

# Bennelong Concentrated Australian Equities Fund

## Performance update

As at 31 March 2018

### Performance

	1 mth	3 mths	6 mths	1 Year	3 years pa	5 years pa	Since Inception** pa
Fund	-2.47%	-0.81%	9.41%	18.73%	14.90%	17.22%	17.85%
Benchmark*	-3.73%	-3.78%	3.67%	2.86%	3.92%	7.62%	10.27%
Value added	+1.26%	+2.97%	+5.74%	+15.87%	+10.99%	+9.59%	+7.58%

Performance figures are net of fees and gross of any earnings tax. 'Value added' calculation does not use rounded performance figures.

\*S&P/ASX 300 Accumulation Index

\*\*Inception date is 30 January 2009

### Portfolio positioning

Portfolio Sector Allocation			
Sector	Fund Weight	Benchmark* Weight	Active Weight
Discretionary	29.9%	4.9%	25.0%
Consumer Staples	22.7%	7.8%	15.0%
Health Care	16.4%	7.8%	8.6%
Liquidity	2.5%	0.0%	2.5%
Industrials	6.4%	7.4%	-1.0%
Materials	16.6%	17.8%	-1.2%
Utilities	0.0%	2.0%	-2.0%
IT	0.0%	2.4%	-2.4%
Telco's	0.0%	2.8%	-2.8%
Energy	0.0%	5.2%	-5.2%
REIT's	0.0%	8.0%	-8.0%
Financials	5.5%	34.1%	-28.6%

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

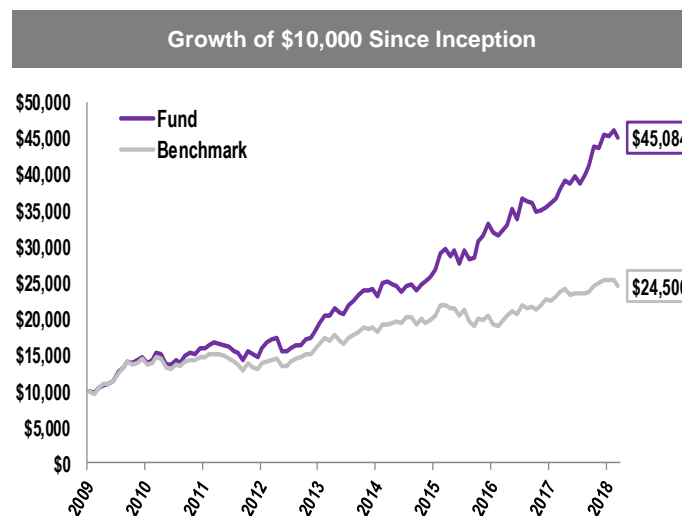
Top Holdings
CSL
Aristocrat Leisure
Costa Group Holdings

### Portfolio characteristics

	Fund	Benchmark*	
Return on Equity	18.0%	12.1%	Premium Quality
Debt/Equity	21.6%	23.3%	
Sales Growth	11.3%	4.3%	Superior Growth
EPS Growth	16.5%	8.3%	
Price/Earnings	21.0x	15.2x	Reasonable Valuation
Dividend Yield	2.7%	4.6%	
Beta	0.86	1	
Active Share	79%	na	Genuinely Active
No. of Stocks	22	300	

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

### Long-term performance



Source: BAEP

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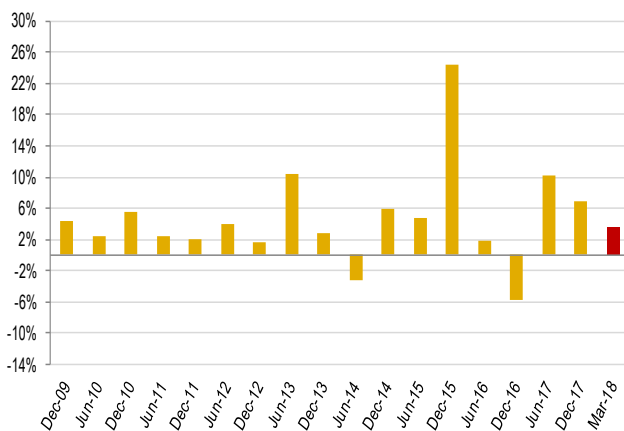
### Quarterly performance review

The Fund's returns over various time periods are set out in the table on the front page. The market was weak over the quarter, but the Fund held up far better than this, thereby outperforming meaningfully.

