

# Bennelong Concentrated Australian Equities Fund

## Performance update

As at 31 December 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	-2.57%	-13.36%	-18.20%	-7.65%	8.22%	11.72%	15.55%
Benchmark*	-0.23%	-8.41%	-7.03%	-3.06%	6.65%	5.60%	9.53%
Value added	-2.34%	-4.95%	-11.17%	-4.59%	+1.57%	+6.12%	+6.02%

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	25.7%	6.4%	19.3%
Health Care	22.4%	8.8%	13.6%
Consumer Staples	13.0%	5.8%	7.2%
Liquidity	1.7%	0.0%	1.7%
Industrials	9.1%	8.0%	1.1%
REIT's	8.0%	7.6%	0.4%
Materials	18.5%	18.1%	0.3%
Communication	1.7%	3.5%	-1.9%
Utilities	0.0%	2.0%	-2.0%
IT	0.0%	2.2%	-2.2%
Energy	0.0%	5.4%	-5.4%
Financials	0.0%	32.2%	-32.2%

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

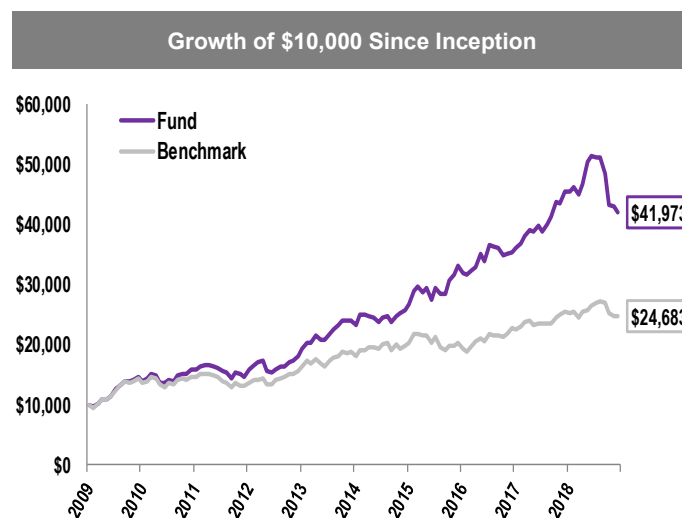
Top Holdings
CSL
BHP Billiton
Costa Group Holdings

### Portfolio characteristics

	Fund	Benchmark*	
Return on Equity	16.0%	12.1%	Premium Quality
Debt/Equity	20.9%	22.6%	
Sales Growth	7.8%	0.6%	Superior Growth
EPS Growth	10.4%	6.0%	
Price/Earnings	19.0x	14.3x	Reasonable Valuation
Dividend Yield	3.2%	5.1%	
Beta	0.97	1	
Active Share	82%	na	Genuinely Active
No. of Stocks	20	295	

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

### Long-term performance



Source: BAEP

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#### Performance review

The December quarter was a tough one for equities, which have been in a general decline since the end of August. As can be expected from time to time, the Fund underperformed over this period. The table on the front page shows the disappointing recent returns as well as the very strong long term returns.

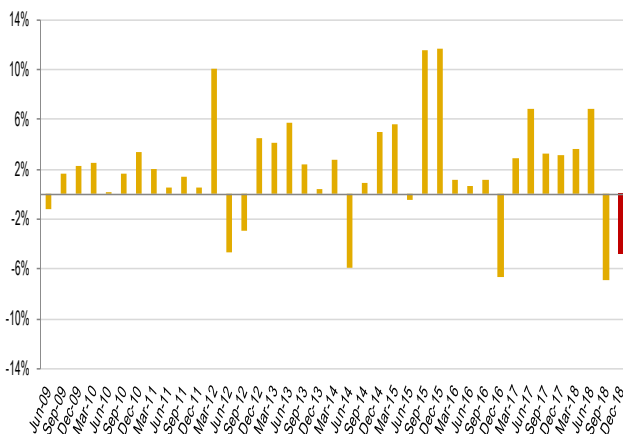
History shows equities are volatile and offer uncertain returns in the short term. Over the long term, however, the ups and downs of equities tend to work themselves out and deliver quite attractive returns. Since 1900, Australian stocks have delivered just over 10% per annum, and since 1993, they have delivered almost 9% per annum.

The last five years have been difficult for the Australian stock market, and have come with falls of about 20% in 2015/6 and 14% more recently. Investors have nevertheless earned an acceptable return of 5.60% per annum.

