

# Bennelong Twenty20 Australian Equities Fund

## Quarterly performance update

As at 31 December 2017

### Performance

	1 mth	3 mths	6 mths	1 Year	3 years pa	5 years pa	Since Inception ** pa
Fund	2.95%	8.81%	10.70%	16.32%	na	na	12.31%
Benchmark*	1.86%	7.74%	8.60%	11.94%	na	na	11.81%
Value added	+1.09%	+1.07%	+2.10%	+4.39%	na	na	+0.50%

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 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
BHP Billiton
Australia and New Zealand Banking
National Australia Bank
Aristocrat Leisure
CSL
Flight Centre Travel
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	20.2%	4.9%	15.4%
Consumer Staples	13.6%	7.5%	6.2%
Health Care	8.3%	7.1%	1.3%
Liquidity	1.0%	0.0%	1.0%
Financials	34.5%	35.0%	-0.4%
Telco's	2.6%	3.0%	-0.5%
IT	0.6%	2.1%	-1.5%
Industrials	5.6%	7.4%	-1.7%
Utilities	0.0%	2.0%	-2.0%
Energy	1.7%	5.2%	-3.5%
REIT's	2.4%	8.2%	-5.8%
Materials	9.4%	17.7%	-8.4%

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



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#### Performance review

Returns for the Fund and the benchmark over various time periods are set out in the table on the front page. The Fund outperformed over the quarter, and over calendar 2017.

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. Within this sleeve, there are a number of stocks that contributed and detracted from relative performance.

#### Contributors over the quarter

Over the quarter, some of the largest contributors to outperformance were:

- **BWX Limited**, the owner of the Sukin brand of skincare creams and other personal care products.

During the quarter, the company acquired Andalou Naturals, which is a leading natural skin, hair and body care brand in the US. The acquisition complements BWX's acquisition earlier this year of Mineral Fusion, the leading natural cosmetics brand in the US. This latest acquisition adds scale to its US operations, while the brands it has bought will be able to leverage BWX's much broader international distribution footprint. To help finance the acquisition of Andalou Naturals, BWX undertook an entitlement offer at what we considered a very attractive price of \$5.92 per share. We participated in this offer for the benefit of the Fund.

At the time of the acquisition, the company reconfirmed its guidance for full year EBITDA growth to comfortably exceed 31%. It also guided that the acquisition of Andalou Naturals was expected to be earnings accretive by an additional 10%.

In Australia, Sukin is the leading brand in the pharmacy channel. It has recently added to its distribution channels by starting to sell through supermarket chain Coles. Early signs are that the brand is achieving good sell-through, without material cannibalisation of sales through the pharmacy channel.

In our view, BWX's shares are attractively priced for likely near-term earnings growth and longer-term potential.

- **Experience Co**, an adventure tourism and leisure company operating in Australia and New Zealand.

The company is building a diversified business that offers a variety of tourist activities such as skydiving experiences, white water rafting, hot air ballooning, canyoning and boat tours.

During the quarter, the company acquired GBR Helicopters for approximately \$20 million. GBR Helicopters provides scenic flights to the Great Barrier Reef, the Daintree Rainforest and other nearby areas.

Also during the quarter, the company acquired two tourism operators in Far North Queensland, Big Cat Green Island Reef Cruises and Tropical Journeys. Both operate tours to the Great Barrier Reef, the Daintree Rainforest, and around Cairns. The acquisition is guided to be substantially EPS accretive.

Both acquisitions were financed by capital raisings in which we participated for the benefit of the Fund.

Also during the quarter, the company reiterated earnings guidance for the 2018 financial year, based on strong trading conditions in the year to date. Longer term, the company should continue to grow through improving and integrating operations and further acquisitions, aided by strong inbound tourism.

- **Costa Group**, Australia's largest agricultural produce company.

During the quarter, the company announced it was buying further shares in African Blue to increase its shareholding from 49% to 90%. African Blue is a blueberries joint venture that produces in Morocco and sells into Europe. As a result of this acquisition, and due to better than expected trading in its core operations, the company at its AGM revised up its previous full year profit guidance from 10% growth to 20% growth. We believe this guidance could yet prove conservative.

For the medium term, the company stated at its full year results in August that it is targeting double-digit growth over a three to five year time horizon. In basic terms, this growth is underpinned by rising consumption – particularly in the fast-growing berry categories in which it is the dominant producer in Australia and its investment in new production capacity. The market is slowing coming around to understanding the quality and strong growth prospects of this company.

- **Aristocrat Leisure**, the slot machine and online social games developer.

During the quarter, the company announced its full year 2017 financial results (it has a September



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year-end). It reported revenue growth of 15% and earnings growth of 36%, which was actually 40% in constant currency terms. The result was solid and was broadly in line with expectations, with outperformance of Aristocrat's digital business balanced out by underperformance of its US slot machines business.

