# Bennelong Twenty20 Australian Equities Fund
## Performance update

As at 30 September 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 | -2.84% | -1.20% | 8.97% | 15.08% | na | na | 11.09% |
| Benchmark* | -1.19% | 1.50% | 9.99% | 14.03% | na | na | 10.75% |
| Value added | -1.64% | -2.70% | -1.02% | +1.05% | na | na | +0.34% |

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 over 50%.

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 Holdings |
|---|
| Commonwealth Bank |
| BHP Billiton |
| Westpac Banking |
| CSL |
| Aristocrat Leisure |
| Australia and New Zealand Banking |
| Reliance Worldwide |
| National Australia Bank |

*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 | 19.7% | 4.3% | 15.4% |
| Consumer Staples | 11.5% | 7.8% | 3.7% |
| Liquidity | 2.3% | 0.0% | 2.3% |
| Health Care | 10.7% | 8.6% | 2.1% |
| Communication | 3.7% | 3.8% | -0.1% |
| Industrials | 7.1% | 7.7% | -0.6% |
| Utilities | 0.0% | 1.9% | -1.9% |
| IT | 0.0% | 2.3% | -2.3% |
| Energy | 2.7% | 6.0% | -3.3% |
| REIT's | 4.3% | 7.7% | -3.4% |
| Financials | 26.3% | 31.9% | -5.6% |
| Materials | 11.6% | 17.9% | -6.3% |

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

bennelong

BAEP
Bennelong Australian Equity Partners

## Performance review

The Fund returned –1.20% while the market returned 1.50%. This is disappointing, but we believe it should be put in context. Over time, the quarter-to-quarter performances have averaged out to provide clients with very above-market returns.

As explained on the front page, our relative performance for the Twenty20 Fund – that is, whether we beat the market or not – will depend on the performance of its ex-20 holdings. In aggregate, our ex-20 holdings underperformed over the September quarter.

Performance attribution

Most of the action in the quarter took place during earnings season in August. This is when almost all ASX-listed companies report their full year financial results.

In general, the companies in the portfolio reported strong results and gave reasonable guidance. However, in the case of a number of our larger positions, the market nevertheless reacted negatively. Their share price falls weighed heavily on the Fund's returns. The main culprits here were stocks like **Flight Centre**, **Costa Group** and **Reliance Worldwide**. Admittedly, these stocks have all been very strong performers for the Fund in recent times, and we are reminded that share prices do not always rise in a nice straight line up.

**Flight Centre**, the diversified travel and leisure company, reported results in August. The company reported underlying profits of $384.7 million, which amounted to 17% earnings growth for the year and was at the top end of its previous earnings guidance of $360-385 million.

It seems the market was expecting even more than what was delivered, and the shares sold off.

Flight Centre is currently undertaking a five-year Business Transformation Program. This program is focused on more tightly managing costs, cutting out unprofitable businesses, turning around under-performing ones, and maintaining strong growth in travel bookings, particularly by emphasising its online operations. The program comes with ambitious financial targets that, if met, would come with very strong earnings growth and material earnings upgrades. Importantly, the company was able to confirm in its latest results that it was on track in respect of these targets.

Flight Centre was able to achieve very strong growth in its international operations. This included growth of ~120% in the Americas region and 30% in Europe. On the other hand, the Australian operations were soft, and in fact underlying profits declined by approximately 4% in the second half of the financial year. It is likely that this also played on investors' minds in their selling down the stock post the result.

We believe this soft Australian performance mostly owed itself to the distraction of the transformation program. In Australia, it required a system overhaul, retraining its sales force, and the rationalisation of its various brands. It is expected that the Australian business will have started to bed down these issues and started to gain momentum as it progresses into the 2019 financial year.

