ALLANGRAY

QUARTERLY COMMENTARY

31 MARCH 2018

COMMENTARY

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This quarter has not been our finest, with the Australia Equity Fund strategy (the portfolio) underperforming the market. There is reason to be optimistic about the portfolio's future earnings and relative valuation, however.

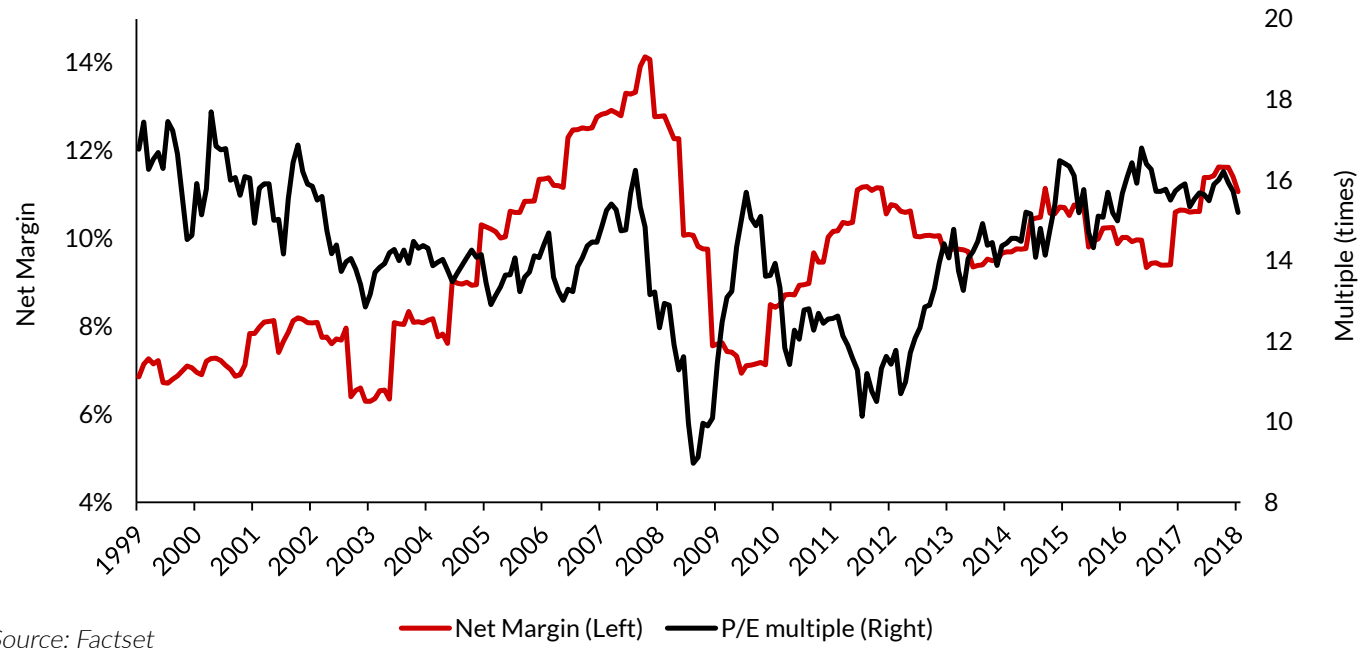
When it comes to assessing valuation, market commentators spend a lot of time opining on the ratio of a company's share price to its recent past and near-term future earnings (its historical and forward PE ratio), and on how that multiple compares to the past. Too often though, these ratios focus on the numerator: price. This is unsurprising, as the price you pay for a company really matters.

But so do the earnings. A company's value is the present value of the future cash flows which an investor will receive from that company. For an investor with an infinite investment horizon, this is mostly in the form of dividends. It is future earnings which drive the level of these future dividends and an assessment of where current earnings are in their cycle, and therefore how sustainable they are, is important.

The valuation trade-off

Investors are usually faced with some form of trade-off: buying depressed earnings at somewhat inflated multiples, or buying inflated earnings at depressed multiples. The other two options are either rare (being fortunate enough to buy low or depressed earnings at low multiples) or a sure path to financial ruin (buying inflated earnings at inflated multiples). It may seem counter-intuitive, but some of the best investments in the portfolio over the last 10 years have been the result of buying depressed earnings at very high multiples. Relative to normalised earnings, these companies turned out to be very attractively priced when we first bought them.

