



**WATERMARK**  
FUNDS MANAGEMENT

# The Leading Edge

QUARTERLY REPORT | December 2014

## What's going on with commodities?



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Justin Braiting  
Portfolio Manager

Economic growth has become more dependent on a resilient US recovery, while most other large industrial economies, with the exception of China, are struggling to grow. Leadership in the Australian share market has also narrowed as investors chase yield, while many other sectors fall by the wayside. Neither development is positive for this bull market. Leadership typically narrows at major turning points in the cycle.

Policy makers, fighting deflationary forces are pushing new boundaries to reflate activity and reach inflation targets. With the ECB moving to quantitative easing and our own RBA considering further rate cuts, we are moving closer to the end game where investors eventually lose confidence in the ability of Central Banks to support economic activity and asset prices.

Excess capacity, particularly in Europe and China is creating deflation and playing havoc with fragile

demand. Falling commodity prices, a corollary of this demand shortfall, are only making matters worse. With this backdrop central banks will remain on a dovish footing and 'competitive easing' will continue to suppress volatility and support share markets. Our own RBA cash rate could easily have a one in front of it within a year. Rates have never been this low, this is true also for Commonwealth Government Securities with the ten year bond yielding just 2.5%. We are clearly in very unusual times.

Given the clear divergence in growth, inflation and policy between regions, interest rates and currencies will bear most of the adjustment, while shares will continue to benefit from ongoing liquidity support. The pattern seen recently where markets corrected on growth scares only to recover following supportive commentary from central banks is likely to be repeated again in the year ahead.

### Weak growth trends to continue.

The global economy has grown at just 2.5% in recent years, well below its historic trend, with developed economies averaging between 1 - 2% and emerging markets growing above 4%. In considering the outlook, we can separate the \$US75 trillion global economy into three groups of equal size with similar trends:

1. The US and China remain the vanguard of global growth. The former is moving toward a self-sustaining recovery, having grown at just 2% p.a. in recent years. This will be partially offset however by a further slowing of growth in China from 7%

Bond and commodity markets are sending a clear signal about future growth and deflation

FIG 1



Source: Bloomberg



last year to a more sustainable 5% in 2016 as rebalancing continues.

2. The second group is made up of countries in the European Union and Japan where economic stagnation and deflation are the order of the day. Growth of any sort would be welcome. They have been growing at just 1% p.a. and this anaemic rate of growth is likely to continue.

3. The remaining countries comprise a mix of emerging economies and commodity producers such as Australia and Canada. Growth is slowing across this group following a fall in commodity prices and a slowing of global trade. In recent years emerging markets have benefited from large cross border capital flows, as investors took advantage of carry trades. This liquidity support is now reversing, as rates in the US normalise. These capital inflows were mainly dollar denominated loans, so the stronger US dollar is putting further strain on lenders, particular commodity exporters.

You can see in Fig 2 how Ex the US and China, economic growth has been weak, with profit growth of listed shares reflecting this, a key reason why returns outside of the US share market have been disappointing.

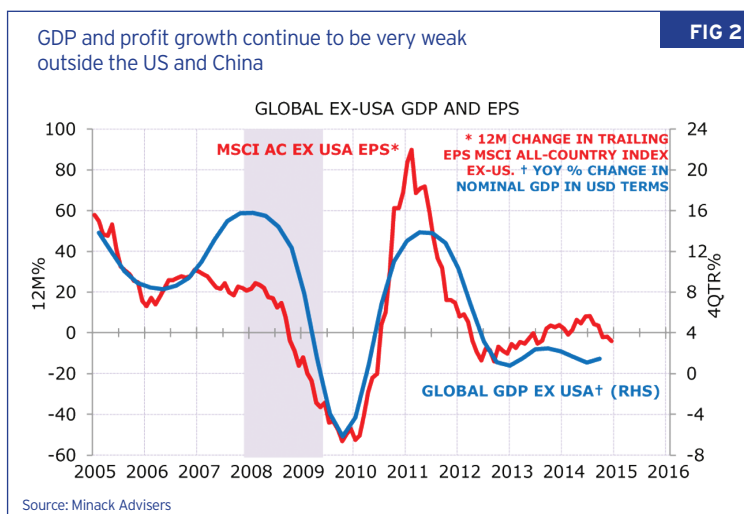
So on balance, when considering the economic backdrop for equities, it is hard to see any sustainable pickup in growth in the year ahead. Bullish commentators would have you believe a strong US economy and aggressive policy action in Europe and Japan will see growth accelerate once the legacy of the balance sheet recession passes. These same commentators have been calling for this resurgence since the recovery began and continue to be disappointed.

The 'debt super cycle' bears would suggest we have reached an apogee of debt accumulation which culminated in the GFC. While in previous cycles policy makers have been able to reflate growth through ever cheaper credit, this approach has reached its natural conclusion with zero interest rates failing to stimulate further credit expansion in this cycle.

Michael Lewitt, editor of the *The Credit Strategist* put it this way "the world appears to have reached a tipping point at which the global economy lacks the productive capacity to service and repay its \$100 trillion of collective debt. The problem is simple, too much debt and not enough growth to repay it".

We have discussed previously how supply side factors relating to demographics, productivity and government policy are restraining growth in advanced economies. An alternate theory considers the excess of global savings over investment demand, explaining why inflation, growth and interest rates are so low. Rising capital efficiency in recent decades has made the capital stock progressively more efficient i.e less investment is needed to generate incremental production resulting in surplus savings. Globalisation has also resulted in a transfer of labour's share of national income to corporate profits which are by definition part of the savings pool.

Last year excess savings in the G7 accounted for 9% of GDP, equivalent to three trillion dollars. In China, a key contributor to the savings glut, the non-government sector has excess savings worth 10% of GDP or \$US 1.1 trillion. Stagnation in Europe has seen the regions investment share of GDP fall sharply. High unemployment and large current account surpluses (expected to reach \$500 billion this year) are a clear sign of the same problem - an excess of savings over investment opportunities.



Whether the demand shortfall besetting the global economy is due to excessive debt or supply side factors is unclear. The underlying forces appear pervasive and suggest soft growth, deflation and record low interest rates are with us for some considerable time.

