Bennelong Twenty20 Australian Equities Fund

Performance update

As at 30 June 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	3.82%	7.84%	4.20%	12.05%	na	na	10.31%
Benchmark*	3.64%	8.05%	11.42%	12.82%	na	na	11.28%
Value added	+0.17%	-0.21%	-7.21%	-0.77%	na	na	-0.97%

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
Goodman
Aristocrat Leisure
Westpac Banking
CSL
Australia and New Zealand Banking
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	13.0%	6.2%	6.9%
REIT's	13.2%	7.7%	5.5%
Liquidity	2.5%	0.0%	2.5%
Health Care	10.9%	8.6%	2.3%
Consumer Staples	6.3%	5.5%	0.8%
Communication	4.2%	3.9%	0.3%
IT	2.3%	2.4%	-0.1%
Industrials	6.9%	8.3%	-1.4%
Utilities	0.0%	1.9%	-1.9%
Energy	1.7%	5.3%	-3.5%
Financials	27.1%	31.5%	-4.4%
Materials	11.8%	18.9%	-7.2%

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

Performance Update

The market was reasonably strong over the June quarter, delivering a return of 8.05%. The Fund lagged slightly, with a return of 7.84%.

Given the makeup of the portfolio, the Fund's return is driven largely by the top 20 stocks, and its relative performance is determined by positions in ex-20 stocks.

The main reason for the underperformance this quarter was **Reliance Worldwide**.

The company downgraded its earnings guidance in May, and the shares declined about 21% on the day. As Reliance was a large weighting in the portfolio, the share price decline had a material impact on the Fund's overall returns.

There were a number of reasons given for the downgrade. Individually, they were probably insignificant, but in aggregate, they were material. They included:

- less-than-normal freeze conditions in the US, which tends to crack or break pipes that then need replacement;
- a reduction in sales to US retailers and wholesalers who were selling down inventory levels (notwithstanding good sell-through to end-customers);
- the exit of certain non-core products in the UK business such as thermal interface units, as management looked to focus the business on better growth opportunities;
- soft demand and increased competition for certain products such as PEXa pipe within its Spanish business; and
- reduced sales in Australia, owing to slowing residential construction activity.

All up, the downgrade to earnings guidance was in the order of 7%. Arguably, the market's reaction – a 21% decline in the share price - was disproportionate to the extent of the downgrade. At any rate, it means there was a de-rating of the earnings multiple at which the stock trades. Currently, its shares trade on approximately 16 times next year's earnings. This is on a par with the market average, but in our view it is a far-better-than-average company.

We believe the market is undervaluing the company's quality and growth. Its quality is underpinned by quite dominant brands, particularly in its core niche market of push-to-connect plumbing fittings. Indeed, despite the recent downgrade, we observe strong sell-through of its core products to end-customers. Its growth is underpinned by share gains in the broader plumbing market, which itself enjoys reasonable growth. This growth has been augmented by its large-scale acquisition of John Guest last year, which acquisition remains on track to add significant value to the company. All up, we would expect double-digit growth in earnings over the next few years.

The share price decline was disappointing and unfortunately hurt the Fund's returns. However, at the now lower share price, the shares come with less downside risk and more upside return potential. We believe they look well placed for attractive returns over the medium term.

We have kept the stock as one of the largest ex-20 stock holdings in the portfolio.

The next largest detractors came from the Consumer Staples sector, with the main one being **Costa Group**.

Costa Group quite materially downgraded its earnings guidance at its AGM in May. Our own research and analysis had indicated increasing risk of this, and we had sold down the position accordingly. This limited the impact from the fall in Costa's share price of around 30%. It currently remains a small position in the portfolio.

The next largest detractor was the **Gold** sector. The Fund does not have any position in gold stocks, and missing out on their strong performance over the quarter therefore hurt performance in relative terms. Gold stocks did well as the gold price rose strongly, hitting highs in Australian dollar terms.

<u>Contributors</u>

We benefited from a large position in **Aristocrat Leisure**. The company reported a strong half year financial result in May, with growth in revenues and EPS of 30% and 17% respectively. This was above the market's expectations, and the shares rose accordingly.

The company's success relies on the continued popularity of its existing and new-release slot machine and online video games. This is where our research on the company is mostly focused. Fortunately, the company has been investing more than expected in design & development - the gaming industry's equivalent to R&D – and this augurs well for its pipeline of new game releases and longer term growth prospects.