Graph 1: S&P/ASX 300 Index PE multiples and margins



Source: Factset

Graph 1 reflects the one-year forward PE ratio of the S&P/ASX 300 Index since 2000 (black line). The current level of close to 16 times earnings is similar to levels that have prevailed since 2015, but are above historical averages. Profitability has also increased in recent years and is up significantly on its post-financial-crisis lows in 2009. This is evident from the red line, which graphs the overall market's net margin (a measure of profitability). It is hard to argue that company profitability today is low, but equally hard to argue that multiples of these profits are particularly high.

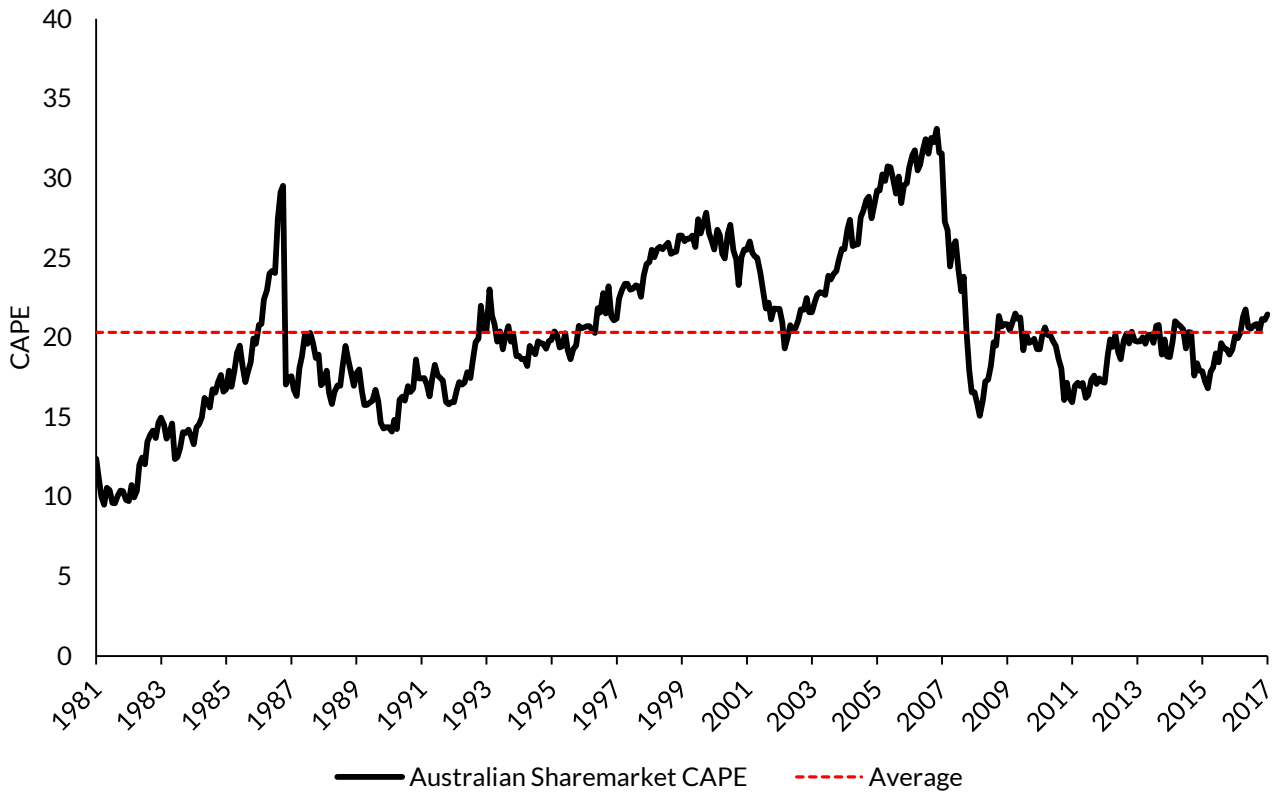
Is the sharemarket expensive?

The Cyclically Adjusted Price Earnings ratio (CAPE) is another way to assess valuations. The CAPE compares the current market level (price) to the average of the past 10 years' earnings, adjusted for inflation.

As Graph 2 shows, on this measure, the Australian sharemarket trades at a multiple of 21.4 times versus its own average of 20.3 times (since 1981). Our sharemarket isn't eye-wateringly expensive relative to its history and appears to be much cheaper than the S&P 500 Index which trades on a CAPE of 31 times, over 30% higher than its average of 23 times.