The Fund itself has been able to deliver clients with even better returns, owing to quite strong outperformance. Over the past five years, the Fund has returned almost 12% per annum, which according to the most recent Morningstar survey places it as the number 1 performing fund in the Australian Equity category over that timeframe.

However, whilst the Fund has performed well over time, it has not outperformed all of the time. This is best seen in the following graph, which shows the Fund's relative outperformance (or alpha) in each quarter since inception. The last two bars evidence the underperformance in the last two quarters.

**The Fund's gross quarterly performance versus the benchmark 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.

Looked at over time, one might observe a cycle in the Fund's performance, with streaks of outperformance

and stints of underperformance. In the end, however, the quarter-to-quarter performances have averaged out quite nicely for our clients.

Throughout, we stay true to our tried and tested investment style. As always, we seek to invest in:

- high quality companies;
- with strong growth outlooks; and
- whose earnings prospects are underestimated.

To our way of thinking, these are the types of companies that most reliably build shareholder value over time. Consistent with the nature of equities, the journey itself is sometimes unpredictable and often punctuated with stints of underperformance, as now.

In the September quarter we saw a sell-off in a number of the 'growth compounders' that represent the core of our portfolio. These included CSL, Reliance Worldwide and Aristocrat Leisure. These stocks had delivered strong returns for the Fund in recent years, but in hindsight their shares had got ahead of themselves and gave up some of their prior gains.

As an example, our largest position is in CSL, the global biopharmaceutical company that has compounded earnings at very high rates of growth for decades now. Its shares got as high as \$230 in early September, but fell approximately 25% by late October with no news to justify the fall. It was the second time in three years that CSL's shares have experienced 20%-plus falls, but they have still returned over 80% over that time. At the current lower share prices of today, CSL is a high conviction pick of ours, with potential for an upgrade to full year earnings guidance in the near term and continued strong growth for the long term.

Some might argue that its shares were too expensive to own at \$230. However, whenever CSL has historically seemed expensive, it has paid to hold on regardless, with the stock outperforming from every point since. Of course, we will trim down or sell out of a position when the valuation or earnings fundamentals justify such a move. Indeed, we have done so in respect of certain long-time holdings in recent months. But, to us, the best returns over time come from sharing in the reliable long term growth in earnings and value of companies like CSL, regardless of their short term trading.

This quarter, the market's sell-off came about with a shift in investor sentiment to one of 'risk off'. Investors sought out safety, and thus the REITs, utilities, gold stocks, and particular big-cap defensives such as Woolworths and Ramsay Health Care held up best. The sell-off was otherwise indiscriminate, whether growth, value, cyclical, momentum or otherwise. And



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importantly for our performance, company fundamentals mattered little, which are of course the focal point of our investment approach. We believe safety (and returns) ultimately derive from company fundamentals, which include one's competitive position, balance sheet strength, cash-flow generation and growth prospects. We believe the risk-off sentiment will tire, and fundamentals will ultimately win out, as they always do.

There were a number of positions that detracted from the Fund's performance over the quarter.

**Aristocrat Leisure**, a world leading gaming company, was one of the largest detractors.

In November, the company reported a strong set of full year results, growing revenues by 48% and earnings per share by 34%. The company continues to take market share in its core slot machines and digital social casino businesses, underpinning strong earnings growth for the foreseeable future. To this end, the company is investing big in design and development (D&D), which augers well for future releases of popular new games. Indeed, it spent over \$400 million on D&D last financial year, and this spend will continue growing alongside revenues.

Notwithstanding strength in its core businesses, the market has become concerned around the prospects for its digital social games business. These concerns have weighed on Aristocrat's shares. Its social games business faces more intense competition and it is not clear at this stage it has the scale, product or strategy to succeed. However, social games account for only about 6% of earnings, and the company can grow nicely even without this business contributing.

Aristocrat now trades on 16 times consensus earnings. Given the momentum in its core business, the significant ongoing investment in D&D, and its strong growth prospects, we believe its shares are very attractively priced at present.

**Flight Centre**, the diversified travel and leisure company, was another large detractor. At its AGM in October, it guided to soft trading in its Australian leisure travel business, but strong trading in its corporate and international operations. All up, the company provided slightly weaker-than-expected earnings guidance, although there may be an element of conservatism built in.