Historically, the Fund has tended to outperform in down-markets. This reflects our risk-focused investment approach. To illustrate, the portfolio's downside capture ratio over the last five years has been 50%. This means the portfolio has on average shared in only half of the market's decline in down markets.

The Fund has quite consistently achieved strong outperformance over time. This is best seen in the following graph, which shows that the portfolio has beaten the benchmark in all but two of the 18 half-years since the Fund's inception.

### The Fund's gross performance versus the benchmark over each half year since inception\*



Source: BAEF. \* 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.

The Fund's strong investment track record reflects a robust, effective and proven investment approach. We continue executing on this approach as we seek to best manage risk and maximise returns for our clients in the future.

### Portfolio positioning

The Fund continues to be invested in a selection of high quality and strongly growing companies that we believe will quite reliably build value over time. In each case, we believe they will be able to deliver to, or even exceed, the market's earnings expectations. This is important, as it is in our view the single biggest driver of stock returns over time.

True to form, many of the companies in the portfolio reported very strong first half results in the February

earnings season, outperforming the market's expectations and, as a result, delivering outsized returns.

The portfolio continues to evolve over time. We continue to see attractive new opportunities emerge, and we added a few new names to the portfolio during the quarter. We have also sold out of some stocks that have matured in terms of their return potential. After performing well, the market has caught up on their potential, and we have less conviction in their likely outperformance from here.

Otherwise, we have up and down-weighted other portfolio positions according to our view on their current risk-return dynamics, as informed by our ongoing research efforts.

One notable change over the quarter has been to increase our exposure to cyclicals, particularly to the resources sector. Given our predilection for predictable, relatively defensive and lower risk investment propositions, we are not naturally given to the sector. However, from time to time, we are willing to invest in miners when the implied commodity price assumptions overweight the downside and give rise to material upside risk. Here, we are focused only on the highest quality miners with low cost, long life assets. Currently, their share prices imply commodity prices well below current spot prices, which in itself leaves decent upside should spot prices hold broadly around current levels.

We continue to avoid many of the pure bond proxies such as the REITs, Utilities and Infrastructure stocks, as well as less obvious bond proxies such as blue chips like Woolworths, Telstra and AMP that offer little if any growth but generous dividends. Many of these stocks have been popular for their yield, which in turn has pushed up valuations, and without growth, their returns appear lacklustre.

### Stock example: Flight Centre

The Fund holds a large position in **Flight Centre**, a position that was built up in early 2017. Flight Centre has contributed significantly to the outperformance of the Fund since then, and it was the largest contributor in the March quarter.

Flight Centre is a diversified travel company best known for its namesake retail stores.

### Short interest

Some view its core travel agency business to be structurally challenged by online competition. According to this view, online booking sites such as expedia.com and the like will hurt brick-and-mortar travel agents. Reflecting as much, Flight Centre has been one of the most heavily shorted stocks on the ASX for some time. Indeed, at the time of our

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purchase for the Fund in early 2017, short sellers were betting against the company to the tune of just over 25% of the free float of the company's shares. This has reduced since then, although the short interest in the stock remains at about 20% (again as a percentage of the company's free float).

#### Percentage of Flight Centre's float-adjusted shares sold short



Source: BAEP, ASIC, UBS

This is not necessarily something to be worried about. Share prices are discounting mechanisms, meaning they discount or factor in the market's views of its future prospects. With sentiment clearly negative, Flight Centre's share price reflected as much, thereby giving us the opportunity to build a position at what we considered to be very attractive levels. At that time, the stock traded on what we believe to be 11x forecast earnings.