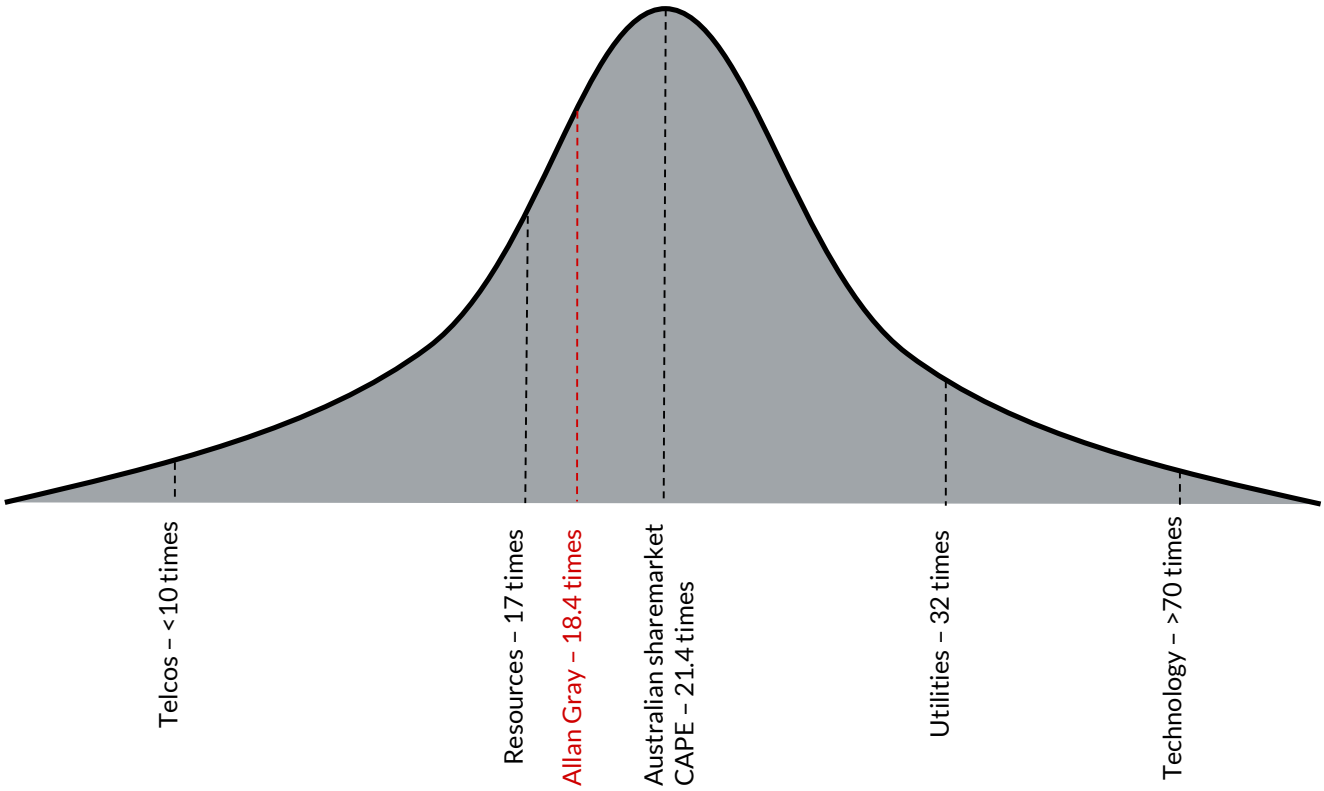
But the less a portfolio looks like the broader sharemarket, the less helpful this CAPE analysis is. Various sub-sectors of the market trade at multiples of historical average earnings which are very different from the 21.4 times average referenced above. This is illustrated in Graph 3 (not to scale) with the two sector extremes being the technology sector on over 70 times cyclically adjusted earnings and the telecommunications sector on less than 10 times.

Graph 2: Cyclically Adjusted Price Earnings ratio (CAPE) since 1981



Source: Barclays, Shiller. Data is presented to 31 December 2017.

Graph 3: **CAPE analysis of market sectors**



Source: Factset. Chart not to scale.

