Bennelong Avoca Emerging Leaders Fund

Monthly performance update

As at 31 August 2018

At a glance

Feature	Fund fact
APIR code	BFL0008AU
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Investment objective	3-5% p.a. above benchmark measured over rolling 5-year periods
Portfolio managers	Jeremy Bendeich/John Campbell
Stock number	30
Fund size	$11.082m
Active stock limit	± 8%
Cash limit	0-10%
Inception date	1 July 2011
Recommended investment period	Long term (five years plus)
Minimum investment	$20,000
Buy/sell spread	+/-0.30%
Entry/exit fees	Nil
Management fee	1.25% p.a. (including GST net of reduced input tax credits) of Net Asset Value of the Fund
Performance fee	17.5% (including GST net of reduced input tax credits) of any amount by which the Fund's investment return (before fees and expenses) is more than 1.25% p.a. greater than the return generated by the S&P/ASX Small Ordinaries Accumulation Index

Performance in review

The S&P/ASX Small Ordinaries Accumulation Index (XSOAI) posted a +2.5% return in August 2018 compared to the S&P/ASX 100 Accumulation Index (XTOAI) at +1.3%. XSOAI outperformed XTOAI by +7.6% over the past year and by +5.9% per annnum over the past three years.

The top five performers in XSOAI in August were Appen +41.2%, Wisetech +40.1%, Retail Food Group +39.0%, Altium +37.4%, and Infomedia +36.8%. The bottom five performers were iSentia Group -54.4%, RCR Tomlinson -47.2%, SpeedCast International -31.6%, Arq Group -27.2%, and Sims Metal Management -26.8%.

The Small Resources Accumulation Index (XSRAI) fell -4.1% in August vs the Small Industrials Accummulation Index (XSIAI) at +4.4%. XSRAI outperformed XSIAI by +5.2% in the year and +13.2% perannum in the three years to 31 August 2018.

Global equity markets diverged in August with strength in the US and Japan, and weakness in both Europe and emerging markets. The MSCI World ex-Aust (loc) rose +1.4%, S&P 500 +3.3%, NASDAQ +5.9%, FTSE 100 -3.3%, German DAX -3.5%, French CAC -1.9%, Nikkei +1.4%, and the Shanghai Composite -5.3%.

Global bond markets saw further flattening of yield curves in the US, where the spread between the US long- and short-term rates reduced by -6bps. US 10 years fell -12bp, Australian 10 years -14bp and German 10 year yields -11bp. Conversely, UK 10 years rose +9bp and JGB 10 years +3bp.

Reporting season was characterised by further ballooning of valuations for companies in the top PE quintile stocks in the ASX300, which rose 4.2pts in August as estimated by JPM. Notably, Appen rose 41% in the month of August, due to an upgrade to FY18 guidance of 8% at the mid-point and WiseTech rose +40% due to FY19 guidance being 10-13% ahead of consensus. Conversely, downgrades to guidance saw iSentia and Speedcast fall -54% and -32% respectively. RCR announced a $57m write-down on a solar contract and subsequently raised $100m equity at $1 per share, a 53% discount to TERP. Furthermore, Afterpay announced a $118m raising to fund their international expansion and acquisition of ClearPay.

Performance

Timeframe	Fund return	Benchmark	Value added
1 month	3.15%	2.49%	0.65%
3 months	1.49%	2.53%	-1.04%
1 year	13.15%	22.32%	-9.17%
3 years p.a.	12.14%	16.88%	-4.74%
5 years p.a.	7.46%	9.18%	-1.73%
Since inception* p.a.	6.02%	4.97%	1.05%

Performance figures are net of fees and gross of any earnings tax. 'Value added' calculation does not use rounded performance figures. *Inception date is 1 July 2011.

The portfolio returned 3.15% in August vs +2.49% for XSOAI, an alpha of +0.65%. Since inception, the portfolio has returned +6.02% vs +4.97% for XSOAI, an alpha of +1.05%.

The top five contributors for August were EQT +53bp, WebJet +50bp, Sims Group +43bp [not held], AUB Group +39pts and Blackmores +34bp.

The top five detractors for August were Western Areas -50bp, Fletcher Building -44bp, Altium -43bp [not held], WiseTech -36bp [not held], and OZ Minerals -27bp.

