



# **WATERMARK**

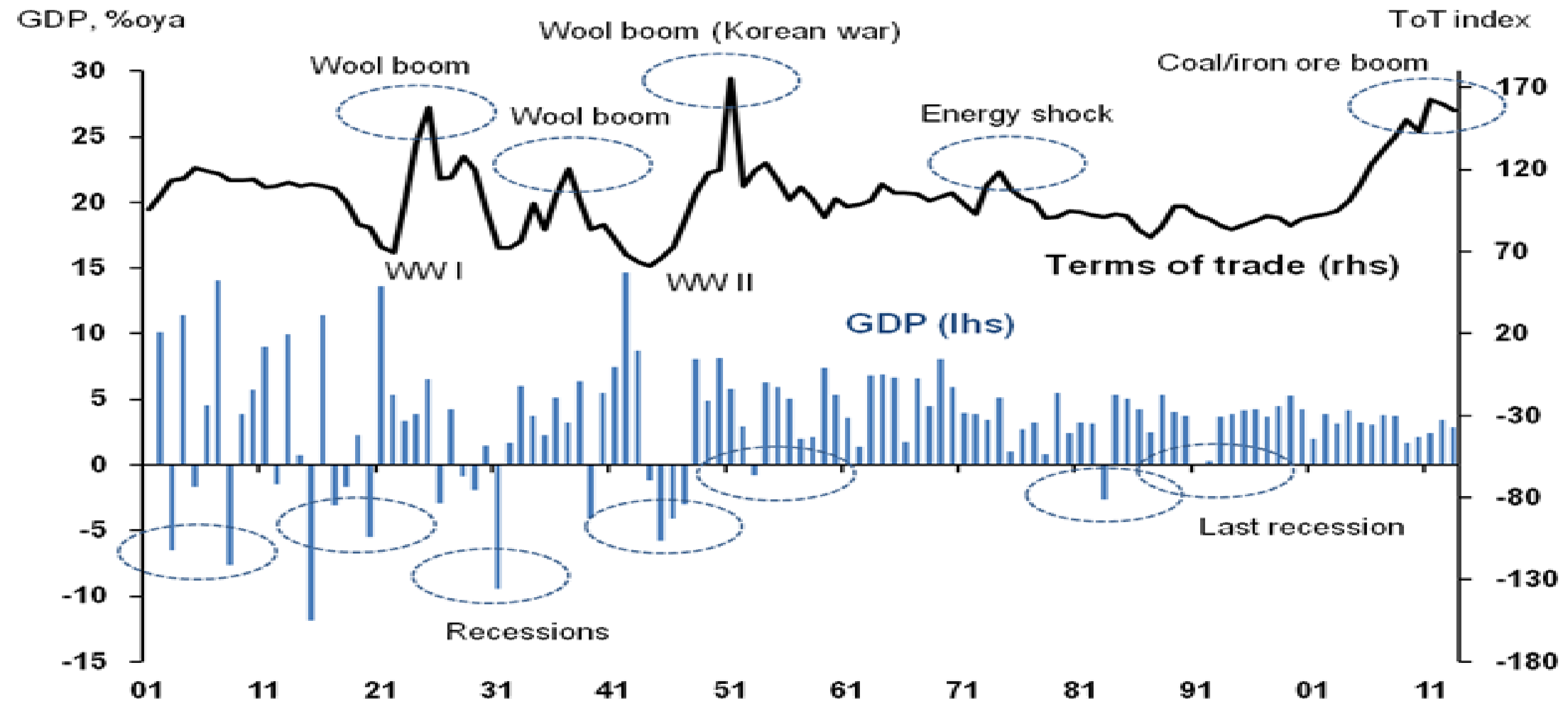
## **FUNDS MANAGEMENT**

Investor Update November 2013

- Outlook for the Australian Economy
- Investment strategy
- Share market outlook
- Questions

# Booms inevitably bust

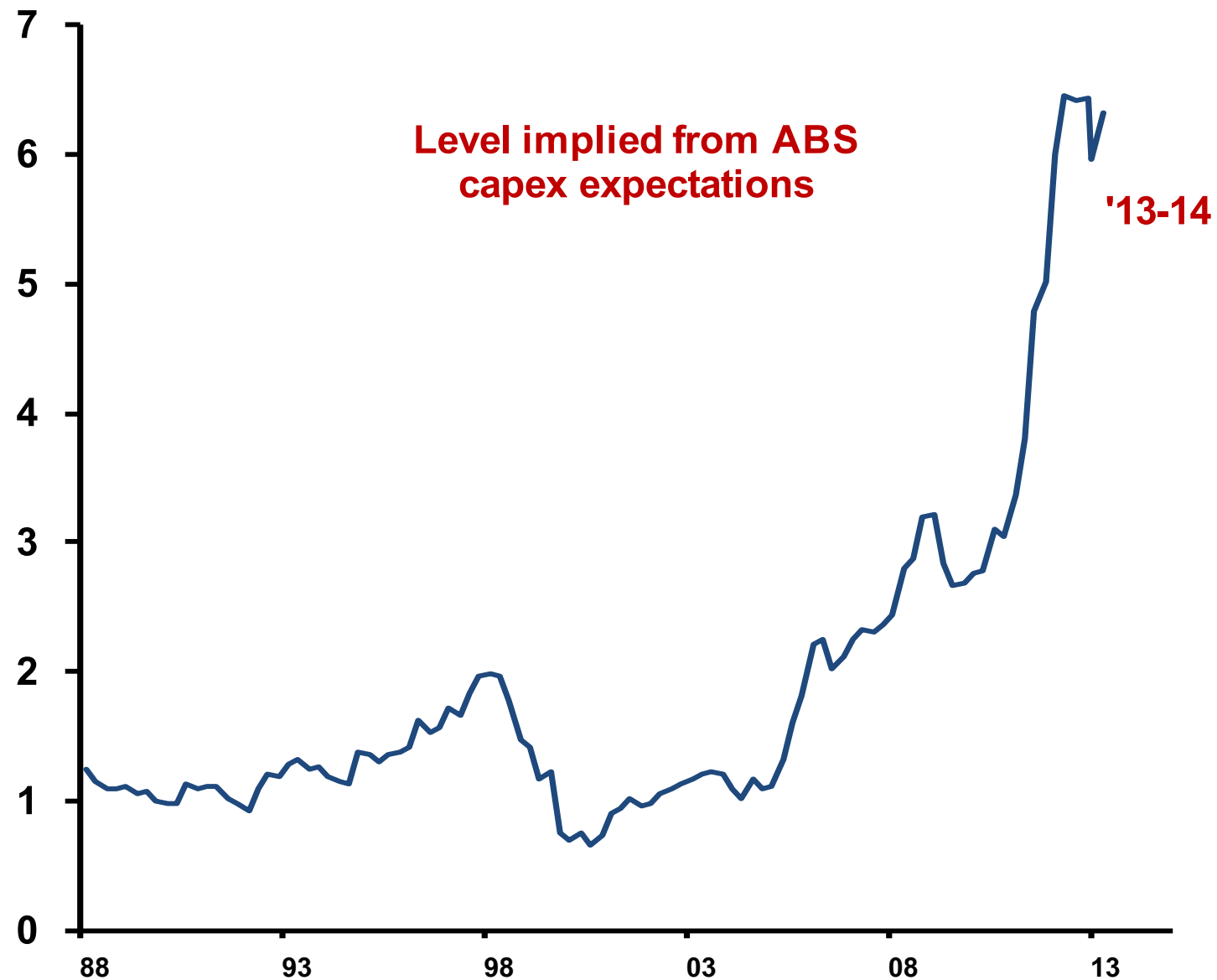
## Australia: terms of trade and GDP growth



# Are we about to fall into the mining ditch?

## Mining investment

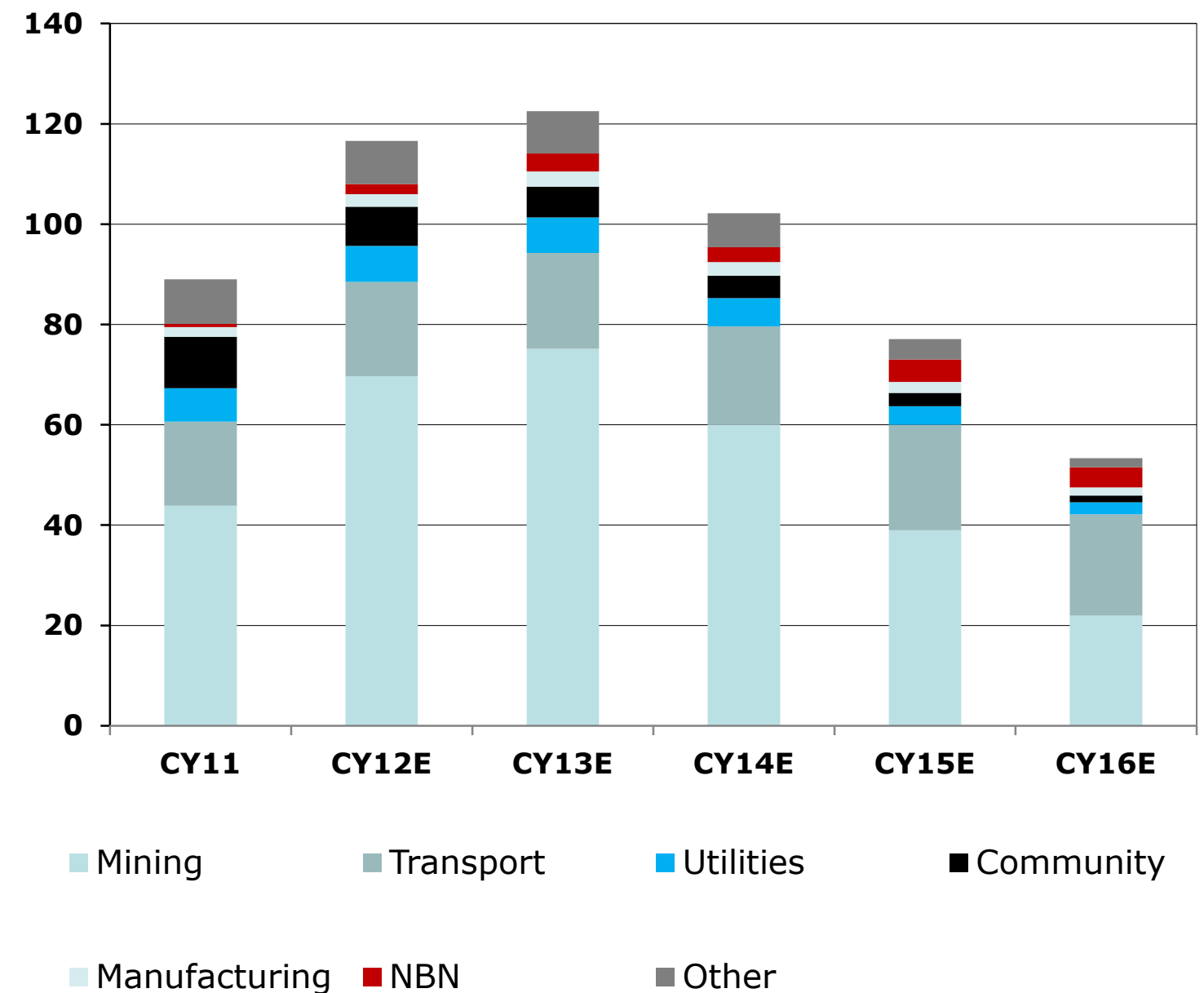
% of GDP



Source: ABS, J.P.Morgan.

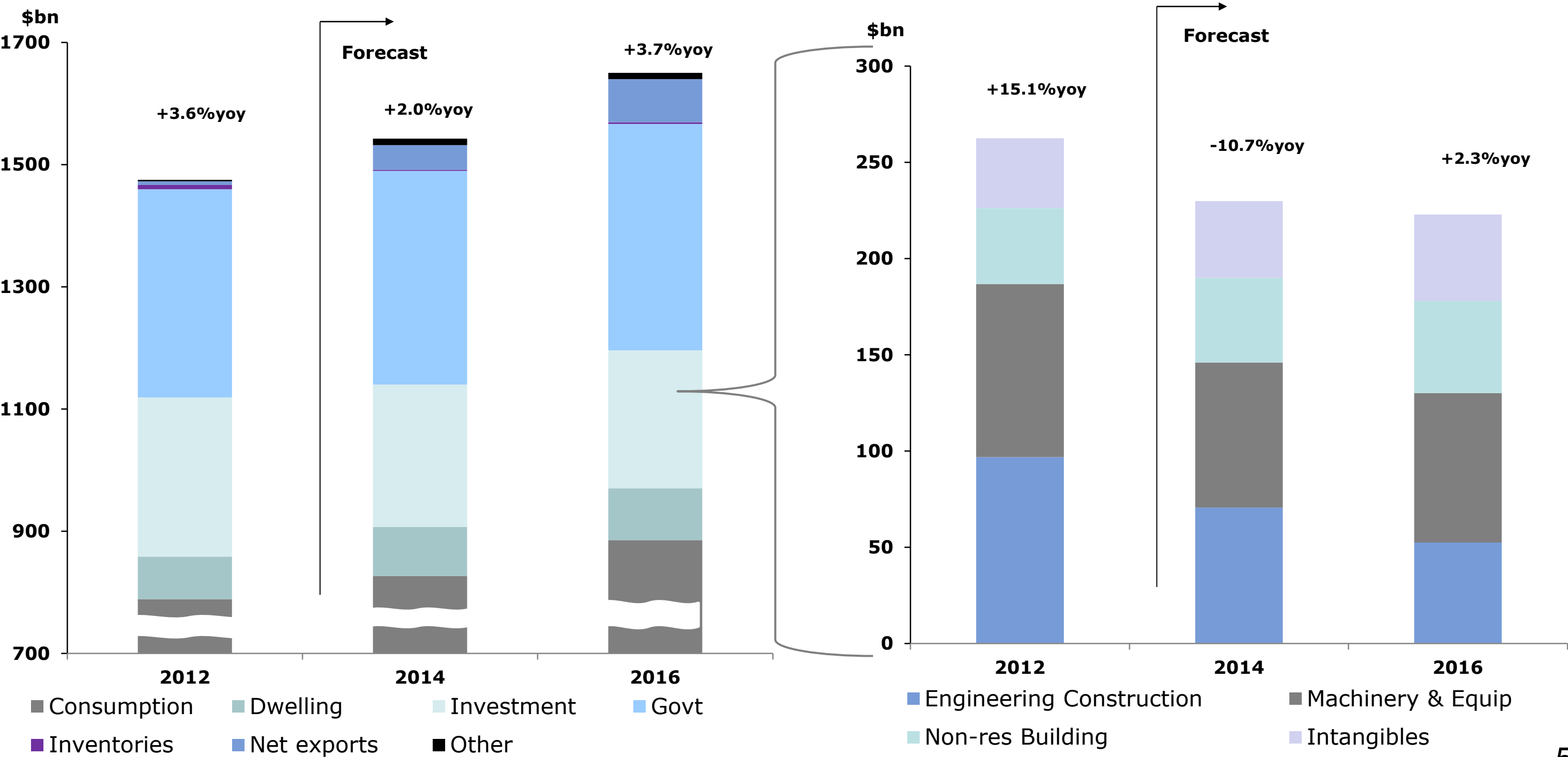
## Australian Investment Profile - Based on GS Project Probability

A\$bn



# Composition of the Australian Economy

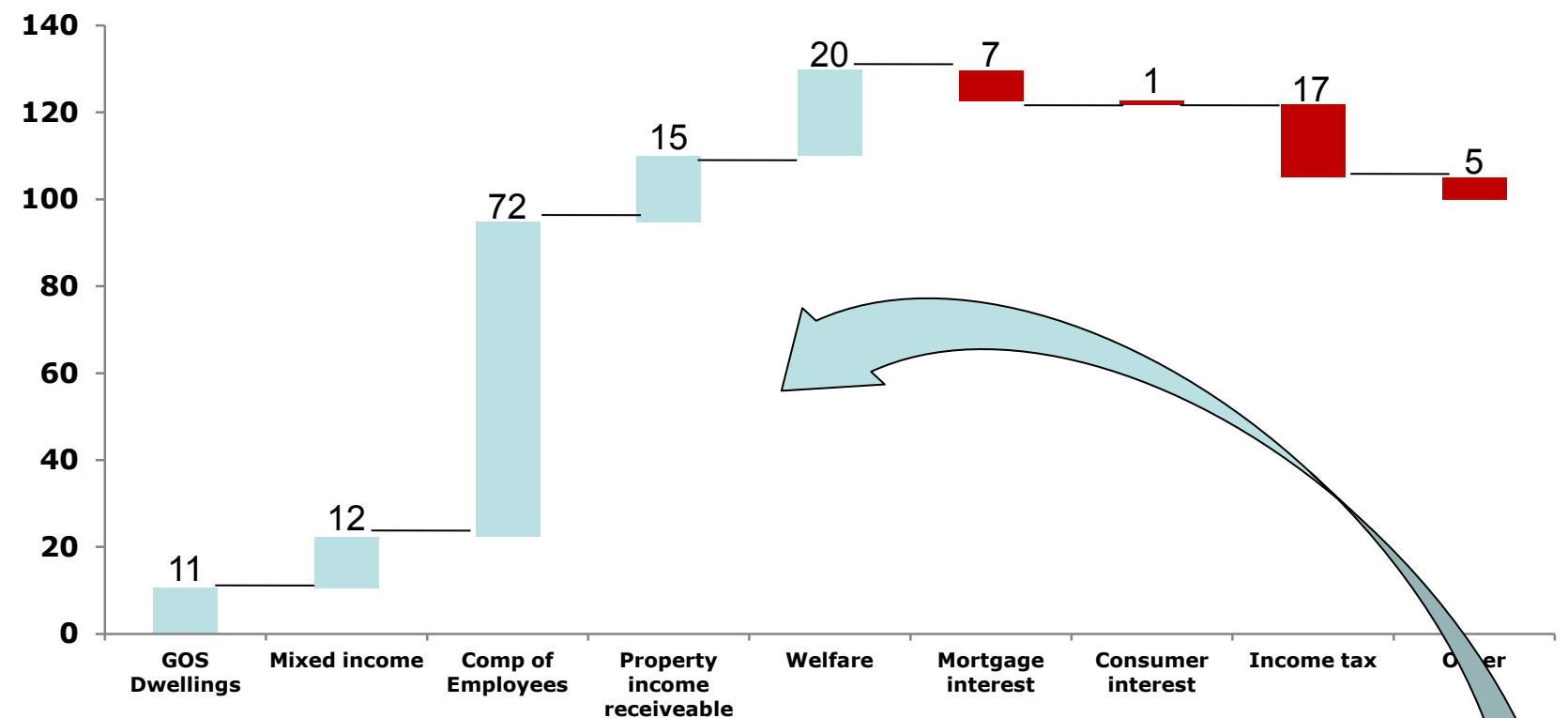
(Trend Growth = +3.25%)



