Bennelong Concentrated Australian Equities Fund
Performance update

As at 30 June 2018

Net client returns (after fees and expenses)

	1 mth	3 mths	6 mths	1 Year	3 years pa	5 years pa	Since Inception** pa
Fund	1.57%	13.81%	12.89%	29.08%	23.02%	19.85%	18.96%
Benchmark*	3.19%	8.36%	4.27%	13.24%	9.14%	9.99%	10.92%
Value added	-1.62%	+5.45%	+8.62%	+15.84%	+13.88%	+9.86%	+8.04%

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	26.4%	5.0%	21.4%
Consumer Staples	21.9%	8.1%	13.8%
Health Care	20.1%	8.4%	11.7%
Industrials	9.3%	7.2%	2.1%
Liquidity	1.5%	0.0%	1.5%
Materials	17.4%	18.5%	-1.0%
Utilities	0.0%	2.0%	-2.0%
Telco's	0.0%	2.2%	-2.2%
IT	0.0%	2.5%	-2.5%
Energy	0.0%	5.7%	-5.7%
REIT's	0.0%	7.7%	-7.7%
Financials	3.3%	32.6%	-29.3%

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

Top Holdings

CSL
Reliance Worldwide
Costa Group Holdings

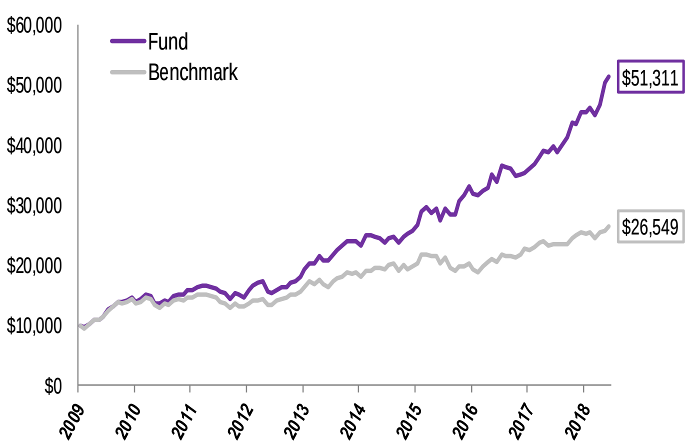
Portfolio characteristics

	Fund	Benchmark*	
Return on Equity	17.9%	12.3%	Premium Quality
Debt/Equity	21.8%	21.9%	
Sales Growth	10.2%	4.2%	Superior Growth
EPS Growth	17.4%	8.7%	
Price/Earnings	24.5x	15.8x	Reasonable Valuation
Dividend Yield	2.3%	4.4%	
Beta	0.85	1	
Active Share	82%	na	Genuinely Active
No. of Stocks	22	297	

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

Long-term performance

Growth of $10,000 Since Inception



Source: BAEP

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BAEP
Bennelong Australian Equity Partners

Quarterly performance review

The Fund's returns over various time periods are set out in the table on the front page.

Over the quarter, the Fund returned 13.81%, meaning it significantly outperformed the market, which returned 8.36%. The Fund benefited from strong returns from some of its largest holdings. The biggest contributors were CSL, Reliance Worldwide and Aristocrat Leisure.

These names typify the kind of stocks in which we seek to invest. All are high quality growth companies that proved again this quarter to have better than expected earnings prospects. As elaborated on below, CSL upgraded earnings guidance, Reliance Worldwide made a significant acquisition that is earnings accretive, and Aristocrat Leisure reported financial results that beat consensus numbers. The three companies also demonstrated significant investment for the longer term future, whether via R&D, acquisitions or otherwise. In our view, they are the type of companies that build earnings, value and wealth for investors over time.

CSL, the global biopharmaceutical company that is the fourth largest stock on the ASX, announced an upgrade to its earnings guidance during the quarter. Back in February, the company provided guidance that it expected full year profits to be in the range of US$1,550 to $1,600 million. In May, it lifted its profit guidance to a range of US$1,680 to $1,710 million. This implies constant currency profit growth this financial year of 26% to 28%. The company continues to spend big on research and development, building out new plasma collection centres and making other investments. This investment benefits the company by widening its competitive moat and supporting its growth profile. We continue to believe the company has better than expected earnings prospects over the foreseeable future. CSL is the largest position in the Fund.

