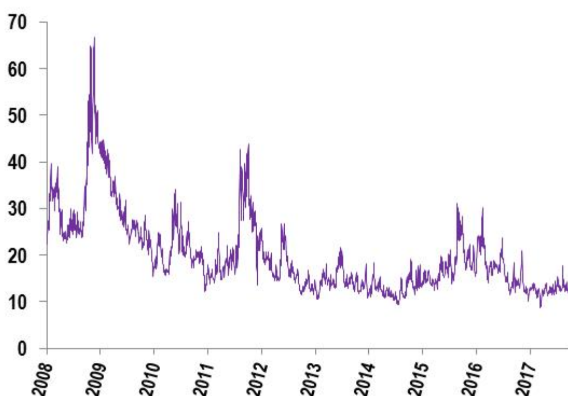
  In addition, there is little talk of the stock market at BBQs, cabbies haven't any good stock tips to give, and few are giving up their real jobs to take up day-trading.

- 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).

  S&P/ASX 200 VIX Index



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. Selective stock-picking, relevantly in the ex-20 segment of the market, may be able to add to the expected muddle-through like returns.

A 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 many high-yielding 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.

Bennelong Twenty20 Australian Equities Fund
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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 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	+/-0.20%
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
Macquarie Wrap
Federation Managed Accounts
AMP North
Powerwrap

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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