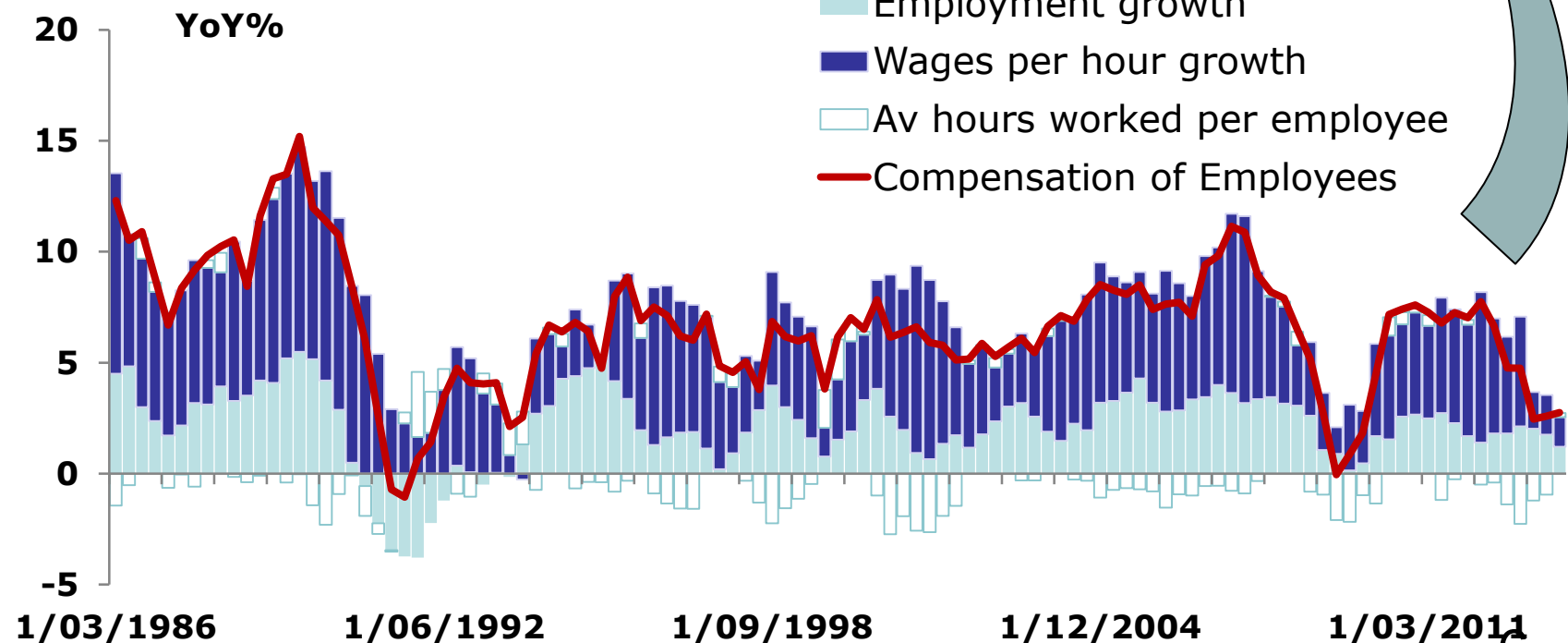
# A softer household sector

- Household income growth has averaged 6.5% from 1990. We expect it to drop to 3-4% in the medium term.
- Employee compensation continues to slow
- Rising unemployment, ongoing cost focus of business and high \$A = low employee compensation
- Lower rates – less benefit to mortgages going forward; businesses continue to de-lever
- Government transfers benign – Public sector consolidation under conservative government

**Share of household disposable income**

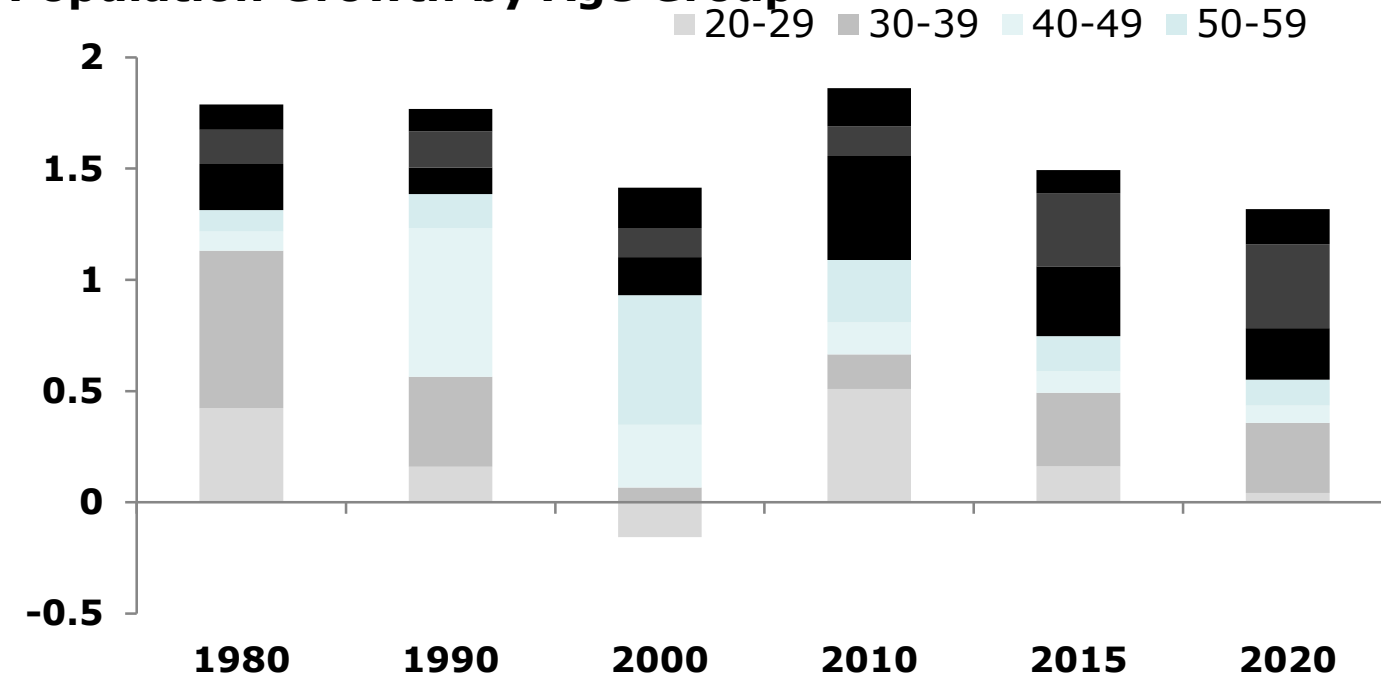


**Compensation of Employees**

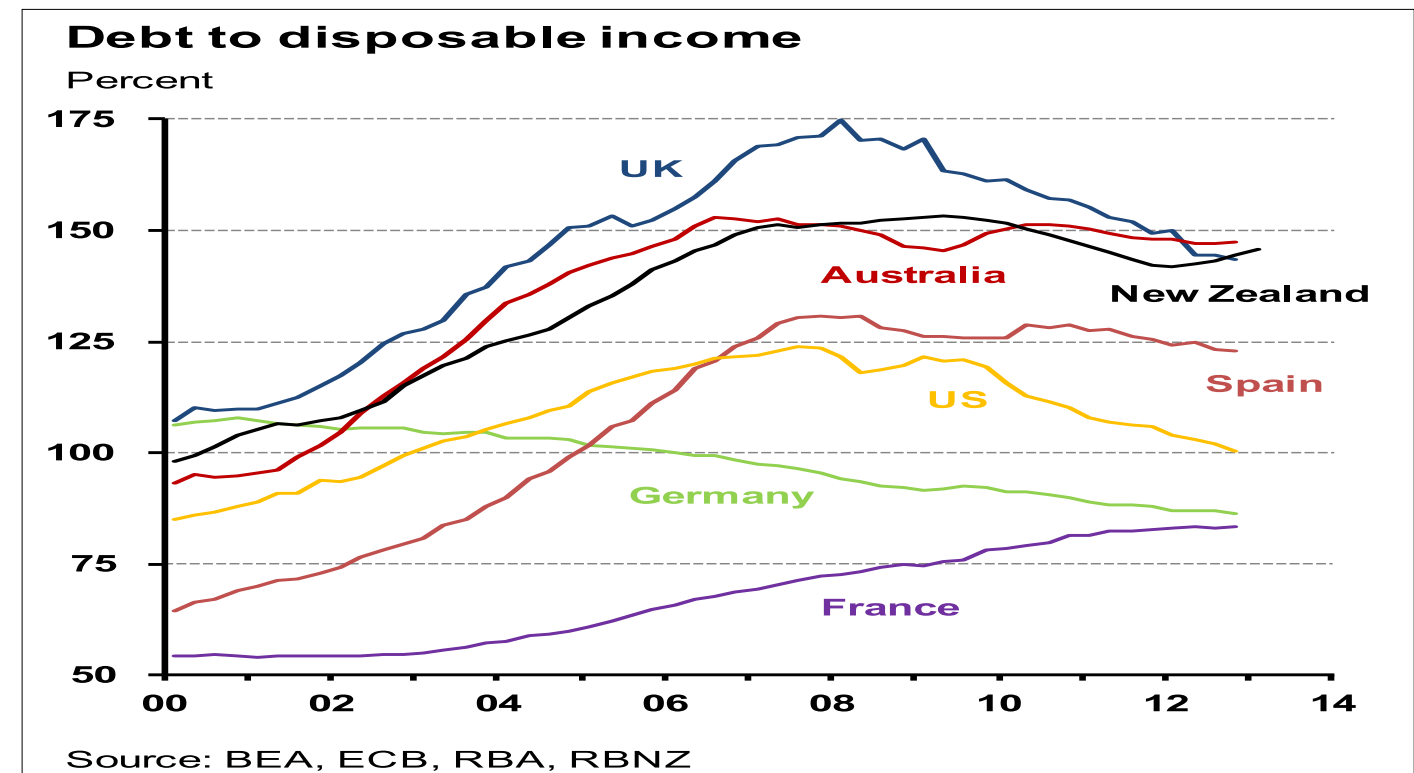
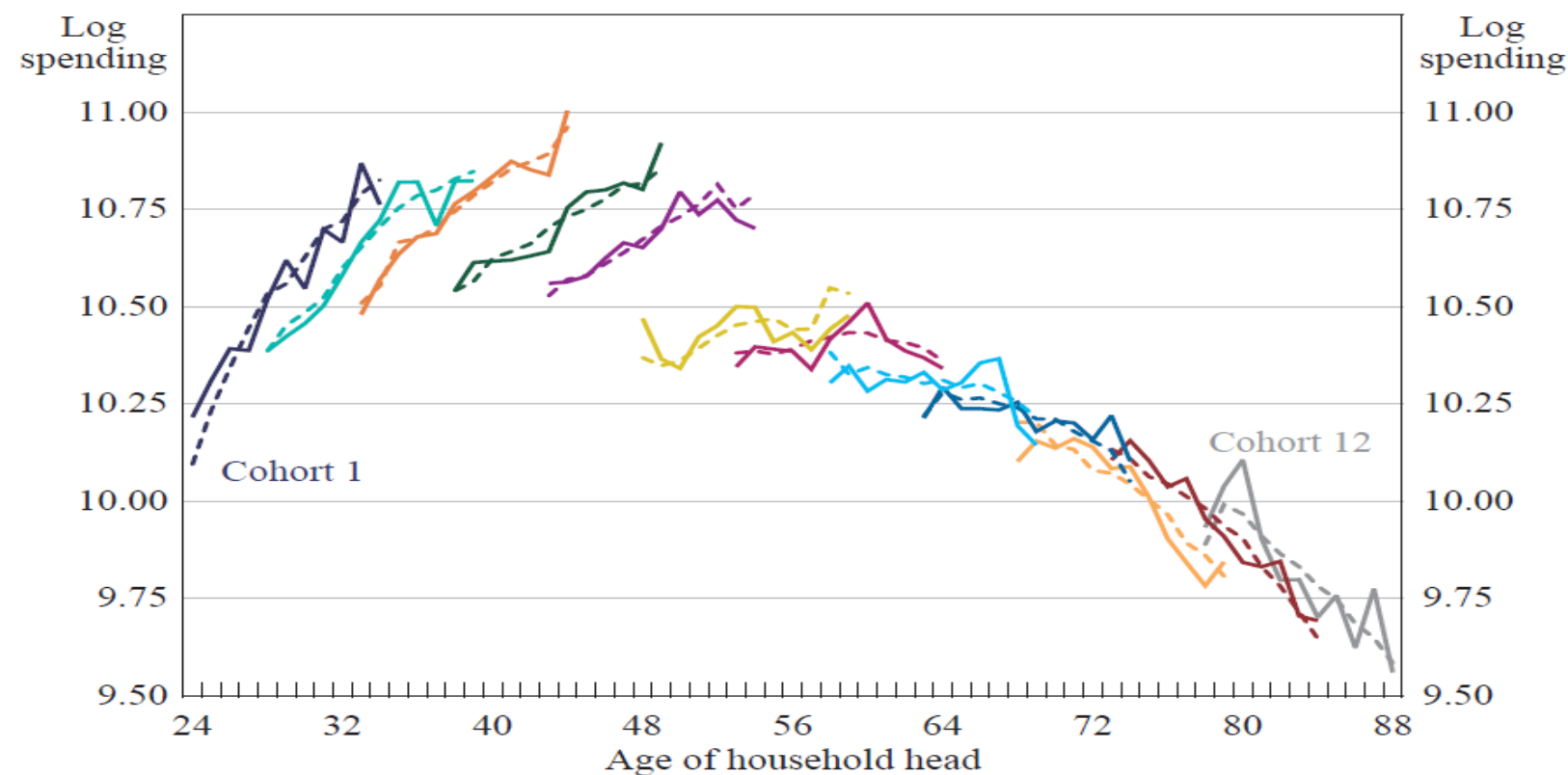
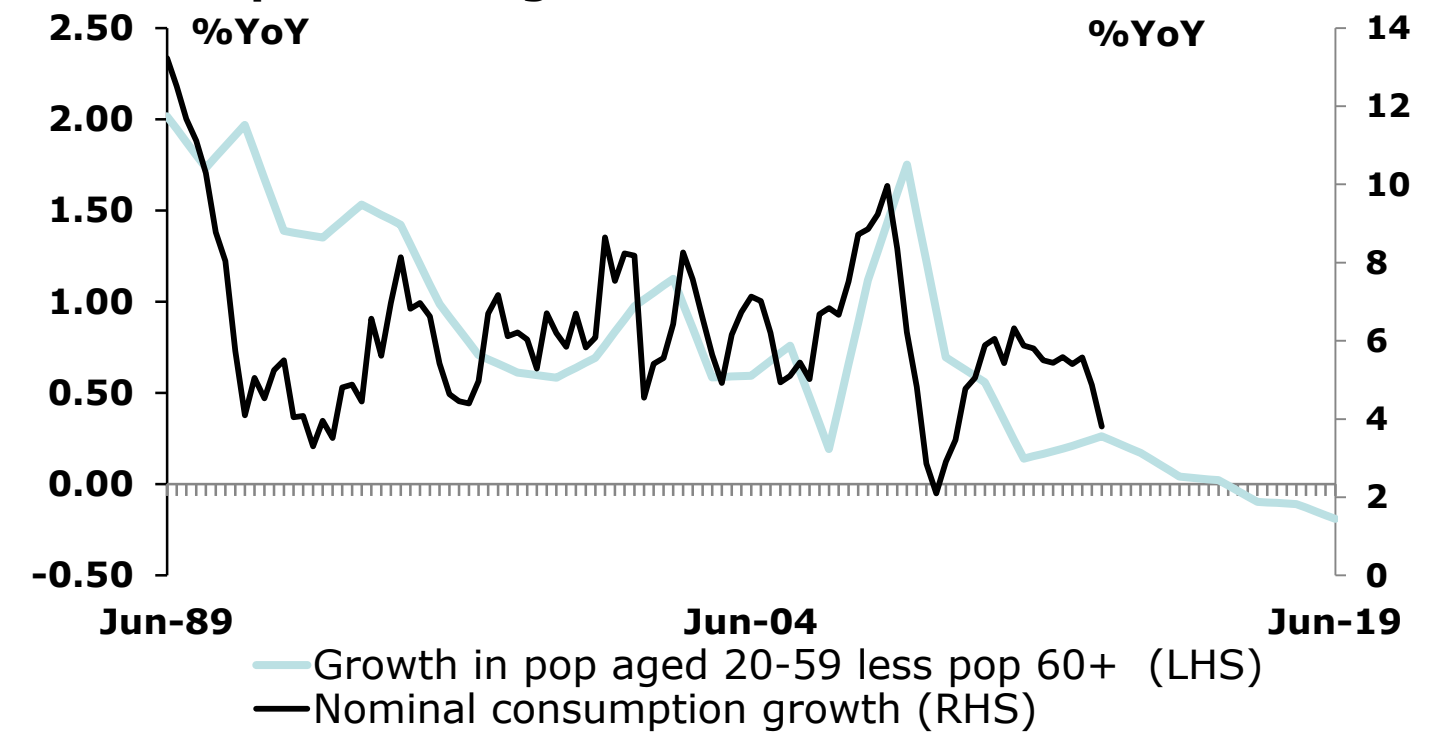