This digital business develops online games. This was initially online casino games, but with the US\$500 million acquisition of Plarium in August this year, it moved into new market segments that include social, combat and other strategy games such as *Vikings: War of Clans*.

At the same time as announcing its 2017 financial results, Aristocrat also announced the acquisition of Big Fish for US\$990 million. Big Fish is an online gaming company that will merge with Aristocrat's existing business to create the second largest player globally in social casino gaming. The acquisition also expands Aristocrat into new genres, including casual gaming with titles such as *Gummy Drop!* and card games such as *Fairway Solitaire*. Aristocrat has the opportunity to improve the returns from Big Fish's games by leveraging its expertise in both casino game algorithmic models and customer acquisition. Conversely, Aristocrat's existing games and capability will be enhanced by Big Fish's expertise in metagame functionality, which basically socialises games by offering player interaction, chat rooms and gifting.

The market appears sceptical of these acquisitions, as evident from the share price declines on the announcement of both acquisitions. It will likely take some time before the market grows comfortable with the strategy. For us, we believe both acquisitions make financial and strategic sense, but as always, will remain ever-watchful of performance in Aristocrat's hands.

With the addition of Big Fish, Aristocrat's digital business will account for approximately 38% of its total revenues. This underpins an increasing base of recurring revenues, which next year should account for approximately 65% 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. Currently, the shares trade on approximately 19x next financial year's earnings – which allows for a full year of both acquisitions – and we believe this valuation is undemanding given the improved quality of its business and the growth ahead.

#### Detractors over the quarter

Some of the largest detractors were:

- **Reliance Worldwide**, a manufacturer of plumbing products and water control valves, including the Sharkbite brand of push-to-connect plumbing fittings.

There were no material negative developments that caused Reliance's shares to come under pressure during the quarter.

The company did, however, hold an investor day in late October. From this, it can be said that the company currently appears to be trading well. This includes in the US, where the market was concerned that ending its exclusive sales arrangement with Home Depot would cause a greater loss of sales than it would pick up from starting to sell through Lowe's and other retailers and wholesale distributors. It seems the brand remains popular to end-customers and valuable to its retail and other customers.

The company also laid out a detailed growth strategy which augers well for longer-term prospects. In basic terms, this revolves around developing or acquiring new products and markets. Some of the main areas of focus were:

1. the continuing development of new products. For example, this year the company will be launching about 130 new SKUs across its Sharkbite, EvoPEX and Cash ACME brands;
2. a move into the new residential and commercial construction markets in the US, where the company currently has very little exposure;
3. the launch of its EvoPEX range in Australia in early 2018; and
4. bolt-on acquisitions, particularly in Europe where it has a relatively small business at present. This follows the acquisition earlier this year of Holdrite, which expanded the company's product suite to include piping support, water heater accessories and firestop systems.

We believe the market seems to be underestimating the strength of Reliance's brands, management team and various longer-term growth opportunities. The company has guided towards 20-24% earnings growth for the 2018 financial year, and we think there are decent prospects that they will exceed this guidance.

- **Flight Centre**, the diversified travel company best known for its namesake retail stores.





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There were no material negative developments that caused the company's shares to come under pressure over the month. That said, its shares have been a strong performer over the year, with the Fund benefiting handsomely. Rarely do you get stocks going up nicely in a straight line.

In August, the company laid out a transformation program for the next five years. This 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. A major driver of investor returns from the stock will come down to its execution on this transformation program, which we will be tracking very closely.

In addition, our underweight position in the Resource and Energy sectors detracted from our relative performance as both sectors outperformed as a result of strength in the price of oil, iron ore and other commodities.

### Portfolio positioning

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

	Fund	Benchmark*	
Return on Equity	14.2%	11.9%	Premium Quality
Debt/Equity	18.4%	24.0%	
Sales Growth	6.5%	4.3%	Superior Growth
EPS Growth	7.8%	5.9%	
Price/Earnings	17.8x	16.5x	Reasonable Valuation
Dividend Yield	3.9%	4.3%	
Beta	0.94	1	
Active Share	40%	na	Genuinely Active
No. of Stocks	49	298	

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

Not a lot has changed over the quarter in terms of the positioning of the portfolio. Attractive new opportunities are not in abundance at present, although we have added a few new ideas to the portfolio.

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

#### Heavy concentration to 'all weather' businesses

We have a heavy concentration towards 'all weather' businesses selling relatively defensive products or services. This includes:

- wine (**Treasury Wine Estates**);
- skincare creams and other personal care products (**BWX Limited**);
- pizzas (**Domino's Pizza Enterprises**);
- fruit and vegetable produce (**Costa Group**);
- hospital services (**Ramsay Health Care**);
- breathing support devices (**Fisher & Paykel Healthcare**);
- plumbing fittings (**Reliance Worldwide**); and
- education services (**IDP Education**).