Reliance Worldwide made a very significant and value accretive acquisition during the quarter, buying John Guest for A$1.2 billion. Reliance is the world's leading manufacturer of brass push-to-connect plumbing fittings, selling predominantly into the US and Australasian markets. John Guest is the world's leading manufacturer of plastic push-to-connect plumbing fittings, and with its headquarters in UK, it sells mainly into European markets. For Reliance, the acquisition adds complementary plumbing products to its range, expands its geographic reach and supports cross-sell opportunities, and comes with cost-out and other synergy benefits. Importantly, the acquisition is expected to be at least 30% accretive to earnings per share, after accounting for synergies. BAEP is the largest shareholder in Reliance Worldwide, and it is the second largest position in the Fund. The acquisition was largely financed through an entitlement offer at a very attractive price and the Fund participated for its full share.

Aristocrat Leisure, the slot machine manufacturer and online social games developer, announced its first half financial results in May. The results beat expectations and were well received by the market. The company was able to grow revenues and profits both by approximately 33%. This growth was underpinned by strength in its online social games business, where two recent acquisitions proved their worth, and which business now boasts over eight million daily active users. The company guided to continued aggressive investment in new product design and development, as well as to continuing strong profitability over the next 12 months.

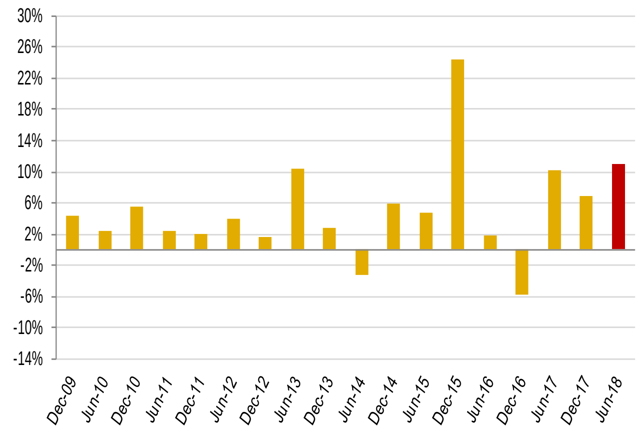
There were a number of other large stock holdings that performed nicely for the Fund over the quarter. A notable one was **BWX**, which received an indicative takeover proposal. The proposal entails a management buy-out that involves the CEO, Finance Director and private equity firm Bain Capital. The proposal was clearly well informed, opportunistic on timing and price, and presumably aimed at taking advantage of the company's strong longer term growth prospects. In response to the proposal, an independent committee of the Board opened up the books to the buy-out team and other potential bidders. This may in turn lead to a formal takeover bid, although there is no certainty one will eventuate. We are taking a wait-and-see approach before deciding on what action to take. BWX was the 10th largest contributor to the Fund's quarterly outperformance, contributing almost 0.5%.

The Fund is a concentrated portfolio of BAEP's highest conviction stock ideas. It is 'index unaware', and thus able to avoid large benchmark weights if considered appropriate. For example, right now the Fund has less than 1% of the portfolio invested in the banking sector, whereas it accounts for 23% of the total value of the market. Over the quarter, this sector quite significantly underperformed, and our underweight stance contributed to relative performance. Indeed, **Commonwealth Bank** was the sixth largest contributor to the Fund's quarterly outperformance, contributing just over 0.5%.

The Fund has been able to beat the market quite meaningfully and with relative consistency over the

long term. This is best seen in the following graph, which shows that the Fund has beaten the benchmark in all but two of the 18 half-years since the Fund's inception.