The company has a net cash position of approximately \$520 million and significant franking credits. It could return this excess cash to shareholders, via dividends or buybacks. Alternatively, it could use this cash to invest further in growing its business, including via acquisitions. Indeed, the company has made a few interesting bolt-on acquisitions in recent months, including the Canadian-based technology company Unmapped, and the

Silicon Valley based corporate travel business Casto Travel.

**Corporate Travel Management** fell on the publication of a short seller's presentation of its bearish investment thesis. After reviewing this presentation, re-testing our own thesis, and further confirmatory due diligence, we took the opportunity to increase our position in the company at the lower prices. Subsequently, the company provided a robust rebuke of the short seller's presentation, guided to strong trading in its business, and has seen its shares firm.

**BWX Limited**, the personal care products company, was weak through the quarter. The company downgraded its full year earnings guidance, noting weakness in the first half owing to slowing sales to China and in the US, and some difficulties in the roll out of a new enterprise-wide IT system. These issues may well prove temporary. Indeed, the company has guided to a return to strong profitability in the second half of the 2019 financial year, which if achieved, sets a base for earnings strength thereon. The shares then trade on a very low multiple of next year's earnings, while there continues to be strong demand for its brands and good opportunities for growth.

Some of the largest contributors to performance over the quarter were **Costa Group** and **BHP Billiton**.

Costa Group was the largest contributor to performance in the quarter. The company announced a small but accretive acquisition and reaffirmed its full year guidance at its AGM in late November. That said, the company announced after year-end that trading has been soft since and reduced its earnings guidance for the December half. Nevertheless, the company is growing earnings by 10%-plus, and we expect this to continue into the foreseeable future.

BHP Billiton performed well over the quarter. Prices for its high grade iron ore and coal remain buoyant, and imply continuing upgrades to consensus earnings forecasts. The company is generating very strong levels of free cash flows at current commodity prices, and it is well positioned to return these cash flows back to shareholders, via both dividends and share buy backs.

### Market outlook

In the short term, the market rarely moves in the way one might expect.

The recent rout in global markets started with fears of rising interest rates in early October, in particular as the US 10-year government bond traded up towards a yield of 3.25%. Interestingly, what then outperformed were the REITs, utilities, gold stocks and sovereign bonds. Investors evidently sought out safety, which reflected risk-off rather than a view of fundamentals. For example, REITs and utilities should ordinarily struggle as rates rise.

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And then subsequently, the economic outlook weakened somewhat. Importantly for global markets, this included the US – with even talk of a recession – China, and elsewhere. Following the economic outlook down, the US 10-year fell to as low as 2.55%. The Australian 10-year fell as low as 2.12%.

Equities continued to decline. However, the market had changed its reason for being bearish, from a case of the economic outlook being too hot - and therefore portending rate rises - to one of cooling. The market sometimes has a mind of its own, and it is not always consistent in the way it thinks.

Nor is it predictable. The clear consensus call through 2018 was for rates to rise and for this to pressure equity valuations. Yet the Australian 10-year actually fell 30bps over the course of the year. Contrary to consensus thinking, REITs, utilities and other yield stocks were among the strongest performers.

Apart from the yin and yang of interest rates and economic growth, markets have a number of other issues to be concerned of. There always are. Some of the main ones today include quantitative tapering/tightening, US-Sino trade issues, the fallout of the Royal Commission, and the upcoming Federal election. Tomorrow will bring yet another set of issues.

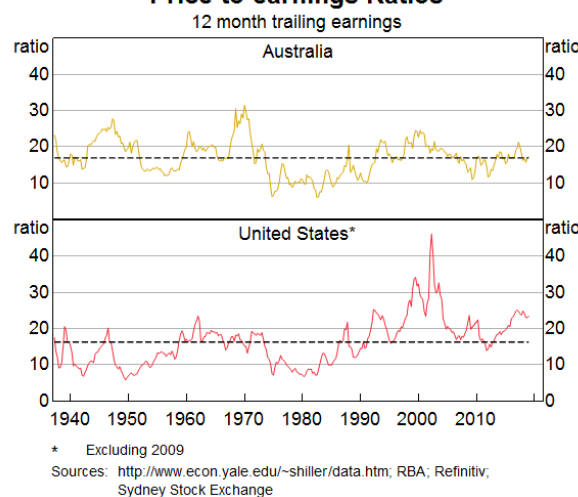
These issues are not to be trivialised, and they can legitimately impact equities, albeit usually in unpredictable fashion. However, equities offer attractive returns over time regardless of these types of issues. The previously quoted long term return from Australian stocks - of slightly more than 10% per annum since 1900 – were delivered through world wars, depressions, booms, busts, and all sorts of governments.

