Direct equities

REPORTING SEASON WRAP

September 2017

It was a glass half-full reporting season for Perpetual Private whereas others might say it was half-empty. Company reporting season reactions are all about the profit results versus expectations. Our expectations were not high going into this period. This predominantly came to pass as we saw positive, albeit low, profit growth in the mid-single digit levels and outlook commentary focused on reinvestment for future growth. We view this as positive and would take sustainability of future profits and dividends over short term profit manipulation any day of the week.

During reporting season we expected, and witnessed, an increasing willingness by management to invest for future growth. This meant short-term profits were not quite as high as they could have been stretched. **CSL** is a great example where R&D expenditure will increase from 7.5% to ~11% of sales revenue from FY18 to pursue new product sale streams over the next one to three years. **AGL, Challenger, Suncorp, Brambles, Magellan** and **Janus Henderson's** management are also investing for growth.

Since earlier this year, we have seen greater confidence by management buoyed by a relatively stable operating environment and revenue predictability. This is providing a better balance between cost efficiency (vs straight cost-out), capital management and reinvestment for future growth.

The post-GFC defensive cost-out and shareholder-friendly capital return strategies are still there, but diminishing in importance for management.

IT IS THE FIRST TIME SINCE THE GFC THAT WE HAVE SEEN A TRUE RETURN TO A MORE NORMAL OPERATING POSITION FOR AUSTRALIAN COMPANIES.

SOLID PERFORMERS

A number of our model portfolio stocks exhibited very solid profit results including Orora, Reliance Worldwide, Amcor, Caltex, Janus Henderson and Wesfarmers. **Telstra** was a key disappointment within the model portfolio. Our base case had assumed that Telstra, flush with cash from NBN Co payments, would be able to hold its dividend per share steady over the next few years by initiating a share buy-back program. Instead, the company re-based its dividend per share lower, surprising the market. More on Telstra can be seen in the 'Stock in the Spotlight' breakout box on page 3.

Other reporting season themes include strength from the resources segment as cashflows ballooned through higher commodity pricing, eliminating balance sheet issues for all but a few. This rude health has flowed back downstream to its supporting industries (mining services, logistics, infrastructure) benefitting the likes of **Aurizon**, **Qube** and **Caltex**.

We also saw a reasonable degree of corporate restructuring as the endpoint of a final phase of asset write-downs and the re-basing of earnings following market dislocations in various industries. Some examples include **Origin**, **Aurizon**, **Brambles**, **Caltex** and **Amcor**.

Perpetual

The generally benign reaction to corporate Australia's earnings releases over August (reporting season) is reflected in a very tightly traded market since May, within a 100-point range. The economic environment is supportive of continued modest revenue and profit growth. While the market is fair to fully valued at present, over time earnings growth will shore this up. Notwithstanding geopolitical risk with the North Korean situation, which may create periods of volatility, we view more of the same ahead.

PORTFOLIO STRATEGY

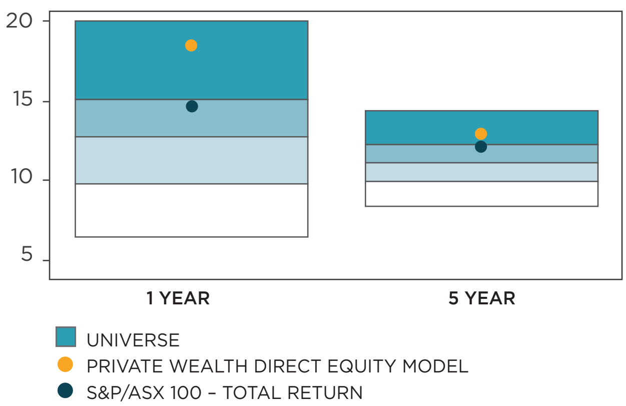
There were many challenges in the 2017 fiscal year to 30 June, mainly through event-driven market volatility (from Brexit to Donald Trump, and now North Korea). Despite this, Perpetual Private's Core direct equity model portfolio delivered 18.6% total return, which was almost 4% ahead of the ASX market return.