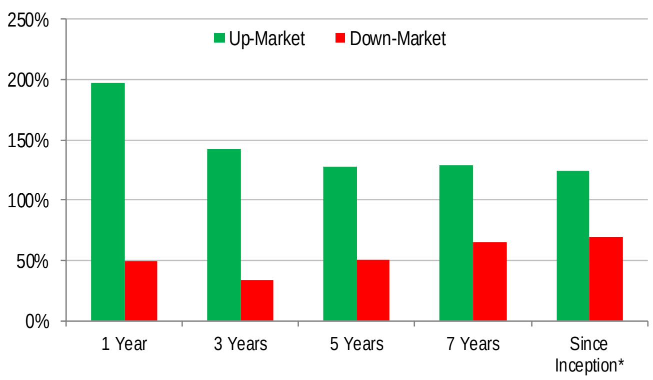
The Fund's gross performance versus the benchmark over each half year since inception*



*Source: 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.*

Historically, the Fund has tended to hold up better than the market when it has been falling. This is evident in looking at the Fund's downside capture ratio, which measures the average fall in the Fund compared to the fall in the market. For the last five years, the Fund's downside capture ratio was just 50%, meaning it avoided half the losses the market incurred when it fell. Indeed, in some falling markets, the Fund has even been able to achieve quite decent positive returns for clients.

Upside and downside capture ratios



*Source: BAEP. * The inception date for the Fund is 30 January 2009.*

To this end, the Fund has a genuine focus on managing risk. Here are some of the ways in which we attempt to do this:

- As before, we remain index unaware, allowing us to avoid risky sectors or large benchmark positions. For example, we were able to escape the brunt of the resources bear market earlier this decade, and more recently, the difficulties of the banking sector.
- We typically target high quality companies with defensible, predictable and lower risk businesses. Many of the companies we invest in sell essential or everyday consumer purchases such as medicines, wines, pizza, skincare creams, fruit produce and other daily staples.
- We are meticulous in our efforts in seeking to avoid earnings risk. In our view, stock returns are fundamentally driven by earnings, particularly as they relate to the market's expectations for those earnings. Share prices invariably reflect the market's expectations for earnings. Thus, the extent any company misses its numbers, downgrades or otherwise disappoints the market, its share price will follow suit. In our numerous company meetings and other industry contact, we are particularly focused on attempting to best understand a company's earnings prospects. This informs our investment decisions, with the intention being to invest in companies with better than expected earnings prospects, and avoiding those in which earnings delivery is at risk.
- We employ macro-economic and quantitative overlays to assess and manage portfolio level risks.

Portfolio positioning

The portfolio continues to evolve over time, with new stock ideas added from time to time, and mature ideas sold down or out.

We really like investing in companies like CSL, Aristocrat Leisure and Reliance Worldwide, in which one benefits over time from the long term compounding of strong earnings growth. However, one must be careful to recognise when things have changed. This was the case with **Ramsay Health Care**. We had owned the stock in the Fund since early 2010, but sold down over the last year or so, and were out entirely at the start of this year. Ramsay's shares had enjoyed a multi-year earnings upgrade cycle, but industry headwinds and other factors caused us to reassess its earnings prospects. This quarter, Ramsay downgraded its earnings guidance, the first in at least a decade. Its shares have followed revised earnings expectations lower.

Stock selection is predominantly a bottom-up

process, with the Fund put together one stock at a time. That said, there are a number of themes that come through in the portfolio:

- We naturally have a significant exposure to defensives. For example, we have a heavy weighting in the portfolio to consumer staples and the healthcare sector, with examples such as Costa Group and CSL.

  That said, we have over the past six months or so lifted our exposure to cyclicals, particularly through the resources sector. Right now, mining share prices are factoring in falls in commodity prices. Based on our research and analysis, this presents upside risk and some cushion on the downside. With an eye to the risks, we have preferred the largest and highest quality miners with low cost, long life assets.
- We have significant exposure to offshore earnings, through global businesses such as CSL, Reliance Worldwide and Aristocrat Leisure.
- Compared to the benchmark, we have a bias away from large caps, with a significant underweight to the top 20 stocks, and an overweight bias towards small caps.
- We continue to avoid the pure bond proxies such as the Utilities and Infrastructure stocks, as well as less obvious proxies such as blue chips like Telstra that offer little if any growth but generous dividends. In general, these stocks have been popular for their yield, which in turn has pushed up valuations, and without growth, future returns appear lacklustre.