Turning to the outlook for the Australian Economy, we expect 2015 to be a challenging year. Household income growth has been soft for some time and the full impact of the fall in mining investment is still to come. While the housing expansion has been a countervailing force, as activity in this sector is likely to peak this year, it will be less of a support in 2015. Fiscal consolidation will detract a further 1% from growth in the next two years as the government struggles to recover a \$30billion shortfall from lower income.

In summary, national income will grow only modestly through the balance of the 2015. Financial conditions will ease however with a lower Australian dollar providing relief to the export sector and lower interest rates helping consumers.

We would expect the sluggish growth trends of recent years to continue in 2015. As was the case last year however, weakness in the global economy is unlikely to trigger a crisis in capital markets as excess liquidity will continue to buttress asset values.

With equity valuations ranging between fair in the worst affected regions like Europe to full in the US, a combination of low growth and extended valuations will limit equity returns going forward.

### Australian Share Market Outlook

The **financial sector** benefited from low interest rates in 2014 as investors sought companies with strong free cash flow and dividends. However, regulatory risk remains high, especially for the banks.

We are cautious on the major banks given our view of increased regulatory uncertainty and subdued earnings growth. While credit growth for the sector is likely to stabilise around 6% in 2015 led by the strong housing cycle, we don't view this to be sustainable as it is close to its post-GFC peak. The banks will struggle to grow earnings in the current environment given profit growth in recent years has been coming principally from falling bad debt charges which have fallen to levels not seen in twenty years and are unlikely to fall much further.

While asset quality continues to be supported by very low interest rates and asset price inflation, there are significant patches of weakness across the economy. Although underwriting standards have generally been strong post-GFC, this situation can change quickly. The release of the Financial System Inquiry's Final Report reaffirmed our thesis that the major banks will be required to hold more capital and that regulatory uncertainty is building. Higher capital constraints will also encumber their ability to push dividend payouts further.

We are also cautious on General Insurance given competitive pressures in personal lines with challenger brands taking customers in motor and home insurance. Revenue growth will be harder to come by at a time when margins have peaked and premiums are softening. *Life Insurance* has undergone a period of high claims and lapses in recent years. These trends now appear to be abating with some revenue recovery likely in 2015.

We prefer the more defensive names amongst the *Wealth Managers* such as *IOOF Limited* and *AMP Limited* over those that are more dependent on a rising share market.

As long duration income yielding assets, the *Real Estate* sector has also benefited from falling bond yields. We expect operating fundamentals to remain challenging in the office, retail and industrial sectors. Our preference is for high quality diversified exposures within the sector such as *GPT* and *Goodman Group*.

**Cyclical Shares** exposed to a soft economy were broadly flat in 2014, however there was significant divergence across the group. Companies in Mining services languished along with their mining customers. As mining is also an integral part of the transport supply chain, transport companies have also struggled. Media companies moved lower along with advertising spend. On the positive side of the ledger, companies that are either trade exposed or have international operations, benefitted from the falling Australian dollar. Building Material companies tracked sideways as the housing cycle picked up pace and Paper & Packaging companies rallied as investors rotated into less volatile industries.

Shares in more cyclically exposed companies have fallen and in many cases now appear to be factoring in a downturn in the economy, which is a clear risk but not our base case. Media and Discretionary Retail are two sectors that have suffered the most from fragile business and consumer Confidence. We have taken advantage of the weakness in Nine Entertainment to build a position. Shares in Mining services have also fallen sharply and offer value in this unloved sector. We will outline the case for our investment in WorleyParsons Limited later in this report.

**Defensive Sectors** delivered strong returns in 2014, with falling bond yields again providing support. Market volatility picked up in the second half of the year further funnelling capital into defensive shares. Concerns around capital adequacy for the Australian banks along with falling commodity prices saw a further shift of funds out of these sectors and into the defensive parts of the market. Healthcare in particular did well. As one of the few truly international sectors in our share market, with a falling Australian dollar, these international businesses become more valuable in Australian dollars.

*Food and grocery retailers* underperformed through 2014 given concerns with discount retailers such as Aldi, who are taking market-share from the majors. Investors are concerned the large incumbents may

have to reduce margins to remain competitive as has occurred in the UK. The *Utilities* sector is dominated by *Origin Energy* and *AGL Limited*. Both companies are struggling with lower oil prices and excess generation capacity respectively.

In 2015 bond yields are likely to move even lower, and hence valuations in this sector will remain elevated. Problems in resources and banks along with concerns with the economic outlook will only provide further support for this very expensive sector.

The **Resources sector** had a horrid second half to 2014, finishing the year with five consecutive negative months. This performance largely mirrored that of the underlying commodity prices which were weighed down by weak demand, rising supply and a stronger US dollar.

As we move into 2015 there looks to be little respite ahead as supply growth is continuing in the face of lower prices. Low bond yields across developed markets are telling us demand, including demand for commodities, will be very soft in the medium term.

China is at the heart of the commodities downturn. Economic growth is slowing as well as shifting in favour of less commodities intensive growth. The Government continues to push through reforms to reduce overcapacity in heavy industries such as steel manufacturing and oil refining. China's property sector has reached a structural turning point, marked by oversupply and faltering investment demand. After a surprisingly strong 2013, a weakening property sector weighed on on Chinese materials demand through 2014. Notwithstanding policy support delivered thus far and to come this year, these measures can only help stabilise but not turn around the downshift.

We maintain a view that the Resources sector is in a

bear market. We continue to have a strong preference for base metals producers over companies mining bulk commodities.

## Performance Review

Conservative portfolio settings were maintained in the December quarter, with cash holdings for the Australian Leaders Fund averaging 78% of the Company's capital and rising to as much as 94% by the end of December. All portfolios lagged their respective benchmarks, against the backdrop of a broader share market advance of 2.6% for the quarter.