# Demographics and deleveraging weigh on consumption

**Population Growth by Age Group**



**Consumption and age structure**



Source: BEA, ECB, RBA, RBNZ

*“Business conditions undershoot again. Capacity utilisation falls sharply – especially in manufacturing, construction, mining and retail – despite low interest rates and improved housing and equity markets. Other forward indicators deteriorate, paring back earlier gains and implying a continuing soft outlook for domestic demand”*

NAB Business Survey





# Outlook for 2014 and beyond

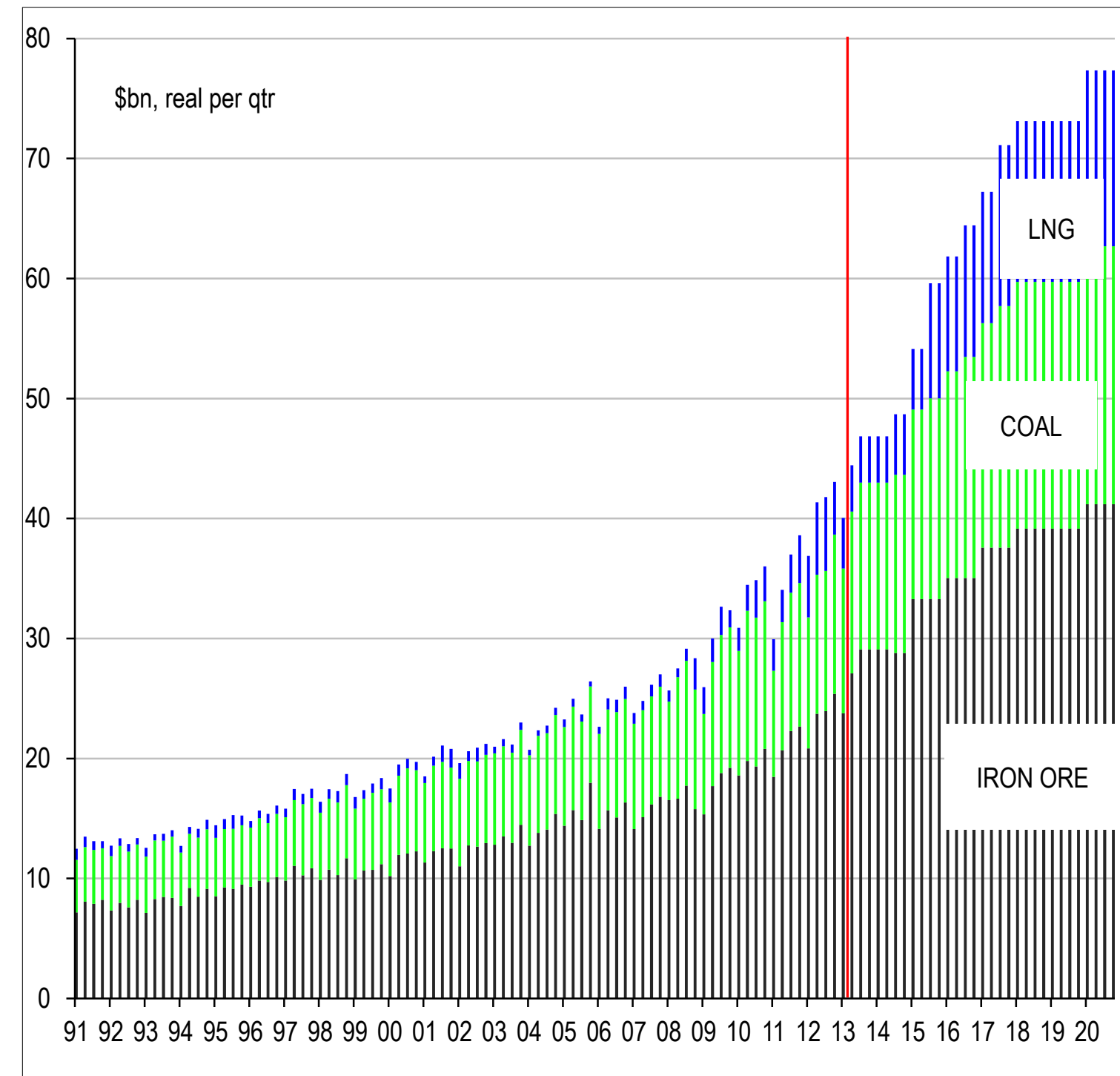
## *Outlook Summary:*

- Weaker growth as mining investment begins to run off and household sector remains subdued
- Some countercyclical support from government but not be enough to counter softness in private sector
- \$A is the wild card- a lower dollar will support activity

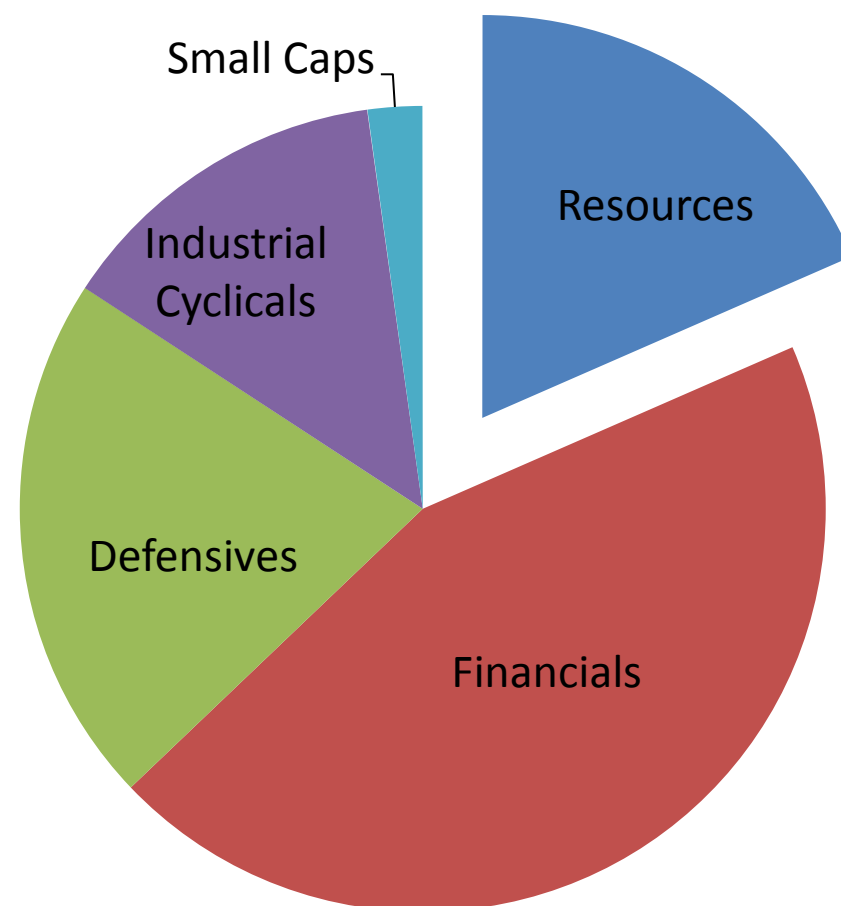
## *Medium term Outlook:*

- Growth in household income should improve from subdued levels
- The investment in mining will start to deliver dividends from 2015 onwards

## Australian exports by commodity



## “Is it over for mining shares?”



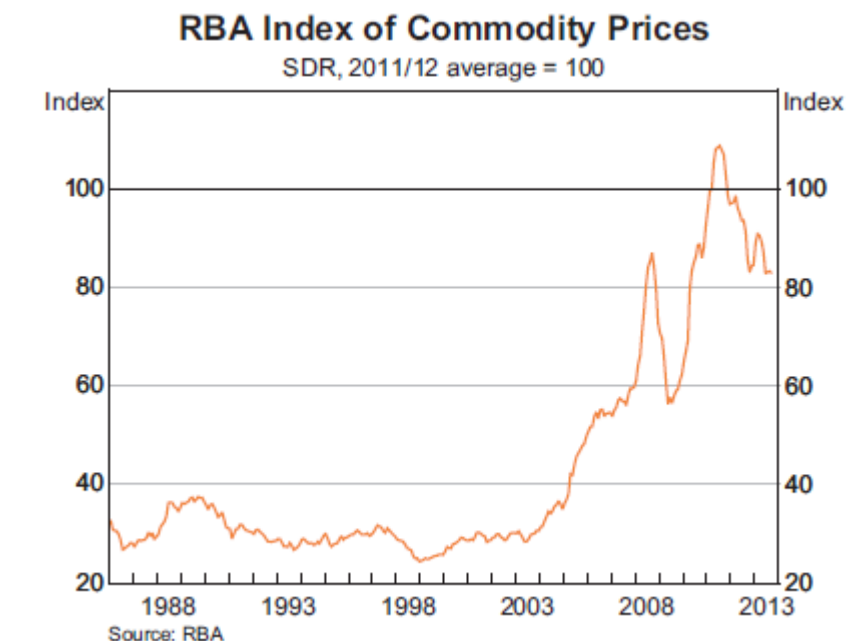
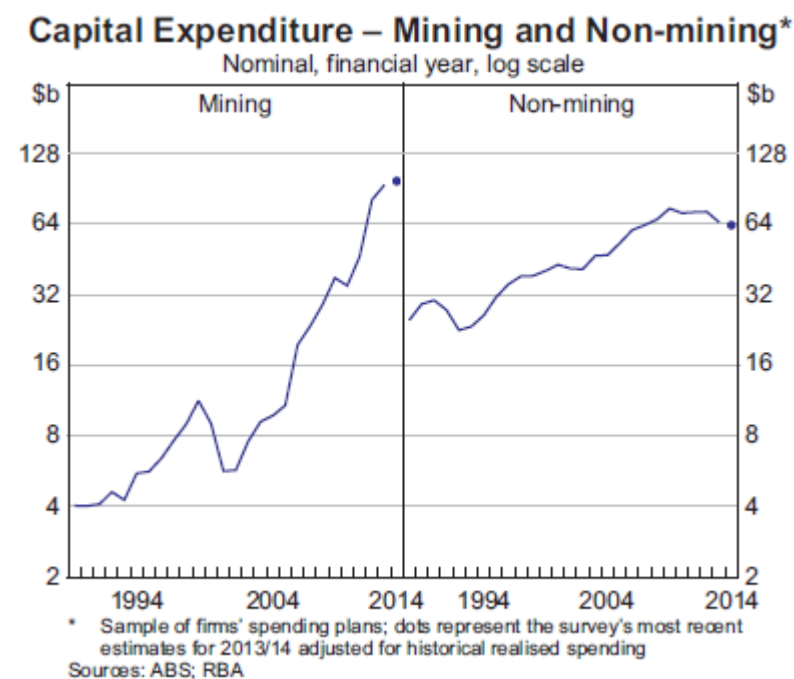
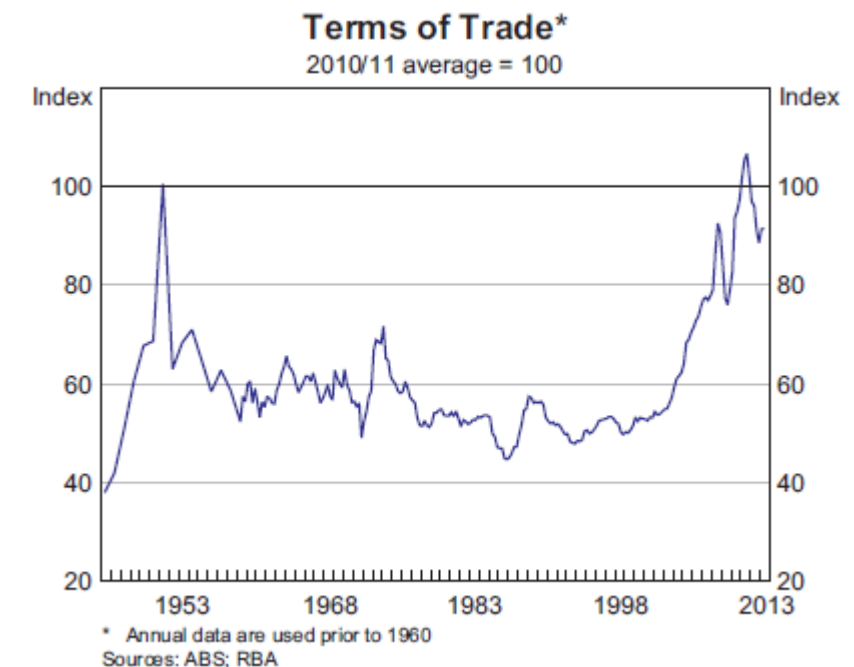
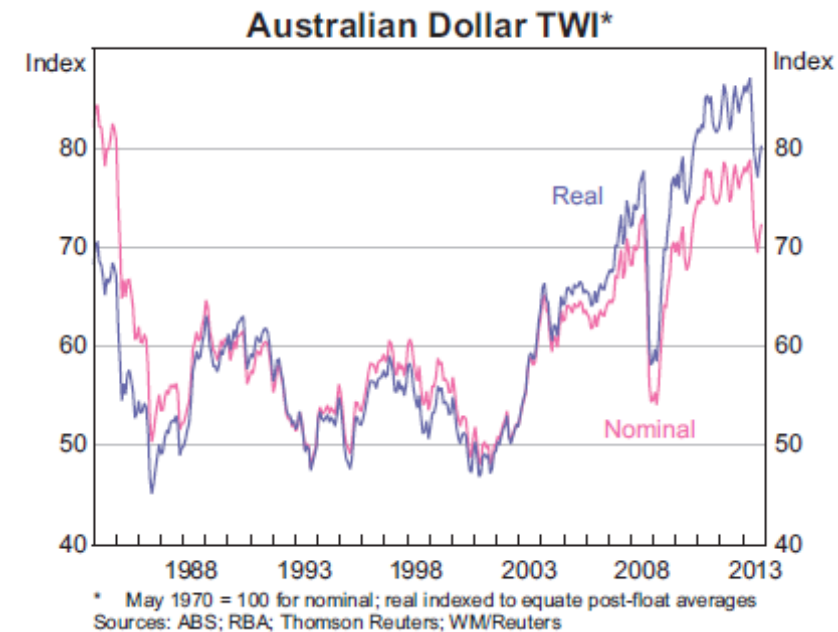
Tom Richardson  
Portfolio Manager

# The Boom is over...

The last decade has seen unprecedented growth in:

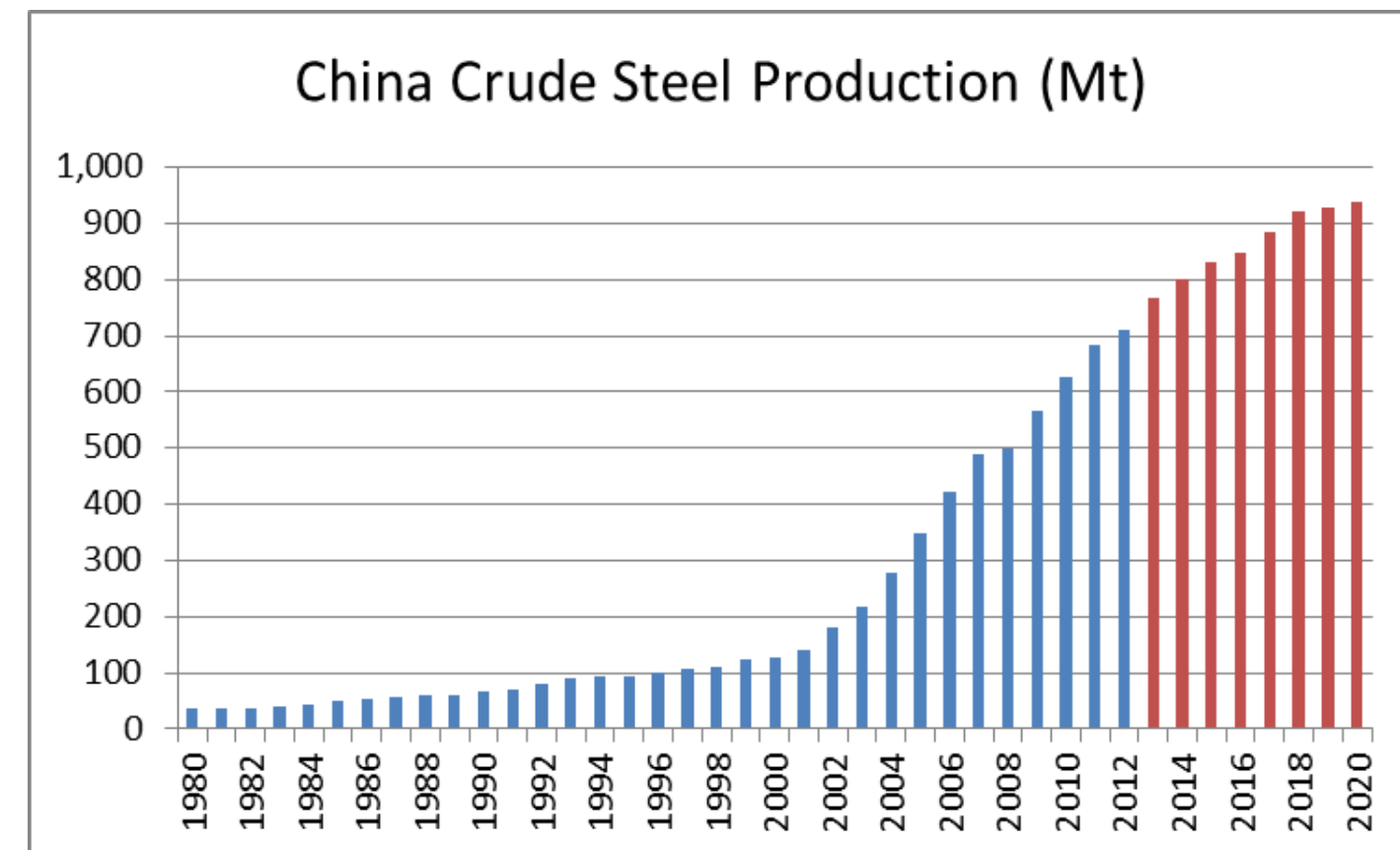
- Terms of trade
- TWI
- Capital expenditure
- Commodity prices

These tailwinds have now peaked and the boom is over.



