Bennelong Avoca Emerging Leaders Fund

Monthly performance update

As at 31 October 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	28
Fund size	$9.58m
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 Accum. Index (XSOAI) posted a -9.6% return in October 2018 compared to the S&P/ASX 100 Accumulation Index (XTOAI) at -5.7%. XSOAI underperformed XTOAI by -0.3% over the past year and outperformed by +2.5% p.a. over the past three years.

The top five performers in XSOAI in October were Saracen Mineral Holdings +31.4%, Lynas Corporation +30.4%, St. Barbara +19.2%, MYOB Group +13.7% and Regis Resources +13.4%. The bottom five performers were Kogan -50.0%, WPP -34.9%, Corporate Travel -34.3%, Pinnacle Investment Management -30.6% and Praemium -30.6%.

The Small Resources Accum. Index (XSRAI) fell -6.1% in October vs the Small Industrials Accum. Index (XSIAI) at -10.6%. XSRAI outperformed XSIAI by +7.9% in the year and +15.4% p.a. in the three years to 31 October 2018.

Global equity markets turned sharply negative in October driven by trade war fears, interest rate fears, high PE fears and US mid-term fears. The MSCI World ex-Aust (loc) fell -6.8%, S&P 500 -6.8%, NASDAQ -9.2%, FTSE 100 -4.9%, German DAX –6.5%, French CAC -7.2%, Nikkei -9.1% and the Shanghai Composite -7.8%.

Global bond yields were generally down in October, though US 10 years bucked the trend rising +10bp. UK 10 years fell -10bp, German 10 years -8b, Australian 10 years -5bp and JGBs flat.

Corporate news in October saw weak business updates from Kogan (stock is now down -70% from its peak, with founders having sold ~$160m of stock at high levels) and WPP; Corporate Travel down -35% driven by a negative report from short seller VGI; WorleyParsons acquiring global competitor Jacobs ECR, part funding it via a $2.9b equity raise; and takeover bids for Navitas and MYOB.

Performance

Timeframe	Fund return	Benchmark	Value added
1 month	-10.37%	-9.60%	-0.77%
3 months	-9.07%	-7.67%	-1.40%
1 year	-4.30%	2.59%	-6.89%
3 years p.a.	6.03%	10.53%	-4.50%
5 years p.a.	3.45%	6.00%	-2.54%
Since inception* p.a.	4.08%	3.37%	0.71%

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 -10.37% in October vs -9.60% for XSOAI, an alpha of -0.77%. Since inception, the portfolio has returned +4.08% vs +3.37% for XSOAI, an alpha of +0.71%.

The top five contributors for October were AUB Group +62bp, Freelancer +50bp, National Storage +41bp, OZ Minerals +36bp and Corporate Travel +35bp (not held).

The top five detractors for October were Seven Group -74bp, WorleyParsons -55bp, Soul Pattinson -35bp (not held), Saracen Mineral Holdings -31bp (not held) and St Barbara -28bp (not held).

Outlook and strategy

Was that a correction, or a sign of things to come? Firstly, as we have been arguing for two years, rising interest rates are inconsistent with extreme valuations in growth stocks. In October, the market sell-off (such as it was) began with rising US long bond rates. Combined with macro and geopolitical uncertainties (trade wars, risk of lower Chinese growth), this spread to fundamental investors selling. At the same time, the rotation out of momentum/growth stocks gained pace. All in all, this created a negative feedback loop leading to broad-based selling across most stocks including low PE economic cyclicals. Only defensive REITs and utilities were spared.

We believe the underperformance in growth stocks has only just started. On our estimates below, both large cap growth stocks and small cap growth stocks have barely de-rated post their August extremes. For small growth, the premium relative to large growth is now actually larger (25% vs 18% pre-reporting season).

ASX 300 INDUSTRIALS	31/07/2018	31/08/2018	9/11/2018
Large cap growth			
FY 19 PE (mean)	30.4x	33.5x	28.9x
Re-rate/(de-rate) on prior month		*10.2%*	*-13.7%*
EPS change on prior month (mean)		-2.3%	-0.7%
Stock price change on prior month (mean)		*7.3%*	-13.9%
Small cap growth			
FY 19 PE (mean)	35.9x	41.5x	36.2x
Re-rate/(de-rate) on prior month		*15.6%*	*-12.7%*
EPS change on prior month (mean)		*0.3%*	*-3.2%*
Stock price change on prior month (mean)		*15.7%*	*-15.2%*
Small cap growth PE premium to large cap growth	*18.0%*	*23.8%*	*25.3%*

Source: Avoca, Factset consensus data

During the month, we took advantage of the broad-based sell-off to add to positions we like – in particular Seven Group Holdings, one of Australia's exceptional industrial franchises. We have been generally deploying funds into lower PE, externally-facing stocks including resources and other economic cyclicals. While some of these too were sold off, we expect they will rebound relatively quickly as markets calm. On the flipside, many of the high PE concept stocks may continue to underperform as they have little genuine valuation support. Sell side analysts, after years of increasing valuations to chase share prices of growth stocks, are now reducing their target price multiples (EV/sales, EV/EBITDA) that they thought appropriate only but a month ago. So perhaps the growth jitters in October have ushered in a bit of reflection and caution.

One positive outcome of the US mid-term elections, with the Democrats gaining control of the House, may be a more conciliatory mood on the trade wars front. If this occurs, then coupled with a reasonably growing global economy and reasonably cheap valuations (excluding growth stocks), this forms a sound backdrop for equities to perform for the next 12 months.

Largest 10 holdings

Stock name	Portfolio weight
SEVEN GROUP HOLDINGS LIMITED	6.84%
AUB GROUP LTD	6.18%
WORLEYPARSONS LIMITED	6.15%
EQUITY TRUSTEES LIMITED	6.13%
BLACKMORES LIMITED	5.64%
AVEO GROUP LIMITED	5.53%
OZ MINERALS LIMITED	5.48%
GUD HOLDINGS LIMITED	5.48%
FLETCHER BUILDING	4.51%
INDEPENDENCE GROUP NL	4.47%

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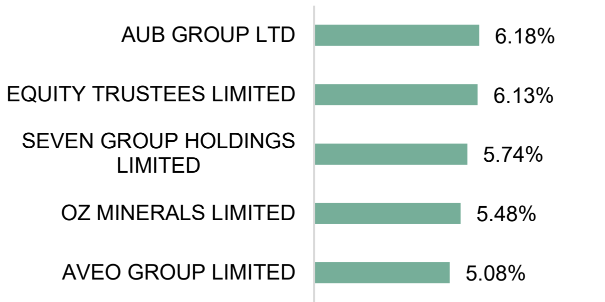
Portfolio analysis

Five largest overweighted stocks



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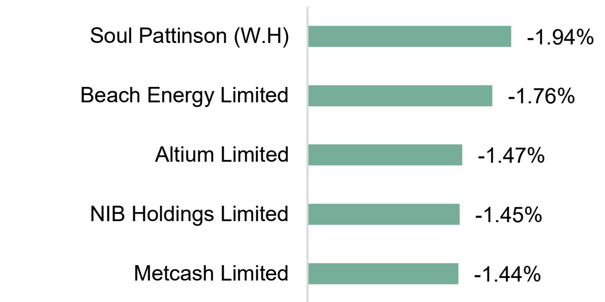

How to invest

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
Federation
IOOF: AET, IPS, SuperWrap, Pursuit Select, TPS
Netwealth: Super Service, Wrap Service, IDPS
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.