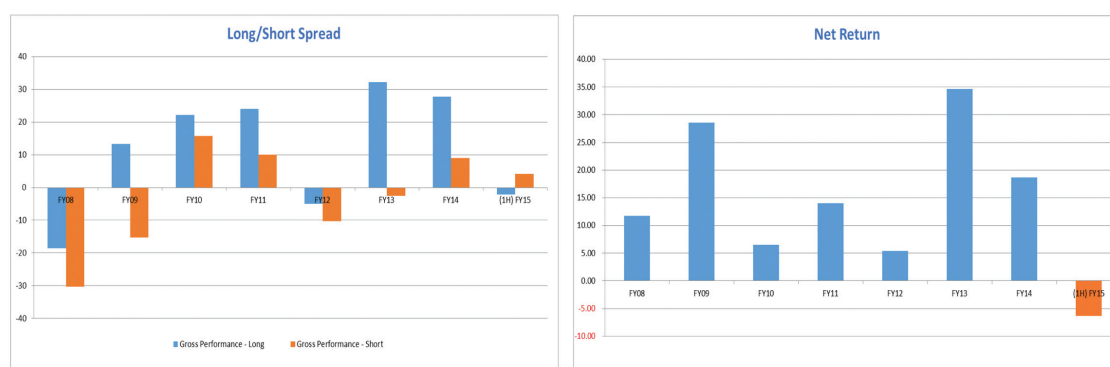
Portfolio performance was disappointing, particularly in respect of key investment objectives; to outperform the Australian share market and protect the value of the portfolios during periods of negative market returns. In relative terms, the short portfolio performed in line with the market, while the long portfolio significantly underperformed and was the source of disappointment.

Poor stock selection, particularly in the long portfolio has accounted for most of the under-performance across the funds. There have been a series of smaller failures, particularly in the financial services and mining sectors. While there have also been some success stories, we haven't been able to identify as many as we have in the past. As the market has become more and more dislocated around yield, we have stepped back from these parts of the market and the portfolio has not participated as these sectors have continued to move higher.

Notwithstanding the performance challenges we currently face, analysis of our long term track record depicted in Figure 3 below reveals how in each of the last seven financial years, we have achieved a positive gross return for our shareholders.

Analysis of Watermark Market Neutral Fund Portfolio Returns

FIG 3



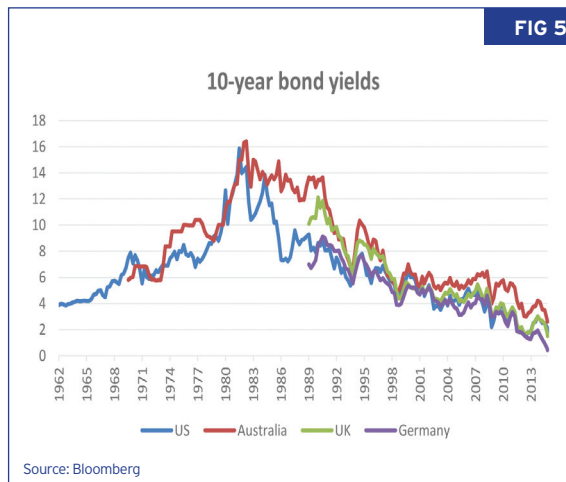
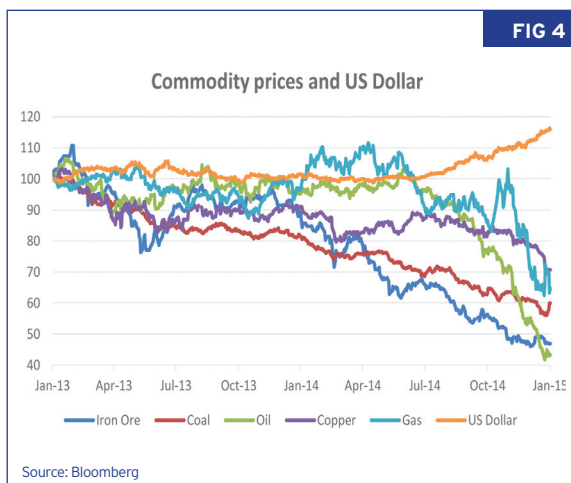
While long/short strategies may at times appear complex, they are actually very simple. When the funds are fully hedged, as they currently are, investors benefit to the extent the long portfolio of shares we like, outperform the short portfolio of shares we don't like (blue and orange bars in Fig 3) irrespective of what the share market does. The funds' gross return is simply the spread between these two bars as shown by the blue bar in the right hand panel of Fig 3. This has been a remarkably stable and reliable strategy until recently. While there has been volatility, it has all been upside volatility with no material draw downs. Every year we have been successful at picking a portfolio of winning shares that have outperformed our short portfolio of losing shares, except for the last six months. While this year is clearly a disappointing break from the past we were due for a setback at some stage and this is clearly our Annus horribilis. We look forward to returning to our historic form, hopefully in the near future.

commodities we need look no further than long term government bond yields which should in theory reflect expectations of long run nominal growth. With yields of between 0.3% and 2.5% for advanced economies seen in Fig 5, bond markets are telling us the demand outlook has never looked so weak.

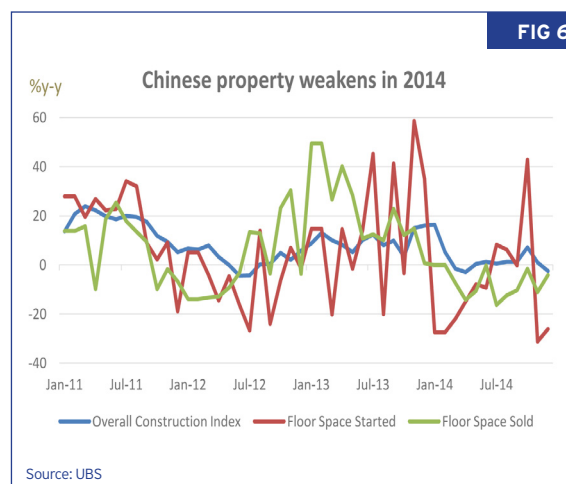
### Feature Piece: What is behind the collapse in commodity prices

Commodity prices suffered precipitous falls across the board during the second half of 2014. Bulk commodities, base metals, hydrocarbons and soft commodities all saw lower prices at the close of the year. While the fundamentals are clear for the oversupplied markets of iron ore and oil, contagion has taken hold as investors rush for the exit.

Commodity markets are quite simple, the market clears at a price where demand meets supply. While the supply side is vastly different for each of these individual commodities, demand is universally weak. To gain an understanding of the current malaise in



While demand across developed markets has continued to be quite soft post the GFC, emerging markets have picked up the slack. However, China is now at the epicentre of the downturn in commodities, as growth slows and the focus shifts away from commodity intensive investment. The Chinese leadership continues to push through reforms to reduce overcapacity in heavy industries such as steel manufacturing and oil refining, adding to demand softness.



