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 with returns being more than 5% below benchmark. 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 – that is, earnings forecasts that we got right were only marginally rewarded whereas positions where we got earnings forecasts wrong were punished. The following are examples of positions held by the fund(s) which we believe were well founded and are consistent with our proven long term investment philosophy, but where company results and events moved the market against us.

Stock positions

Pay TV provider **Sky Network Television** was reasonably priced, had good earnings quality and the fund(s) 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 marked down 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.

The fund(s) had a small short position in Logistics company **Toll Holdings** mainly through our valuation metrics and poor market sentiment. Toll reported a 20% fall in profits. However, on the same day, it was subject to a $6.5 billion takeover bid by Japan Post, which represented close to a 50% price premium. 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 on average to be short the generally poorer quality companies even though there is a chance that they may be subject to a takeover bid.

Another detractor this month was mining and energy contractor **ALS**. The fund(s) had a short position in this company based on poor earnings outlook, market sentiment and earnings quality. Many of the miners and energy companies have recently made serious cuts in capital spending as they seek to manage the new environment of lower commodity prices and reduced 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(s) had a negative view on the stock based on our estimate of earnings direction (which was ultimately borne out), as well as negative market sentiment. 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 favourable, we remain concerned around Dominos ability to continue to grow earnings at such a rapid pace and still be able to maintain the overall quality of the company's earnings.

Model enhancements and outlook

Like last reporting season (August 2014), aggregate market-level earnings have been flat, and as the "cost out" theme

BlackRock

(the focus on expense reduction) has slowed, margins were also generally flat to slightly down. 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 implemented via increased debt, which has been facilitated by 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.

In spite of recent performance, we remain confident in our systematic, evidenced based Scientific Active Equity (SAE) process. We regularly examine, adjust, and enhance our investment models to ensure that we incorporate the latest innovations and insights with the aim 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 enhancements to the Australian model in order to improve performance. 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(s) for the current market environment. Recently we reduced the exposure of Value within the fund(s), 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 streams. We have high conviction in our Earnings Quality metrics and have left their input weights unchanged, and our Timing factors have also been left the same. And finally, while we do not attempt to do "beta timing" in our portfolios, we do believe that the current market conditions favour an increased exposure to our insights that exhibit trending attributes.

In summary, while we have made many incremental changes to our investment strategy, we maintain our conviction that over the medium to long term, the fundamental drivers of positive equity returns are inexpensive valuations, high earnings quality, positive earnings directions and favourable market sentiment. These core underlying economic factors have delivered strong returns over the longer-term period in our underlying equity long/short strategies – both in Australia and abroad.

We recognise the difficulty the recent performance has created for you and your clients and want to assure you that we are doing everything we can to get performance back on track.

Thank you for your on-going support, and if you have any questions please contact your Account Manager or our Client Services team on 1300 366 100.

Important Information

This document has been issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975 AFSL 230 523 (BIMAL), who warrants by receipt of this document that they are a wholesale client as defined under the Corporations Act 2001 (Cth). This document is intended only for wholesale clients and must not be relied or acted upon by retail clients.

BIMAL is the responsible entity and issuer of units in the BlackRock Australian Equity Opportunities Fund ARSN 152 420 061 and the BlackRock Australian Equity Absolute Return Fund ARSN 156 366 291. A Product Disclosure Statement (PDS) is available for the Fund and can be obtained by contacting us on 1300 366 100 or visit our website www.blackrock.com.au. You should obtain and consider the PDS before deciding whether to acquire, continue to hold or dispose of units in the Fund.

This document provides general information only and has not been prepared having regard to your objectives, financial situation or needs. Before making an investment decision, you need to consider whether this information is appropriate to your objectives, financial situation and needs. Any potential investor should consider the latest disclosure document or PDS in deciding whether to acquire, or to continue to hold, an investment in any BlackRock fund. BIMAL, its officers, employees and agents believe that the information in this document and the sources on which the information is based (which may be sourced from third parties) are correct as at the date of this presentation. While every care has been taken in the preparation of this document, no warranty of accuracy or reliability is given and no responsibility for this information is accepted by BIMAL, its officers, employees or agents. Except where contrary to law, BIMAL excludes all liability for this information.

Any investment is subject to investment risk, including delays on the payment of withdrawal proceeds and the loss of income or the principal invested. While any forecasts, estimates and opinions in this document are made on a reasonable basis, actual future results and operations may differ materially from the forecasts, estimates and opinions set out in this document. BIMAL does not guarantee the repayment of capital or the performance of any product or rate of return referred to in this document. Past performance is not a reliable indicator of future performance.

This document sets out the performance of the investment strategy as implemented for a particular client portfolio under market conditions relevant at the time. The performance of the investment strategy in relation to a different client portfolio may produce different performance information due to the different client requirements, the effect of the exercise of discretions by the portfolio manager, trading costs and market conditions. This document is not a securities recommendation. This document is not intended as an offer or solicitation with respect to the purchase or sale of any securities in any jurisdiction. No part of this document may be reproduced or distributed in any manner without the prior written permission of BIMAL.

FOR WHOLESALE CLIENTS USE ONLY AND NOT FOR RETAIL CLIENTS.

© 2015 BlackRock, Inc. All Rights Reserved. BlackRock® is a registered trademark of BlackRock, Inc.