

Wheelhouse Global Equity Income Fund

Monthly performance update

As at 31 December 2018

Performance

| | 1 month | 3 months | 6 months | 1 year | Since inception p.a. |
|--------------------------|----------------|-----------------|----------------|--------------|----------------------|
| Income | 1.48% | 1.40% | 2.86% | 8.01% | 6.69% |
| Growth | (2.98%) | (8.04%) | (3.10%) | (0.69%) | (1.08%) |
| Total Fund return | (1.50%) | (6.64%) | (0.25%) | 7.32% | 5.62% |
| Benchmark* | (4.27%) | (11.10%) | (4.56%) | 1.52% | 4.48% |
| Income Index** | (4.19%) | (9.95%) | (3.65%) | 3.05% | 3.63% |

Performance figures are net of fees and expenses. Inception date is 26 May 2017.

*Benchmark is the MSCI World Index ex Australia.

**The Income Index is used to assess the performance of the Fund over a shorter period than the longer-term investment horizon of the benchmark. It comprises 50% of the Fund's benchmark (the MSCI World Index ex Australia) and 50% of the Put Write Index, an all income index which serves as a proxy for the Fund's income-generated returns.

Monthly performance review

The Fund returned (1.50%) in December, ahead of the benchmark return of (4.27%). This return comprised:

- A return of (5.15%) from the portfolio (in USD); and
- A positive return of 3.65% from the strengthening of the Australian dollar versus US dollar.

Lower risk returns

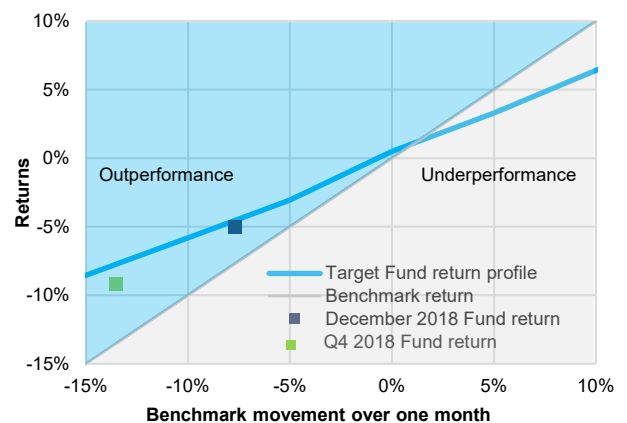
The strategy's high-income generation and active downside protection strategy are designed to lower risk and deliver equity returns with a smoother, more retiree-friendly return profile. As a result, returns are expected to add relative value in weak and low-growth markets, and to drag in more positive markets. We assess this targeted return profile in USD to strip out the influence of the AUD/USD currency movements.

Income vs total return (12 month rolling)



Source: Wheelhouse

Targeted monthly return profile



Wheelhouse is a retirement solution designed to deliver better investment outcomes to Australian retirees. Our philosophy is based on three pillars:

- investing in global equities as a **growth asset** to address longevity risk;
- shaping returns to be **retiree-friendly** with lower volatility, better capital protection and consistent income; and
- delivering a **lower cost** solution to help improve outcomes.

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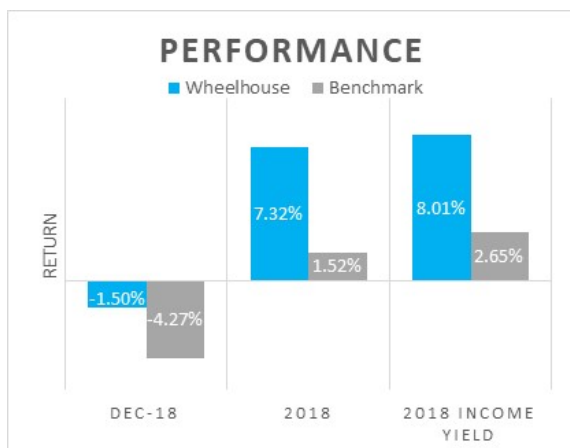
Performance

Global markets recoiled in Q4 as many of the market tailwinds that had been propelling this bull market for nearly 10 years finally ran out of steam. While nothing was particularly 'new news', the increasing sense that US growth is slowing combined with the US Federal Reserve retaining a tightening bias, seems to have been the primary catalyst. Concerns on trade wars and a US Federal Government shutdown added to the market's sense of uncertainty in December.