The key to this success was sticking to our investment philosophy and process, backing a portfolio of quality companies with long-term return sustainability. We have remained positioned for the longer term by owning good quality companies that continue to deliver returns (e.g. Amcor, Orora, CSL and ResMed). Fundamental analysis also helped us avoid a handful of negative stock movements (Brambles -25%, Sirtex -65%, Vocus -40% and Estia -60%).

Finally, a deliberate overweight portfolio positioning in South32 enabled us to benefit from a spike in commodity prices, even though we were negative on the iron ore price, thus having only a small position in BHP. The fundamentals backed the call with South32 being near debt-free at the time. Being overweight in South32 helped us hedge against the risk of a resources rally.

FIGURE 1: PERPETUAL PRIVATE DELIVERED 18.6% 'TOP QUARTILE' RETURN IN FY17

HIGHEST TO LOWEST FUND MANAGER RETURNS BY QUARTILE



Source: Morningstar and Factset, 2017. Perpetual Private Direct Equity Model return is before fees and on a fully invested basis.

Looking forward, we do not envisage major changes to the way our model portfolios are positioned. We are circumspect that the strength in commodity prices will continue and therefore remain cautious on the resources sector. Banks are neither too expensive nor too cheap. We are well underweight CBA as it faces a multitude of reputational issues.

Despite the housing market not appearing like it will unravel any time soon, we are confident that the peak has been reached. We have removed two housing market leverage plays from our portfolio, Adelaide Brighton and JB Hi-Fi, during the last financial year.

While we avoided, and benefited from, the slump in **Brambles'** share price since late 2016 from ~$13 per share to the low $9 range, this also provided an opportunity for us to revisit a quality organisation.

After considerable investment research and in-depth analysis, we introduced an initial holding of Brambles into our portfolios in August. To us, the risk–return trade-off had turned 180 degrees. Brambles now offers investors an opportunity to buy a quality, diversified business at a discount relative to its historical valuation. We recognise that there are still some headwinds facing the US business, but feel long-term investors will benefit from a reversal in these cyclical trends overtime.

While we have an optimistic outlook which suggests a skew to global cyclicals, we continue to defer to a balanced portfolio across sector, geography and economic drivers. There are no obvious tilts at a macro level just yet.

OUR BEST CHANCE TO PROTECT AND GROW CLIENT WEALTH IS TO BE DISCIPLINED AROUND OUR INVESTMENT PHILOSOPHY TO GUIDE STOCK SELECTION DECISIONS.

We continue to search for long-term holdings in companies that have strong market positions with a source of competitive advantage, solid management, sustainable earnings regardless of the economic cycle and a conservative balance sheet.

HOW DID OUR MODEL PORTFOLIO FARE?

Perpetual Private's model portfolio stocks are a subset of the 'quality' universe which includes stocks that meet our investment criteria. Our model portfolio stocks performed well when compared to the last 15 reporting seasons.

STOCK IN THE SPOTLIGHT

TELSTRA UNBUNDLES ITS DIVIDEND

Telstra's FY17 results were solid, demonstrating its ability to win market share and compete successfully in a changing environment. However, it announced complicated changes to its capital allocation strategy that caused uncertainty and disappointment, resulting in an immediate share price drop.

Telstra has been forced to reassess its capital allocation strategy as a result of the Federal Government's re-nationalisation of Telstra's copper wire (fixed) network via the National Broadband Network (NBN). Telstra is being partially compensated through a mixture of one-off and ongoing receipts from NBN Co. As a result, Telstra has been forecasting a reduction in operational earnings of $2–3 billion by 2022 from a base of $11 billion in 2014. To accommodate this change in long-term earnings, Telstra has changed its ordinary dividend policy. It will now payout 70–90% of underlying (excluding NBN receipts) earnings rather than almost 100%, which it has been paying. A final dividend for FY17 of 15.5c per share was declared, which was unchanged and expected, taking the full year payout to 31c per share. Guidance for the FY18 dividend is a much lower 22c per share.