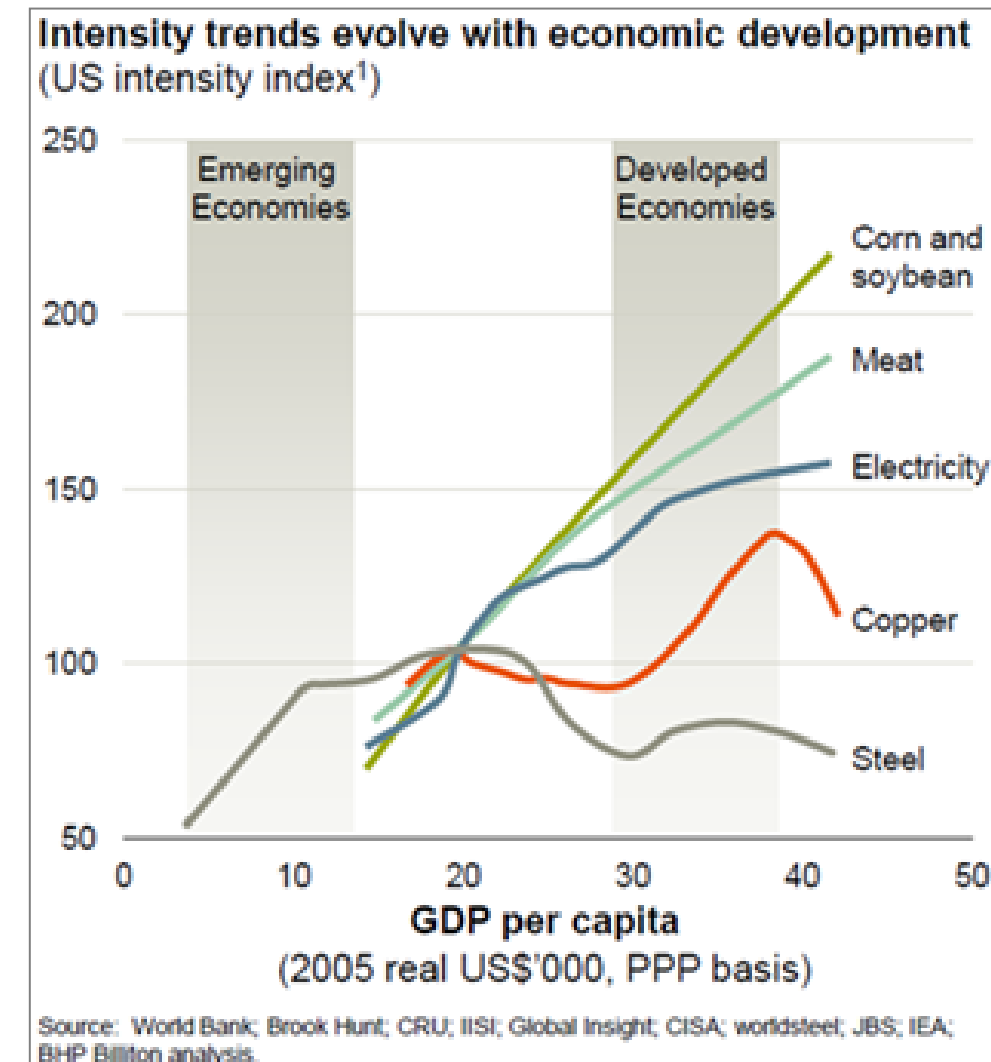
## ...however not a bust

- Chinese demand unlikely to collapse.
- Equilibrium to be re-established with increased volume and lower prices.
- Low cost miners will still generate strong profits in a lower price environment



# Not all commodities are the same

- Individual commodities have different life cycles with the demand profile varying through industrial development.
- In the early stages, large amounts of steel are required as this has the highest productivity payoff.
- The growth baton then passes from construction to manufacturing and plant.
- As a country becomes more developed and living standards improve, growth in bulk commodities slows, and demand for consumer items accelerates.



# We are cautious on Australia's bulks

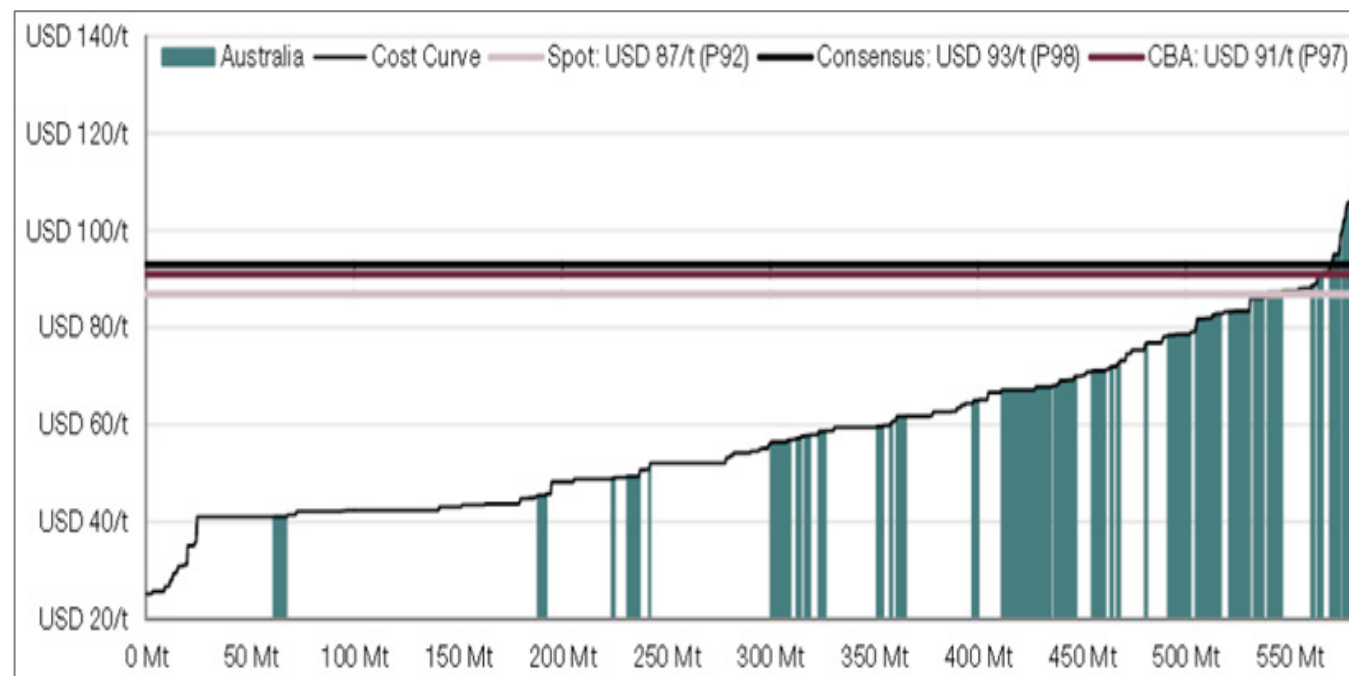
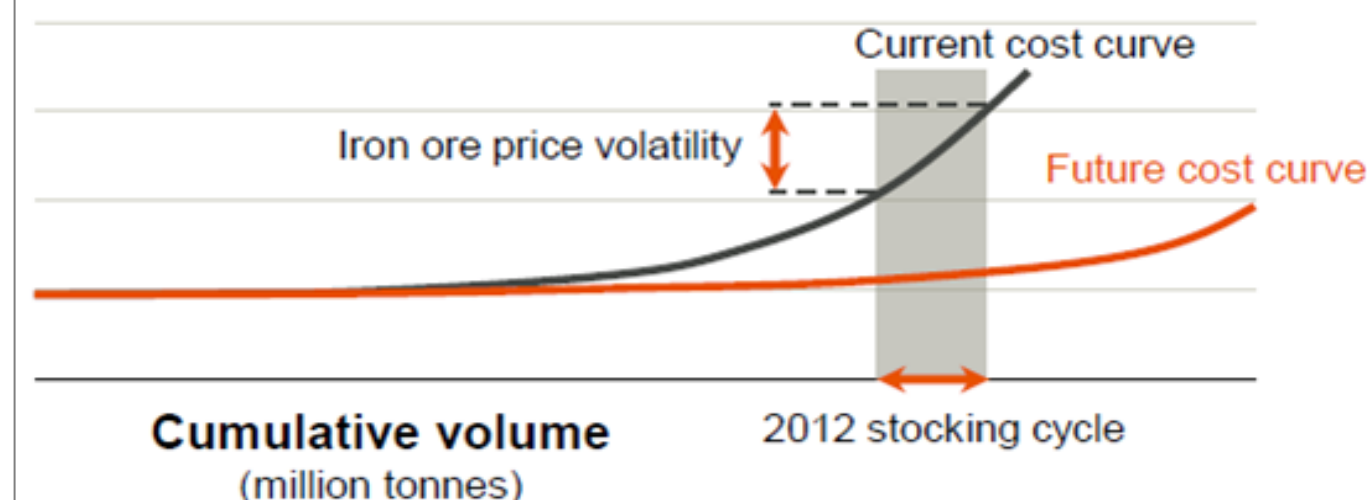
## IRON ORE

- Chinese steel demand +8% this year – well ahead of expectations and this has supported the iron ore price.
- However the low-cost operators are expanding production which will flatten the cost curve.
- The majors will benefit at the expense of high cost operators.

## COAL

- Australia has seen a dramatic shift up the cost curve driven by widening strip ratios, infrastructure tariffs and significant operating inflation.
- China is relatively self-sufficient in coal and new investment in East-West rail has reduced operating costs.
- Thermal coal has come under further pressure from the abundance of new shale gas increasing US coal exports.

**Schematic iron ore cost curve**  
(US\$/t, CIF China)





# Industrial Metals – Mixed outlook

## COPPER



Demand to remain strong as China continues electrification and consumer growth

Supply impacted by

- Declining grades
- Production disruptions
- Mine closures not being replaced by the industry

## NICKEL



Supply surge driven by new technology – Nickel pig iron.

Mine closures due to low prices is helping balance the market, but still a way to go.

## ALUMINIUM



Demand will continue to rise as China develops, however structural oversupply of smelting capacity.

Alumina is now largely priced on spot and will benefit from any bauxite shortages.

## ZINC



Positive outlook for zinc driven by a number of major mines scheduled to close by end-2016.

However it is difficult to gain exposure to zinc through Australian listed companies.

# The outlook for some commodities is strong.....

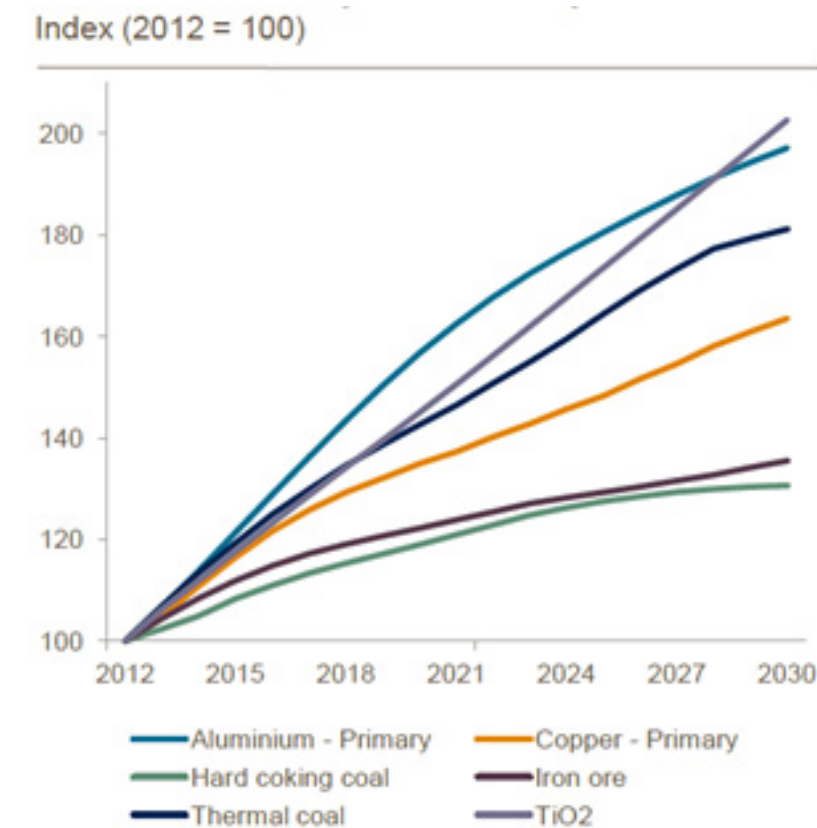
## Mineral Sands

- Long term structural demand for titanium dioxide as shown in the chart produced by Rio Tinto.
- Demand for zircon will continue to be driven by higher urban living standards in China.
- Highly favourable industry structure in both zircon and titanium dioxide. This was evident in 2012 when Rio and Iluka suspended production keeping the market tight.

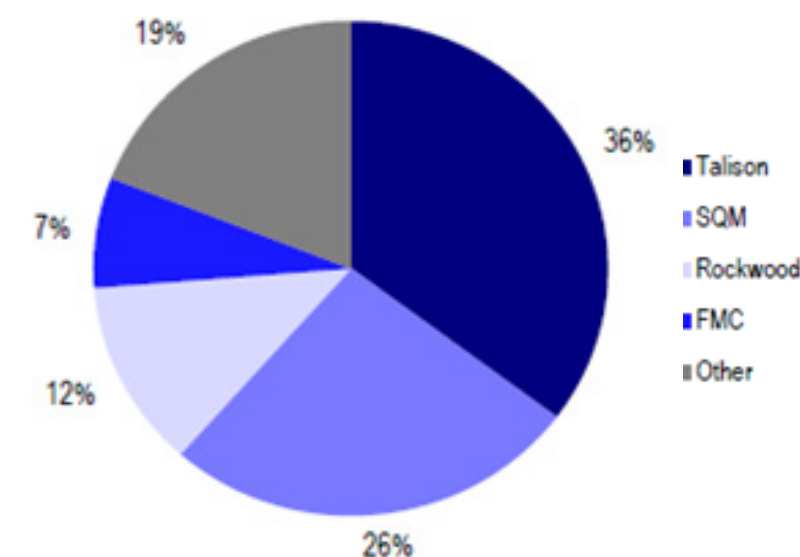
## Lithium

- Demand for lithium-ion batteries has increased 30% pa over the last decade and now accounts for one third of lithium demand.
- Smartphones and tablets have driven the growth, with electric vehicles to supercharge this.
- Highly concentrated industry structure with currently four major producers controlling the market.