While technically this didn't quite touch the 20% pullback threshold that defines a bear market, it does appear that the concept of investment risk as being defined singularly as FOMO (Fear of Missing Out) has passed, and with it the mentality to simply 'buy the dip'. We believe the definition of risk has shifted back to its more historical and rational definition – Fear of Losing Money (FOLM has replaced FOMO!).

When risk is defined as 'Losing Money', typically 'Quality' becomes a far more valuable investment commodity. A company's balance sheet receives more attention, as do the competitive advantages of the products they sell. Pricing power, particularly in a low growth or potentially inflationary environment, also receives greater scrutiny and the market begins to price these securities accordingly. In short, fundamentals begin to reassert themselves as investors begin to value downside protection and security over missing out on the last dollar of return.

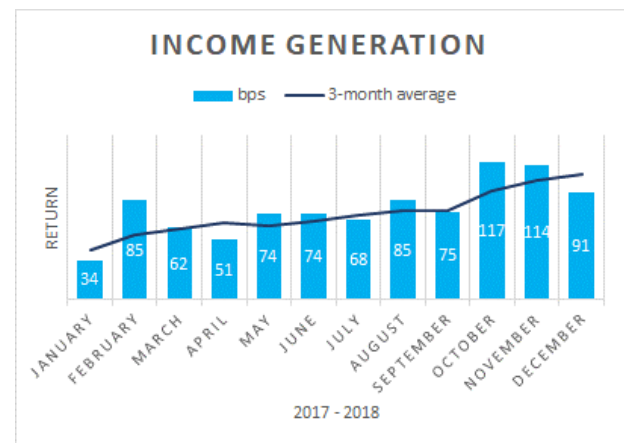
For retirees, we believe downside protection is an essential element of any investment strategy, along with regular income generation and some growth. A key difference in Wheelhouse's approach is that we supplement our exposure to 'Quality' companies with a proprietary downside protection strategy that is always-on. In December this strategy delivered increasing protection levels the more the market fell – just as it was designed to do.



Source: Wheelhouse

Income generation

In addition to downside protection, consistent income generation is an essential ingredient of a typical retiree-friendly investment strategy. At Wheelhouse the bulk of our investment returns are income-driven. By relying less on capital growth (shares going up) and more on a regular income stream, the Fund's returns are expected to be far more stable and predictable, and a source of real return in low growth environments. The consistent nature of our monthly income generation is highlighted in the following chart, with the increasing trend in recent months driven by higher levels of market volatility (the higher the market uncertainty, the higher we expect our income generation to be).



Source: Wheelhouse

Downside protection

During market corrections or crises, the Fund's downside protection strategy is expected to come to the fore and provide the heavy lifting in terms of protecting capital.

There is an important aspect of this strategy that might not be readily apparent from simply looking at the monthly performance numbers. The strategy is designed to deliver **convexity** to the Fund's returns in a severe drawdown – an unusual and we believe highly valuable characteristic in an equity fund designed for retirees.

In essence, convexity dynamically de-risks a portfolio when the market declines. However, more than simply de-risking, the risk reduction occurs at an accelerating rate the more severe the market decline.

As there is no way of knowing ahead of time when the market is about to crash, the only way genuine convexity can occur is if the portfolio always contains securities that aggressively appreciate in value as the market falls. In this way, the risk reduction occurs at an increasing rate when it is needed most critically – without having to trade or sell a single security.

