

Bennelong Twenty20 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	-1.44%	-9.81%	-10.89%	-4.61%	6.02%	na	6.51%
Benchmark*	-0.23%	-8.41%	-7.03%	-3.06%	6.65%	na	6.75%
Value added	-1.21%	-1.40%	-3.86%	-1.55%	-0.63%	na	-0.24%

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
National Australia Bank
Reliance Worldwide

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	17.3%	6.4%	10.9%
Liquidity	4.8%	0.0%	4.8%
Health Care	11.8%	8.8%	3.0%
Consumer Staples	7.5%	5.8%	1.7%
REIT's	8.5%	7.6%	0.8%
Communication	2.9%	3.5%	-0.6%
Industrials	6.8%	8.0%	-1.2%
Utilities	0.0%	2.0%	-2.0%
IT	0.0%	2.2%	-2.2%
Energy	1.9%	5.4%	-3.6%
Financials	27.6%	32.2%	-4.5%
Materials	10.9%	18.1%	-7.2%

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



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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 recent and longer 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 three 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 more than 6% per annum.

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 quarter.

The market's sell-off in the December quarter 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 held up best. The sell-off was otherwise indiscriminate, whether growth, value, cyclical, momentum or otherwise. And 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.

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.

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.

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

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.



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Goodman Group, the industrial property company, was a position that we initiated earlier in the year and has become a reasonable sized position in the portfolios. Coming from a near-death experience in the GFC, the company has significantly de-risked. It owns less, manages more, and has a very lightly geared balance sheet. The safety of its earnings profile, balance sheet strength and structural growth tailwinds presented as a port in the recent market's storm.

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.

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.

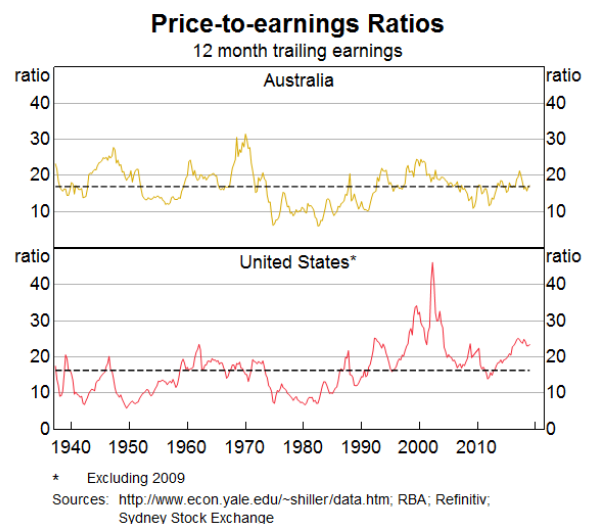
Apart from the yin and yang of interest rates and economic growth, markets have a number of other issues to be concerned of. There always are. Some of the main ones today include quantitative tapering/tightening, US-Sino trade issues, the fallout of the Royal Commission, and the upcoming Federal election. 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 (and 15 times for the ex-20 benchmark). 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).



For comparison, the earnings yield on Australian stocks is around 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 for the ex-20 benchmark of nearly 11% 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,



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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.

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 4% for the ex-20 benchmark.

Portfolio positioning

When investing in the ex-20 sleeve of the portfolio, stock selection is predominantly a bottom-up process. That said, there are a number of themes that come through in the ex-20 sleeve of 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 have significant exposure to offshore earnings, through global businesses such as Aristocrat Leisure, Goodman Group and Reliance Worldwide.
- We do not have any exposure to the resources sector, as we are generally wary of the quality of resource stocks outside the top 20. Naturally, the Fund owns the resource and energy names in the top 20.
- 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.

Otherwise, the top 20 holdings of the Fund present a nice counterbalance.

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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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