Interestingly, good returns do not always require good times. Since 1993, the Australian economy has experienced strong growth and avoided recessions, and it has benefited from a credit upcycle and generally declining interest rates. Yet returns were slightly lower than the long term average, at slightly below 9% per annum (see the RBA's speech titled [The Long View on Australian Equities, December 2018](#)).

Today, there are a number of reasons to be constructive on the outlook for Australian equities, especially after the recent falls.

For a start, valuations are attractive right now. The Australian market's PE multiple sits at around 14 times. As shown in the following chart pulled from the RBA speech just referenced, our equities sit at historical averages (in contrast, US equities sit well above historical averages).

### Price-to-earnings Ratios



For comparison, the earnings yield on Australian stocks is 7% (post-tax) compared to benchmark government bonds yielding less than 3% (pre-tax). The competition of rising rates is also proving illusory.

Underpinning the attractive valuation metrics, corporate profitability looks reasonably healthy. Current expectations are for aggregate earnings growth of 6% over the next 12 months. Admittedly, there is elevated earnings risk in the market at present, not least because of likely slow economic growth, and in this environment investors should expect downgrades and the like. But even accounting for slippage in expectations, we see decent earnings growth which will in turn further reduce the market's PE multiple and grow valuations.

Furthermore, Australian corporate balance sheets generally look very healthy. With a few exceptions, they continue to deleverage, as they have since the troubles of the GFC.

Interestingly, this is in contrast to US corporates which have leveraged up massively. Most of this new debt has gone towards unproductive uses, such as share buy-backs and acquisitions. This has left them somewhat vulnerable, as it seems are investors in corporate debt. In contrast, Australian corporates that have undertaken buybacks such as BHP are doing so to return excess cash flows or the proceeds of assets sales. And Australian corporates undertaking big acquisitions – such as Reliance Worldwide, Reece and Worley Parsons - are largely doing so with equity finance rather than debt. In contrast, Australia's debt build up has been within the household sector, and principally for housing, which is where it seems the risks extend from.

Finally, sentiment remains mostly negative. Of course, this is a big reason why equities trade where they do, at relatively attractive valuations.



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There are always reasons to be both bullish and bearish, in good markets and bad. In falling markets, investors usually find reason in the bear arguments, which obviously appear to carry the most logic. But investor sentiment can easily change. Sometimes there is a clear reason for the change, and sometimes not. Indeed, some of the current issues concerning markets could actually present as the catalyst for a change, for example with the finalisation of a Sino-US trade agreement or an innocuous Royal Commission report.

Any change is of course unpredictable, but at some stage investors will focus back on the fundamentals and relative attraction of equities. In the meantime, investors are being paid for their patience with a dividend yield of about 5% for the market (which equates to an almost 7% yield if grossed up for franking credits).

### Portfolio positioning

Stock selection is predominantly a bottom-up process, with the portfolio put together one stock at a time. That said, there are a number of themes that come through in the portfolio, consistent with our investment approach:

- We have a heavy orientation towards growth, particularly structural growth arising from market share gains, the introduction of new products or services, and strong industry growth tailwinds. We believe structural growth will be rewarded in the context of a likely slow economy.
  - We naturally have a very heavy weighting in lower risk, predictable and defensively positioned businesses. For example, we have a heavy weighting in the portfolio to consumer defensives and healthcare names, which are also generally showing decent growth.
  - We have an underweight stance to cyclicals, particularly domestic cyclicals. We are particularly cautious on housing and consumer-facing sectors.
  - We do not own any of the banks in the portfolio, reflecting our index-unaware approach. This is not because we are so negative on the banks; just that they do not warrant a position in what is a high conviction portfolio.
  - We have significant exposure to offshore earnings, through global businesses such as CSL, Aristocrat Leisure and Reliance Worldwide.
  - We are overweight the resources sector, but have concentrated our position in the sector to the quality of the two majors, BHP and Rio Tinto, which are mining high grade product, have strong cash flow generation and balance sheets, and are in earnings upgrade cycles.
- 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 own just three stocks in the ASX 20 Index. Most of the other top-20 stocks are low-growth domestic plays that are unexciting to us.
  - We have sought to avoid exposure to leveraged balance sheets, believing that corporate debt presents as one of the biggest risks in the market. This has steered us away from infrastructure, utilities and most REITs.

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

### 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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