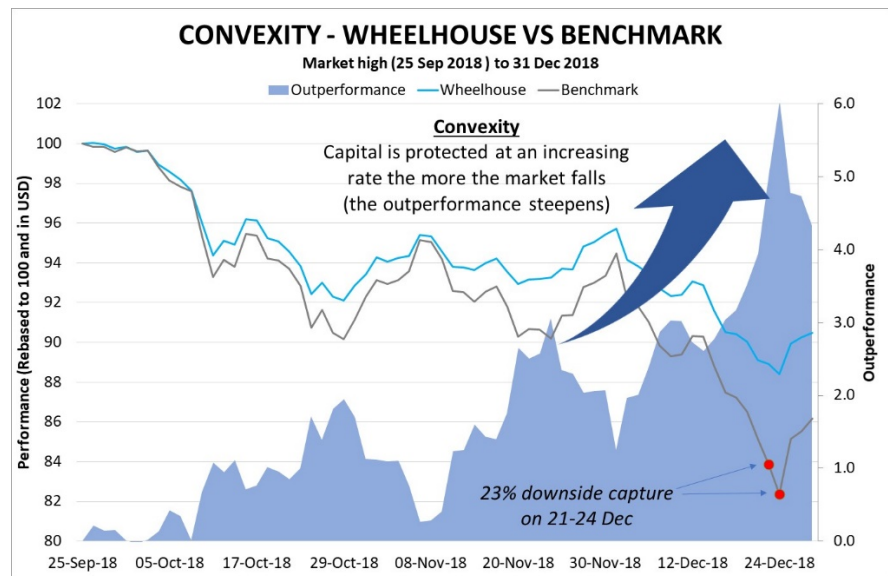
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In the chart on the right, we illustrate what convexity looks like in the Wheelhouse Fund.

While we were close to 100% invested during the quarter, when markets had fallen by more than 8% from their highs we only shared in 54% of further losses.

Importantly, at the market's nadir on 21-24 December, we only shared in 23% of the market's decline on these days.

The more the market falls, the more risk is dynamically removed from the portfolio.



Source: Wheelhouse

Convexity is better than cash in a crisis because of this dynamic risk reduction feature. For example, even a portfolio with 50% in cash, and assuming the manager had the timing perfectly right, would not have protected capital as well on these days as a portfolio with convexity (assuming no idiosyncratic benefits).

During the quarter the downside protection strategy added 365bps in value, which provided the bulk of our value-add in terms of capital protection and benchmark outperformance.

It's important to clearly define what our downside protection strategy is designed to do.

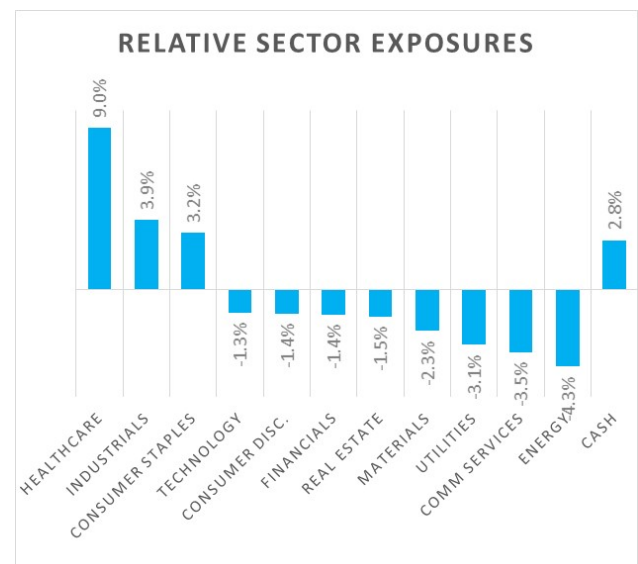
- The strategy is designed to reduce losses in all market downturns, targeting 50-60% of the market's decline beyond a fall of 10% from its high. It is not designed to 100% insulate the portfolio from any loss. While we could design the strategy this way, the cost of such a 'risk-less' approach would likely offset all of the growth of the portfolio. Without some risk there can be no return.
- The cost of this protection is expected to range between 100-150bps each year depending upon market conditions, although with active management we believe it will be far less. For example, since inception of the fund the average 'cost' of the strategy has actually been a positive 150bps contribution annually, due in large part to monetisations in February and Oct/Dec 2018.

In stronger markets with no corrections, the strategy will likely be a mild drag on returns. However, we believe the value of having meaningful convexity in the portfolio that is 'always-on' – designed to engage as much for market overnight shocks (e.g. Black Monday 1987) as it is for

more cyclical drawdowns such as Q4 2018 – will add significant value to our investors' outcomes where capital protection is paramount.