China's property sector has reached a structural turning point also, marked by housing oversupply and faltering investment demand. After a surprisingly strong year in 2013, a weakening property sector weighed on Chinese demand throughout 2014. While

recent policy support from the central government and the PBOC is helpful, these measures will only stabilise but not turn around the slump.

As you can see in Fig 4, the US Dollar has strengthened in response to the divergent economic trends noted earlier in this report at the expense of commodities prices which have fallen. As most commodities are priced in US dollars but produced elsewhere, production costs will fall as the dollar rises, leading to downward pressure commodity prices. The rout in commodity prices is an extension of the US dollars' ascendancy.

We have discussed at length the outlook for Australia's key export commodities: iron ore, coal and gold in recent editions of The Leading Edge. In this issue we focus on oil and LNG - soon to be Australia's largest export.

### Oil price collapse has complex origins and universal implications

After nearly four years of price stability, the price of a barrel of oil has been in freefall since August last year. Where global oil demand of 92 odd million barrels of oil a day (mbpd) has been growing consistently at close to 1.5 million barrels, growth has slumped to half this rate (less than 1%) while supply growth has surged with the advent of new unconventional extraction techniques. This imbalance has left storage facilities filled to capacity, new investment curtailed and spot prices tumbling as the market searches for a bottom.

However, this supply and demand juncture is not a recent phenomenon as the falling price of oil may suggest - this crisis been brewing for some time. Demand has recovered only sluggishly since the financial crisis, but the US supply from conventional and unconventional sources has steadily increased for a number of years. So we must ask the question - why did prices not fall earlier?

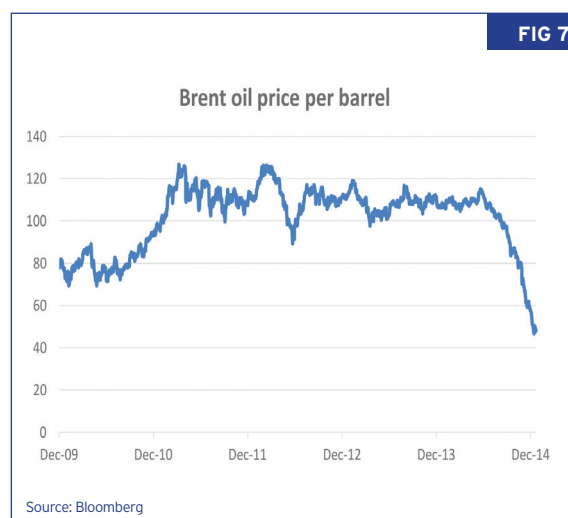
### No longer a managed market - Saudi Arabia takes a position

Saudi Arabia is far and away the largest oil producer in OPEC at nearly 10 mbpd. As such, the kingdom has a great deal of power and responsibility at the table in determining production levels. From the beginning of 2011, right up until the end of last year the OPEC heavyweight acted as a "traffic officer", with its output flexing up and down to meet global demand. 2011-2014 was a period of intense geopolitical upheaval

in the Middle East that saw erratic oil production from countries such as Libya, Iraq and Iran due to war, insurgency and sanctions. The Saudis played the officer role exceptionally well, keeping prices stable in a very narrow band at \$100-120 per barrel. However, the Saudi's were the only nation reducing production and it quickly became clear that to maintain those prices they would need to cede significant market share.

Let us assume that Saudi Arabia continued their strategy of balancing the market to maintain prices. With surging growth from US shale producers and increasing supply from traditional sources, Saudi production would have needed to decline by 40% over the next 3-4 years, or some 4mbpd to balance the market. This would have had two major implications for the kingdom. Firstly, extracting 40% less oil translates to 40% less revenue should the price have remained the same. Secondly and more importantly, this major decline in production and global market share would diminish their international importance and influence. A prescient example of this can be seen with Iran who in recent years became irrelevant as sanctions were placed on the nation due to its nuclear program - a massive downgrade for OPEC's one-time second largest producer.

Late last year when production from a more stable Libya rose from 300kbpd to 1mbpd, the Saudis did not curb production but actually increased supply by 150kbpd. Opening the pipelines gave the market a signal of their intentions and the price began to fall accordingly, and quickly - perhaps even faster than Saudi Arabia had expected.



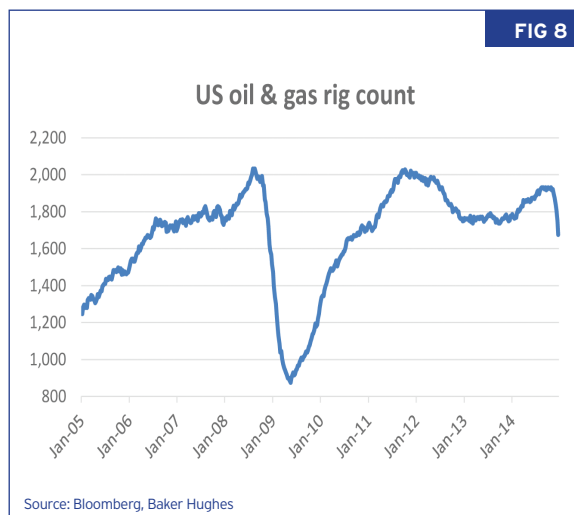
The Saudi's have clearly made a stand to protect their position. They feel the responsibility for balancing the



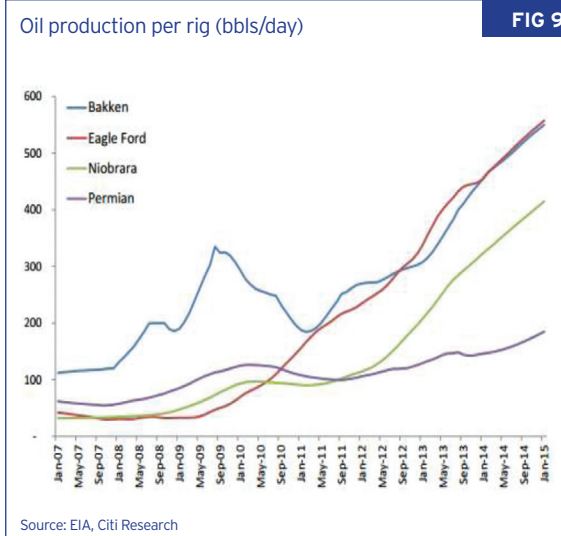
market should be shared by all producers – both inside and outside of OPEC. However, it was obvious that no one else was willing cut production. Hence, production cuts would be forced on high cost producers.