If only the path to riches was as easy as buying the companies/sectors trading at the lowest multiples of historical earnings. Unfortunately the technology sector is not necessarily seven times as expensive as the telecommunications sector. Technology earnings have almost doubled over the past 10 years and are expected to grow further next year, resulting in the sector trading at about 27 times next year's consensus earnings. Were that growth to continue, the sector could currently be extraordinarily cheap. Equally, the telecommunication sector's historical earnings cannot be sustained. Most of this sector's earnings come from Telstra Limited whose earnings are in transition following the roll out of Australia's National Broadband Network. If earnings fall significantly from here, 10 times earnings might be expensive.

Solely focussing on the CAPE has other shortcomings too. Companies and sectors may have undergone structural changes which make the future very different to the past and when it comes to investing, it is future earnings that matter! A sector or company may have invested heavily in productive assets over the past 10 years resulting in reasonable expectations of higher future earnings.

Valuing the portfolio against the market

In trying to assess the portfolio's relative valuation, we have tried to identify, company by company, where we are in its earnings cycle and how much one pays for those earnings. Table 1 reflects some of our findings, which are expressed at the overall portfolio level.

Table 1: **S&P/ASX 300 Index valuation versus the portfolio**

At 31 March 2018	S&P/ASX 300 Index	The Portfolio
P/E multiple (forecast)	15.2x	15.4x
Cyclically adjusted PE	20.0x	18.4x
Forecast earnings ÷ cyclically adjusted earnings	130%	91%

Note: A company's enterprise value is its market capitalisation plus its net debt.

Source: CapitalIQ, Factset, Allan Gray

The portfolio and broader sharemarket trade at a similar multiple to next year's consensus earnings. However, there are reasons to believe that the portfolio's earnings are significantly more depressed than the sharemarket's.

The portfolio's earnings are well down on historical levels with next year's forecast earnings 9% below cyclically adjusted levels. This compares to the sharemarket whose earnings are forecast to be 30% above their cyclically adjusted average. For a similar price, at face value, investors are buying an earnings stream which is nearly 40% more depressed than the sharemarket. The portfolio's CAPE is 18.4 times and modestly below the market's at 20 times.

But do these depressed earnings mean the portfolio is cheap relative to the broader sharemarket? Not necessarily. You could argue that the portfolio's earnings are likely to grow more slowly than the sharemarket and should command a lower multiple. Or worse, that they're structurally impaired and not cyclically depressed, with future earnings likely to be even lower than current earnings. You could also conclude that an analysis of historical earnings is irrelevant unless assessed together with the amount a company has invested in its future earnings, both organically and via acquisition. On each of these plausible pushbacks, the portfolio fares reasonably well relative to the broader market.

Consensus estimates put the portfolio's earnings growth at 12.9% in 2019, well above the sharemarket's earnings growth and not reflective of a portfolio in terminal decline (of course, consensus could be wrong). The portfolio has also invested very heavily in the future. This is best evidenced by the number of shares each company has on issue – an increasing amount is generally accompanied by some form of investment or debt reduction. The portfolio's weighted average shares on issue is 18% above the average of the past 10 years, a sign of significant investment over recent years. Expectations of future earnings growth in excess of the market is therefore not unreasonable, even if the proceeds from this share issuance were simply used to pay down debt.

Despite the difficulty in presenting a fail-proof measure of valuation, it appears that we pay a market multiple for an earnings stream which, in all likelihood, is significantly more depressed than the overall sharemarket. If we're right, opportunities like this are rare and relative returns from here could be strong. If we are wrong, the downside doesn't appear to be large. Just the kind of pay-off profile we like.

EQUITY FUND PERFORMANCE

Allan Gray Australia Equity Fund — Class A units

	Allan Gray Australia Equity Fund	S&P/ASX 300 Accumulation Index	Relative Performance
ANNUALISED (%)			
Since Public Launch on 4 May 2006	8.2	5.4	2.8
10 Years	8.1	5.2	2.9
5 Years	11.0	7.6	3.4
3 Years	12.0	3.9	8.1
1 Year	7.6	2.9	4.7
NOT ANNUALISED (%)			
Latest Quarter	(5.4)	(3.8)	(1.6)

Allan Gray Australia Equity Fund — Class B units

	Allan Gray Australia Equity Fund	S&P/ASX 300 Accumulation Index	Relative Performance
ANNUALISED (%)			
Since Class Launch on 26 October 2012	13.2	9.5	3.7
5 Years	10.8	7.6	3.2
3 Years	11.6	3.9	7.7
1 Year	7.0	2.9	4.1
NOT ANNUALISED (%)			
Latest Quarter	(5.3)	(3.8)	(1.5)