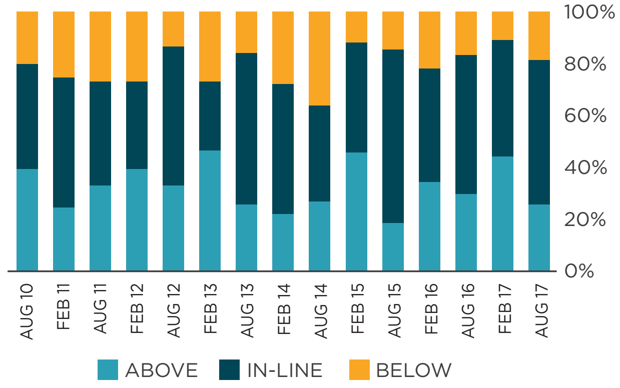
Telstra also intends to pay fully franked special dividends from its one-off NBN Co receipts over the next few years, in addition to the new ordinary dividend policy. These receipts should total about $9 billion. About 75% will be distributed, equating to about 25c per share in special dividends.

Telstra had hoped to receive a lump sum payment by bringing forward known recurring cash flow from NBN Co receipts by securitising 40% of these receipts for about $5 billion in cash up front. These funds would have been used to pay down debt and fund a large buy-back program of about $3 billlion (7%) of shares in FY18. The NBN Co scuttled this plan in August.

Telstra is performing well operationally and is flush with cash, at least into the medium term. Telstra's earnings post-2020 will depend on its ability to efficiently reinvest for growth and its competition in the market. We believe Telstra is best placed to successfully compete in the long term.

This is demonstrated in **Figure 2**, where 81% of results either met or exceeded our expectations (long-term 'average' 79%). This aligns with the trend of a mild reporting season where a greater proportion of companies produce in-line results (56% of our model stocks versus a 46% average).

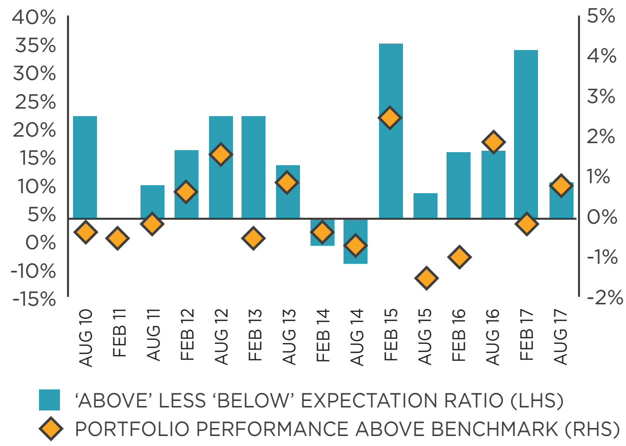
FIGURE 2: STUCK IN THE MIDDLE – MODEL STOCK RESULTS VERSUS EXPECTATIONS



Source: Perpetual, September 2017

Figure 3 below indicates the ratio of 'above' expectation results minus 'below' expectation results was slightly positive at 7%. It also demonstrates the portfolio's positive relative performance of 0.74% above benchmark during August. Measuring the strength of a company's result versus expectations (above, in-line, below) is a subjective evaluation and there is not always a direct link to portfolio performance relative to the benchmark; however, in this period there was a correlation.

FIGURE 3: 'ABOVE LESS BELOW' EXPECTATIONS VERSUS PERFORMANCE



Source: Perpetual, September 2017

The pleasing outperformance of the portfolio during August was led by its investments in Orora (total return of +12% for the month), Origin Energy (+11%), Wesfarmers (+8%) and Caltex (+7%) which all reported good results. The bank sector had a difficult year, due in large part to a negative 7% return by CommBank. We expect the aftermath of CommBank's well-publicised series of compounding and interrelated regulatory, cultural and customer issues to be long-lasting with an ongoing stream of most likely negative news flow. The share price should settle soon but is unlikely to rebound in the near term and it remains the smallest bank holding in the portfolio.

Crown Resorts was the largest single detractor to the portfolio's performance with a negative 9% return for the month. A surprise increase in the company's tax rate caused downgrades to future earnings expectations. While we believe earnings have now re-based following its Chinese issues and growth should return, the timing of the return is uncertain. We believe the new dividend policy should provide a floor in the share price going forward as it is currently trading on a dividend yield of 5%.