Commodity Demand Trajectories



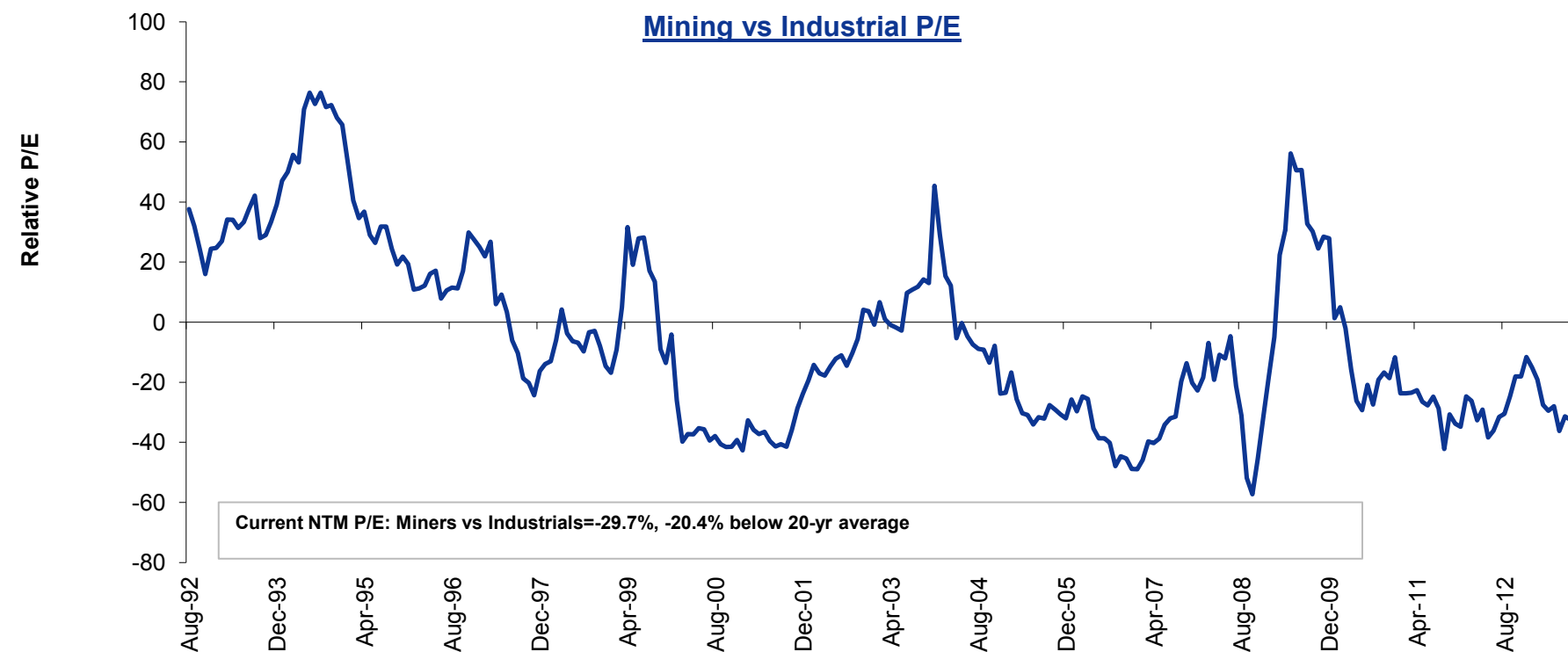
Concentrated Lithium Supply

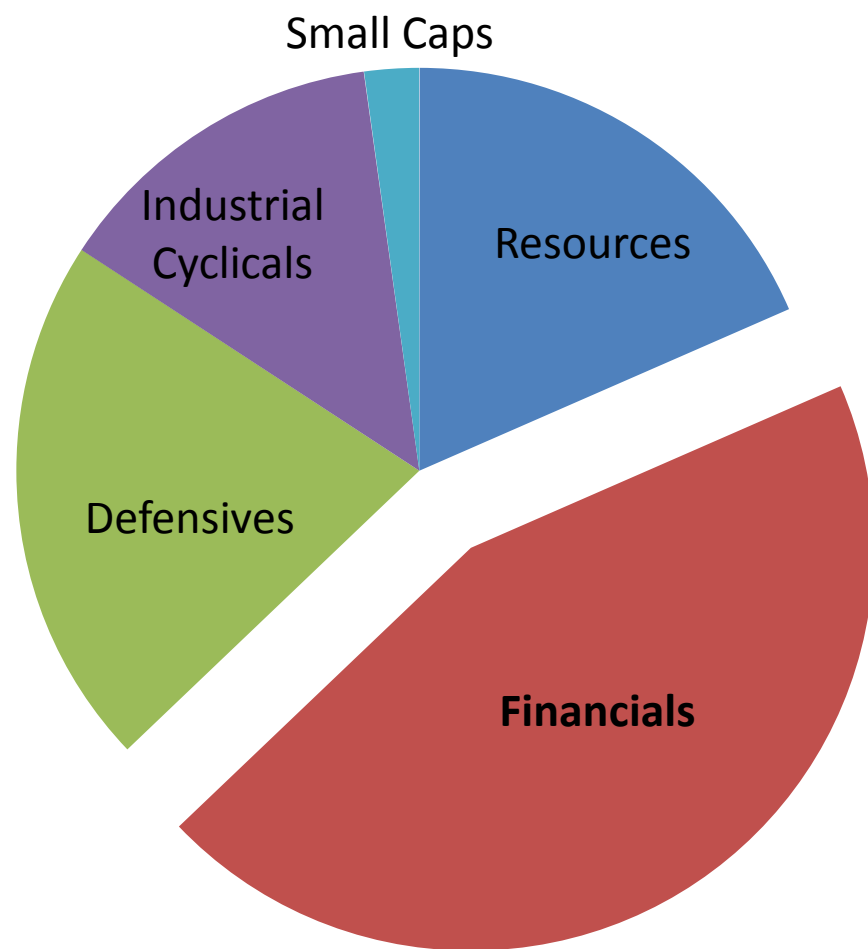




While the mining boom may be over, we are not expecting a mining bust

- Though commodity markets are well off their highs, they are still above historical prices
- Commodity markets are not as tight as previously as supply has responded to higher prices
- The economics of investing in mining companies is very much in tact and many remain profitable at trend commodity prices
- While valuations in most sectors look full, mining shares look okay here given upgrades and low relative multiples



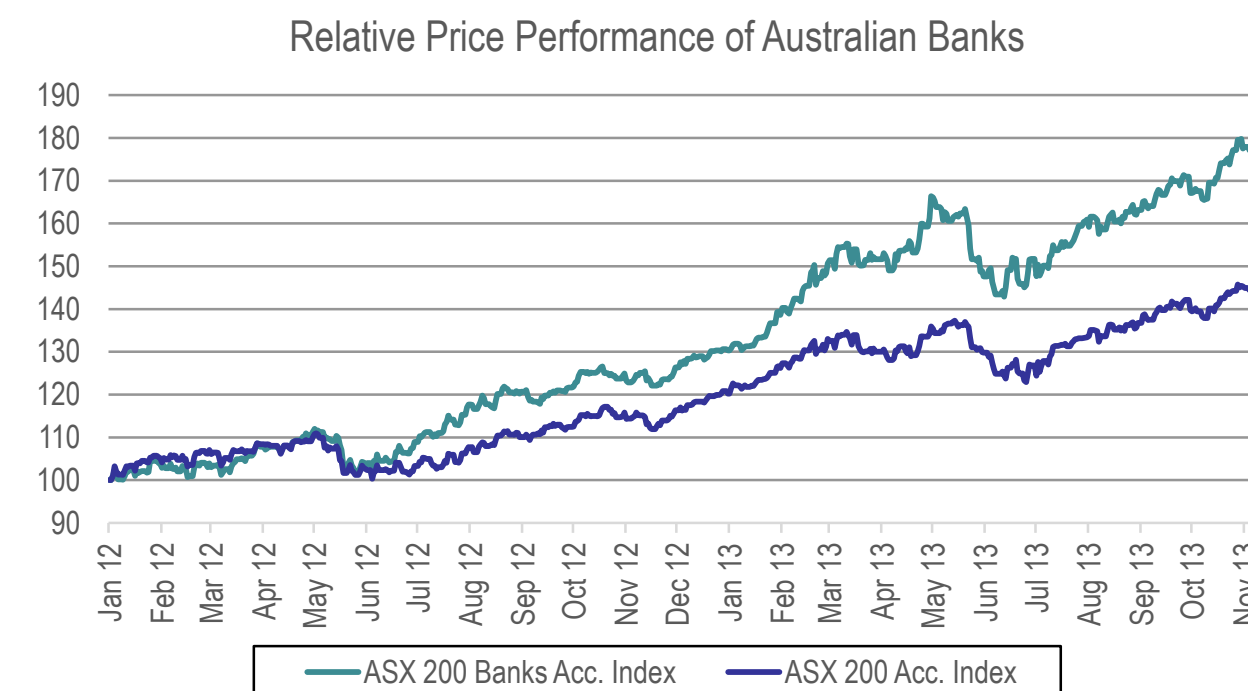


“Is this as good as it gets  
for Australian Banks?”

Omkar Joshi  
Investment Analyst

# Australian banks are in a 'sweet spot'...

- Australian banks are in a position of strength and have outperformed both the broader Australian market and most global banks in the last 12 months
- Profitability has been strong due to disciplined margin management, deployment of cost-cutting initiatives and improving bad debt charges
- Historically low interest rates and tightening of mortgage lending standards after 2008 have led to improved asset quality
- Strong levels of organic capital generation have meant banks were among the first globally to adhere to new Basel III capital requirements



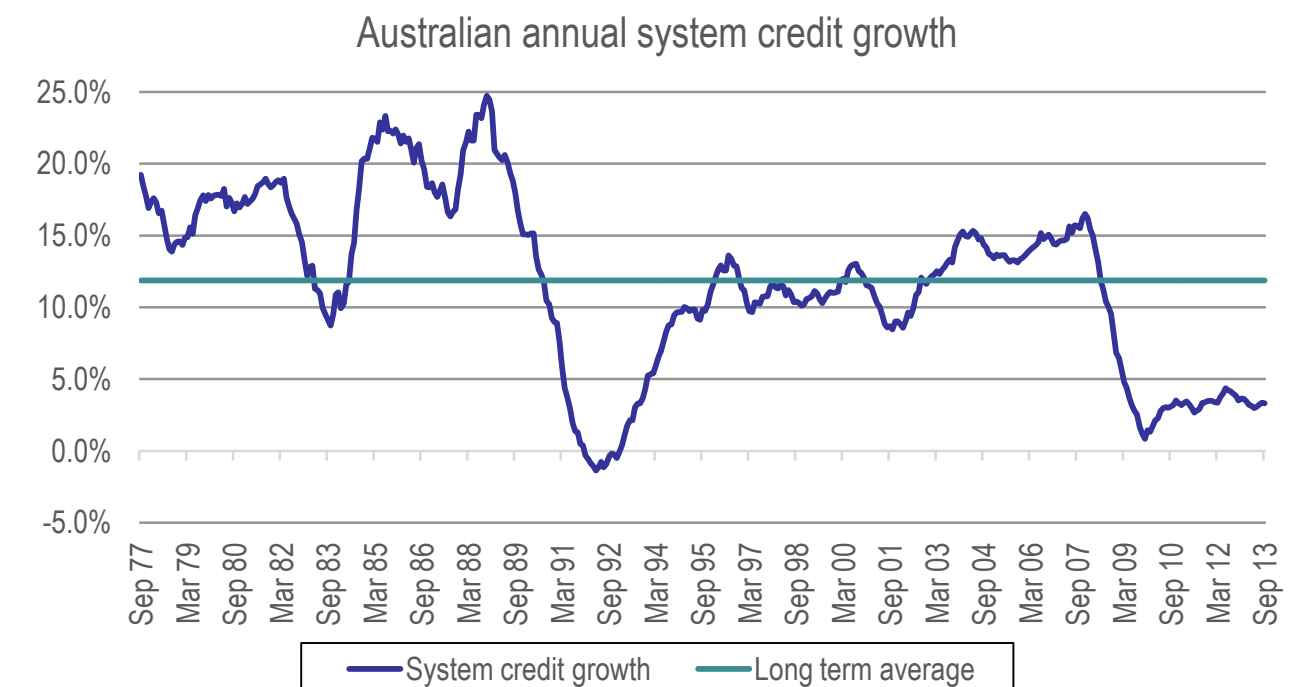
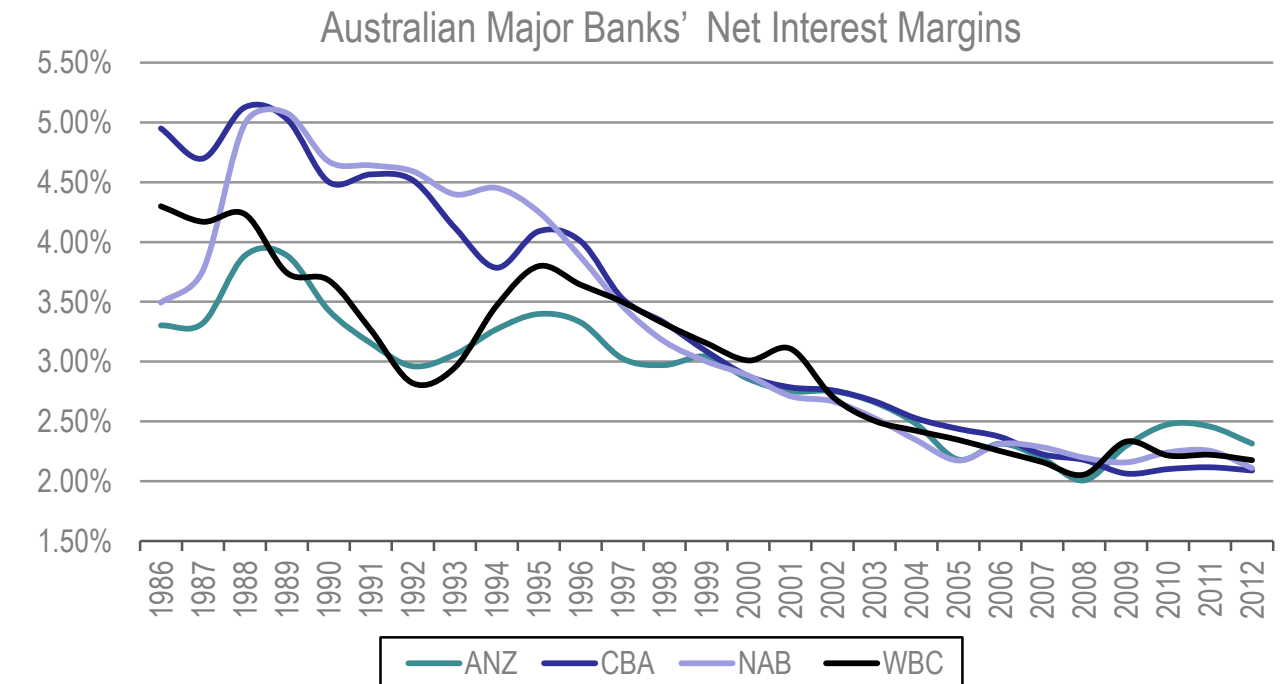
Source for both charts: Reuters, Watermark Funds Management estimates

# ...but pressures are emerging

- Margin pressures building with lower cash rates and limited ability to claw-back margins
- Bad debt charges are at a cyclical low point with impaired assets still elevated and bad debt charge write-backs unlikely to continue
- Regulatory uncertainty is building
  - APRA is still to announce its final position regarding further capital requirements
  - Coalition government has pledged to conduct a financial system inquiry
- Banks now look expensive compared to their historic trading range, long-term average P/E multiple and based on their long-term average P/E multiple relative to the broader Australian market

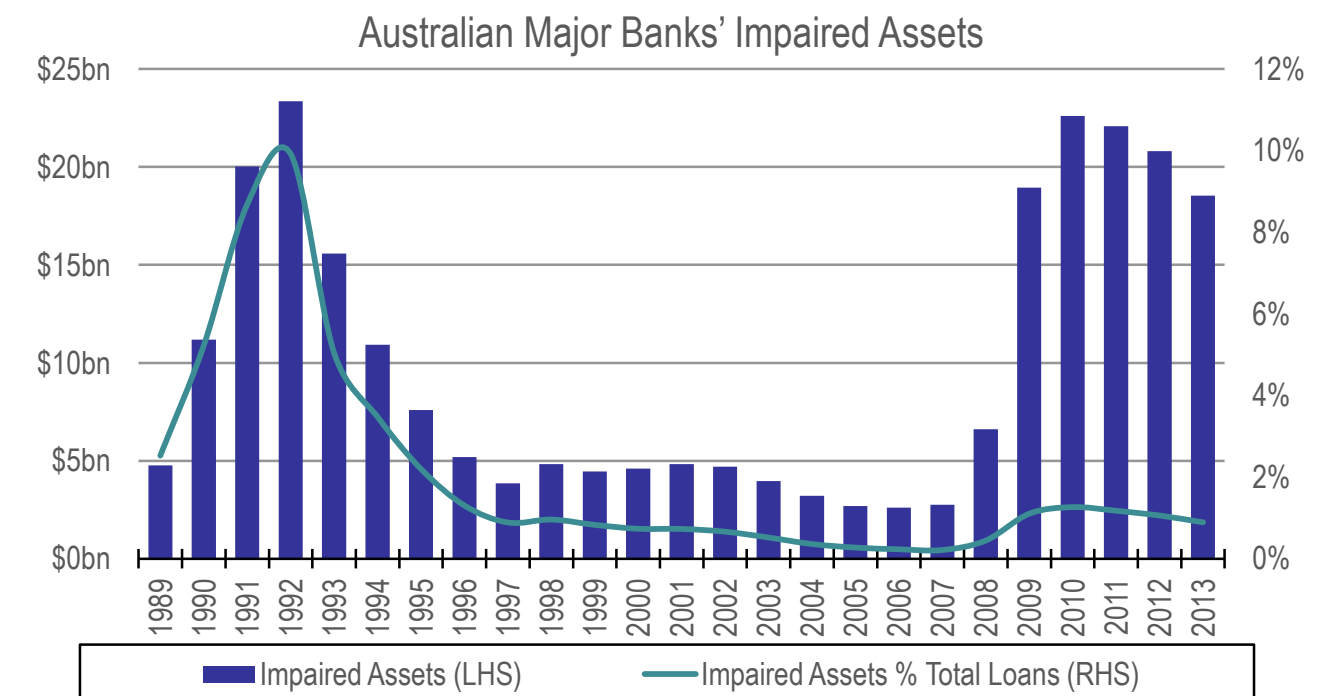
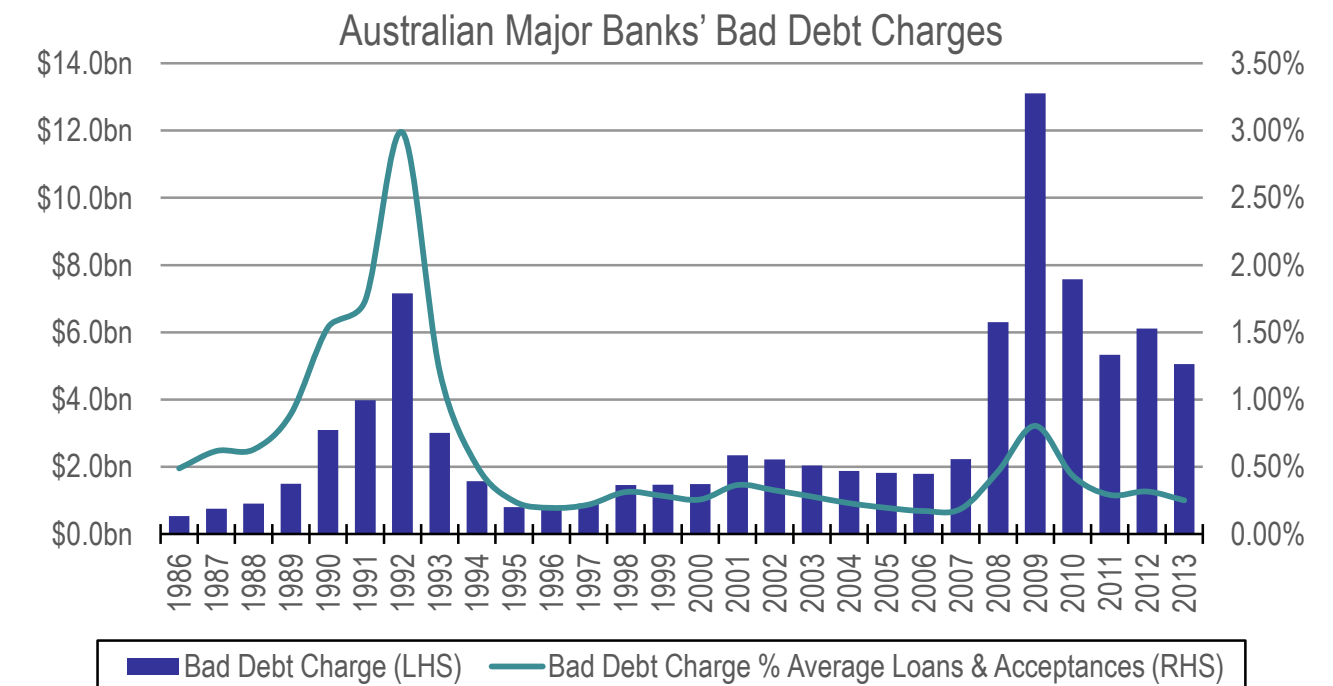
# Margin pressures building