#### A diversified, customer-centric & growing business

In reality, Flight Centre's business is much more diversified than just its namesake stores. It has:

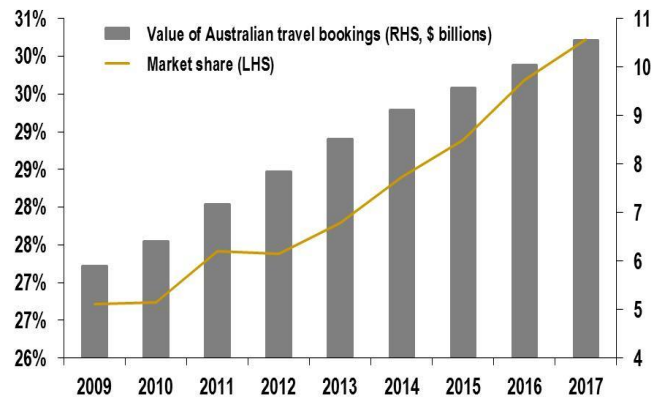
- other retail formats, including Cruiseabout and Student Flights;
- online-only businesses such as StudentUniverse.com.au, the leading travel booking site for the youth market;
- its own travel product, including ownership of bus tour operator Top Deck;
- travel-related businesses such as the currency 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 over \$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. The corollary of this outperformance is that it has taken market share. As seen in the graph below, this has been the case even in Australia, its most mature market. These facts hit up against the bearish narrative that questions Flight Centre's competitive position.

#### Australian dollar bookings & market share



Source: BAEP, ABS, UBS

Lest there be any doubt as to whether Flight Centre has a place in today's hi-tech world, one need only consider that it globally processes over \$20 billion of travel bookings, and that \$20 billion worth can't be wrong.

#### The turnaround

We owned the stock during its strong run up in 2012 to 2014, but subsequently sold down. We took a large stake in the company again in early 2017. What prompted us to do were signs of a renewed focus on cost discipline. This is something that had been missing in prior years. The company had been able to grow travel bookings nicely – at a compound rate of 7% per annum – but it was just as good at growing costs.

The renewed cost focus that we observed culminated in its announcement at its 2017 results of a five year transformation program. This program is focused on cutting out unprofitable businesses, lifting under-performing businesses, and more tightly managing costs. At the same time, the program acknowledges the need to maintain strong growth in travel bookings, including a concerted effort in respect of their online operations.

The transformation program came with ambitious financial targets that, if achieved, imply very strong earnings growth. The announcement of the program prompted upward revisions to the market's earnings expectations, as indicated in the graph below.



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#### Consensus EPS Forecasts for Flight Centre



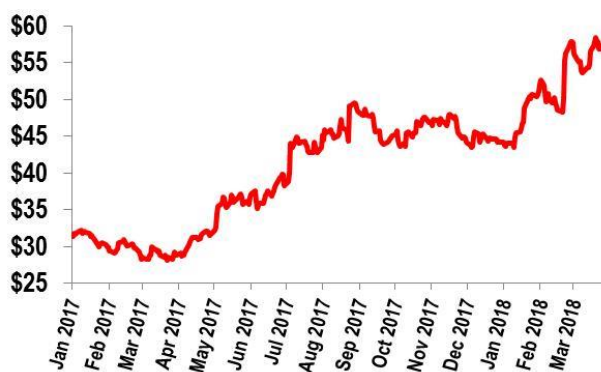
Source: BAEP, BAML, IBES

#### The results

The company's first half year result reported in February showed momentum was continuing to build. In particular, travel bookings were up 9% to \$10.2 billion, costs growth was contained to 3%, earnings grew 23% to \$139 million, and full year guidance was lifted, to a range of \$360-385 million.

The result presented clear evidence that growth is actually making its way down to the bottom line. It has meant that earnings expectations have continued to rise. This, in turn, has allowed the negative perception around the stock to start to gradually lift. It is akin to the investment 'double play', in which the earnings greatly improve, and with it, there is a re-rate of the company's shares through a higher valuation multiple.

