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EQUITY INVESTORS

Blended Australian Equities Portfolio

Q1 FY19 Quarterly Investor Letter | September 2018

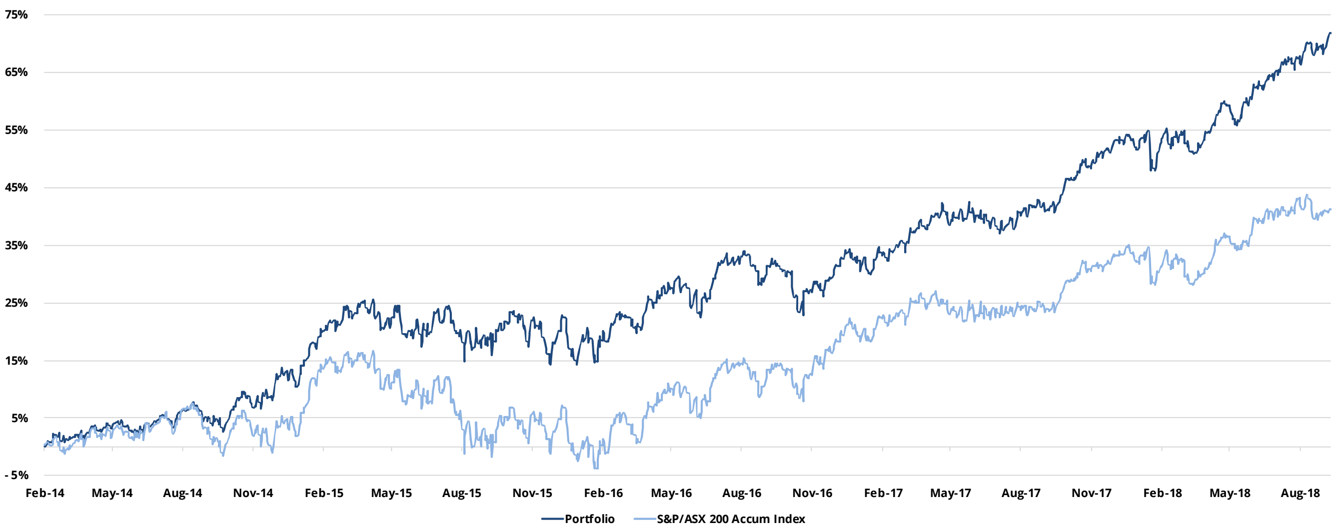
> "The US economy is operating at full potential. When flying at maximum altitude, the view in all directions slopes downward, sometimes gently and sometimes precipitously. For the time being, however, the predominant belief remains that economic growth is steady or even climbing."
>
> **Al Wojnilower 2018**

Over the September Quarter developed equity markets remained in a sanguine mood, despite the escalation of a myriad of geo-political challenges. Buoyed by a robust US economy and a company reporting season that delivered earnings growth broadly in line with market expectations, the Australian share market recorded another quarter of positive returns.

The Blended Australian Equity Portfolio finished the September Quarter up 5.55% (including franking credits) compared to the ASX 200 Accumulation Index up 1.53%. The major positive contributors to the investment performance were Brambles (BXB), Washington H. Soul Pattinson (SOL), Nearmap (NEA) and Cleanaway Waste Management (CWY). The main detractors to performance were News Corporation (NWS), Adelaide Brighton (ABC), and Origin Energy (ORG), which was divested during the quarter. The investment performance was also constrained by a cash weighting of c18%, as valuations remain broadly elevated and finding value in an absolute sense remains challenging.

The Blended Australian Equities Portfolio commenced investing in February 2014. Since its inception, the portfolio has achieved a compound annual return of 12.48% (including franking credits) compared to the ASX 200 Accumulation Index of 7.79%.

Investment Performance since Inception (%)



Source: Praemium Ltd

Performance Table - Blended Portfolio

Historical Return	Blended Australian Equities	ASX 200 Accumulation	Relative
Financial Year 2015	15.4%	5.7%	9.7%
Financial Year 2016	6.2%	0.6%	5.6%
Financial Year 2017	11.2%	14.1%	-2.9%
Financial Year 2018	16.6%	13.0%	3.6%
Financial Year to Date	5.6%	1.5%	4.1%
Since Inception (p.a)	12.5%	7.8%	4.7%
Risk Adjusted Return	1.11	0.92	
Dividend Yield	4.62%		

Source: Bloomberg & Praemium Ltd

Figures shown are before fees and inclusive of franking credits.^ Gross yield including franking credits for the previous 12 months.
Past performance is not an indication of future performance