- Persistently low system credit growth has led to banks using the price lever to keep growing housing loans
- Ongoing decline in cash rates are negatively impacting margins
- Deposit price competition has only marginally eased
- Wholesale funding costs have neared their lowest levels in 5 years and have minimal room for further improvement
- Out-of-cycle interest rate changes have become increasingly politically sensitive



# Can bad debts go lower?

- Bad debt charges appear to have reached a cyclical low point
- Rising net-write-offs have been funded through declining provision coverage
- Bad debt charges have benefited from provision write-backs as asset quality has improved
- The quantum of bad debt charge write-backs recently seen is unlikely to continue

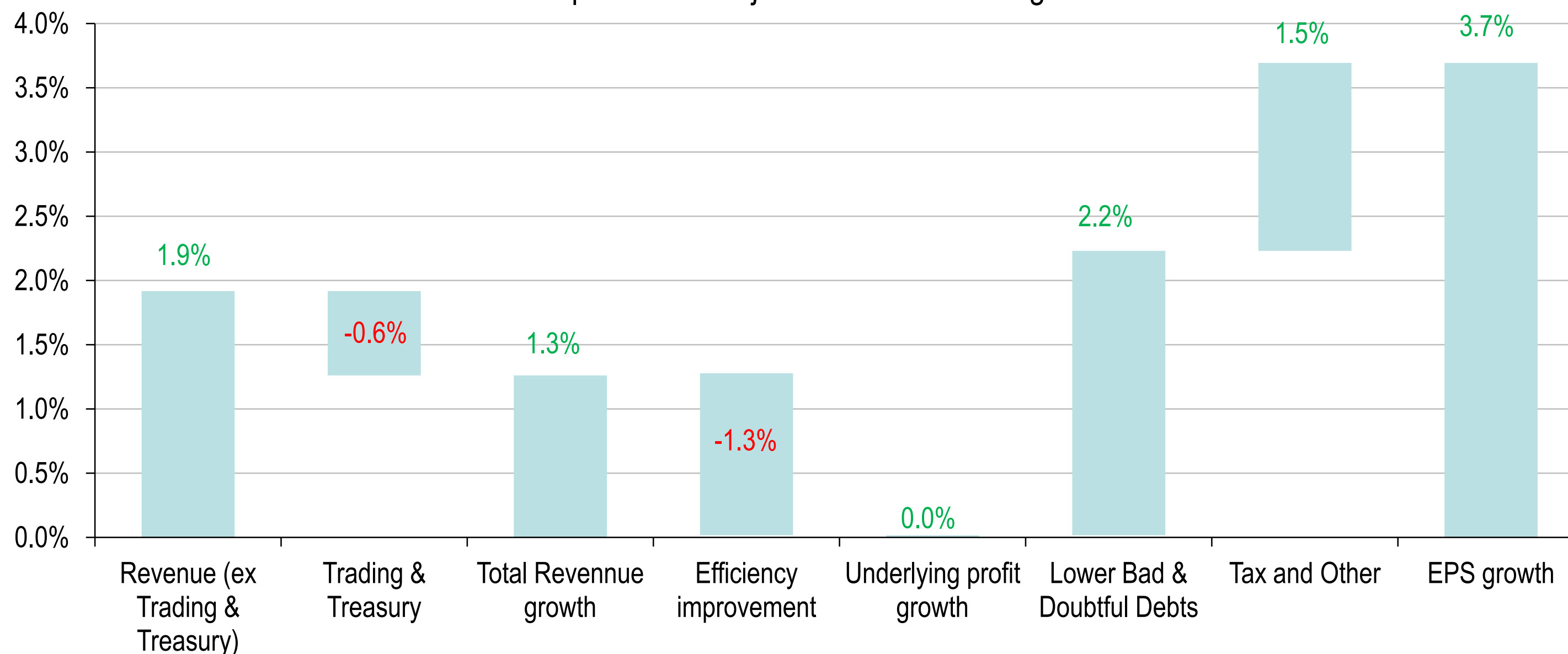


Source for both charts: Credit Suisse

# No underlying profit growth

Lower bad debt charges primarily underpinned EPS growth in the recent bank reporting season

Decomposition of Major Banks' 2H13 EPS growth

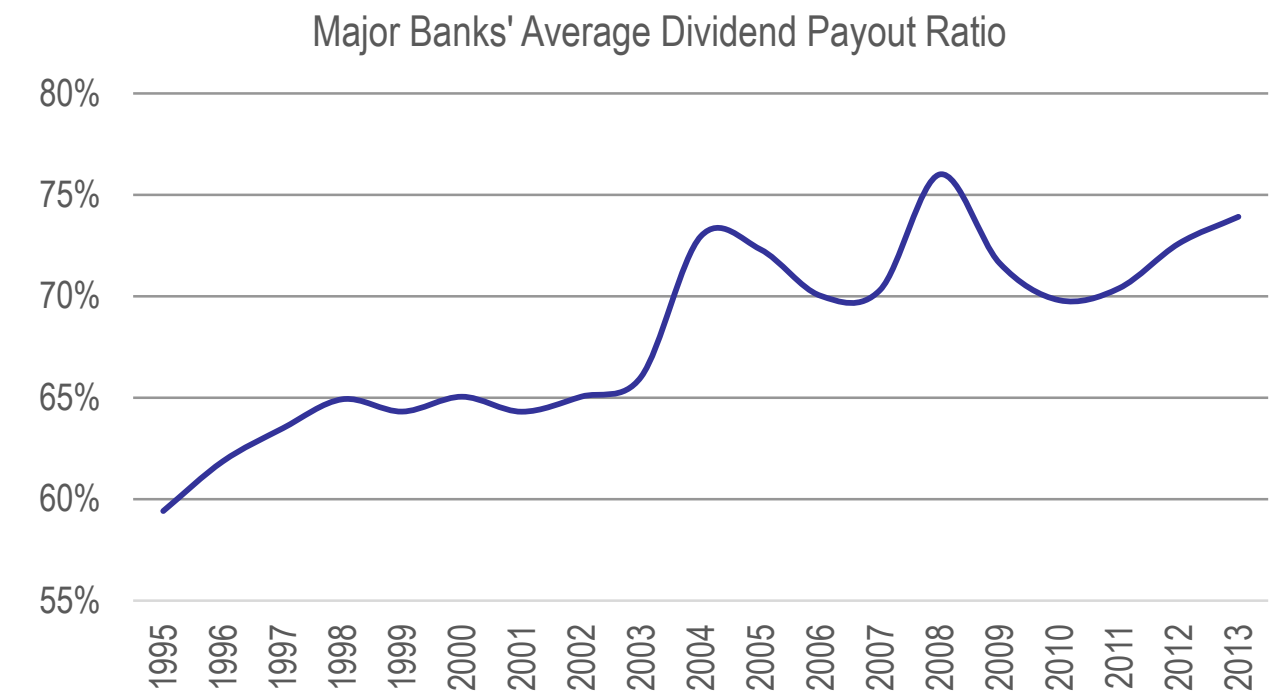


Source: UBS



# Regulatory uncertainty building

- APRA is yet to finalise its domestic systemically important bank (D-SIB) requirements in Australia, as well as the Level 3 capital adequacy standards
- Regulatory uncertainty limits scope for further increases to dividend payout ratios
- Coalition have indicated their intention to hold a broad-ranging financial system inquiry
- Terms of reference for inquiry are still unknown
- Potential for near-term adverse sentiment to weigh on major bank share prices but with regional banks potentially benefiting

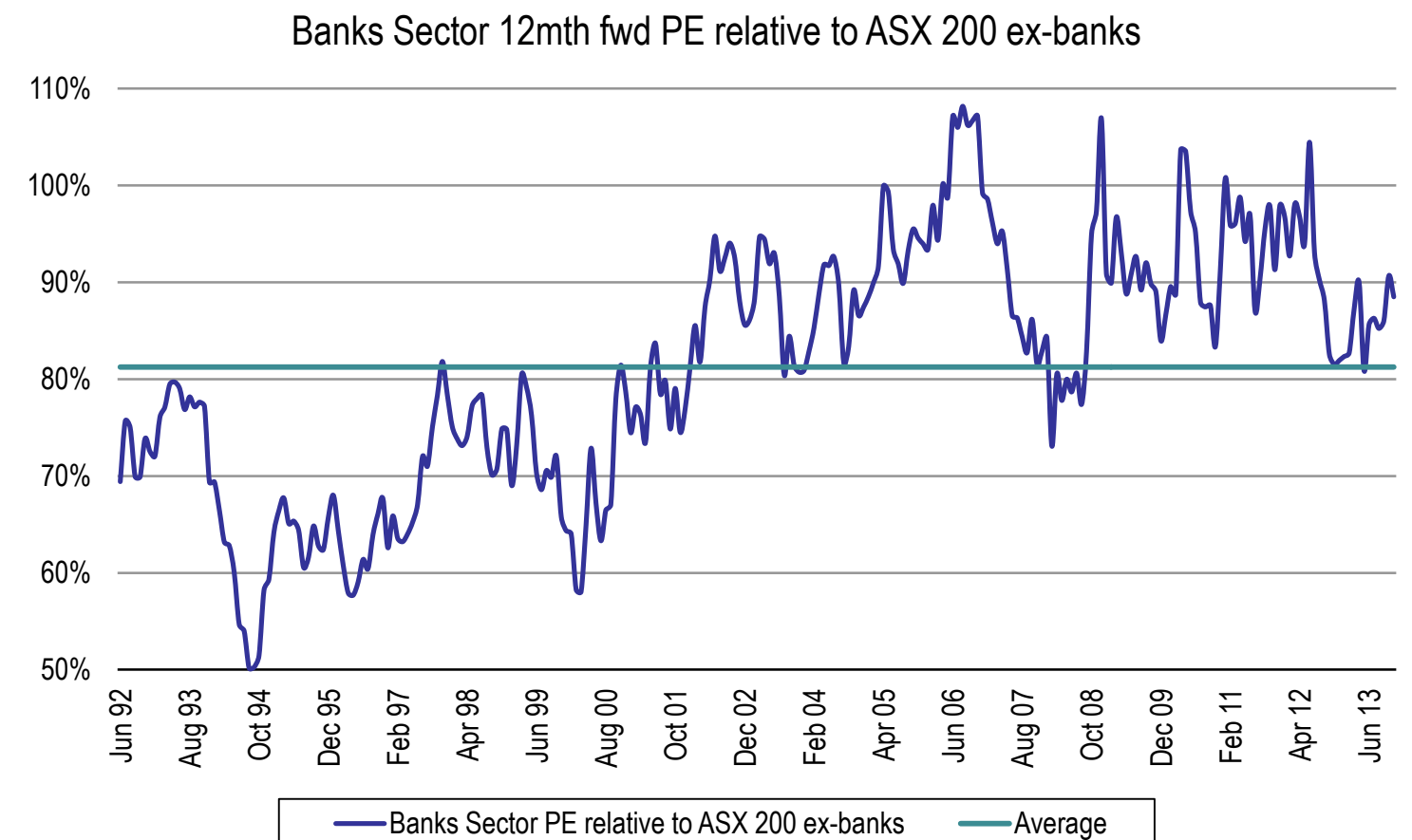
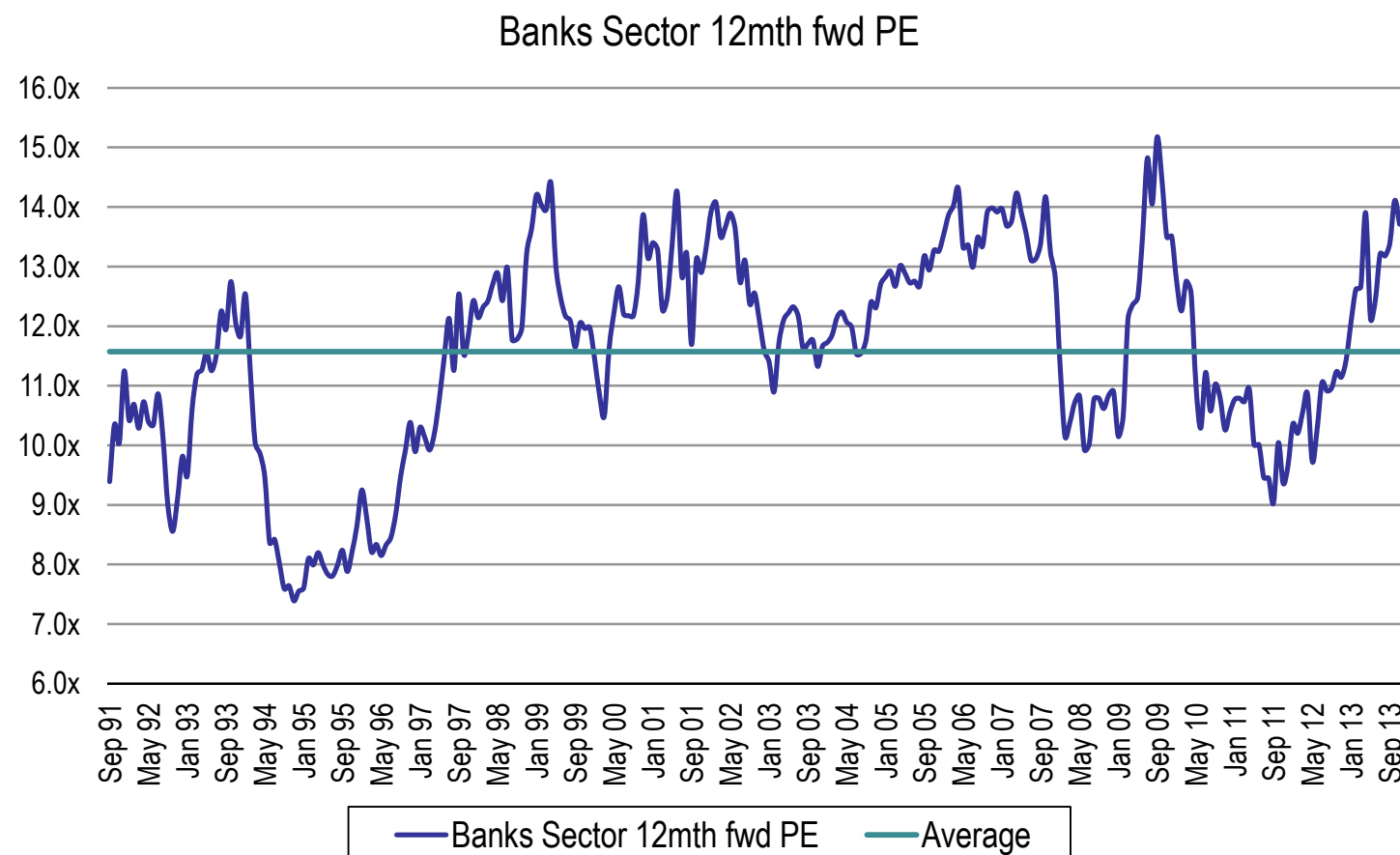