Outlook and strategy

As regular readers of our monthly would well know, we have been cautious on the (inflated) prices of quality / long duration equities for the past two years. Over this time, the valuation metrics of these quality equities have gone up, in some cases dramatically. The metrics of pretty much every other equity style (e.g. industrial cyclicals) have remained unchanged or even fallen (REITs). A key factor driving that dichotomy has been QE and the resultant flattening of the yield curve. QE is tailing off and we will see how this impacts but it seems reasonable to assume that just as it was a positive driver of inflated equity valuations as it ramped up, it will be a negative driver as it ramps down.

More recently, the curve ball of trade wars has been introduced to the mix which investors have interpreted as negative for industrials / resources and neutral for technology / quality. Our base case is that trade wars will eventually be resolved (otherwise Trump's supporter base will be hurt, which he will be at pains to avoid).

In an Australian context, the upshot of all this has been to propel many equity names to near all-time high valuation metrics. For instance, Cochlear has been re-rated from a prospective PE of 30x early 2017 to 43x today –in spite of EPS downgrades. You have to go back to the tech wreck period to find a higher PE for Cochlear (when Cochlear was significantly underpenetrated globally and had decades of double-digit sales growth in front of it). With quant momentum now dominating FUM flows, who can say what turns these valuation excesses around and when?

Australian small caps FY18 reporting period was notable for two things:

1) FY18 and FY19 small industrials EPS consensus was downgraded by -4% and -3% respectively (worst outcome in three years); and
2) the highest PE quintile going into reporting season provided the best returns

In fact, four of the highest PE names (Afterpay, Appen, Altium and WiseTech) provided > 60% of XSO's returns for the month.

Although all four names issued positive guidance, the consensus change to forecasts was minimal and left many sell-side pundits scratching their heads. Some quotes from post-reporting season summaries are instructive.

Goldman Sachs: "Struggling to make sense of the moves… high quality stocks had a record earnings season that looked very disconnected to fundamentals."

JPMorgan: "The August 2018 results season will be remembered for the rise and rise of high PE / high momentum names. On our reckoning, the multiple of the top PE quintile leapt 4.2pts in August. In of itself an extraordinary move, made much more so by the fact that EPS for this cohort fell on average."

CLSA: "Industrials rallied 2.9% even as consensus downgraded FY1 by -4.4% and FY2 by -4.2%."

At some point, this quant-led, valuation unaware merry-go-round will stop, potentially abruptly. The question for investors is: how long do you play chicken with these vastly inflated quality names?

Largest 10 holdings

Stock name	Portfolio weight
AVEO GROUP LIMITED	6.26%
EQUITY TRUSTEES LIMITED	6.15%
WORLEYPARSONS LIMITED	6.10%
SOUTHERN CROSS MEDIA GROUP LIMITED	5.81%
INDEPENDENCE GROUP NL	5.76%
AUB GROUP LTD	5.55%
BLACKMORES LIMITED	5.09%
SEVEN GROUP HOLDINGS LIMITED	4.81%
OZ MINERALS LIMITED	4.23%
FLETCHER BUILDING	4.13%

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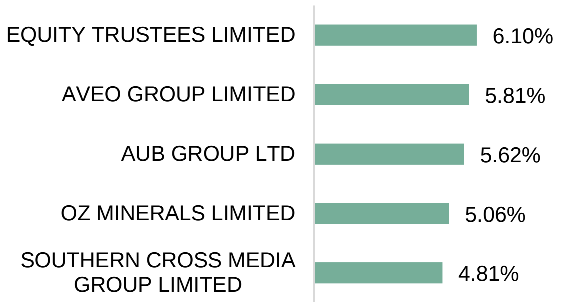
Portfolio analysis

Five largest overweighted stocks



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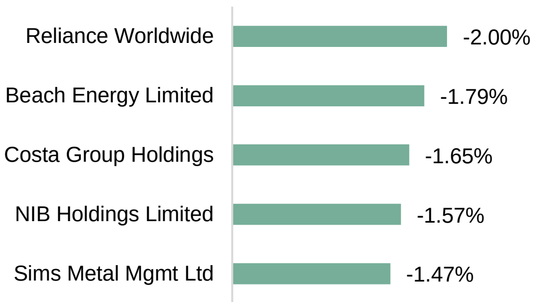

How to invest

The Fund is open to investors directly via the PDS (available at avocaim.com.au) or a range of platforms.

Platforms
BT: Wrap, Super Wrap, Panorama
Federation
IOOF: AET, IPS, SuperWrap, Pursuit Select, TPS
Netwealth: Super Service, Wrap Service
Powerwrap: Smartwrap

Contact details

For more information, call 1800 895 388 (AU) or 0800 442 304 (NZ) or visit avocaim.com.au

The Fund is managed by Avoca Investment Management, a Bennelong Funds Management boutique.