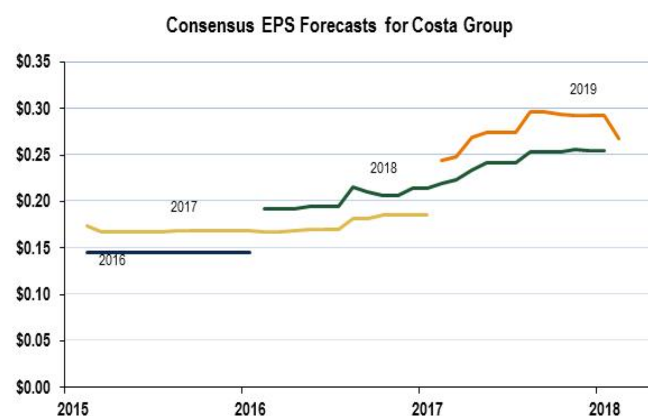
With the recovery in Australia, continued momentum in its international operations, and execution of other growth opportunities, we believe earnings growth will surprise the market on the upside.

We took advantage of the share price fall to materially increase our weighting in the stock at attractive prices. On consensus numbers, its shares trade on approximately 17 times this year's earnings. However, the company has a net cash position of approximately $520 million – this is after deducting all debt and client funds – and the value of this cash pile is ignored in the calculation of its PE multiple. Indeed, the PE multiple would be closer to 15 times on an ex-cash basis.

As it is, Flight Centre could return excess cash to shareholders, via a dividend or buyback. In this respect, we note the company has ample franking credits. Alternatively, it could use the cash to invest further in growing its business, including via acquisitions. An example is its acquisition in September of Unmapped, a Canadian-based technology company that provides travel documentation, communication and itinerary management software to the travel industry.

**Costa Group**, Australia's largest agricultural produce company, reported financial year results that were in line with expectations. Specifically, it reported profits of $77 million, amounting to very strong growth of 26%.

For the 2019 financial year, the company guided to earnings growth of at least 10%. The market was underwhelmed by this guidance and consensus forecasts were downgraded, as seen in the graph below. Its shares sold off as a result.




*Source: BAEP, BAML. As at 30 September 2018.*

We believe this guidance could well prove conservative. After all, the initial guidance for last year was also for 10% and it ultimately delivered 26%. Our more optimistic view of near term earnings is based on our research into production growth and price increases, particularly in respect of berries, mushrooms and avocadoes. That said, we expect the first half to be soft, with the second half of the financial year to more than make up for the difference.

As to the longer term outlook, the company guided to annual growth of 10% over a 3-5 year timeframe. This long range guidance reflects upon the predictability of its growth agenda.

In basic terms, this longer term growth is underpinned by growing demand, which Costa is feeding by growing production. Specifically, the company is investing material sums in capex to expand production of blueberries, mushrooms and tomatoes, and it is looking to continue building out its avocado business via acquisitions. In addition, the company is expanding its acreage of blueberry farms in China, and it has recently taken over full ownership of its Moroccan venture.

As an agricultural company, Costa is exposed to agricultural risks, including to the vagaries of weather and the ups and downs of produce prices. The company has mitigated this exposure, including through geographic diversification of its farms and the use of protected cropping practices. For example, frost conditions in NSW from July/August have caused reduced industry supply of blueberries. Costa is largely immune from this given its use of frost fan technology, and it will therefore benefit from the higher prices that have come as a result of limited supply. Based on our research, wholesale blueberry prices are materially higher in this 'peak' season versus last year – this is also reflected in higher retail prices at Woolworths and other retails – and this will materially add to earnings. Costa is the dominant producer of blueberries in Australia, and has developed unique varieties that allow it to supply produce all-year round, including outside of peak season.

While Costa's share price fall hurt performance over the quarter, it also presented us with the opportunity to materially increase our weighting in the portfolio at what we considered very attractive prices. In our view, Costa is a high quality, strongly growing company that we have high conviction in based on our more optimistic view of its near and longer term earnings prospects.

**BWX Limited**, the personal care products company, was another large detractor over the quarter.

In May, the company announced it had received an approach for a possible takeover. The proposal was in the form of a management buy-out that involved the then CEO and Finance Director together with private equity firm Bain Capital. The Board ran a process to elicit firm offers from the MBO team as well as other potential bidders. This included opening the company up to due diligence.

In August, the company reported its 2018 financial year results, which were slightly disappointing. EBITDA grew by 52% to approximately $40 million, assisted by recent acquisitions. It also guided to strong earnings growth for this upcoming financial year.