Our investment process and philosophy helped avoid the very sharp negative reactions during August. Vocus lost a third of its market value on the back of poor operating result and two private equity suitors walking away. Domino's (-18%) and Healthscope (-16%) also disappointed their investors.

TABLE 1: QUALITY UNIVERSE STOCK RATINGS CHANGES

Stock	Ratings changes
Janus Henderson	Upgrade to **buy**
Origin Energy	Downgrade to **accumulate**
Computershare	Upgrade to **hold**
Qube	Downgrade to **accumulate**
Healthscape	Downgrade to **hold**
Flight Centre	Upgrade to **accumulate**
Tox Free Solutions*	Downgrade to **accumulate**
Harvey Norman	Downgrade to **reduce**
Ramsay Healthcare	Downgrade to **hold**

* Indicates stocks that lie outside the ASX 100 index.

The full list of our quality stock universe and their results versus expectations can be seen in the following table, with our model portfolio stocks highlighted in **bold**.

TABLE 2: PERPETUAL PRIVATE QUALITY STOCK RESULTS VERSUS EXPECTATIONS[1]

ABOVE EXPECTATIONS	**Amaysim***, **CSL**, Domino's Limited, **InvoCare***, **Orora**, **Reliance Worlwide***, Cochlear, JB Hi-Fi, **Caltex**, IOOF Holdings, **Janus Henderson Group**, Oil Search, Tatts Group, Computershare	TOTAL: 14
IN LINE WITH EXPECTATIONS	Adelaide Brighton, **Amcor**, **Bapcor***, CarSales.com, Flight Centre, **Origin Energy**, Star Entertainment Group, **BHP Billiton**, AGL Limited, **ANZ**, **Commonwealth Bank**, Fortescue Metals Group, Rio Tinto, **Tox Free Solutions***, Asaleo Care*, APN Outdoor, Boral, **Cardno***, Magellan, **South32**, **Wesfarmers**, **AMA Group***, **Aust Stock Exchange**, **Brambles**, **Crown**, **National Australia Bank**, Seek, Woolworths	TOTAL: 28
BELOW EXPECTATIONS	Ansell, Healthscope, **Insurance Aust Group**, REA Group, Sonic Healthcare, **Suncorp Group**, Aurizon Holdings, Ramsay Health Care, **Telstra**, Challenger, Harvey Norman, Navitas, **Qube**, **ResMed Inc.**, Sirtex Medical, Vocus	TOTAL: 16

Source: Perpetual Private subjective evaluation based on reported earnings vs market forecasts, earnings quality, share price reaction and other qualitative factors; model portfolio stocks (ASX 100 & ASX 300) in bold. * Indicates stocks that lie outside the ASX 100 index. 1. Only includes companies that reported earnings to 30 June 2017.

TABLE 3: PERPETUAL PRIVATE CORE LARGE COMPANY MODEL PORTFOLIO (AS AT 08/09/2017)

