BlackRock

BlackRock Australian Equity Opportunities Fund and BlackRock Australian Equity Absolute Return Fund.

February performance update

February was a very poor month for the BlackRock Australian Equity Opportunities Fund and the BlackRock Australian Equities Absolute Return Fund. Like the August 2014 reporting season, investors continued their quest for dividend yield and rewarded companies with high growth, with little regard to payout ratios and whether that growth is sustainable.

Our forecasts of earnings direction this reporting season have been reasonable, but there appears to be an unbalanced response to earnings hits and misses. The following are examples of positions held by the fund which we believe were well founded and consistent with our proven long term investment philosophy but where company results and events moved the market against us.

Long positions

The fund had a long position in telecommunications company **iiNet** based on our valuation metric, its modest multiple compared to its peers, and positive market sentiment for the company leading up to its results announcement. iiNet reported increases in revenue, profit, and customer satisfaction, along with reductions in customer churn and overall leverage. In addition they reported a higher dividend, up 17% from last year. All of these positive signals failed to placate investors who were disappointed that profits were below expectations. In our view the 10% fall in price after the announcement was not justified by the news released by the company. The latest iiNet subscriber numbers are showing growth but the market seems to have little patience for well-managed companies continuing to build a solid earnings stream.

Pay TV provider **Sky Network Television** was reasonably priced, had good earnings quality and the fund had a long position. Sky's result made guidance – with increased revenues, profit and interim dividend. Yet the stock was punished by investors who reacted more to a reduction in subscriber numbers during the second half of last year than to the positive results. Historically the company tends to add more subscribers in the first half of the year and the drop was only 1% of total customers. Further, there were gains in the number of commercial and wholesale subscribers. We think the company was unduly punished as it has actually been able to increase profits by increasing revenues in a difficult market and had done so by improving customer margins. This contrasts to many companies who are maintaining their profits in the face of zero revenue growth by simply reducing costs.

Short positions

Logistics company **Toll Holdings** was subject to a $6.5billion takeover bid by Japan Post, which represented close to a 50% price premium. The fund had a small short position in Toll mainly through our valuation metrics and poor market sentiment. While there is often the potential for corporate activity in out of favour stocks, it is hard to predict. Our experience is that in the long run, it is better to be short the generally poorer quality companies even though there is a chance that they will be subject to a takeover bid.

Another detractor this month was mining and energy contractor **ALS**. We have had a short position in this company based on poor earnings outlook, market sentiment and earnings quality. The miners and energy companies have just made serious cuts in capital spending as they seek to manage the new environment of lower commodity prices and demand – not a good outlook for contractors. But recent stabilisation of commodity prices saw renewed interest in mining services and the ALS share price has risen – at one stage by over 25%. Even though commodity prices may have stabilised, it would be unlikely that miners will start increasing their need for contractors. We do not see a significant change in the company's outlook to warrant a 25% increase in price, and maintain our short position based on continuing poor fundamentals.

Gaming stock **Crown Resorts** had a poor report, stating profits were 47% lower. The fund had a negative view on the stock based on our estimate of earnings direction (which was ultimately borne out), as well as negative market insights. In its favour we thought the valuation was reasonable but this was not enough to give us a positive overall view. Frustratingly even though we were on the correct side of the earnings announcement, the stock's price reacted in the opposite direction. Apparently investors had been concerned about a slowdown in Macau but the news was not as bad as expected. It also helped that Crown maintained their dividend, even with lower profits. Debt on the other hand has grown, as the company took the opportunity to increase debt by another $750 million. We have also seen this theme play out over the broader market.

Dominos Pizza trades at a forward price earnings multiple of well over 50 times. It is a company which has grown through acquisition and is currently favoured by the market. To its credit it has been able to meet guidance and investors have rewarded it handsomely. The question for the company is can that high level of expected growth be maintained? We note that margins in Australia may be healthy but the margins in the overseas markets where it has aggressively expanded are less than half of domestic margins. While we respect that market sentiment is currently good, we remain concerned around Dominos ability to continue to grow earnings at such a rapid pace and the overall quality of the company's earnings.

Summary and outlook

Like last reporting season, aggregate earnings have been flat. And as the cost out theme has slowed, margins were generally flat. While some companies have maintained dividends and dividend payout ratios, others have increased them and been rewarded by the yield hungry market. In some instances this has been facilitated by increased debt, which has been possible in the low interest rate environment. But is this sustainable?

As a patient, prudent investor we prefer to be in companies that generate their own cash and reinvest that to grow, rather than in companies that are unable to generate enough revenue to cover their expenses and borrow money to try and execute rapid growth.

Our systematic, evidenced based Scientific Active Equity (SAE) process remains the same. We regularly examine and adjust our model to ensure that we incorporate the latest innovations and insights to generate alpha. We also leverage the resources and knowledge of BlackRock's global SAE team to learn from their experiences in other markets. For example the US has already been experiencing low interest rates and Europe is entering the same. In both markets, as well as globally, our SAE funds have continued to deliver alpha.

We continue to make improvements to the Australian model. Three new signals have been added and one signal has been removed. The decision to add and remove signals is not just based on recent performance; rather it is an examination of the sensibility behind the idea. It is also important that signals are independent of each other to provide uncorrelated, diverse returns. Weighting of the insights is then used to position the fund for the current market environment. Recently we reduced the exposure of Value within the fund, and we have continued to reduce its importance. Not only has Value underperformed in the local market, but we have also seen poor Value performance in our overseas funds. To balance this reduction we have increased exposure to trending type insights (Earnings Direction and Market), which takes advantage of our ability to harness the ever growing information data stream. We have good exposure to Earnings Quality, so have left its weight unchanged, and Timing has also been left the same.

We maintain our view that in the medium to long term, the fundamental drivers of the market are good valuations, high earnings quality, positive earnings directions and favourable market sentiment, taking into account market timing. This longer term view has been rewarded in the past for this fund and for our global SAE funds.

We do not attempt to time the market rather we remain positioned for the time when fundamentals drive the market. However until then, and in response to the current environment, we have increased our exposure to the more trending types of insights. It is our belief that this will lead to the best overall outcome for the fund(s).