### Unconventional shale oil bonanza rattles the established order

Firmly in the Saudi's sights are the unconventional shale oil producers in the United States. The economics for producing a barrel of oil from shale is vastly different to conventional reservoirs. In a conventional oil field, large sums of capital are invested up front to develop the project, but once this money has been spent, the ongoing operating costs are very low. To develop an unconventional field, hundreds of wells are drilled incrementally with every well essentially requiring a discrete investment decision. If the price is not high enough, less economic wells will not be drilled. Due to the high decline rates of these wells, production should begin to drop quite quickly. While a decline in investment from US shale is inevitable, it will not happen straight away as drilling rigs are contracted for up to a year in advance and most operators have hedging in place protecting them from the full impact of lower prices. Figure 8 shows how the number of rigs deployed have only just begun to fall, but this is just the beginning, many more will be parked up in months to come.

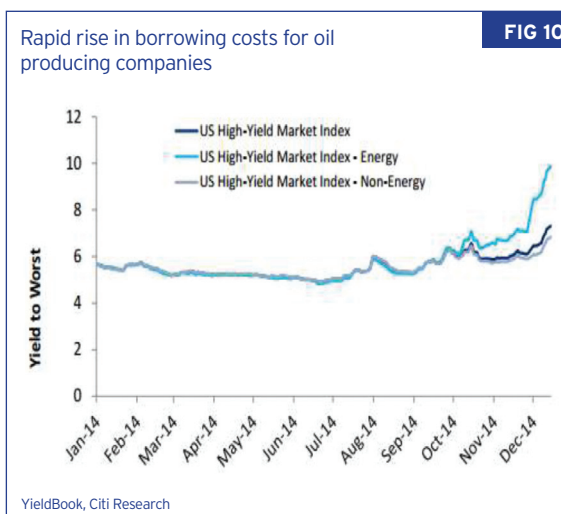


Tight oil or shale production is still in its infancy. Technological innovation within the industry has been rapid and will continue to develop at pace. Productivity growth reduces costs and increases output, making shale more competitive as seen in Fig 9. With their survival at stake, these companies are driving down costs at a rapid rate.



US shale production is like a ladder. Towards the top, the “sweet spots” in the more productive fields will still be economic even at \$30/barrel, while as we move further down the rungs, marginal fields drop out even as the oil price moves below \$80/barrel.

One factor that may accelerate the decline in investment for all players is the level of indebtedness across the industry. Investors searching for yield have thrown capital at the sector on the promise of high returns when oil was over \$100/barrel. Many of these projects are now uneconomic at current prices. With yields on these debt securities blowing out, many of these companies have lost access to debt markets. Fig 10. Shale oil companies will need to refocus their attention on servicing outstanding debt, while cutting back on drilling and development. The impact of lower oil prices and higher borrowing costs have only just begun to affect the market and we are watching closely for defaults.



## Where to from here?

Despite these clear and obvious short-term challenges, the medium to long term outlook for oil remains robust. Unlike other extractive industries such as coal and iron ore, where high quality mines contain over 100 years of reserves, oil reservoirs suffer ongoing depletion. From the moment a new field begins production, oil companies work hard (and spend a lot) to maintain this level of output. This can be seen in the International Energy Agency (IEA) oil production outlook below. Production from existing fields currently at 67 mbpd will fall by at least a third to 43 mbpd in the next decade. This significant fall in global output will have to be replaced by reserves yet to be developed and oilfields in new frontiers such as deep water and tar sands.

World oil production by type

FIG 11

	1990	2013	2020	2025	2030	2035	2040	2013-2040	
								Delta	CAAGR*
<b>Conventional</b>	65.2	81.1	82.6	83.8	84.1	84.2	84.6	3.4	0.2%
Crude oil	59.6	68.6	68.0	68.4	67.8	67.0	66.4	-2.3	-0.1%
Existing fields	58.6	67.3	52.8	43.0	35.1	29.1	22.9	-44.3	-3.9%
Yet to be developed	-	-	13.2	17.4	18.7	19.3	21.3	21.3	n.a.
Yet to be found	-	-	0.5	5.5	10.3	13.8	16.4	16.4	n.a.
Enhanced oil recovery	1.0	1.4	1.6	2.4	3.6	4.8	5.8	4.4	5.5%
Natural gas liquids	5.6	12.5	14.6	15.4	16.4	17.2	18.2	5.7	1.4%
<b>Unconventional</b>	0.4	6.1	10.8	12.6	14.3	15.6	16.2	10.0	3.6%
Tight oil	-	2.9	5.5	6.2	6.6	6.4	5.4	2.5	2.3%
<b>Total</b>	65.6	87.3	93.4	96.4	98.4	99.8	100.7	13.4	0.5%

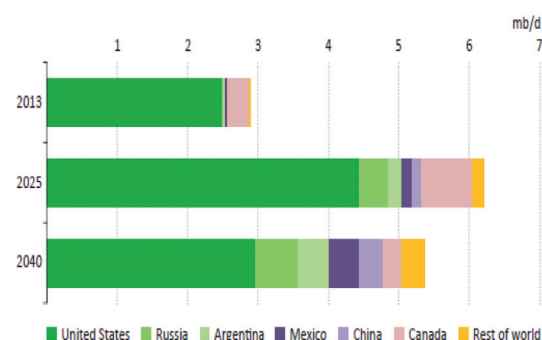
Source: IEA World Energy Outlook 2014

Most of these undeveloped resources would be uneconomic below \$50/barrel. This is why the forward curve for oil is in contango, with prices expected to rise over the next three years to incentivise this development. However, shale production has altered the medium term outlook. Just as shale oil companies are able to withhold production when the price signal falls, it is relatively easy for producers to ramp up production again. Therefore, should the price rise back to \$80/barrel, US oil production will quickly begin to increase again. This essentially caps the price in the medium term.

It is important to note that shale oil reserves, especially the high quality basins, are not an infinite resource. Even in a high oil price environment, US tight oil production was expected to peak by the middle of the next decade, declining thereafter as basins are exhausted. As this production ceases to grow, the market will require more output from alternative and more marginal sources such as deep water and Canadian oil sands, again supporting a higher longer term price.