Highest and lowest annual return since launch

Allan Gray Australia Equity Fund - Class A units	Return %	Calendar year
Highest	55.1	2009
Lowest	(45.9)	2008

Allan Gray Australia Equity Fund - Class B units	Return %	Calendar year
Highest	33.4	2016
Lowest	(4.7)	2015

Returns shown are net of fees and assume reinvestment of distributions. Returns are annualised for periods of one year and over. Annualised returns show the average amount earned on an investment in the relevant Class each year over the given time period. Actual investor performance may differ as a result of the investment date, the date of reinvestment of income distributions, and withholding tax applied to income distributions.

The highest and lowest returns earned during any calendar year since the launch of each Class are shown to demonstrate the variability of returns. The complete return history for each Class can be obtained by contacting our Client Services team.

EQUITY FUND HOLDINGS

(CLASS A AND CLASS B)

Fund holdings as at 31 March 2018

Statement of net assets (unaudited)

Security	Market Value AUD 000's	% of Fund
Woodside Petroleum	155,182	11
Newcrest Mining	123,536	9
Alumina	118,624	8
Origin Energy	106,621	7
Metcash	87,992	6
QBE Insurance Group	80,255	6
Woolworths Group	48,917	3
Sims Metal Management	47,977	3
Telstra	46,226	3
AusNet Services	44,396	3
Chorus	41,825	3
Sigma Healthcare	36,764	3
Southern Cross Media Group	36,725	3
WorleyParsons	33,294	2
Austal	32,675	2
National Australia Bank	32,372	2
HT&E Limited	31,373	2
Oil Search	29,605	2
Navitas	29,492	2
Sirtex Medical	26,043	2
Peet	25,361	2
Australia and New Zealand Banking Group	22,485	2
Downer EDI	21,858	2
ALE Property Group	16,597	1
Starpharma Holdings	16,248	1
SKYCITY Entertainment Group	15,500	1
Positions less than 1%	118,982	8
Total Security Exposure	1,426,927	98
ASX SPI 200 ™ Futures Contract (06/2018)†	**13,766**	**1**
Net Current Assets	**12,431**	**1**
Net Assets	1,453,124	100
Price per unit - Class A (cum distribution)	**AUD 1.685**	
Price per unit - Class B (cum distribution)	**AUD 1.6882**	
Total Assets Under Management for the Australian equity strategy (AUD 000's)‡	**AUD 5,090,509**	

† Futures contracts are fully backed by cash holdings.
‡ Allan Gray Australia Pty Ltd also manages segregated accounts that have substantially the same investment goals and restrictions as the Fund.

BALANCED FUND PERFORMANCE

Allan Gray Australia Balanced Fund

	Allan Gray Australia Balanced Fund	Custom Benchmark*	Relative Performance
ANNUALISED (%)			
Since Public Launch on 1 March 2017	11.2	7.5	3.7
1 Year	9.7	6.1	3.6
NOT ANNUALISED (%)			
Latest Quarter	(1.3)	(0.3)	(1.0)

** The Custom Benchmark for the Fund comprises 36% S&P/ASX 300 Accumulation Index; 24% S&P/ASX Australian Government Bond Index; 24% MSCI World Index (net dividends reinvested) expressed in AUD; and 16% JPMorgan Global Government Bond Index expressed in AUD.*

Returns shown are net of fees and assume reinvestment of distributions. Returns are annualised for periods of one year and over. Annualised returns show the average amount earned on an investment in the relevant Fund each year over the given time period. Actual investor performance may differ as a result of the investment date, the date of reinvestment of income distributions, and withholding tax applied to income distributions.

BALANCED FUND HOLDINGS

Fund holdings as at 31 March 2018

Statement of net assets (unaudited)

Security	Market Value AUD 000'S	% of Fund
Equity		
Domestic Equity		
Woodside Petroleum	2,513	4
Newcrest Mining	2,329	3
QBE Insurance Group	1,866	3
Alumina	1,756	3
Origin Energy	1,656	2
Metcash	1,536	2
Woolworths Group	1,081	2
Telstra	1,000	1
Sigma Healthcare	954	1
Southern Cross Media Group	921	1
HT&E Limited	834	1
Oil Search	776	1
Peet	766	1
Austal	725	1
AusNet Services	705	1
Domestic Equity Positions less than 1%	4,509	6
Global Equity		
AbbVie	1,493	2
BP	1,213	2
Chorus	1,048	1
Royal Dutch Shell	1,030	1
Bristol-Myers Squibb	950	1
XPO Logistics	899	1
Mitsubishi	745	1
Samsung Electronics	730	1
Symantec	721	1
Global Equity Positions less than 1 %	14,401	21
Total Equity^	47,157	67

^ The Fund holds derivative contracts which reduces the effective net equity exposure to 61%.