In September, the company announced it had not received an appealing takeover offer and that the company would therefore remain independent and listed on the ASX. The company also confirmed the interim CEO and CFO would continue in their roles in place of the previous CEO and Finance Director that were part of the MBO team. We believe they will capably lead the company into the future.

We continue to believe BWX has a bright future. On consensus earnings, its shares trade on approximately 15 times this year's earnings. Whilst the company may remain distracted in the near term by the fallout of the failed takeover, we are comforted by the market position of Sukin and its other brands, and the many longer term growth opportunities in front of it.

## Portfolio positioning

When investing in the ex-20 sleeve of the portfolio, the inclusion and weighting of any particular stock will depend on our conviction levels. For us, conviction comes from our belief in the company's ability to meet or beat the market's earnings expectations. Most of our conviction comes from undertaking very detailed research and analysis. This involves meetings and follow-ups with the company itself, as well as 'channel checks' with other industry sources such as competitors, suppliers and customers.

During the quarter, we took the opportunity to up-weight our highest conviction ideas, including stocks like Costa Group and Flight Centre. We very much like the potential in these stocks, particularly given where their shares prices currently sit. On the other side, we trimmed positions where our conviction levels reduced. Specifically, there were a couple of portfolio companies that reported what we considered to be underwhelming results, but which nevertheless saw their shares rise higher.

The changes have greatly improved the risk/return dynamics of the portfolio, and we believe the portfolio is well positioned for attractive returns ahead.

## Outlook

We remain constructive on the market, being neither outright bearish nor bullish.

We believe the market is acting in its normal orderly way. Indeed, we believe Australian equities look relatively attractive, although there is the need to remain selective.

There are always bull and bear arguments on the market. In an attempt to simplify our thinking, we would point out three reasons for being constructive on the market.

1. Stock fundamentals look solid

   This was confirmed by the recent earnings season. Aggregate earnings growth for the market last year was 8%. This year another 7% is expected. After a grind in corporate earnings since the GFC, it seems ASX-listed corporates are starting to see some earnings momentum finally start to build.

   As well, corporate balance sheets have in general been strengthening over the years and now look very strong. On consensus numbers, the aggregate gearing ratio will fall from about 22% two years ago to 18% by the end of this year (excluding the banks, in respect of which prudential capital levels have also strengthened).

2. Valuations are relatively attractive

   The market trades on less than 16 times consensus earnings, which is only slightly above its historical average of 14-15 times. The market yields approximately 4.5%, which after grossing up for franking credits, gives investors a 6% yield. This appears very attractive in the context of low rates and the growth equities also offer on top.

   Indeed, cash, bonds, property and most other classes sport valuation metrics far beyond historic averages, quite in contrast to Australian equities.

   Many point to the length of the current upcycle. However, from the very depths of the GFC almost 10 years ago, the market index has not yet doubled (the US market is up over 4x). Over that time, the Australian market has had two corrections of 20% or thereabouts – in 2011 and 2015/6 - which hits up against the argument we have enjoyed a bull market for far too long.

3. Investor sentiment is supportive

   Share prices naturally discount the prevailing investor sentiment. Sentiment is far from euphoric. Indeed, many investors still seem to be cautious and wondering when the next correction is coming?

   Reflecting this sentiment at the institutional level, many fund managers have significantly upped their cash holdings, according to BAML's most recent investor survey. At the retail level, there is little stock talk at BBQs, nor are Uber drivers given to stock tips, and margin lending has plateaued at historically low levels.

Of course, there is always a need to be diligent and manage risk. Importantly, our investment approach is as much about reducing the downside risk as it is about upside returns. Right now, we believe the portfolio is well positioned on a risk/return basis.

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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, 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 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 is managed in accordance with BAEP's robust, disciplined and proven investment philosophy and process.
- 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 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 (Elements Investment, Elements Pension, iAccess, My North, North, Portfolio Care, Portfolio Care eWrap, PPS, Summit, Wealthview eWrap Inv) | |
| AON | Federation |
| CFS (FirstWrap) | Macquarie Wrap (IDPS, Super) |
| Credit Suisse | Netwealth (Super Service, Wrap Service, IDPS) |

## 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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