Forecast tight oil production by country

FIG 12



Source: IEA World Energy Outlook 2014

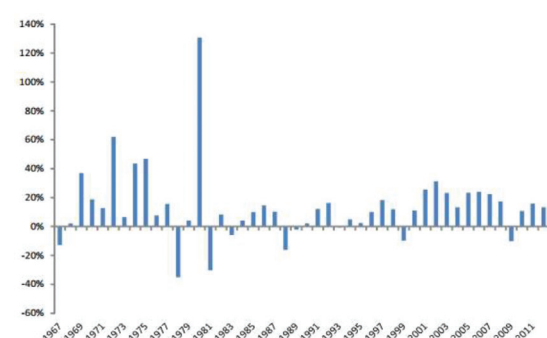
## Investment opportunities in the pipeline- WorleyParsons Limited

While the large oil producers with long life assets have fared reasonably well through the rout, engineering services company WorleyParsons has not been so fortunate, with its share price tumbling by 50% in the last six months. We believe this has created an opportunity to invest in a high quality business on attractive terms.

As we outlined above, depletion and decline rates are a challenging feature of oil reservoirs. A consistent level of investment is required to maintain output and meet ongoing demand. Over time this has led to a relatively stable level of capital spend within the industry. Fig 13 shows that sustained reductions in capital outlay are extremely rare. The current cycle has seen a dramatic fall in the oil price following a period of high investment spend by many oil companies. We expect to see a significant fall in capex over the next two years, but beyond that investment levels will stabilise and rise as new oil fields are developed to meet global demand.

Upstream hydrocarbons capex

FIG 13

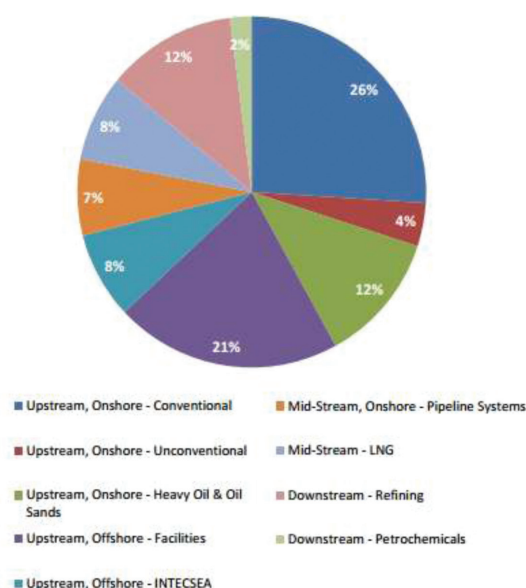


Source: Rystad Energy, Morgan Stanley Research

WorleyParsons has grown and developed over time to be diversified both in terms of its hydrocarbons exposure and its global reach. The services business is not purely exposed to oil field development and earnings from construction and engineering but also offers consultancy and advisory services. This broad scope of skills will lead the company through the dry patch as downstream and midstream investment continues to be required within the industry.

WorleyParsons diversified hydrocarbons exposure

FIG 14



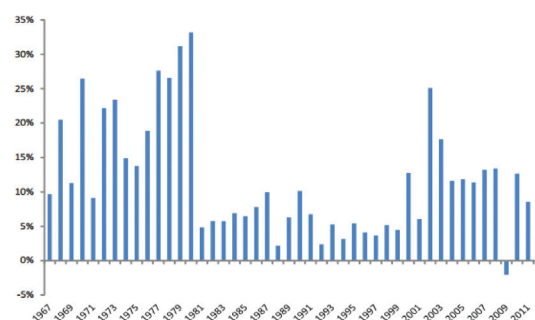
Source: Company data, Morgan Stanley Research

An attractive feature of WorleyParsons' portfolio is its exposure to maintenance capex, which can be as much as 50% of what the majors spend. This expenditure is far less volatile than development capex and the chart below shows only one reduction in the last 50 years. This ongoing investment is critically important to oil companies as they look to sustain output levels. An increase in decline rates of 1-2% globally would take 1mbpd of oil off the market in one year, balancing the market. Hence we believe that even if this spend was reduced, it would be transitory with significant production impacts.

WorleyParsons has developed a strong presence in many regions outside of Australia. In the 2014 financial year, Australia and New Zealand accounted for only 17% of aggregated revenue - 83% was earned outside the region. The decline in the Australian dollar against all currencies will benefit the reported earnings of the

Upstream opex

FIG 15



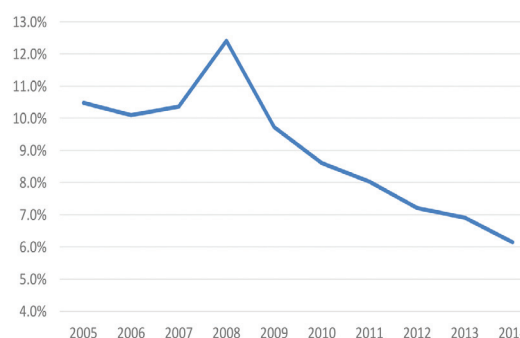
Source: Rystad Energy

company, and with experts predicting the dollar could fall as low as 75 US cents in 2015, the bottom line will be further supported.

Company specific issues have created a drag on economic performance for a number of years. The business grew very quickly over a short period and the management structure became overly complex, adding unnecessary costs. A major restructure occurred last year, just before the collapse in the oil price. The reshuffle has removed significant overheads and costs at a time when the company will need to be at its most competitive.

FIG 16

WorleyParsons EBIT margin



Source: Company data, Watermark Funds Management

Despite the clear headwinds facing the company and the industry in general, we believe these are more than priced in and that WorleyParsons is attractively priced. The business is highly cash generative with a strong balance sheet. A flexible cost structure should see a level of earnings protection. While the next few years will be difficult, the market in which WorleyParsons operates is attractive in the longer term.