#### Flight Centre Share Price Chart



Source: IRESS

#### Valuation

Following the share price rise, the stock trades on approximately 19x consensus earnings for next financial year. We believe this still remains relatively attractive, particularly if consensus numbers again

prove too conservative, which we think is very possible.

Interestingly, Flight Centre is a good example of the perils of relying on the PE multiple as one's valuation guide. For comparison purposes at least, Flight Centre is penalised in its PE multiple for its cash-rich balance sheet.

As at its last balance date, Flight Centre held just over \$1 billion in cash, another \$203 million in investments - mostly liquid short term fixed interest securities - and had only \$91 million of debt. In effect, it had net cash of \$1.122 billion (after allowing for its debt).

Now, \$745 million of this amount was held on behalf of customers, who had paid Flight Centre in advance of trips not yet taken. Such is the power of Flight Centre's business model that it operates with negative working capital, meaning it collects payment from its customers for pre-booked flights and the like before it is required to pay its suppliers for the same. Importantly, however, Flight Centre gets to keep the interest earned on this 'free float' of customer funds. A PE multiple only captures value according to the earnings that result from interest earned on this free float. With rates low, a PE multiple ascribes very little value.

Even allowing for customers' funds, the company had a net cash position of \$377 million (again, after debt). Again, the PE multiple will only capture the value of the interest earned, which is approximately \$8 million. Applying the current PE multiple of 19x implies this \$377 million cash pile is only worth \$152 million. Or looked at another way, the correct PE multiple for the interest earnings is currently 47x.

Conceivably, Flight Centre could return the excess cash to shareholders, via a dividend or buyback. It could even add to this by taking on a moderate amount of debt. Either way, there is unappreciated option value in the prospect of monetising its strong balance sheet.

As it is, the strong balance sheet affords Flight Centre the capacity to tough out difficult trading conditions and to be opportunistic in respect of any investment opportunities that might arise. Arguably, its PE multiple does not reflect this defensiveness and/or optionality.

#### The risks

From here, a major driver of stock returns will come down to management's execution on the transformation program. Should they continue to execute successfully, the market will likely need to continue upgrading its earnings expectations. At BAEP, we will continue our research and analysis of the company, willing to add or sell as the facts



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warrant. One of the main things we will be focused on is management's execution against the transformation program. This includes the company continuing growth in the value of travel bookings, even in the face of a possible slowdown in consumer spending.

#### Highlighting the BAEP investment approach

Flight Centre is a good case study in highlighting BAEP's investment approach.

Firstly, at the core of our investment approach is to identify underappreciated earnings power. This entails undertaking very deep research and analysis to arrive at a different view to the market on a company's earnings prospects. In Flight Centre's case, there appears to have been two fundamental reasons for the market's underappreciation of its earnings power. Firstly, a false narrative prevailed around its disadvantaged competitive position, and this coloured investor's outlook. Secondly, investors were extrapolating stagnant earnings, but the company was embarking on a turnaround that was to set its earnings on a new growth trajectory. Indeed, turnarounds represent a rich area of opportunity for us at BAEP, as discussed in our publication [Being BAEP: Profiting from turnarounds \(8 November 2016\)](#).

Secondly, we focus on the actual facts in determining the quality, growth prospects and earnings power of a company. Regardless of whatever the powerful narrative is at the time, our analysis will be premised on an objective assessment of the facts and figures. Importantly, this will be based on real-world research that encompasses a large number of meetings with the company itself, as well as its suppliers, customers, competitors, regulators and other relevant industry contacts. In Flight Centre's case, it was important to understand what was going on inside the company rather than focusing exclusively on outside factors.

If the facts warrant, we are more than willing to invest whilst many others are betting against the company via short selling of its stock. Indeed, many of our best performers over time have come from investing in stocks that are heavily shorted. After all, the short sellers will eventually be required to buy back the shares they have sold short. That said, we are ever-conscious of short sellers, and of the possibility they may be right and we are wrong. We seek to understand and test their views against ours, and we are willing to look through any short term noise that may unfairly colour the fundamentals of the company.