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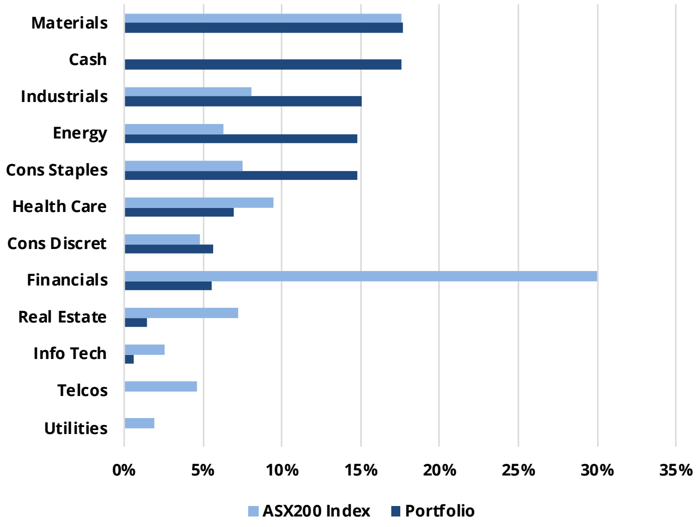
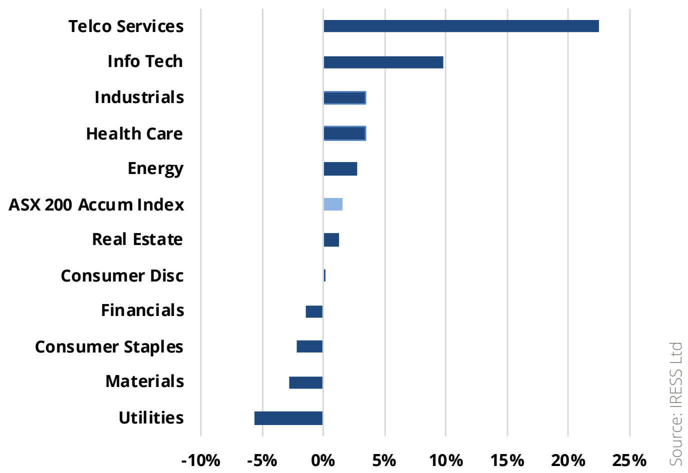
Relative sector weights - September 2018



Sector returns - Q1 FY19



A heightened consciousness of regulatory risk is playing a greater role in re-shaping our investment portfolios. A maelstrom of regulatory risk is encroaching on the banking, energy and health care sectors. Our portfolios remain underweight in financial services, regulated energy markets, and to the providers of healthcare services in the aged care and private health sectors.

This mercurial political landscape has largely contributed to a dysfunctional national energy market, whereby neither climate change nor investment considerations are being adequately addressed.

> "If governments continue to escalate their interventions to change the rules after investments have been made in export projects, they increase the prospect of investors assessing Australia as being too risky a destination for their funds."
>
> **Kevin Gallagher CEO Santos**

Over the September Quarter we actively changed our exposure to the energy sector. We exited Origin Energy, having already reduced the position during July. The FY18 result was in line with guidance but the outlook for FY19 disappointed because Origin will absorb the impact of rising NSW wholesale electricity prices rather than pass these on to consumers at a cost of $80m. This is a decision based on the increasingly hostile political and regulatory environment, with both sides of parliament competing to reduce costs to consumers and in the process damage retailer returns.

Our energy exposure has decisively tilted toward companies unconstrained by regulatory intervention. As such, we purchased Cooper Energy and Senex that are well placed to supply uncontracted gas to the east coast gas markets.

Cooper Energy is expected to grow its revenues from $67.5m in FY18 to more than $300m in FY20, with production from the Sole field in the Gippsland Basin, followed by its Mantra development. Senex is developing the Atlas project in Queensland which is in a well-defined area surrounded by LNG export projects. Senex's revenues are expected to grow from FY18 $73.1m to more than $200m in FY20. Our decision to own both companies is to diversify the risk of project timing and completion and to aggregate a position in the major sources of new domestic gas supply for the east coast in the near term and out to the mid-2020's. Importantly, these companies are not integrated electricity retailers nor LNG exporters, so they are not the focus of political regulatory scrutiny while they are adding to the domestic gas supply.

Company & Industry Analysis

During the FY18 company reporting season we attended investor briefings and held one-on-one meetings with senior management & industry participants that provided an invaluable source of detailed knowledge, the key highlights included:

- The re-rating of Australia's most expensive stocks is typical of a late phase bull market. Strong momentum of fund flow has driven a sharp re-rating of **high price earnings ratio (PER) stocks**. The top quintile for the ASX 200 is now trading at 50% premium to the median stock on the ASX 200, this is the highest premium in almost 20 years. [1] This is representative of valuations for CSL, COH and RMD in the healthcare sector and Cleanaway Waste Management in the industrial sector.

- **High PER vulnerability** when earnings growth begins to slow. This is typified by the retracement in the share price of Ramsay Healthcare whereby earnings per share growth has slowed from 12%-14% in FY16 to the company forecasting c.2% in FY19.

- The chilling effects of **regulatory intervention** across a growing list of industries including: aged care, banking/financial services, retail energy markets, private health insurance.