# Fund Snapshot

31 December 2014



## Net Tangible Asset (NTA) Backing

Month	November 2014	December 2014
NTA before tax on unrealised gains	\$1.32	\$1.29
NTA after tax	\$1.32	\$1.31

## Performance (Net of all Fees and Expenses)

Period	S&P/ASX All Ordinaries Accum. Index	Net Equity Exposure	Contribution Market <sup>1</sup>	Security Selection <sup>2</sup>	ALF (net returns)
1 Mth	1.9%	16.7%	0.3%	-1.4%	-1.1%
6 Mths	2.3%	22.4%	0.3%	-9.5%	-9.2%
Fin. YTD	2.3%	22.4%	0.3%	-9.5%	-9.2%
1 Yr	5.0%	31.1%	1.3%	-4.4%	-3.2%
3 Yrs p.a.	14.3%	42.5%	5.7%	12.9%	+18.6%
5 Yrs p.a.	6.4%	57.4%	1.9%	8.3%	+10.2%
Since Inception p.a.	9.1%	-	-	-	+14.2%

<sup>1</sup> The "Market" column displays the contribution to return achieved in the period from the Fund's exposure to the share market weighted on a monthly basis. Due to timing differences, the contribution is not necessarily the same as the average equity exposure for the period multiplied by the market return.

<sup>2</sup> All fees and expenses are netted off against stock selection

## Net Equity Exposure



## Monthly Net Returns

Cal. Yr.	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2004		0.40	1.40	0.21	-0.05	2.25	1.08	-0.32	4.59	2.83	4.43	2.39
2005	0.25	1.27	-0.95	-6.11	-0.36	4.84	2.02	2.69	4.79	-3.02	3.85	3.74
2006	1.52	1.96	6.39	2.94	-2.11	1.35	-3.19	4.35	1.68	7.25	2.83	2.52
2007	3.09	-1.61	3.55	1.15	2.67	2.03	-1.03	3.43	3.33	1.05	-0.30	-1.90
2008	-11.5	-8.37	1.36	4.40	1.48	-7.16	-1.31	5.14	-5.43	-16.3	-6.62	2.97
2009	2.23	2.88	16.03	6.65	7.89	7.00	9.18	12.36	6.54	-0.65	0.81	0.12
2010	-3.45	2.23	4.21	-2.06	-7.07	-2.29	2.82	-3.86	2.33	0.00	2.67	12.01
2011	1.95	1.93	3.61	1.67	-1.76	-1.75	-4.11	-6.84	-8.40	6.45	-1.49	0.86
2012	4.88	4.74	3.26	1.20	-2.36	0.73	3.72	3.62	0.26	-1.30	6.54	3.43
2013	3.41	1.64	2.96	2.74	0.51	2.23	3.81	3.46	2.79	3.96	-0.63	-0.03
2014	-0.22	4.04	-1.37	2.64	1.18	0.33	-3.63	-2.38	1.30	-1.26	-2.53	-1.10

## Australian Leaders Fund

ASX Code	ALF
Listed	Feb 2004
Capital	\$326.9m
Market capitalisation	\$364.3m
Share price	\$1.43
NTA before tax	\$1.29
Shares on issue	254.8m
Fully franked dividend (FY14)	6.0¢
Dividend yield (fully franked)	8.4%

## Company Overview

The Australian Leaders Fund (ALF) is a listed investment company, comprising a portfolio of publicly traded Australian shares. As a Long/Short Equity fund the manager looks to take advantage of mispricing opportunities across the full breadth of the share market. As a 'variable beta' fund at any point in the investment cycle the fund may be fully invested, market neutral or short the market depending on the market outlook. Watermark aims to add value through both security selection and the hedging of share market risks. It is the Board's intention to try and deliver to shareholders a consistent and growing stream of fully franked dividends over time.

## Investment Strategy

The primary goal of the investment process is the identification of mispriced securities. The manager looks to buy the shares of good companies on occasions when they are undervalued by the share market. ALF is different to other funds however, in also selling short the shares of businesses that are fundamentally challenged, where these shares can be sold for more than they are worth. Proceeds raised from selling these shares are an additional source of funds for the company's balance sheet. These funds can either be retained in cash as a hedge for the fund's assets, or re-invested in the shares that the manager prefers. By adjusting the relative size of the 'long' and 'short' portfolios and the degree of hedging in place, the manager can set the amount of market risk (beta) retained in the fund.

## Investment & Management Team

### Justin Braithling

Chief Investment Officer/  
Portfolio Manager

### Tom Richardson, CFA

Senior Investment Analyst

### Joshua Ross

Investment Analyst

### Omkar Joshi, CFA

Investment Analyst

### Delian Entchev

Investment Analyst

### Tim Bolger

COO & Head of Distribution

### Shannon Wells

Office Manager



# Fund Snapshot

31 December 2014



## Net Tangible Asset (NTA) Backing

Month	November 2014	December 2014
NTA before tax on unrealised gains	\$0.96	\$0.95
NTA after tax	\$0.97	\$0.96

## Performance (Net of all Fees and Expenses)

Performance at 31 December 2014	1 Mth	6 Mths	Fin. YTD	1 Yr	3 Yrs %pa	5 Yrs %pa	Since Inception %pa
WMK (net return)	-1.1%	-7.5%	-7.5%	-1.8%	N/A	N/A	2.4%
RBA Cash Rate	0.2%	1.3%	1.3%	2.5%	N/A	N/A	2.5%
Outperformance (net)	-1.3%	-8.8%	-8.8%	-4.3%	N/A	N/A	-0.1%

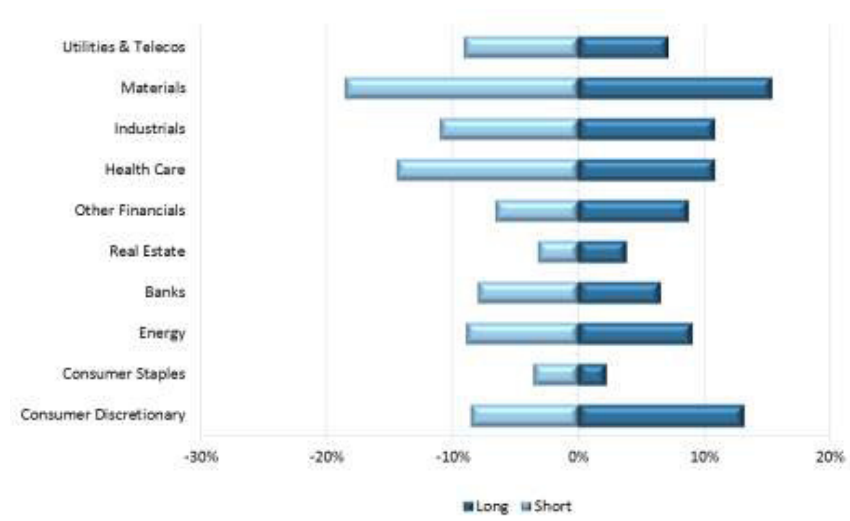
## Monthly Net Returns

Cal. Yr.	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2013							1.32	1.59	0.38	1.58	0.63	-0.14
2014	1.64	1.14	-1.39	2.69	1.20	0.82	-4.22	-1.97	2.98	-1.87	-1.44	-1.12