BALANCED FUND HOLDINGS

Security	Market Value AUD 000'S	% of Fund
Fixed Income		
Domestic Fixed Income		
Australian Government Bonds	13,963	**20**
Global Fixed Income		
Global Fixed Income	4,563	**7**
Total Fixed Income	18,526	**26**
Commodity Linked Investments		
SPDR Gold Trust	2,263	**3**
Total Commodity Linked Investments	2,263	**3**
Total Security Exposure	67,946	**97**
Term Deposits and Cash	**1,843**	**3**
Net Current Assets	**371**	**<1%**
Net Assets	70,160	**100**
Price per unit (cum distribution)	**AUD 1.1298**	

STABLE FUND PERFORMANCE

Allan Gray Australia Stable Fund

	Allan Gray Australia Stable Fund	RBA Cash	Relative Performance	Distribution
ANNUALISED (%)				
Since Public Launch on 1 July 2011	7.1	2.5	4.6	
5 Years	6.4	2.1	4.3	
3 Years	7.1	1.7	5.4	
1 Year	4.2	1.5	2.7	
NOT ANNUALISED (%)				
Latest Quarter	(1.1)	0.4	(1.5)	

Highest and lowest annual return since public launch

Allan Gray Australia Stable Fund	Return %	Calendar year
Highest	14.4	2016
Lowest	2.1	2015

Returns shown are net of fees and assume reinvestment of distributions. Returns are annualised for periods of one year and over. Annualised returns show the average amount earned on an investment in the relevant Fund each year over the given time period. Actual investor performance may differ as a result of the investment date, the date of reinvestment of income distributions, and withholding tax applied to income distributions.

The highest and lowest returns earned during any calendar year since the public launch of each Fund are shown to demonstrate the variability of returns. The complete return history for each Fund can be obtained by contacting our Client Services team.

STABLE FUND HOLDINGS

Fund holdings as at 31 March 2018

Statement of net assets (unaudited)

Security	Market Value AUD 000's	% of Fund
Woodside Petroleum	9,032	4
Newcrest Mining	8,287	3
Alumina	5,893	2
Origin Energy	5,434	2
Metcash	5,082	2
QBE Insurance Group	4,226	2
Telstra	3,639	1
Positions less than 1%	21,339	9
Total Security Exposure	62,931	26
Term Deposits and Cash	**180,905**	**74**
Net Current Assets	**2,040**	**<1**
Net Assets	245,876	100
Price per unit (cum distribution)	**AUD 1.2059**	