#### Other examples

Like Flight Centre, our position in the Fund's other top holdings reflects our view of their underappreciated quality and growth.

**CSL Limited** is the dominant player in the global plasma-derived medicines market.

The company trades on 29x next year's consensus earnings. Some might consider this rich, but CSL has earnings power that continues to surprise the market. At its half year result in February, the company reported earnings growth of 31%, strong operating momentum, and an upgrade to full year guidance. Consensus is for earnings growth of just 23%, which could require further upward revision.

More importantly, the market appears in our view to be underappreciating the sustainability and extent of growth over the longer term. As earnings compound away over time, the PE multiple should amortise down very quickly. For example, if the company continues to compound earnings at 20% per year, its PE will more than halve in less than four years. Soon enough, this great Australian company would trade on a sub-market PE multiple.

This longer term growth is underpinned by very heavy investment in growth opportunities. Relevantly, this includes a massive investment in its research and development activities, which are aimed at finding new uses for existing bio-medicines and finding new ones. Next year CSL will spend approximately US\$800 million on R&D. These costs are immediately expensed in the year incurred, thereby depressing current year's earnings for the benefit of the longer term. The impact on earnings is material, given pre-tax earnings of US\$2.4 billion. Were this R&D accounted for as a capital cost and expensed over time, earnings would be one-third higher, and the PE of 29x would reduce to a more palatable 22x. Companies like CSL are penalised in a PE comparison to the extent they invest for growth, because any investment depresses near-term earnings, which in turn elevates the PE multiple.

**Aristocrat Leisure** is a world-leading gaming company. Its historical focus has been on making slot machines, but in recent years it has built out a business developing digital social games that now accounts for almost 40% of revenues.

Aristocrat has transformed its business over the past five years. This has come about through an enormous investment in the design and development of games, which in turn has led to an advantaged product portfolio. In part as a result of this product superiority, and in part as a result of the expansion of its digital games business, the company has increased the percentage of recurring revenues to approximately 65% of its total revenues. This is important because it makes for a more predictable earnings base, which in turn justifies a higher earnings multiple.

The move into the digital space was enabled through two large acquisitions last year, being Plarium and Big

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Fish. The market remains skeptical of these acquisitions, adopting a wait-and-see approach that will require it to have seen some strong financial results reported. From our research, the enlarged digital business is currently performing well.

The company trades on 18x next year's consensus earnings, which we think could prove conservative. Even if not, we believe a multiple of 18x undervalues its product superiority, quite predictable business model and strong growth prospects. Like CSL, earnings incorporate a large upfront hit on account of significant design and development expenses. These D&D expenses represent almost 20% of pre-tax earnings, thereby penalising the PE multiple. In addition, there is further upside from corporate tax reductions in the US, where a majority of earnings are derived, and which the market is arguably yet to fully price in.

**Costa Group** is Australia's largest agricultural produce company, growing and marketing mushrooms, avocado, berries, citrus fruits and tomatoes.

Investors have been wary of investing in the agricultural sector, for good reason. However, as we have discussed in past commentaries, Costa has built a far more defensible and profitable business than most will be familiar with for the sector.

At its half year result, the company beat the market's expectations, and raised its full year profit growth guidance to approximately 25%, up from 20% previously. We believe there is a reasonable probability that this will prove conservative yet still. For the medium term, the company has stated it is targeting double-digit growth over a three to five year time horizon. This growth will be underpinned by rising consumption, investment in new production capacity, and further expansion of offshore ventures. The market is slowly coming around to understanding its quality and strong and reliable growth prospects.

### Outlook

While it is always difficult to predict short term moves, it seems the Australian stock market looks well positioned to provide reasonably attractive returns over the foreseeable future. As we discussed of our portfolio positioning, we continue to find attractive new ideas, which for a bottom-up stock picker is one of the best indications that decent returns lie ahead.