Source: Credit Suisse

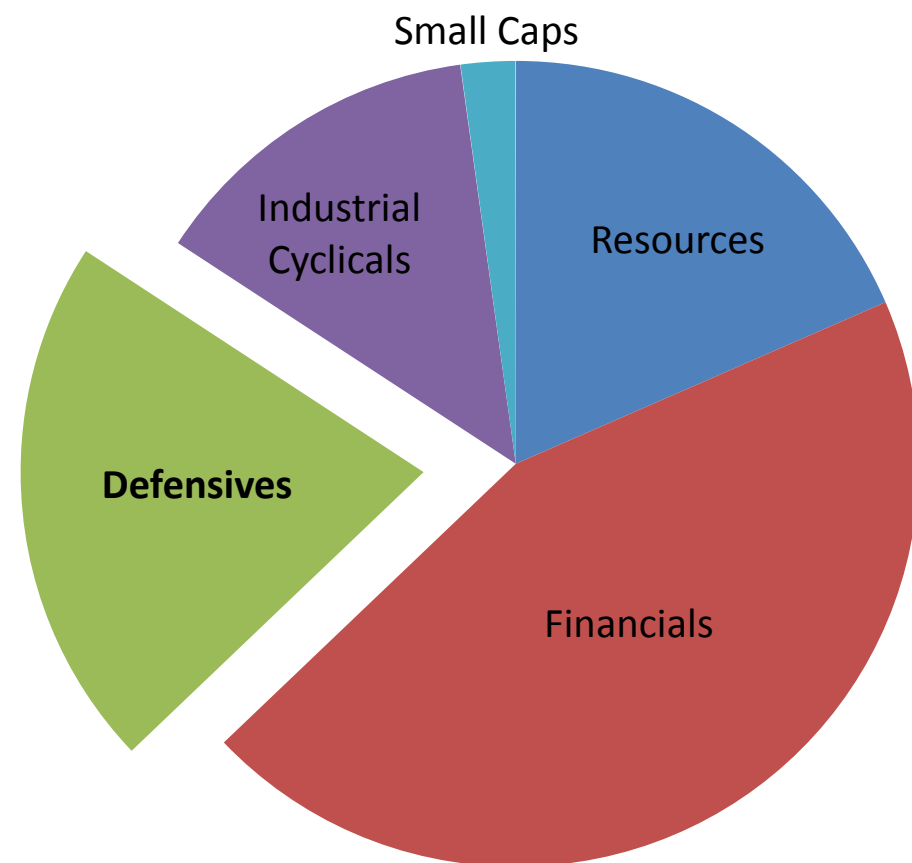


# Banks now appear expensive

- Bank share prices are trading at all time highs compared to their historic trading range
- Banks have re-rated significantly and are now trading at historically high P/E multiples
- Banks are expensive compared to their long-term average P/E multiple relative to the broader Australian market



Source for both charts: IBES, Reuters

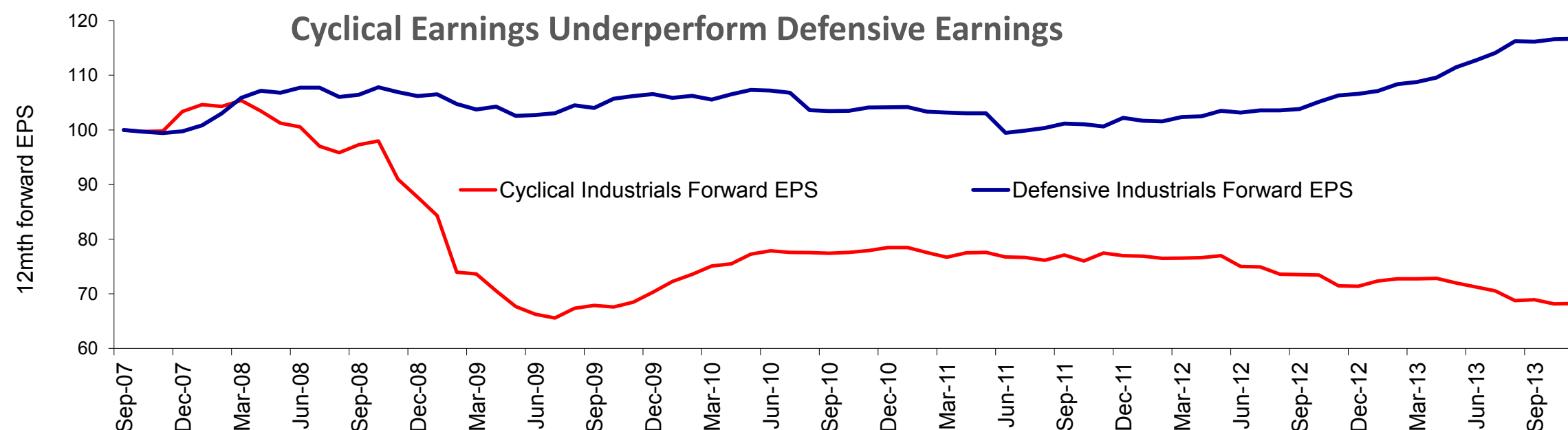


“Are Defensive shares still the best place to invest?”

Joshua Ross  
Investment Analyst

# Recovery led by defensive sectors

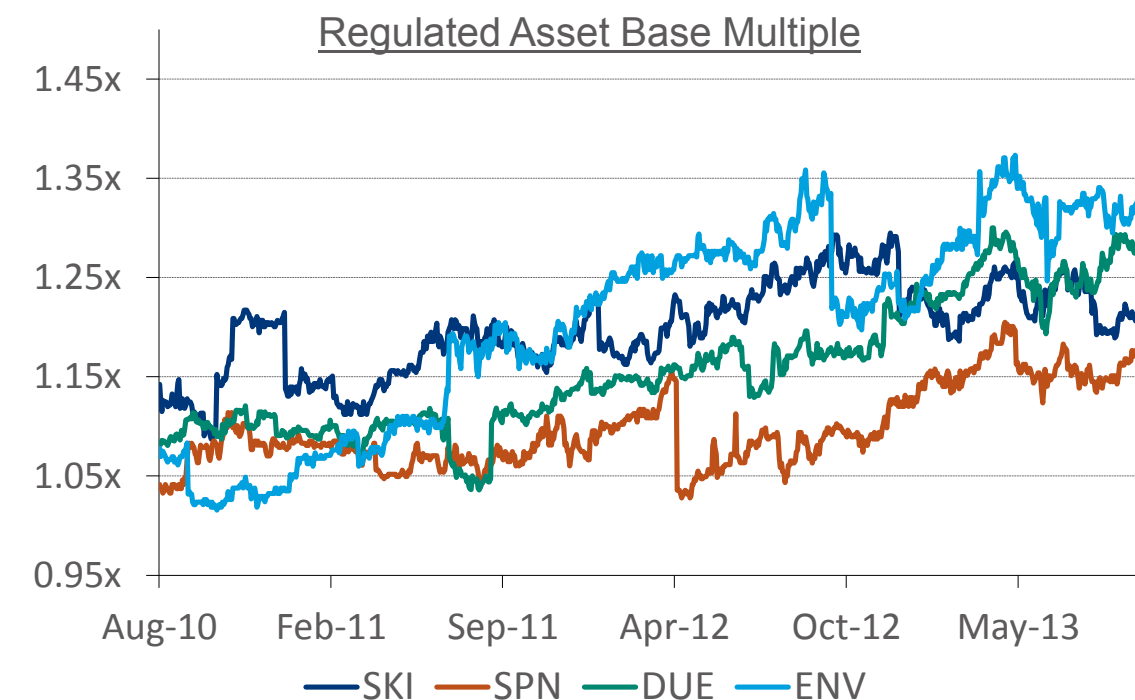
- In a normal business cycle, cyclical shares exposed to a recovery in economic activity would lead the market. This recovery has been highly unusual in that up until very recently, defensive sectors have lead the market higher.
- Aggressive monetary easing from policy makers has forced reluctant investors to take on risk in the share market. These investors have bought defensive securities offering attractive yields as a substitute for income securities.
- Furthermore, because the recovery has been so weak outside of mining, profit momentum for cyclical shares has been very disappointing.



- We have been Overweight Defensives and remain so given the soft economic outlook

# Defensive Sectors - Low growth

- **Utilities & Infrastructure** – highly regulated, we will invest in monopoly assets with stable regulatory oversight. Australian Energy Regulator signaling intention to reduce return at a time when RAB multiples are at their peak.
- Preferred pick is Transurban – regulated toll-roads, modest traffic growth and predictable toll escalation. Privileged position with a raft of new opportunities as government looks to outsource infrastructure.
- **Retail Staples** – Wesfarmers attractive; Successful turnaround of Coles, Bunnings store-rollout.
- **Gaming** – Macau structural growth. Crown preferred exposure, City of Dreams mass-market leader.

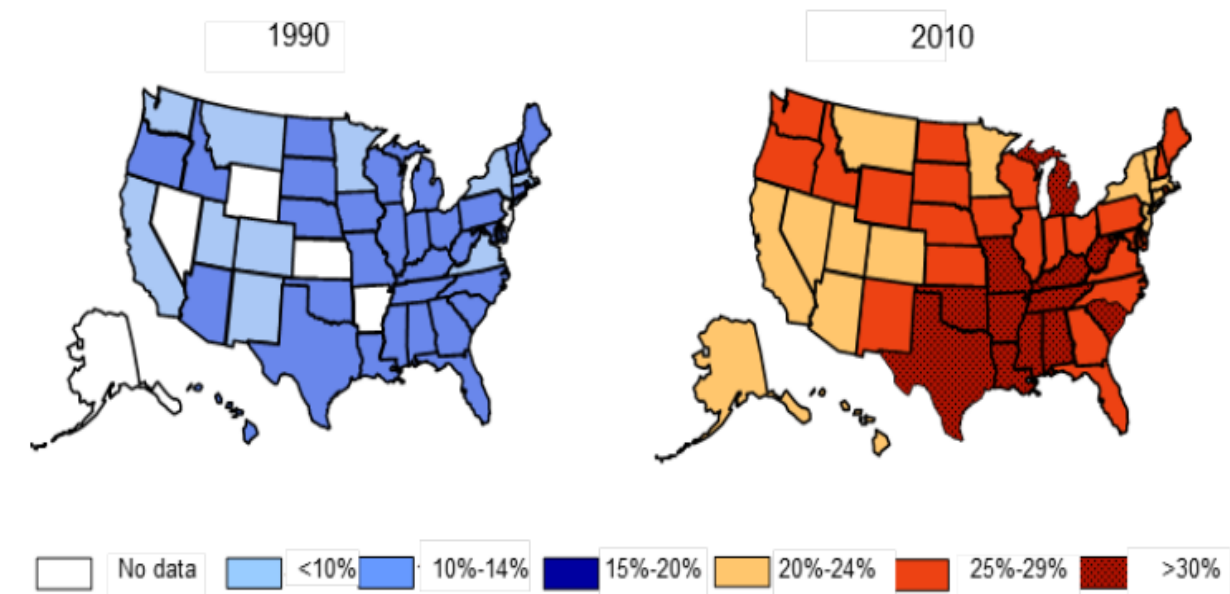


Coles as a % of Woolworths	Annualised Sales per sqm	Annualised EBIT per sqm
2009	77%	39%
2010	80%	41%
2011	84%	47%
2012	88%	53%
2013	91%	58%

# Growth Defensive Sectors

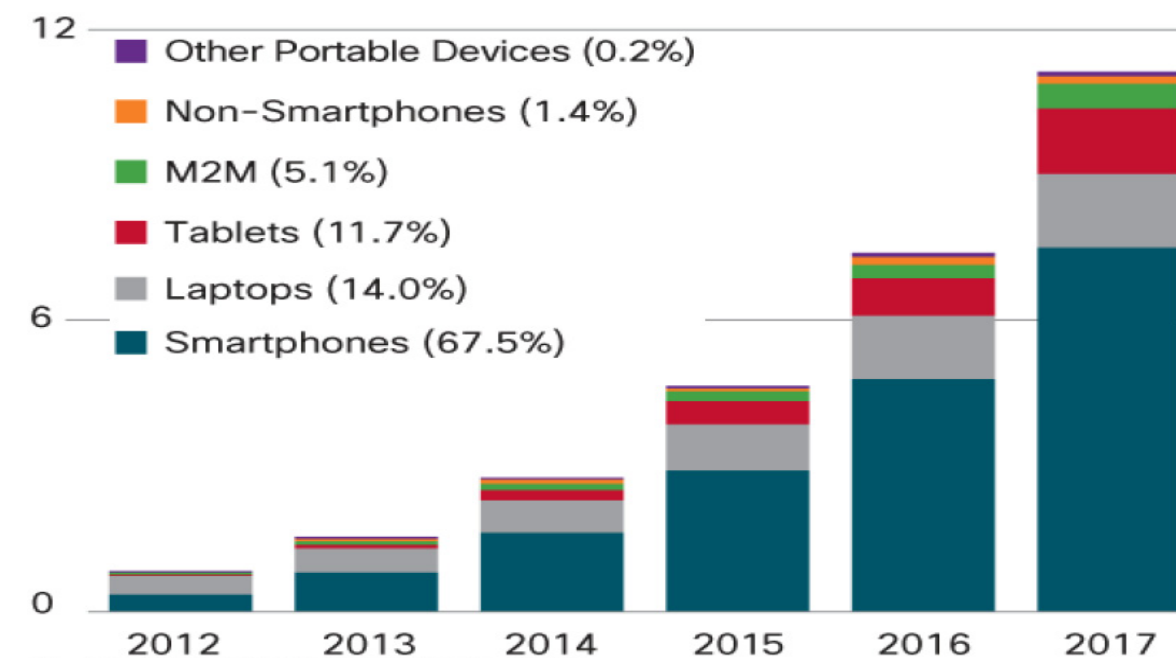
- **Healthcare** – Healthcare is a strong growth sector, underpinned by ageing populations across developed countries, rising obesity levels and disease incidence, and a burgeoning middle class in emerging markets.
- Australia has developed world leading science in biotherapies (CSL) and medical devices (Cochlear, Heartware, Resmed).
- **Telecom and the digital economy** – investments in data infrastructure and access technologies. These include Amcom, NextDC, Telstra, Big Air and Netcomm Wireless.