#### Heavy concentration in global businesses

We also have a heavy concentration towards exporters and global businesses with "exportable competitive advantages". They all have valuable attributes that can be leveraged into profitable growth in offshore markets. These include:

- brands (such as **Treasury Wine Estates'** Penfolds wines or **BWX's** natural Sukin brand);
- intellectual property (**Costa's** intellectual property in blueberry production that allows better quality and all-year-round availability); and
- innovative products (**Reliance Worldwide's** Sharkbite push-to-connect plumbing fittings and **Aristocrat's** market leading slot machine games).

### Market outlook

Our last quarterly performance report addressed a number of positive signs for the market, including a lack of general public enthusiasm for stocks. The idea was to provide some balance for the many investors who seem circumspect about valuations and market levels. Investor sentiment seems to have since shifted up a notch, aided by and abetting the decent run over the past quarter. This should give investors poise for some caution.

Investors are in a believing mood these days, especially at the more speculative end of the market. Investors are back chasing IPOs for what they believe to be an inevitable 20%-plus first-day pop, even if of suspect quality. What is new and lacks much historical track-record allows an enthusiastic view of the future and entails little by way of disproof. Witness the recent demand for lithium stocks, disruptive technology names, pre-revenue concept stocks and bitcoin. In these cases, value seems to be largely in the eye of the beholder.



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rather than any observable fundamentals. One should note, however, that at this stage, enthusiasm for the unproven is not widespread. Similar enthusiasm has not made its way up to the large end of the market.

The more bullish tone in equity markets is understandable. The present set of conditions is ideal for stocks. Economic growth, at least globally, is strong and mostly strengthening, causing similar growth in corporate earnings. Meanwhile, it has not been strong enough for long enough to meaningfully lift inflation and thus also interest rates, which still remain extremely accommodative.

In this environment, equities continue to look attractive relative to most other asset classes such as cash, bonds and property. In aggregate, the Australian stock market trades on an earnings yield of approximately 6%, a grossed-up dividend yield of just under 6%, and offers expected earnings growth for this upcoming 12 months of 5-6%. For comparison purposes, the benchmark 10-year Government Bond yields just 2.6%.

The market's good run of late, together with low levels of volatility, seems to be encouraging investors. This is important as many have been reluctant stock investors, scarred by the GFC and ever fearful of another collapse just around the corner. As we have seen in past cycles, the effect can become self-fulfilling. Whether this optimism continues into a full-blown bull market is difficult to predict.

Since the GFC, bad economic news has been good news for stocks, most particularly because it resulted in further monetary easing. In these present Goldilocks-like conditions, good news is good news.

However, there will be a point when good news becomes bad news. This could be when the good news starts to not be as good as expected, perhaps portending a recession. Or more pertinently, it might be when interest rates start to rise materially higher and liquidity starts to tighten. This appears to be the greatest risk for equities at present, at least at the broader market level. Just as equities benefited from low rates, they will also suffer as they rise. The Australian market in particular is very sensitive to interest rates. It is one of the highest-yielding markets in the world, replete with bond proxies and bond-like blue chips.

For what it's worth, our view is that rates may lift, but not dramatically so. Inflation remains benign, and there are good reasons why this might persist for some time yet, including factors relating to innovation, demographics and under-employment. That said, our views on interest rates do not really influence our stock picking or portfolio construction, although we do manage around the risk of higher (or lower) interest rates where we consider it sensible.

In light of the above, we believe it makes sense to take a constructive view of markets at present, being neither closed-minded bearish nor ever-believing bullish. This at least opens you up to take advantage of opportunities when and as they arise. As before, opportunities are not abundant at present, but they are out there. They are mainly found outside of the top 20 stocks, with the top 20 stocks mostly attractive for their nice dividend yields. It is interesting to note that the ex-20 segment of the market has started to outperform the top 20 in recent years. On the other hand, the ex-20 segment can present a lot more risk, and this warrants a greater degree of skill, experience and hard work. Fortunately, investing is a game of pick-and-choose, and being selective as we are at BAEP means we can avoid stocks we think might struggle, and focus on those where the prospects are bright. In this respect, and as always, we focus on high quality growth stocks whose earnings prospects appear to us to be underappreciated by the market.



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### About BAEP

Bennelong Australian Equity Partners (BAEP) is a boutique fund manager focused on Australian equities. It was founded in 2008 in partnership with Bennelong Funds Management. BAEP is a genuinely active fund manager with a consistent and disciplined investment approach.

BAEP's investment philosophy is to selectively invest:

- in high quality companies;
- with strong growth outlooks; and
- underestimated earnings momentum and prospects.

BAEP's investment process is research-intensive with a focus on proprietary field research and is supported by economic and quantitative insights.

### About the Fund

The Bennelong 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](http://baep.com.au).

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

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