

# Bennelong Australian Equities Fund

## Performance update

As at 31 March 2019

### Net client returns (after fees and expenses)

	1 mth	3 mths	1 Year	3 years pa	5 years pa	10 years pa	Since Inception** pa
Fund	1.32%	10.62%	11.07%	12.18%	9.19%	13.17%	13.32%
Benchmark*	0.73%	10.92%	11.74%	11.39%	7.39%	10.25%	10.41%
Value added	+0.59%	-0.29%	-0.67%	+0.80%	+1.80%	+2.91%	+2.91%

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 30 January 2009

### Portfolio positioning

Sector	Fund Weight	Benchmark* Weight	Active Weight
Discretionary	19.0%	6.4%	12.6%
Health Care	20.2%	8.4%	11.8%
Materials	21.8%	18.9%	2.9%
REIT's	10.7%	7.9%	2.9%
Consumer Staples	7.9%	5.5%	2.4%
Liquidity	1.4%	0.0%	1.4%
Utilities	0.0%	2.0%	-2.0%
Communication	1.6%	3.7%	-2.1%
IT	0.0%	2.5%	-2.5%
Industrials	5.5%	8.2%	-2.7%
Energy	0.0%	5.6%	-5.6%
Financials	11.8%	30.9%	-19.1%

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

### Top Holdings

BHP Billiton  
CSL  
Aristocrat Leisure

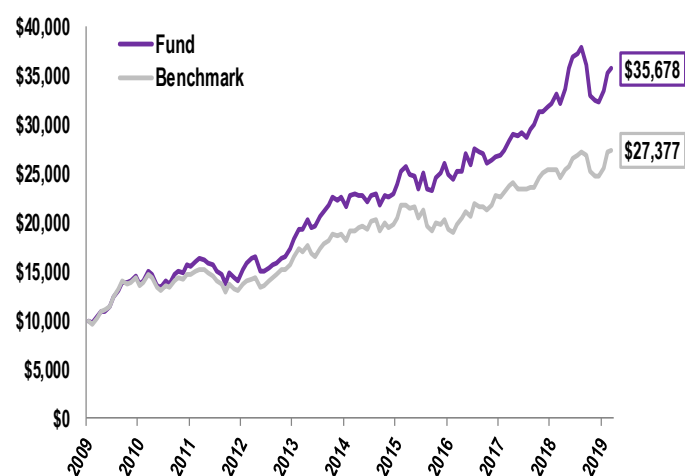
### Portfolio characteristics

	Fund	Benchmark*	
Return on Equity	16.6%	12.0%	Premium Quality
Debt/Equity	22.0%	23.8%	
Sales Growth	8.8%	1.0%	Superior Growth
EPS Growth	10.8%	5.2%	
Price/Earnings	19.3x	15.7x	Reasonable Valuation
Dividend Yield	3.3%	4.7%	
Beta	1.01	1	
Active Share	72%	na	Genuinely Active
No. of Stocks	25	300	

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

### Long-term performance

#### Growth of \$10,000 Since Inception



Source: BAEP



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### Fund performance & attribution

The market recovered hard in the March quarter, with the ASX enjoying one of its best quarters for the past decade. The Fund also recovered hard, albeit returning just behind the benchmark.

The main detractors from performance over the quarter were Reliance Worldwide and Costa Group.

**Costa Group** announced in early January that it had been experiencing weaker-than-expected trading, and it lowered its earnings guidance for the December half and the current June half. This largely owed itself to weakness in demand for its key products, including berries. We believe this weakness was mostly short-term in nature, and not indicative of longer term issues.

Indeed, at its half year result, Costa continued with its guidance for greater than 30% earnings growth for the 2019 calendar year. We in fact believe there is a very decent probability the company will do even better.

Looking out further, the company is making sizeable investments to expand production, and an important part of this is in its Chinese berry venture. The investments being made are warranted by strong growth in its key product categories - notwithstanding the recent short term weakness - and they should underpin relatively reliable long term earnings growth.

Costa's shares were sold off hard following its announcement in January, and this unfortunately hit the Fund's performance. Whilst partly recovering, its price-to-earnings multiple now sits at bottom end of the range at which it has historically traded. Investors will likely need to regain confidence in earnings delivery before re-rating its shares back upwards. The risk-return equation now presents nicely. Today's investor expectations are built on circumspection, and this improves the probability the company performs better than expected. The potential combination of strong growth in earnings and an upward re-rating of the multiple paid for those earnings offers the possibility of a 'double play' that could give rise to very attractive returns.