Comparison of obesity trends in the US

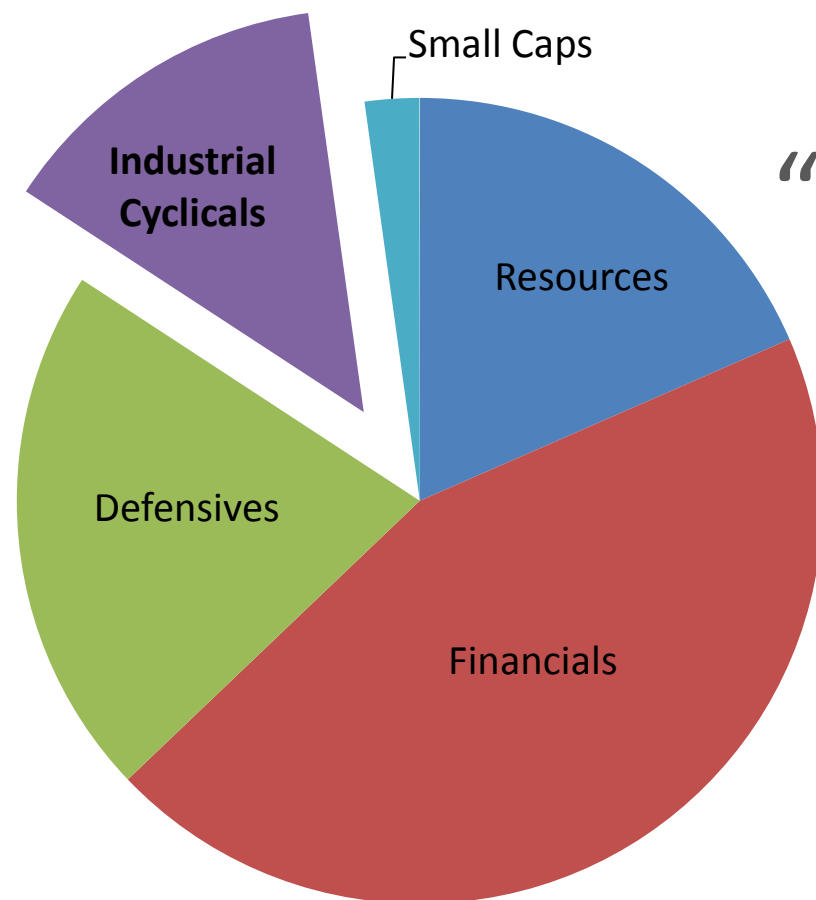


Source: Data obtained from CDC

Smartphones Lead Traffic Growth  
Exabytes per Month



Source: Cisco VNI Mobile Forecast, 2013



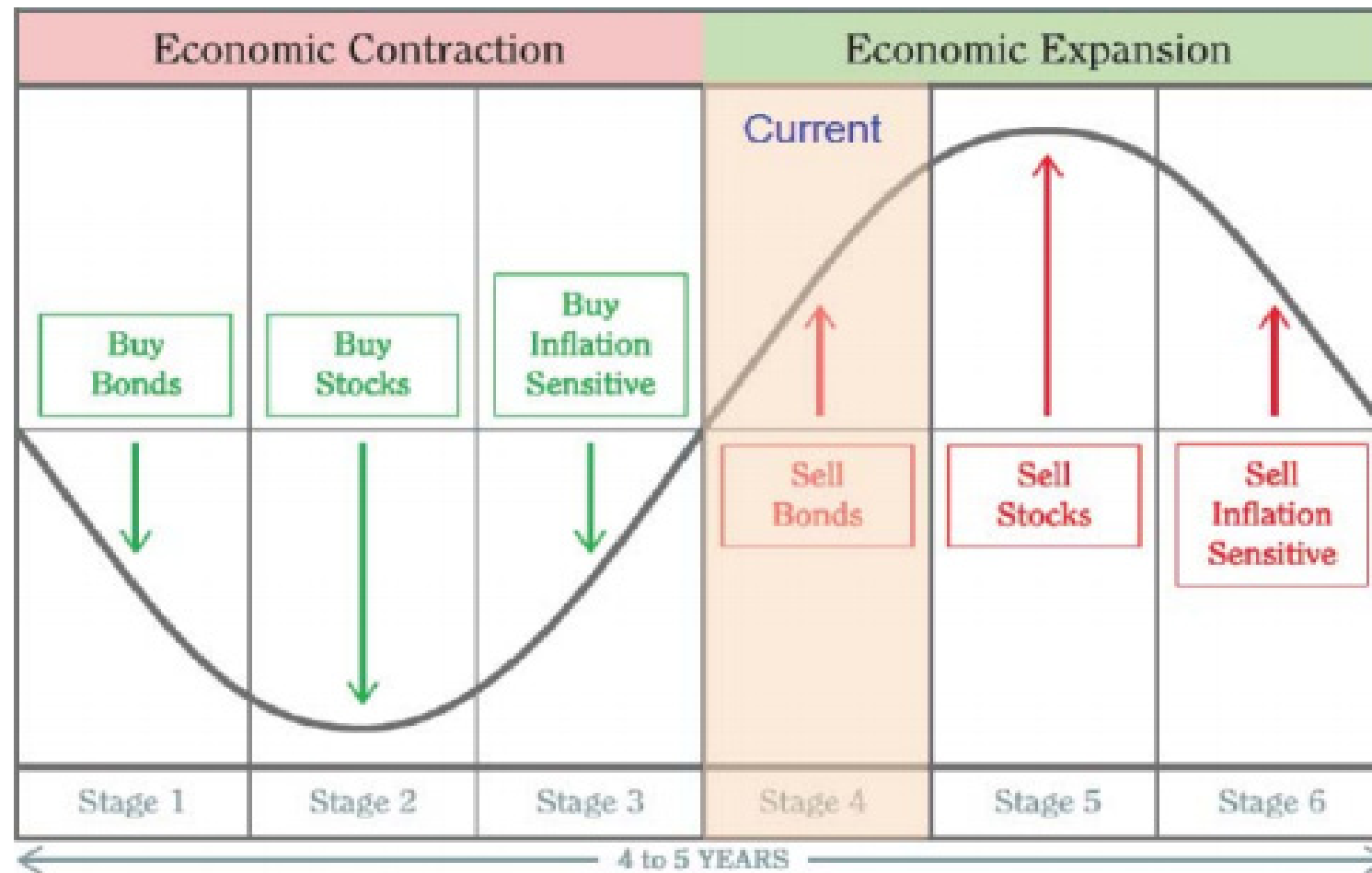
“Is it time to shift into cyclical shares? ”

Justin Braitling  
Portfolio Manager

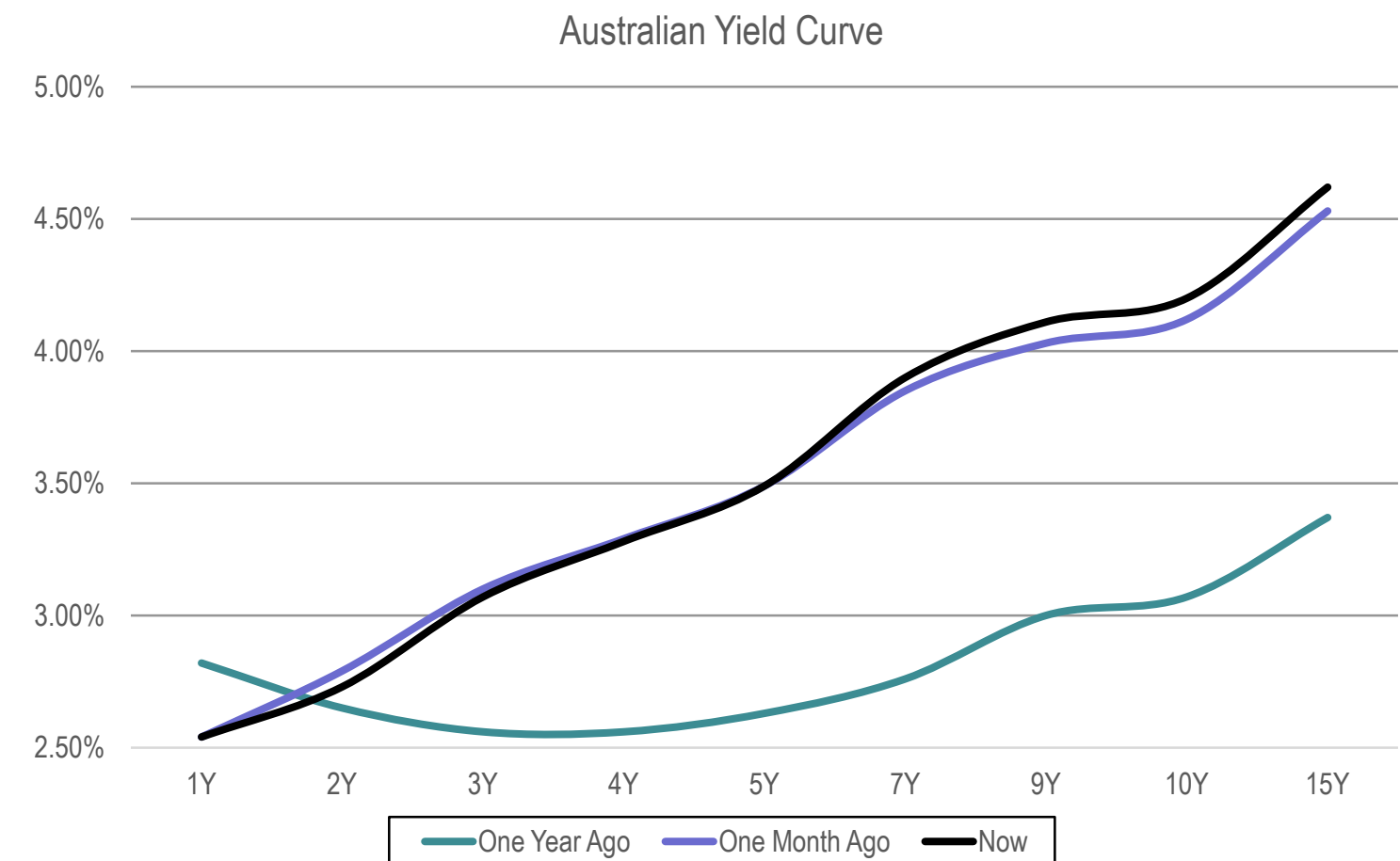


# Where are we in the cycle?

We are of the view that we are in the midst of a rotation into cyclical stocks characterised by a sell off in bonds resulting in rising yields



Source: Pring Turner



Source: Reuters

# The search for cheap cyclicals

- Investors are looking to shift into cheap cyclicals as the market continues to become increasingly expensive
- Cyclicals have significantly outperformed the broader Australian market in the last 12 months
- We are cautious on the outlook for cyclical securities at present given our soft outlook

Sector	12M Return
Media	68.8%
Discretionary Retail	65.0%
Developers & Contractors	10.1%
Transport	37.9%
Steel	65.0%
Building Materials	50.6%
ASX 300	23.9%

*Source: Reuters, IRESS*



- **Media:** New media continues to take share from old media, however pockets of opportunity exist around this theme
- **Discretionary retail:** Preference for high quality retailers and those with hard asset backing
- **Developers & contractors:** It's an extremely tough operating environment where management are the key differentiators. We are witnessing an enormous divergence in performance
- **Transport:** Preference for companies with cost-out potential as top line remains muted
- **Building materials:** Preference for companies exposed to US housing recovery as the pick up in demand from Australia has been largely priced in

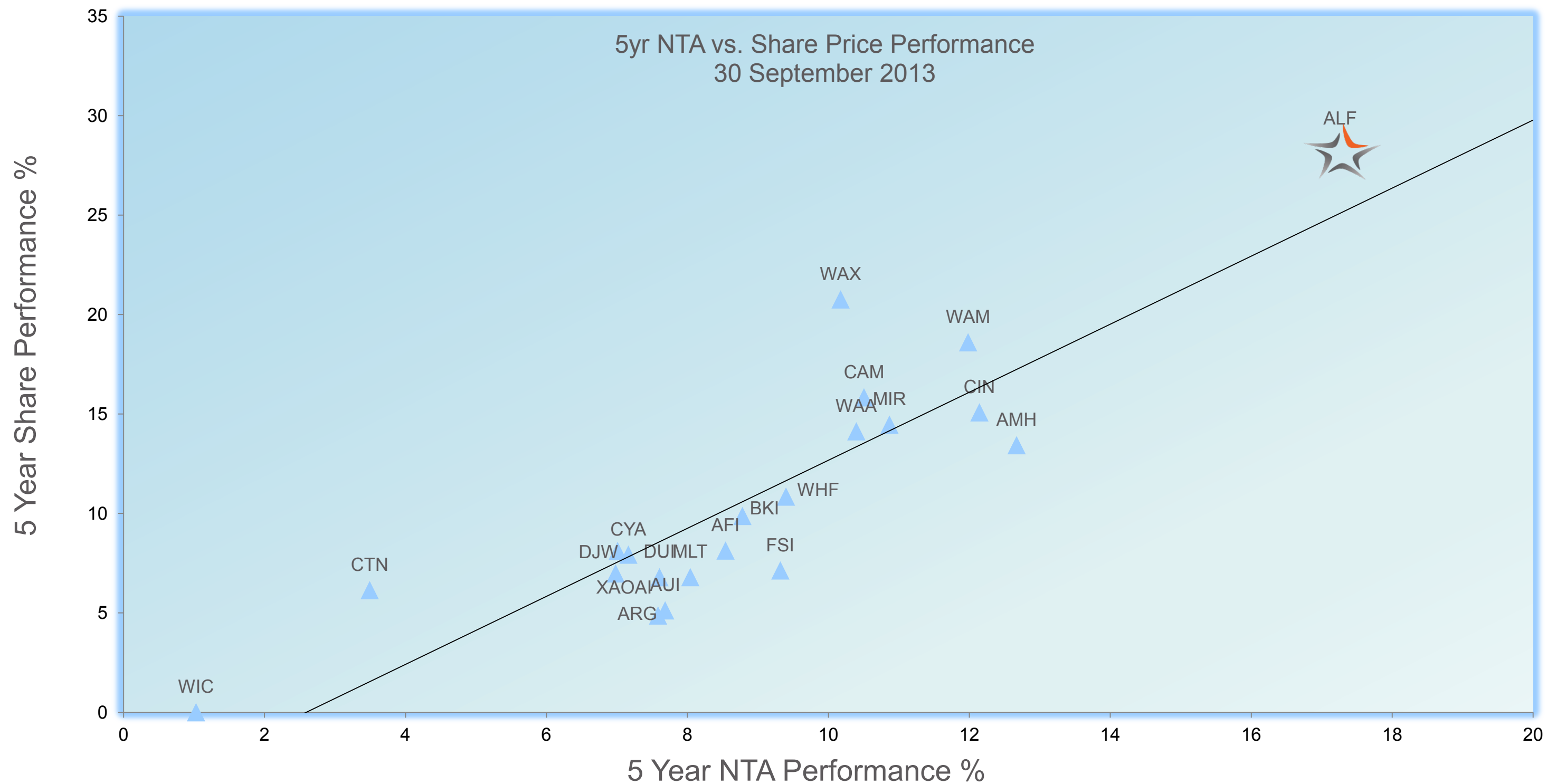
- We expect growth to be soft next year. Because of this company profits will grow modestly at best.
- Shares have risen well ahead of profits in 2013 in expectation of a robust recovery – shares are now primed for disappointment if a weaker outlook does emerge.
- Shares may well rise further however, assisted by ultra easy monetary conditions.
- Risks are building. Asset bubbles, debt sustainability and policy tightening are ongoing risks that may manifest in a market reversal as shares become overvalued.
- We will continue to maintain our cautious portfolio settings. As markets advance further we will shift out of equities into cash.

# Australian Leaders Fund Returns

Reported Performance as at 31 October 2013

ALF	1 YEAR	3 YEARS (P.A.)	5 YEARS (P.A.)	SI (P.A.)
Long	33.6%	18.1%	23.9%	-
Short	4.9%	-1.1%	4.5%	-
Net	44.5%	22.2%	26.2%	16.5%
All Ords Accum Index	24.7%	9.3%	11.1%	9.8%
Net Outperformance	19.8%	12.9%	15.1%	6.7%

# Performance drives returns



Source: Bell Potter Research

# Australian Leaders Fund Limited (ALF)

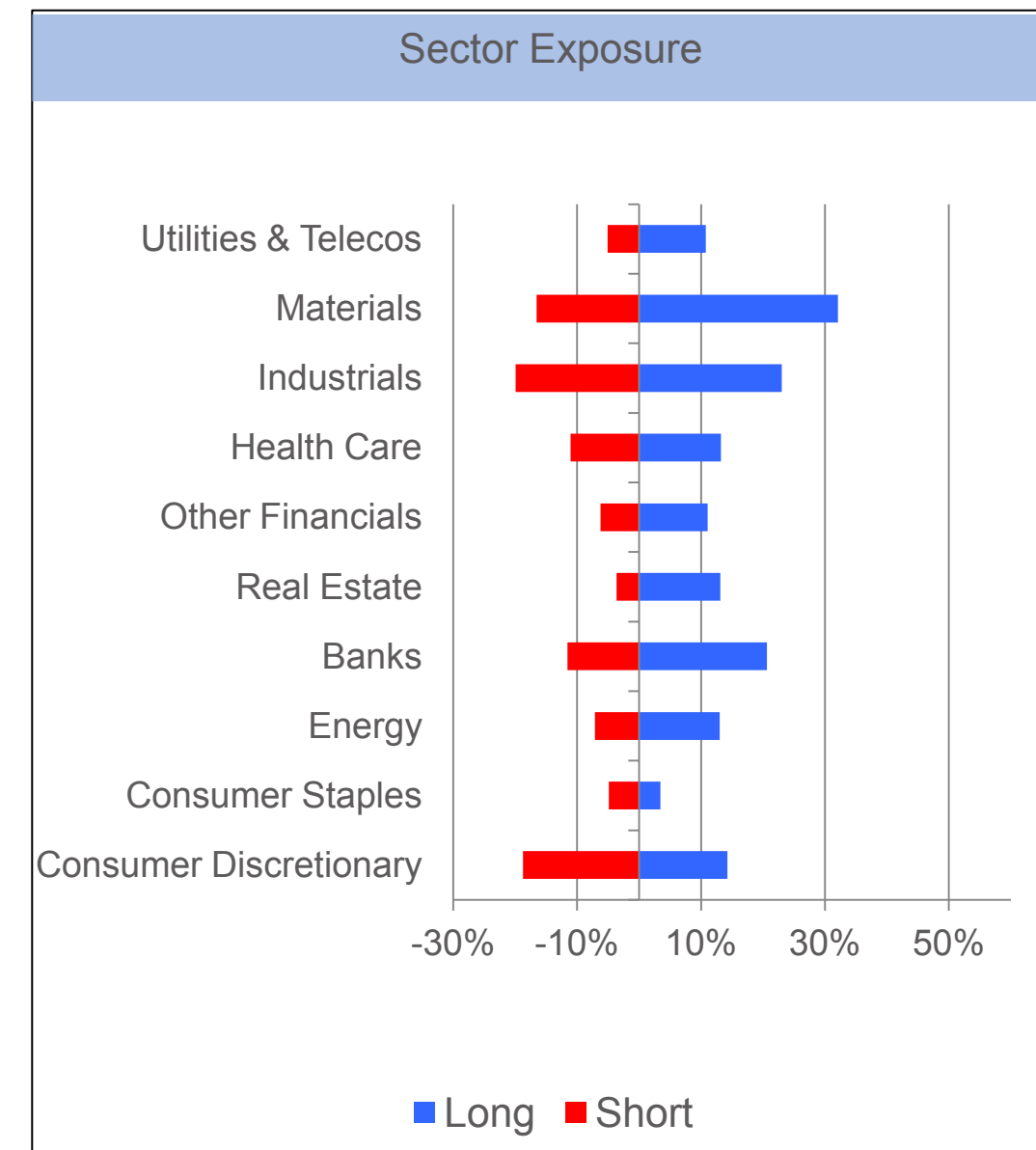


Australian Leaders is a listed investment company with an absolute return focus that invests in the shares of leading and emerging companies listed on the Australian Stock Exchange. ALF is different to a traditional fund in its use of hedging strategies to enhance returns and manage market risk. The investment manager Watermark has established a successful track record in Absolute Return Funds.

Company Statistics	
Share Price – ALF	\$1.67
Option Price - ALFO	\$0.32
Market Cap (Millions)	\$343
NTA @ 31 <sup>st</sup> October 2013 after tax	\$1.47
Premium/Discount to post-tax	14%
Dividend Yield (2013 12c FF)	7.2%
Management / Performance Fee	1/20%

Fund Statistics - 31st October 2013	
Long (Millions)	\$488
Short (Millions)	-\$331
Net Exposure (Millions)	\$157
Cash and Hybrids (Millions)	\$159
Fund NAV AUD (Millions)	\$316
Net returns since inception (p.a)	16.5%
All Ordinaries Accumulation Index	9.8%
Outperformance	6.7%

Top 10 Long Holdings
ANZ
Westpac
BHP Billiton
Rio Tinto
Mayne Pharma
Transurban
WorleyParsons
Wesfarmers
QBE
CBA



# QUESTIONS