For the broader market, we would point out that:

- investor sentiment is cautious, and in some cases skittish;
- valuations look very reasonable; and
- earnings are both solid and growing nicely.

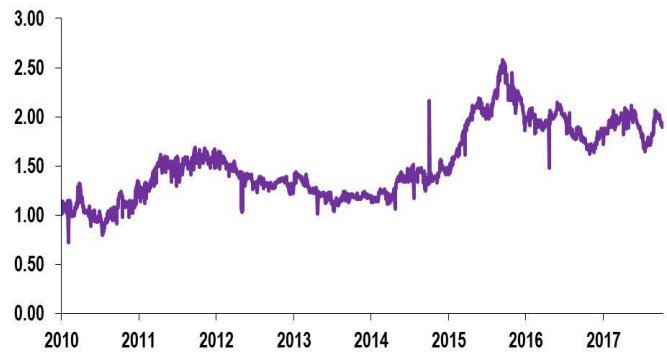
These factors support our bottom-up assessment of a positive outlook for returns.

### Investor sentiment is cautious

The consensus seems to assume we are late cycle, in the late stages of a bull market, or that valuations are topy.

We can observe that a number of institutional fund managers have gone to relatively high levels of cash and that short selling remains elevated.

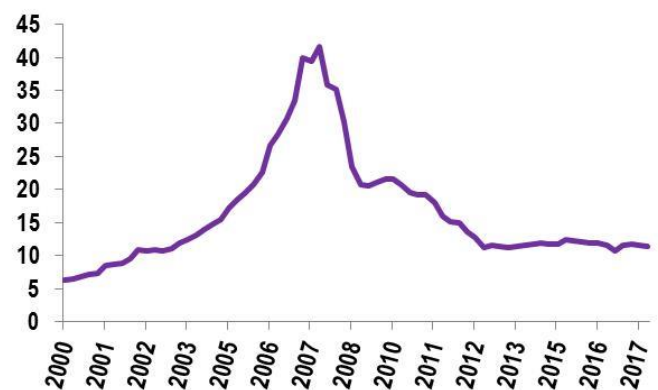
### Percentage of the ASX's float-adjusted shares sold short



Source: BAEP, ASIC, UBS

At the retail level, investors seem far from excited by equities. There is little in the way of stock talk at BBQs, nor of Uber drivers handing out stock tips. Meanwhile, margin lending remains at decade-lows.

### Total margin lending on the ASX (\$ billions)



Source: RBA Statistics

In fact, many investors fear what may lie around the corner, and overall the market in fact appears somewhat skittish. We saw two good examples in the March quarter.

In early February, the Department of Labor reported the average hourly wages to have increased 2.9% in January. This set off inflationary concerns, causing US markets to fall 10% over the next few days, and



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the ASX to fall 5%. In late March, the threat of Sino-US trade wars caused markets to also fall, in the order of 5% for the US markets over ensuing days and 2.5% for the ASX. Interestingly, the ASX has proved more resilient to these ruptures than offshore markets.

Markets are biased in the attention they are giving to the negatives. Witness the fanfare that accompanied the rise in long term rates from late last year. The 10-year Australian bond yield rose from 2.47% in late November to a high of 2.91% in early February. Little fanfare has accompanied the 25bp fall in the yield since.

Indeed, rather than the bull market most assume we are in, the market has been relatively flat over the last few years. In fact, over the past year, the total return (including dividends) has been less than 3%. Over the past three years, it has been less than 4% (again, including dividends). This is hardly a red-hot bull market.

#### Valuations are relatively attractive

Importantly, cautious investors mean cautious share prices. This makes for relatively attractive valuations.

The market trades on a PE multiple of about 15x next year's earnings. This compares to the long term average of around 14x, but seems to us to be attractively priced given where long term rates are and the quality and growth of earnings.