Outlook

<u>Relatively attractive valuations</u>

Although having a decent run of late, equities still seem to present as an attractive option in the competition for investors' dollars. On consensus numbers, the Australian stock market trades on 15.8 times forward earnings. This is about 10% above the historical average of roughly 14 to 15 times (it depends on how far back one goes). This is more than fair in the context of the current low rate environment. For context, the benchmark 10-year Government bond yields just 2.6%, is pre-tax, and is incapable of growing. Australian stocks offer a dividend yield of 4.5%, or just under 6% when grossed up for franking credits. More generally, Australian stocks appeal in competition with cash and most bonds and property assets, with investors increasingly less positive on the latter two. If one knew for sure bond yields would not rise much from here, stocks would stand out as downright cheap. And underpinning stocks' relative appeal, corporate earnings appear solid, with nice growth and consensus forecasts holding up, at least for now.

<u>Improving investor sentiment and markets</u>

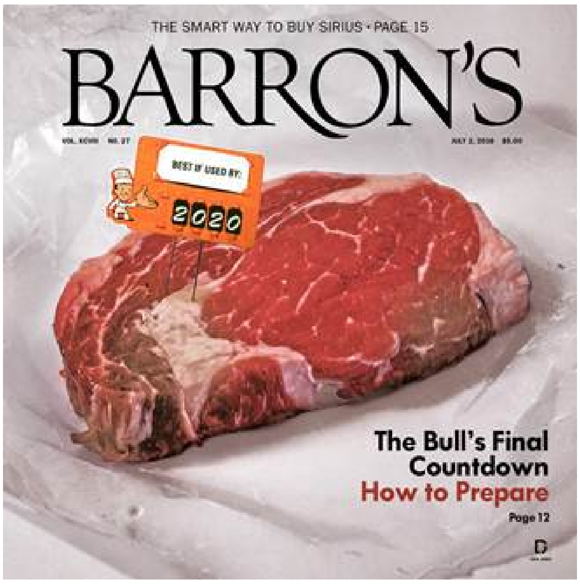
From the depths of the GFC in early March 2009 to the end of June this year, the Australian stock market has risen 96%. The total return, which also includes dividends reinvested back into the market, has been approximately 194%. Over that time, investors have been climbing a wall of worry. The market has been in a general uptrend, but there have also been a few decent falls along the way. These have acted as a check on investor confidence. The market twice fell by 20% or more, being in mid-2011 and then again in late 2015/early 2016. In the two and a half years since the last fall, the market has risen nicely. It now sits at decade highs and about 10% short of the all-time high set in 2007. Volatility has remained low, despite consensus calls earlier this year that it would pick up. This has also been helpful in improving investor confidence. Still today, the general public remains unenthused by stocks, with margin lending at decade-lows, little stock talk at BBQs, and Uber/taxi drivers uninterested in handing out stock tips.

<u>The next correction?</u>

Indeed, there continues to be a large cohort of investors waiting for the next correction, albeit they seem to have pushed out their expectations on timing and magnitude. This reflects the improving investor sentiment, which remains somewhat cautious. The feeling is reflected in the Barron's magazine covers that follow, admittedly a mostly US centric magazine.

Cover of Barron's in May 2016

Most recent cover of Barron's



As always, big-picture macro risks abound, including rate rises, trade wars, Chinese financial instabilities and excessive Australian consumer leverage. Most likely, the stock market will ultimately manage its way through these issues. Corrections are inevitable, but in the end, the risk is not the occasional correction, as unpredictable as they are, but being underinvested over the long term. Many will understand this in the case of Australian property, where waiting for the crash was a big opportunity cost. Likewise, 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 relatively attractive compound returns. From here, the market continues to offer relatively attractive long term returns, although it continues to require a more selective approach.

Growth versus value

Whilst the market appears relatively attractive at the aggregate level, a big valuation gap appears to have opened up between 'growth' and 'value'. The divide results from the strong outperformance of growth over value in recent years.