## Gross Portfolio Structure

Investment Type	30 November 2014		31 December 2014	
	\$m	%	\$m	%
Listed Securities - Long	88	105%	72	87%
Listed Securities - Short	-83	-99%	-77	-93%
Net Exposure	5	6%	-5	-6%
Cash	79	94%	88	106%
Capital	84	100%	83	100%

## Sector Exposures



## Watermark Market Neutral Fund

ASX Code	WMK
Listed	Jul 2013
Capital	\$83.1m
Market capitalisation	\$77.9m
Share price	\$0.89
NTA before tax	\$0.95
Shares on issue	87.5m
Fully franked dividend (FY14)	5.0¢
Dividend yield (fully franked)	5.6%

## Company Overview

The Watermark Market Neutral Fund (WMK) is a listed investment company that invests predominantly in Australian shares. The fund will maintain a market neutral structure with no greater than 10% of the company's assets exposed to the share market on a net basis at any one time. It is the Board's intention to try and deliver to shareholders a consistent and growing stream of fully franked dividends over time.

## Investment Strategy

The primary goal of the investment process is the identification of mispriced securities. In a market neutral strategy the manager constructs two portfolios: a "long" portfolio of preferred shares and a "short" portfolio of less preferred shares. As the portfolios are roughly of equal size, this is a fully hedged structure aiming to minimise exposure to market movements. The fund profits to the extent the long portfolio outperforms the short portfolio plus the interest received on the fund's capital which is retained in cash.

## Investment & Management Team

**Justin Braithling**  
Chief Investment Officer/  
Portfolio Manager

**Tom Richardson, CFA**  
Senior Investment Analyst

**Joshua Ross**  
Investment Analyst

**Omkar Joshi, CFA**  
Investment Analyst

**Delian Entchev**  
Investment Analyst

**Tim Bolger**  
COO & Head of Distribution

**Shannon Wells**  
Office Manager

# Fund Snapshot

31 December 2014



## Net Asset Value (NAV)

Month	November 2014	December 2014
NAV per unit	\$1.2352	\$1.2189
Increase/Decrease	-1.58%	1.32%

## Performance (Net of all Fees and Expenses)

Performance at 31 December 2014	1 Mth	6 Mths	Fin. YTD	1 Yr	3 Yrs %pa	5 Yrs %pa	Since Inception %pa
WARF (net return)	-1.32%	-7.95%	-7.95%	-1.51%	15.71%	11.49%	13.98%
RBA Cash Rate	0.21%	1.27%	1.27%	2.53%	3.02%	3.66%	4.38%
Outperformance (net)	-1.53%	-9.22%	-9.22%	-4.04%	12.69%	7.83%	9.60%

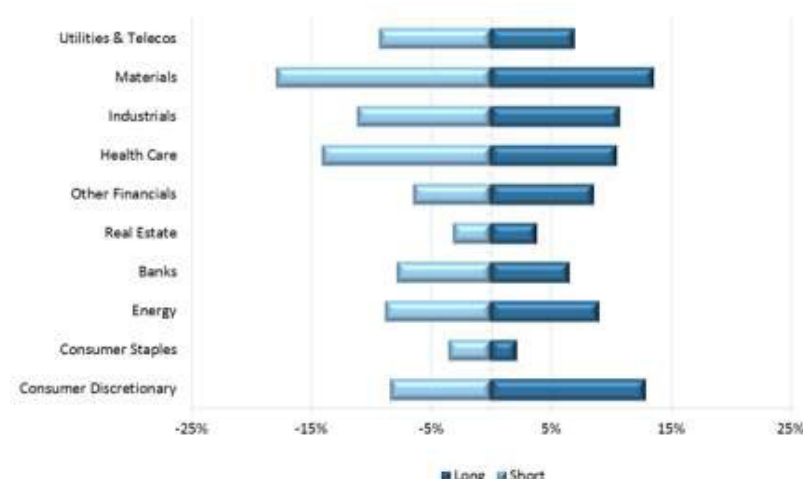
## Monthly Net Returns

Cal. Yr.	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2012	-	-	-	-	-	-	-	1.36	0.97	0.00	6.51	2.88
2013	-0.71	0.21	4.60	1.55	5.83	5.31	1.11	2.57	1.43	1.86	0.35	-0.06
2014	1.71	1.45	-1.17	2.80	1.21	0.84	-4.38	-1.77	2.52	-1.57	-1.58	-1.32

## Gross Portfolio Structure

Investment Type	30 November 2014		31 December 2014	
	\$m	%	\$m	%
Listed Securities - Long	40.9	101.7	33.6	83.7
Listed Securities - Short	-39.2	-97.5	-36.8	-91.6
Net Exposure	1.7	4.2	-3.1	-7.8
Cash	38.5	95.8	43.3	107.8
Capital	40.2	100	40.2	100

## Sector Exposures



## Watermark Absolute Return Fund

Firm Assets	\$450m
Fund Assets	\$40.2m
Inception Date	Aug 2012
Strategy	Equity Market Neutral
Fund Domicile	Australia
NAV per unit	\$1.235
Redemptions	Daily
Management fee	1.5%
Performance fee	20%
Benchmark	RBA Cash Rate

## Fund Overview

The Watermark Absolute Return Fund (WARF) invests predominantly in Australian shares. The fund will maintain a market neutral structure with no greater than 10% of the company's capital exposed to the share market on a net basis at any one time. The Fund's objective is to increase the value of your investment over the long term via capital growth and income while minimising your exposure to market volatility.

## Investment Strategy

The primary goal of the investment process is the identification of mispriced securities. In a market neutral strategy the manager constructs two portfolios: a "long" portfolio of preferred shares and a "short" portfolio of less preferred shares. As the portfolios are roughly of equal size, this is a fully hedged structure aiming to minimise exposure to market movements. The fund profits to the extent the long portfolio outperforms the short portfolio plus the interest received on the fund's capital which is retained in cash.

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