Looked at another way, the market trades on a dividend yield of 4.6%. This grosses up to 6% after taking account of the franking credits. This compares very attractively to most other asset classes, including the benchmark 10-year Australian Government Bond yield of approximately 2.65%.

If there were a 10% "correction", the market's PE would fall to well under 14x, the long term average. If there were a 20% "crash", it would fall to 12x. In all probability, this presents as too good for it to come true.

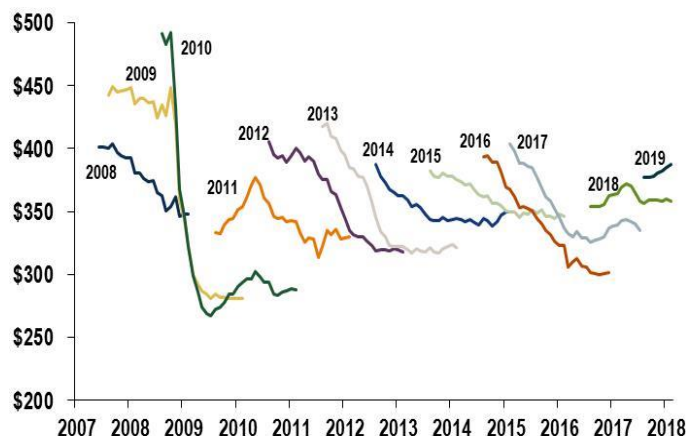
#### Earnings are growing nicely

Supporting earnings multiples, the earnings themselves are of a high quality and growing nicely.

In terms of quality, the February reporting season showed reasonably conservative accounting, materially less "one offs" and greater cash flow conversion of earnings. In addition, after years of de-gearing, ASX-listed balance sheets look strong overall (although there are pockets of over-leverage such as in the Infrastructure sector).

In terms of growth, the market's EPS is forecast to grow at approximately 8%. Interestingly, for the first time in a decade, earnings expectations have actually held up, and for next financial year, even lifted. This supports the strength of the "E" in the PE multiple.

#### Consensus EPS Forecasts for the S&P/ASX 300



Source: BAEP, BAML, IBES

#### The upshot

For the rational investor, the risk is not the occasional drawdown, as irregular and unpredictable as they are, but being underinvested over the long term. Time in the market - not timing the market - is the key to equities because, whilst the near term is always uncertain, the long term is quite certain to provide attractive returns. Even those unlucky enough to have invested in the ASX at its highs on 1 November 2007, will have achieved about 35% since, or 3% per annum. Even investing at the worst possible time saw returns on a par with cash.

We continue to be constructive on the market. As said before, we continue to evolve the portfolio, positioning it to where we are finding the best opportunities. We have a portfolio full of high quality, strongly growing companies that are continuously growing value for our investors.

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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 Concentrated Australian Equities Fund typically holds 20-30 stocks across the entire spectrum of the Australian sharemarket. 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 a genuinely active and high conviction fund manager, meaning potentially significant deviation from the benchmark and with prudently concentrated portfolios.
- BAEP is an award winning and highly rated equities fund manager with an experienced and performance-orientated team.
- The Fund comprises a concentration of some of BAEP's best stock ideas.
- 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	BFL0002AU
Benchmark	S&P/ASX 300 Accumulation Index
Investment objective	4% 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	30 January 2009
Recommended investment period	Medium to longer term (five years plus)
Buy/sell spread	+/-0.25%
Entry/exit fees	Nil
Management Fee	0.85% p.a. of Net Asset Value of the Fund
Performance Fee	15% of any amount by which the Fund's return is more than 2% 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, or via a range of platforms.

#### Platforms

AON	Linear
BT (Wrap, Super Wrap, Investment Menus, Panorama)	Macquarie Wrap (IDPS, Super, Accumulator)
CFS (FirstWrap, IX)	Netwealth (Super Service, Wrap Service)
Federation	Oasis (Wealthtrac)
Hub24 (Super, IDPS)	Powerwrap (Smartwrap)
IOOF (AET, IPS, Pursuit Select, TPS)	

### 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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