INFORMATION ABOUT THE FUNDS

	Allan Gray Australia Equity Fund	Allan Gray Australia Balanced Fund	Allan Gray Australia Stable Fund
Investment objective	The Fund seeks long-term returns that are higher than the S&P/ ASX 300 Accumulation Index (Benchmark).	To seek long-term returns that are higher than the Custom Benchmark. In doing so, the Fund aims to balance capital growth, income generation and risk of loss using a diversified portfolio.	The Fund aims to provide a long-term return that exceeds the Reserve Bank of Australia cash rate (Benchmark), with less volatility than the Australia sharemarket.
Who should invest?	Investors looking for contrarian investment style exposure to the Australian sharemarket and who are able to take a long-term view and endure performance fluctuations.	Investors with an investment horizon of at least three years who want to easily diversify their portfolio within a single fund and are looking for less ups and downs than investing solely in shares. The Fund invests in shares, fixed income, cash and commodity investments sourced locally and globally.	Investors with a two-year or longer investment horizon who are looking for an alternative to traditional money market and income generating investments. The Fund's portfolio can hold a combination of cash and money market instruments (100% to 50%) and ASX securities (up to 50%) in pursuit of stable long-term returns.
Dealing	Daily (cut-off at 2pm Sydney time. A different cut-off applies if investing via mFund, where applicable).		
Buy/sell spread	+0.2%/-0.2%	+0.2%/-0.2%	+0.1%/-0.1%
Fees and expenses (excluding GST)	**Class A** Management fee comprises: • Fixed (Base) fee – 0.75% per annum of the Fund's NAV. • Performance fee – 20% of the Class' outperformance, net of the base fee, in comparison to the Benchmark. A performance fee is only payable where the Class' outperformance exceeds the high watermark, which represents the highest level of outperformance, net of base fees, since the Class' inception. **Class B** Management fee comprises: • Fixed (Base) fee – Nil. • Performance fee – 35% of the Class' outperformance in comparison to the Benchmark. A performance fee is only payable where the Class' outperformance exceeds the high watermark, which represents the highest level of outperformance, since the Class' inception.	Management fee comprises: • Fixed (Base) fee – 0.75% per annum of the Fund's NAV. • Performance fee – 20% of the Fund's' outperformance, net of the base fee, in comparison to the Custom Benchmark. A performance fee is only payable where the Fund's outperformance exceeds the high watermark, which represents the highest level of outperformance, net of base fees, since the Fund's inception.	Management fee comprises: • Fixed (Base) fee – 0.25% per annum of the Fund's NAV. • Performance fee – 20% of the Fund's outperformance, net of the base fee, in comparison to the Benchmark. A performance fee is only payable where the Fund's outperformance exceeds the high watermark, which represents the highest level of outperformance, net of base fees, since the Fund's inception.
Minimum initial investment	AUD 10,000/AUD 500 per month on a regular savings plan.		
Additional investment	AUD 1,000/AUD 500 per month on a regular savings plan.		
Redemption	No minimum applies for ad hoc redemptions. A minimum of AUD 500 per month applies on a regular redemption plan. Investors must maintain a minimum account balance of AUD 10,000.		

NOTICES

Sources

The source for the S&P/ASX 300 Accumulation Index and the S&P/ASX Australian Government Bond Index is Standard & Poor's. "S&P" is a trademark of S&P Global, Inc.; "ASX" and "ASX 300" are trademarks of ASX Operations Pty Limited ("ASXO"); and "S&P/ASX300" exists pursuant to an arrangement between ASXO and Standard & Poor's.

The source for the MSCI World Index is MSCI Inc. "MSCI" is a trademark of MSCI Inc.

The source for the JP Morgan Global Government Bond Index is J.P. Morgan Securities LLC. "JP Morgan" is a trademark of JPMorgan Chase & Co.

The third party information providers do not guarantee the accuracy, adequacy or completeness of this information, and no further distribution or dissemination of the index data is permitted without express written consent of the providers. None of those parties shall have any liability for any damages (whether direct or otherwise).

Returns

Fund returns are gross of all income, net of all expenses and fees, assume reinvestment of distributions and exclude any applicable spreads.

Risk Warnings

Managed investment schemes are generally medium to long-term investments. Past performance is not indicative of future performance. Each Fund's unit price will fluctuate and the Fund's performance is not guaranteed. Returns may decrease or increase as a result of currency fluctuations. When making an investment in a Fund, an investor's capital is at risk. Subject to the disclosure documents, managed investment schemes are traded at prevailing prices and can engage in borrowing and securities lending.

Fees

The base fee and the performance fee (if applicable) are calculated and accrued daily, and paid monthly. A schedule of fees and charges is available in the relevant Fund's disclosure documents.

US and European Persons

The Funds do not accept US persons as investors and are not marketed in the European Economic Area (EEA). Investors resident in the EEA can only invest in the Fund under certain circumstances as determined by, and in compliance with, applicable law.

Other

Equity Trustees Limited, AFSL No. 240975 is the issuer of units in the Allan Gray Australia Equity Fund, the Allan Gray Australia Balanced Fund and the Allan Gray Australia Stable Fund and has full responsibility for each Fund. Equity Trustees Limited is a subsidiary of EQT Holdings Limited, a publicly listed company on the Australian Stock Exchange (ASX:EQT). Allan Gray Australia Pty Limited, AFSL No. 298487 is the Funds' investment manager. Each Fund's Product Disclosure Statement and Information Booklet (together, PDS) are available from www. allangray.com.au or by contacting Client Services on 1300 604 604 (within Australia) or +61 2 8224 8604 (outside Australia). You should consider the relevant Fund's PDS in deciding whether to acquire, or continue to hold, units in the fund.

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