As it is today, so-called value stocks appear far cheaper on commonly used metrics such as price-to-earnings or price-to-book multiples, but offer little if any growth and often come with heightened business and/or earnings risks. In some cases, capitalism is creatively upending their old business models. Notable examples include the big banks, miners and stocks like Telstra, AMP, Qantas and Fairfax, which all trade on single-digit or low-teen PE multiples. So-called growth stocks are offering far less business/earnings risk and of course come with more growth, but often trade on pretty lofty multiples. Notable examples include CSL, Cochlear, REA Group and A2 Milk, some of which we own in the portfolio.

The common thinking, which is mostly supported by historical precedent, is that value performs best when earnings are supported by a recovering or strengthening economy, as we saw in 2009. Meanwhile, it is thought that growth stocks have since benefited from the post-GFC macro environment of low growth and low rates. Their growth came to be more highly valued because of its relative scarcity, whilst their valuations benefited from lower discount rates, as applied to the long duration of their cash flows that are more heavily weighted to outer years. So the consensus view goes, growth will continue to outperform in the later stages of a bull market, for however long it lasts. Taking advantage of all this to position one's portfolio assumes one can predict cycles, which proves itself to be virtually impossible.

Another practical problem is how to define value and growth. The market does not divide itself neatly between the two, with some stocks crossing over and some not fitting into either. In practice, the two styles are best used to define stocks at the extremes, being stocks either with very high growth or a very low PE.

At any rate, future returns ultimately depend on the specifics of the individual stock, however it is so labelled. For example, despite growth's recent outperformance, Domino's Pizza Enterprises has performed poorly over the last two years despite being a go-go growth stock. On the other hand, deep value plays Qantas, Bluescope Steel and many of the mining services companies have delivered stellar returns over that time period. In the end, growth is just a component of the value equation, and the two styles don't necessarily compete.

This is not to dismiss the reality that growth and values styles go in and out of favour. Indeed, the Fund has more recently benefited in some measure from the outperformance of growth over value. In the end, however, it all evens itself out over the market cycle. Interestingly, according to Morningstar's most recent performance tables, the two best performing Australian equities fund managers over the longest reported time periods represent growth - that's us - and a contrarian deep value approach. Ultimately, it is stock picking that counts.

In general, the return on any stock will depend on how its business performs compared to what is priced into its valuation. As the above examples show, investing in growth stocks requires the investor to have confidence in the extent of their growth, such that the growth actually delivered proves the shares to have been attractively valued after all. A year and a half ago, CSL's shares traded down to $95 and on a 'toppy' 25 times then forward consensus earnings forecasts. In the following two years, the company will have grown earnings cumulatively by 60%, quite materially outperforming the market's earnings expectations. Knowing this back then would have led most investors to conclude its shares were very good value. As it turns out, investors have repriced its shares to account for this outcome. They now trade at almost $200.

Similarly, investing in value requires confidence that the earnings will at least hold up, lest one buys into a value trap. Indeed, the best performing value stocks are those that surprise with strong growth. When we first purchased Flight Centre for the Fund over a year ago, it was a 'value' stock trading on 10 times forward earnings but was perceived by investors to have weak earnings prospects. The company actually ended up growing earnings 21% for the year. This dramatically turned around investor perceptions of its future, and in hindsight made its then share price look very cheap. Reflecting as much, its shares have more than doubled since.

The upshot is that investors need to treat each stock on its merits, whether value or growth, with a particular focus on earnings risk. Given our bias towards growth, we are particularly conscious of this risk. As said before, we continue to evolve the portfolio, with new stock ideas added from time to time, and mature ideas sold down or out. We believe the portfolio is well positioned to grow in value over time, regardless of corrections, style changes or whatever else might impact markets from time to time.

Bennelong Concentrated Australian Equities Fund

Performance update

As at 30 June 2018

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, disciplined and proven 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 macro-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 can invest in stocks beyond 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.
- The Fund is managed in accordance with BAEP's robust, disciplined and proven investment philosophy and process.
- 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 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	
ANZ (Grow, PortfolioOne)	Linear
AON	Macquarie Wrap (IDPS, Super, Accumulator)
BT (Wrap, Super Wrap, Investment Menus, Panorama)	MLC (Navigator Wrap)
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.

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