Stock	Code	Sector	Model portfolio weight (%)	ASX 100 Index weight (%)	Relative weight (%)	Consec. no. of months in portfolio	Forecast P/E (x)[2]	Forecast earnings growth (%)[3]	Net forecast yield (%)[2]	Gross forecast yield (%)[2]	Franking (%)	Beta
ANZ Banking Group	ANZ	Banks	7.7	6.13	+1.57	> 60	12.3	8.1	5.7	8.1	100	1.23
Commonwealth Bank	CBA	Banks	4.42	9.16	-4.74	> 60	12.5	1.5	6.0	8.6	100	1.12
Westpac Bank	WBC	Banks	7.55	7.56	-0.01	> 60	12.7	2	6.2	8.8	100	1.26
National Aust Bank	NAB	Banks	6.80	5.83	+0.97	> 60	12.2	2.1	6.5	9.2	100	1.18
ASX Limited	ASX	Non-bank Financials	3.27	0.73	+2.54	> 60	22.4	4.6	4.0	5.7	100	0.86
Janus Henderson Grp	JHG	Non-bank Financials	4.94	0.21	+4.73	39	13.5	10.8	4.0	4.0	0.0	1.27
Suncorp Group	SUN	Non-bank Financials	3.67	1.17	+2.50	15	13.7	6.0	6.0	8.6	100	0.94
BHP Billiton	BHP	Metals & Mining	3.51	6.33	-2.82	> 60	18.5	-6.2	3.3	4.7	100	1.56
South32	S32	Metals & Mining	5.28	1.19	+4.09	28	14.4	-10.5	3.4	4.8	100	1.62
DuluxGroup	DLX	Other Materials	2.30	0.19	+2.11	12	18.9	3.1	3.9	5.5	100	0.76
Incitec Pivot	IPL	Other Materials	4.51	0.42	+4.09	24	16.6	10.5	3.4	3.4	0.0	1.08
Origin Energy	ORG	Energy	3.25	0.98	+2.27	> 60	13.0	37.5	0.8	0.8	0.0	1.66
Qube Holdings	QUB	Util & Infrastructure	2.7	0.24	+2.46	21	31.7	13.3	2.2	3.1	100	0.93
Amcor	AMC	Industrials	4.74	1.29	+3.45	49	18.2	8.2	3.8	3.8	0.0	0.77
Brambles	BXB	Industrials	2.97	1.05	+1.92	1	18.2	6.2	3.2	3.7	30	0.83
Orora	ORA	Industrials	4.52	0.27	+4.25	45	18.4	6.9	3.8	4.3	30	0.91
Caltex Australia	CTX	Consumer Staples	5.47	0.61	+4.86	15	13.3	6.3	3.8	5.5	100	0.80
Wesfarmers	WES	Consumer Staples	7.03	3.46	+3.57	> 60	16.4	3.8	5.3	7.5	100	0.75
Crown Resorts	CWN	Cons. Discretionary	2.81	0.32	+2.49	35	21.7	9	5.1	6.4	60	0.88
CSL	CSL	Health Care	4.93	4.31	+0.62	> 60	29.4	11.3	1.5	1.5	0.0	0.76
ResMed	RMD	Health Care	2.3	0.40	+1.90	> 60	25.2	5.3	1.9	1.9	0.0	0.46
Telstra	TLS	Telecommunications	5.33	3.18	+2.15	17	11.0	-6.1	6.0	8.5	100	0.66

1. 12-month forward market estimate.
2. Forecast compound average growth in EPS (excluding exceptional items) over three years.

TABLE 4: PERPETUAL PRIVATE SATELLITE (EX-100 INDEX) STOCKS

Stock	Code	Sector	Model portfolio weight (%)	ASX 100 Index weight (%)	Relative weight (%)	Consec. no. of months in portfolio	Forecast P/E (x)[2]	Forecast earnings growth (%)[3]	Net forecast yield (%)[2]	Gross forecast yield (%)[2]	Franking (%)	Beta
AMA Group	AMA	Cons. Discretionary	2.93	0.02	+2.91	15	17.2	17.5	3.6	5.1	100	1.44
Amaysim	AYS	Telecommunications	3.52	0.03	+3.49	9	10.7	20.6	6.8	9.7	100	2.44
Bapcor	BAP	Cons. Discretionary	3.29	0.1	+3.19	35	17.1	26.4	3.3	4.7	100	1.29
Cardno	CDD	Industrials	3.61	0.03	+3.58	60	24.9	24.0	N/A	N/A	100	1.01
InvoCare	IVC	Industrials	3.15	0.11	+3.04	> 60	26.4	7.4	3.2	4.5	100	0.79
Tox Free Solutions	TOX	Industrials	3.35	0.03	+3.32	48	19.4	-3.9	3.8	5.4	100	0.19
Reliance Worldwide	RWC	Other Materials	3.2	0.09	+3.11	17	23.9	16	2.2	3.1	100	0.67

1. 12-month forward market estimate.
2. Forecast compound average growth in EPS (excl. exceptional items) over three years.
3. Satellite stocks are designed to represent up to 25% of a higher growth, higher risk portfolio where the other 75% is represented by core model portfolio stocks. This creates a small company tilt to the large company core model.

MORE INFORMATION

Perpetual Private 1800 631 381
Email perpetualprivate@perpetual.com.au
www.perpetual.com.au/advice

Perpetual