Morningstar portfolio

During the quarter the share portfolio performed largely in line with the benchmark. Our relative sector exposures are highlighted below.



Source: Wheelhouse

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For a defensive equity portfolio that outperformed during the recent market drawdown, it's worth highlighting some differences in our portfolio construction.

- We remained nearly fully invested during the quarter (cash <3%). As we rely on a dedicated downside protection hedge, the process means we don't have to try and time market ups and downs. This enables us to be fully invested at all times in pursuit of equity returns. As investors, we are paid to take equity risk, and while we reshape equity returns to lower risk and better align returns with a retiree's typical objectives, we don't rely on using an allocation to cash to attempt to time market corrections.
- With the exception of healthcare, there are no significant sector weights relative to the benchmark. Large sector exposures can make returns dependent on getting a handful of factors or investment themes correct; or they can work against you. In retirement, with less time to recover from drawdowns or investment mistakes, we believe large factor exposures unnecessarily increase risk.
- We are underweight more traditional defensive sectors such as utilities and real estate. As our downside protection strategy is integrated into our equity portfolio, we are comfortable having the best quality companies in the portfolio from the breadth of the economy, and can rely less on bond-proxy type sectors that may exhibit less growth, be more levered, and thus be more exposed to a secular rising interest rate environment in the US (even if we take a pause in 2019).

To sum up, relying on an integrated downside protection strategy allows us to utilise a far more diversified equity portfolio that covers nearly all corners of the global economic landscape, in order to generate equity returns with lower risk over the cycle.

Outlook

2018 was the first year in nearly 30 years that the S&P500 endured two separate corrections of 10% or greater – one in Feb/March and then again in Q4. In contrast, this follows on from 2017 where the Index enjoyed the longest run since 1928 with not so much as a 5% pullback.

We believe the change in market dynamics over the past 12 months reflects for the most part the change in investor perception of risk (from FOMO to FOLM!), plus a recognition of greater uncertainty with regards to the global economic cycle.

Unfortunately, the problem with trying to time market ups and downs is that more often than not, they prove damaging to investor outcomes. If one had invested in the S&P500 for the past 15 years and simply missed out

on the 10 best trading days – less than one day per year – then annual returns would have fallen from 7.8% to 3.0%. Miss out on the best 20 days over this period and annual returns fall to zero. Clearly this would have a material impact on many retirees' investment objectives.

The headwinds to the market have been well publicised – slowing growth, rising rates, trade wars and political brinkmanship. The challenge in the current environment is to assess how much of this is already priced into the current 'near-bear' market. We suspect probably most.

However, this does not mean we expect a smooth path to market recovery. Market volatility measures in recent months have been significantly elevated and we expect this to persist as opposed to a return to the low volatility environment we had grown accustomed to since the GFC. These 'new-normal' conditions we believe are pervasive and consistent with historical evidence that volatility tends to move in 'regimes' that can span years.

Loose monetary policy and years of Quantitative Easing (QE) gave credence to the old adage that a rising tide floats all boats. As we move into this new era of higher market uncertainty and a recalibration of investor risk, the benefits of strong balance sheets and quality businesses will return to the fore. As evidenced in 2018, we believe the Wheelhouse approach of investing in quality global businesses, combined with enhanced income generation and active downside protection, leaves us well placed to deliver on our retiree-focused objectives.

For more information on our approach to downside protection and the importance of capital protection in retirement, we encourage you to read our 2017 white paper *The retiree and the 100-year storm – the impact of tail events on financial outcomes*. Please email wheelhouse@wheelhouse-partners.com for a copy.

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*Morningstar's 'Moats'

The Fund's underlying portfolio is based on the Morningstar® Developed Markets Ex Australia Wide Moat IndexSM, a semi-active index that was constructed specifically for Wheelhouse Partners.

The stocks comprising the Index are based on the fundamental view of Morningstar's team of more than 100 stock research analysts. The Index composition changes quarterly, based primarily on selecting the most attractively-valued securities in the coverage universe.

The concept of economic 'Moats' underpins the Morningstar investment philosophy and can be categorised into the following five sources.