- The banking sector is facing mounting **headwinds** of higher compliance costs, credit contraction and higher wholesale funding costs. Earnings quality is at risk as property prices decline and borrowers move from "interest only" loans to "principle and interest" repayments.

- The impact of **reduced credit availability** is impacting the property development sector. Specifically, Brickworks cited a slowing of property development pipeline due to lack of bank finance.

- Technology **disruption** in the banking sector. We spoke with a major retailer who is replacing its point of sale (both online & offline) with a global payments system that avoids bank merchant fees, historically a rich source of revenue for the banking sector.

- A greater focus by large companies incorporating **technology** to better understand its customer base and improve competitiveness using data analytics, digitalisation & automation.

- Industrial companies citing the significant impact of **cost inflation** of rising energy prices, labour scarcity and higher transport costs. Most notable with Australian companies operating in the US where the strongest economy in 30 years is placing unprecedented cost pressures on supply chains.

- Companies increasing pay-out ratios via **special dividends**. Our portfolios were beneficiaries of special dividends from Adelaide Brighton, IAG, QUB and Woolworths.

- Early signs of an uplift in **capital expenditure** by the major resource companies.

Investment Conclusion

As the Australian equity market is close to decade highs finding value in an absolute sense is proving to be challenging. Hence, at this point in the equity market cycle we are increasingly looking for stock ideas with a value bias. Our portfolios are weighted toward companies that provide a "margin of safety" either through holding companies that have already rebased their returns to more sustainable levels (Brambles, Coca-Cola Amatil, QBE & Woolworths) and/or companies focused on capital discipline and healthy balance sheets (ASX, BHP, & Wesfarmers).

Our investment process of an active company and industry visitation program continues to underscore the value of identifying catalysts and inchoate themes in the Australian share market.

Marcus Bogdan
Chief Investment Officer

Richard Colquhoun
Portfolio Manager

[1] *Hasan S Tevik, Australian Investment Strategy, MST Marquee.*

Appendix

Portfolio Objective

The portfolio seeks to generate long-term capital appreciation by investing in Australian listed equities. The portfolio aims to do so with lower volatility and greater downside protection relative to the ASX 200 Accumulation Index benchmark.

Investment Principles

Our investment approach aims to generate long-term risk adjusted returns, by investing in companies that focus on producing high-quality earnings and operate in industries that exhibit favourable long-term growth prospects. More broadly, we consider a range of attributes which we view as important qualities in the companies we invest in. We construct and manage the Blended Australian Equities Portfolio with eight consistent guiding principles:

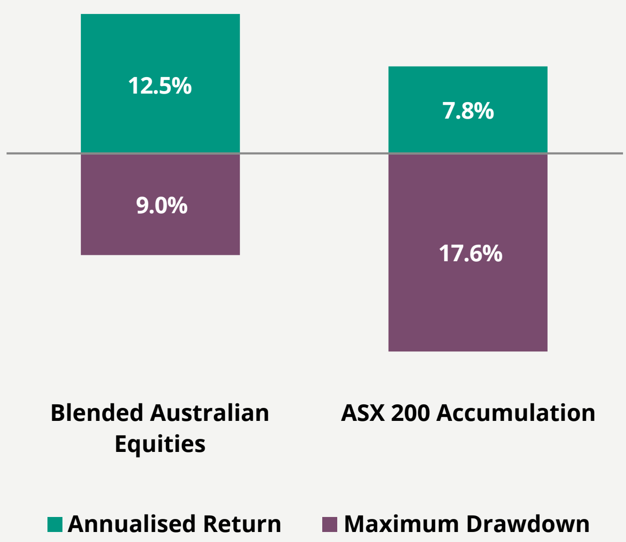
- Grow capital and income over the long term;
- Focus on the quality of company earnings;
- Identify quality assets at an attractive valuation;
- Generate a suitable return on capital employed;
- Invest in companies operating in robust industry structures;
- Select for balance sheet latency and sustainability of dividend income;
- A corporate governance structure that actively promotes alignment with key stakeholders; and
- A vigilant process of portfolio risk analysis.

Benefits of Active Management

A key benefit of active portfolio management is the recognition that return, and risk are inseparable. A core portfolio objective of the Blended Australian Equity Portfolio is to generate returns that exhibit lower volatility and greater downside protection relative to the ASX 200 benchmark index. The accompanying chart illustrates the value of understanding the interlocking nature of return and risk.

The chart below shows both the annualised return (green bar) generated by the Blended Australian Equities Portfolio compared with ASX 200 Accumulation Index, and the maximum loss/ drawdown (orange bar) in the value of the portfolio compared to the ASX 200 Accumulation Index **since the portfolio's inception** in February 2014. Maximum drawdown measures the magnitude of the worst loss an investor would have incurred by investing in the portfolio or benchmark. Drawdown is a useful measure of risk management, as it indicates the portfolio's response to periods of market stress as well as the relative sensitivities to market risk.

Return and Drawdown since Inception



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