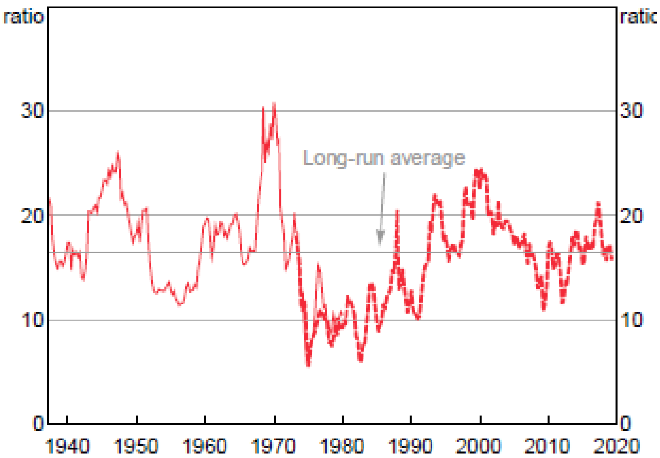
The Fund had a number of other positive contributors, but rather than discuss them, we wanted to focus on explaining the reasons behind the underperformance.

Market Update

The market has returned about 20% in the first six months of this calendar year. After its march higher, the market now sits near all-time highs hit in late 2007. It seems reasonable to take heed.

Valuations are starting to climb, although they remain only slightly above historical averages. As the RBA pointed out in its recent publication titled *A History of Australian Equities*, and as illustrated from its graph below, the current price-to-earnings ratio is about at its long-term average.

ASX 100 Price-to-earnings ratio
12-month trailing earnings



Source: RBA

Interestingly, there is relatively little difference in the valuations for ex-20 stocks and the broader market. Currently, the ex-20 index trades on 17.1 times this financial year's earnings; the ASX 300 Index trades on 16.5 times earnings. This difference is as tight as it has been in some considerable time, suggesting little premium for the stronger growth on offer among ex-20 stocks. It suggests a reasonable probability that ex-20 stocks can outperform from here.

While the ASX is valued around its long-term average, there is a lot going on underneath the hood.

There is quite extreme investor favoritism towards safe-haven stocks. These include bond proxies like REITs, utilities and infrastructure stocks; gold stocks; and the 'defensives' such as Ramsay Health Care. Mostly, they offer earnings certainty, yield and a place to hide from a weakening economic outlook.

At the other extreme is the favoritism towards the more speculative and sexy disruptive growth stocks. These include the WAAAX stocks and other tech names like Nearmap and Audinate. With large markets to disrupt and seemingly nothing to stand in their way, these stocks appeal with an offer of long duration growth.

Arguably, valuations for both are becoming questionable, and in any event, reliant on a continuation of the macro picture defined by weak growth, earnings uncertainty and low interest rates.

In this way, the market is largely being driven by macro factors at present. In the end, however, stock prices cannot forever ignore their longer term fundamental drivers of valuations, earnings and growth.

Between the extremes of the safe-havens and disruptive growth are a lot of other really good companies whose shares prices don't have the same upwards momentum and whose valuations appear very reasonable.

Admittedly, these have much more earnings risk and/or far less growth (earnings risk being the risk that companies disappoint in the earnings they deliver versus expectations). Indeed, a number have downgraded their earnings guidance in recent months, particularly domestic cyclicals such as retailers, builders, casinos, media companies and the like. There have been a number of reasons given for these downgrades, but clearly business conditions were becoming worse than what was previously expected. After all, there is a reason why the RBA has been cutting rates.

The market's reaction to these downgrades has been quite brutal. In doing so, investors have been extrapolating shorter term softness into longer term valuations. This reflects a shorter term focus than normal, which often comes about when levels of risk aversion are elevated. The outcome is that there are some quite attractive valuations on high quality and nicely growing companies such as Reliance Worldwide.

On the other hand, one must remain particularly focused on earnings risks at present. At BAEP, this is a key tenet of our investment approach. To the extent that one can get comfort on this front, there are decent returns available from the market with the help of some careful stock selection. We will endeavor to seek these out through our active management of the ex-20 segment of the portfolio.

Bennelong Twenty20 Australian Equities Fund

Performance update

As at 30 June 2019

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	Macquarie Wrap (IDPS, Super)
CFS (FirstWrap)	Mason Stevens
Credit Suisse	Netwealth (Super Service, Wrap Service, IDPS)
Federation	Wealth O2

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.