Shares in **Reliance Worldwide** have also de-rated over the past six months, but this has occurred without any deterioration in the prospects for its business.

Among the issues the market has been concerned of are:

- a slowdown in US housing starts (despite around 85% of revenues being from the more resilient repair and remodel markets);
- fallout from Brexit hitting its newly acquired John Guest business;
- rising copper prices, which adds to the cost of manufacturing its brass plumbing fittings (it has historically been successful in ultimately passing on higher input prices to its customers); and
- freeze events in the US, from which Reliance can benefit as a result of broken piping.

These issues do not alter the longer term prospects of the company, and mostly act as a distraction from what fundamentally underpins the investment case.

In February, the company reported decent half year results and reaffirmed full year earnings guidance. Importantly, underlying sales growth remains strong at 9.5% and last year's John Guest acquisition in Europe is performing well.

The market initially reacted positively to the result and its shares traded up nicely. However, the founding family took this as an opportunity to sell its remaining 10% stake in the company. Given the size of the block of shares sold, the discounted sale price, and the implications of an insider selling out, the sell-down weighed on the company's shares. It will be the company's operating performance that determines investors' returns from here, and in this respect, we see the recent results – and our ongoing on-the-ground research – as indicating continuing strong momentum in the business.

On consensus numbers, Reliance's shares trade on around 18 times next year's earnings. We believe this is very attractive given its quality and growth prospects.

The largest positive contributors to performance for the quarter were **IDP Education, Rio Tinto, Breville** and **Goodman Group**.

These are all global businesses operating across a range of different industries that again reported very strong financial results.

### Market outlook

Investor sentiment still remains cautious despite the strong recovery over the past quarter. It usually takes some time for investors to come out of their shells after a large retracement like we had at the end of last year. Matching that, the consensus outlook remains weak, particularly in respect of domestically focused stocks and the broader domestic economy.



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We observe that investors are still very much attracted to what is perceived to be safe. This is seen in the continued recent outperformance of bonds, gold stocks, REITs, infrastructure and comfort stocks like Woolworths that are now trading expensive. Investors are, however, incrementally paying more attention to fundamental drivers like earnings and growth. Importantly for the Fund, this will be supportive of returns.

Reflecting the cautious investor sentiment, valuations are relatively attractive. On consensus numbers, the market trades on 15.7 times next year's earnings, and is paying a dividend yield of 4.7% (which grosses up with franking credits to around 6%). These metrics are around historical averages despite record low interest rates and other assets generally valued far beyond historical norms.

The issue is in the earnings. Based on consensus numbers, earnings are expected to grow just over 5% over the next 12 months. However, in our view, there is significant earnings risk right across the market. This is the risk that a stock disappoints the market by delivering earnings that fall short of expectations. Our view implies that earnings projections are optimistic, which in turn would mean the true price-to-earnings multiple for the market is actually somewhat higher.

We believe it is necessary to be particularly conscious right now of earnings risk taken within one's portfolio. On the other hand, to the extent that companies can deliver to expectations, we believe investors can expect attractive returns.

### **Current positioning**

We are positioned with this in mind. In general, the portfolio is built through a bottom-up view of stocks. That said, there are a number of themes that flow through the portfolio at present. The following discusses these themes.

- We have a typical orientation to high quality companies. Many stocks in the portfolio carry on quite low risk, predictable and generally defensive businesses. To this end, the portfolio has a heavy exposure to healthcare, everyday consumer purchases such as food and wine, and the REITs.

The table on the front page notes a large allocation to the Discretionary sector. It is worth explaining that this table uses the GICS codes for its sector classification. In our view, the term "discretionary" does not properly characterise the companies in which we are invested in this particular GICS code. These companies

include, for example, IDP Education, Domino's Pizza and Aristocrat Leisure, which in our view are all relatively defensive.