- **Cost advantage** - Matters most when price is a big factor in a purchase decision. Typically sourced from cheaper processes, better locations or unique assets.
- **Efficient scale** - Absolute size is less important than relative size (better to dominate a niche market).
- **Intangible assets** - Brands, patents and regulatory licences. Often found in Consumer and Industrials, and less so in Financials.
- **Network effect** - Extremely powerful, where the product value increases with the number of users. Dominant networks get larger at the expense of smaller.
- **Switching costs** - Sticky customers, spans many industries but particularly present in Financials.

New addition – Reckitt Benckiser Group plc

Reckitt Benckiser (RB) is a global household & personal-care, plus more recently infant nutrition, business based in the UK. Shares of RB were added to the portfolio in December. The following is reproduced with permission.



*Investment thesis – Reckitt Benckiser Group

The acquisition of Mead Johnson and the disposal of the foods segment are two significant steps towards the repositioning of RB's portfolio in businesses with pricing power and wide margins. Pricing/mix has deteriorated in several food, household, and personal-care categories in recent years, amid greater competition from the hard discounters' private-label lines and lower barriers to entry in the e-commerce channel. However, consumer health and near-food categories such as infant formula are among the product categories that we believe retain pricing power, and RB's focus on consumer health and its entry into infant formula are likely to ensure price/mix remains a growth driver for several years to come.

The firm's products include a variety of household and personal-care brands, such as Calgon, Lysol, Finish, and Mucinex, many of which have the number-one or -two position in their categories. For example, Nurofen is the number-one painkiller in the U.K. with a share of roughly 25%, and is a close number two in Australia with a 22%. Furthermore, the addition of Mead Johnson further improves the company's category-leadership position in the favourable infant formula category. In the U.S., Enfamil holds a 29% share, almost a dead heat with Abbott and Nestle.

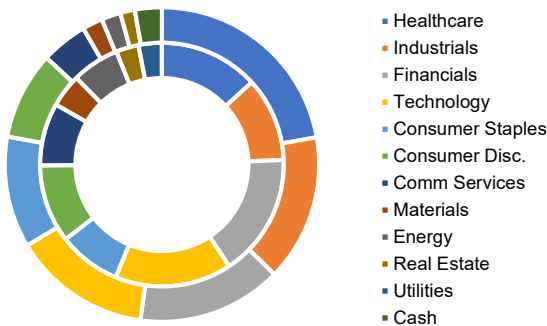
Infant formula is an engineered food product designed to replicate the benefits of human breast milk as closely as possible. The brand is based upon scientifically proven value-added products in a category in which parents are reluctant to trade down and to pay a premium for familiar brands.

The firm operates in 60 countries and sells products in more than 200, generating around 40% of sales from emerging markets.

Source: Morningstar Equity Research, as at 4 January 2019

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Sector exposure



Outer circles: Wheelhouse
 Inner circles: Benchmark

Currency exposure



| Contributors | Detractors |
|--------------------------|-----------------------|
| Express Scripts | Hoshizaki |
| McDonalds | Blackbaud |
| Eli Lilly | Amazon |
| Twenty-First Century Fox | Utd Technologies Corp |
| Roche | Zimmer Biomet |

How to invest

The Fund is open to investors directly via the PDS, available on our website, or the following platforms.

Platforms

Hub24 (Super, IDPS), Netwealth (Wrap, IDPS), Powerwrap (IDPS)

Contact us

For more information, call 1800 895 388 or visit wheelhouse-partners.com

Fund at a glance

| | |
|-------------------------------|---|
| APIR Code | BFL3446AU |
| Benchmark | MSCI World Index (ex-Australia) |
| Stock range | 50 to 100 stocks |
| Buy/sell | +/- 0.30% |
| Cash limit | 0-10% |
| Recommended investment period | Medium to longer term (five years plus) |
| Investment amount | Initial investment minimum: \$10,000 |
| Fees and charges | 0.79% p.a. (including GST net of reduced input tax credits) of the NAV of the Fund. There is no performance fee. |
| Inception date | 26 May 2017 |

Note returns are expressed in AUD unless USD is specified, and are net of fees and expenses unless specified as gross.

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