- We have a typical orientation to 'structural' earnings growth. This is growth reliant on more reliable and enduring reasons such as:
  - market share gains (eg, Aristocrat's slot games in the US and elsewhere);
  - strong industry growth tailwinds (eg, IDP Education and the growth in university placements and the need for English language testing);
  - the release of new products or services (eg, CSL's development of new bio-medicines); and/or
  - geographic expansion (eg, Costa's expansion into China, Morocco and possibly new markets in time).

This structural growth differs from that reliant on the cycle, one-time cost-out programs or other temporary reasons. The benefit of structural growth is that it comes with ongoing accretion in shareholder value.

- We have a heavy exposure to global businesses and minimal exposure to domestic-only businesses.
- We have a sizeable exposure to the resources sector. This exposure is selective and comprises just BHP and Rio Tinto.

We have discussed the specific reasons for investing in these two names in past performance reports. In brief, our view is that supply-demand is tighter than commonly perceived for premium grade iron ore and met coal, which in turn is supportive for commodity prices and earnings upside. The iron ore tightened even further over the quarter due to a dam wall collapse at one of Vale's mines in Brazil and regulatory action stopping production at other nearby mines to shore up their safety.

BHP and Rio Tinto trade on relatively low multiples of earnings and cash flows, appear disciplined in their investments, and are returning profits back to shareholders in the form of dividends and buybacks.

- We have minimal or underweight exposure to the risks in relation to the consumer, housing, banks and domestic cyclicals. Whilst cheaper than the rest of the market, these sectors



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generally give rise to quite significant earnings headwinds and risks.

On the banks specifically, we believe they remain attractive businesses. However, the winds are changing for the sector, including on the economic, political and regulatory front. The banks trade relatively cheap and are yielding 6% fully franked or more. On the other hand, they appear to offer little earnings growth or upside over the medium term. They also face reasonably significant risks related to their exposure to the housing cycle and to a potentially unfriendly new Labor Government. All up, the risk-reward does not justify a larger position in what is generally a high conviction portfolio of around 25-30 stocks.

- We have an underweight stance to many of the other supposedly safe 'blue chips' like Telstra, Woolworth and IAG. In our view, their valuations are generally full and they offer little earnings growth or upside to compensate. The consequence is the portfolio is significantly underweight the top 20 stocks (it is overweight to mid-cap stocks).
- We have no exposure to highly leveraged balance sheets, as are quite commonly found in infrastructure, utilities and most REITs.
- That said, the portfolio has a large exposure to the REITs. This is quite atypical for the Fund, as the portfolio has not historically had any or much exposure to the sector. We first initiated a position in the sector in June last year.

We have been very selective in our REIT exposure, with a focus on the industrial and office sub-sectors. The largest REIT position is Goodman Group. The company is a global developer, fund manager and part-owner of industrial warehouses. It is strategically focused on properties located in built-up metro in-fill areas of major capital cities, and in supporting clients like Amazon and Alibaba in their increasingly critical supply chains. At its half year results, Goodman reported that earnings grew 9.4% for the half, and upgraded full year guidance from 7% to 9.5% growth. The company offers attractive earnings visibility for the foreseeable future, with a development pipeline valued at approximately \$10 billion, including over \$4 billion of current work-in-progress. The company is very well financed, with gearing last reported at 6.5%.

- For all stocks, and as before, we remain very focused on earnings risk, which we see as significant across the market at present. Our

focus on earnings risk is a key tenet of our investment approach.

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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 Australian Equities Fund typically holds 25-60 stocks across the entire spectrum of the Australian share market. 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 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	BFL0001AU
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	± 6%
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	0.95% p.a. of Net Asset Value of the Fund

### How to invest

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

#### Platforms

AMP: Elements Investment, Elements Pension, eWrap Investment Acc, eWrap Pension Acc, iAccess, Investment Service, Multifund, MyNorth, North, Pension Service, Portfolio Care, Portfolio Care eWrap, Summit, Super Service, Synergy, Wealthview eWrap Inv

ANZ (Grow, PortfolioOne) IOOF (AET, IPS, Lifetrack, Portfolio Services, SuperWrap, Pursuit Select, Employer Super, TPS)

AON Netwealth (Super Service, Wrap Service, IDPS)

BT (Wrap, Super Wrap, Panorama) Oasis (Voyage, Matrix)

CFS (FirstWrap, IX) One Answer (Frontier, OnePath)

Hub24 (Super, IDPS) Wealthtrac

### 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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