



WATERMARK
FUNDS MANAGEMENT

The Leading Edge

QUARTERLY REPORT | **September 2014**

Are low interest rates creating asset bubbles?

In this edition of the Leading Edge we consider the risks of asset bubbles forming and look at how we can mitigate these risk through hedging.



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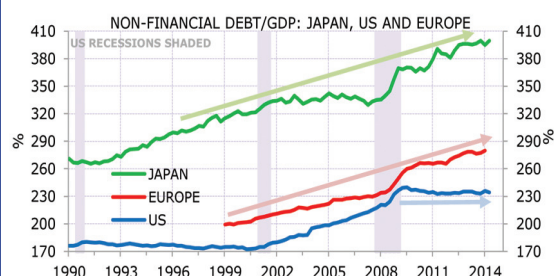
Justin Braiting
Portfolio Manager

Chief Investment Officer's Report

Weak economic growth persists across Advanced Economies six years on from the financial crisis. As time passes it is becoming clearer this is the new normal for the developed world as the balance sheet recession continues - little real progress has been made on the deleveraging front outside of the US where debt levels have stabilised (Fig1).

Debt levels have deteriorated further

FIG 1



Source: Minack Advisors

While policy makers have gone to extraordinary lengths to stimulate demand, the problem is a less well known supply side phenomenon. Falling workforce participation, an aging capital stock and weak productivity has left the OECD with structurally lower growth. High indebtedness along with anaemic growth in productive capacity points to a protracted period of weaker growth ahead - this is most evident in Europe and Japan.

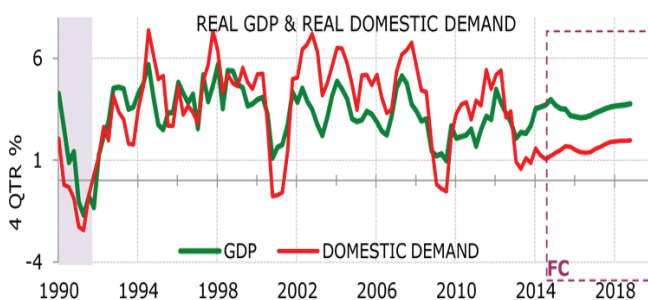
A simple analysis of the US labour market reveals some of the challenges that lie ahead. Unemployment

has plummeted from 10% three years ago to 6% currently while growth has barely edged above 2% p.a. Even with a soft demand backdrop, the output gap is closing rapidly because of supply side constraints. Policymakers will have to consider tightening financial conditions even with growth tracking well short of historic levels. This development played out in the response to September US Federal Reserve FOMC meeting, where financial markets were spooked as the Fed lowered its growth outlook while simultaneously raising forward interest rate guidance.

What does this mean for shares, with softer growth to continue and interest rates set to rise? It means we are well past the sweet spot in the cycle for shares, as monetary policy is now set to tighten even though the recovery is not self-sustaining. In a normal business cycle, as interest rates fall, shares appreciate relative to underlying profits (P/E expansion). As interest rates rise, this will reverse and we should see P/E's compress. In a normal cycle this 'de-rating' would be more than offset by strong profit growth as the business cycle matures. However, given our sluggish economic outlook we suspect it will be harder for shares to advance far from here as investors anticipate a tightening of policy and growth is not strong enough to propel profits higher.

While we are seeing many of these same supply side pressures here in Australia, we do have the benefit of strong population growth. With the mining boom behind us, we are now dealing with its legacy as Australia has become a high cost destination for business. A further drag on national income from falling commodity prices along with lower investment spending will weigh on domestic demand in the medium term. Production measures of growth (GDP) will exceed domestic income as export volumes from mining investment start to deliver. It is domestic demand (excluding exports) that counts for the share market however, and these measures of demand will be a lot weaker as shown by Fig2.

FIG 2



While our base case is for soft growth in the medium term, there is a clear risk of a downturn at some stage given the headwinds we face and the challenges abroad.

Most listed companies released their full year results in August and profits came in more or less in line with expectations. While in recent years results have been disappointing, falling short of lofty expectations - after years of disappointment, analysts have lowered growth forecasts to reflect the more challenging environment. Industrial companies reported a modest 3% increase in profits. On removing companies exposed to the weaker mining sector, profit growth increased to a more respectable 7%. There was a clear divergence between "domestic" companies where trading was soft and "international" companies where growth was stronger. Looking to the year ahead, with weakness in the domestic economy set to continue, a disproportionate share of profit growth will continue to come from companies that have successfully expanded offshore. These offshore earnings will become all the more valuable if the Australian dollar falls further. Profit growth for bank shares has come largely from falling bad debt charges in recent years which look to have bottomed. With policy conditions set to tighten and regulators pushing banks to raise capital ratios, profit and dividend growth for the banking sector will be lower. Modest profit growth from industrial shares in the year ahead will be offset by further falls in mining profits as iron ore, coal and oil prices are falling precipitously.

Our overall view of the share market is largely unchanged. A combination of weak profit growth and extended valuations (Fig3) suggests there is little upside from here. At the same time risks remain elevated given high levels of indebtedness across the OECD. With monetary policy set to tighten, volatility which has been absent recently is likely to return.

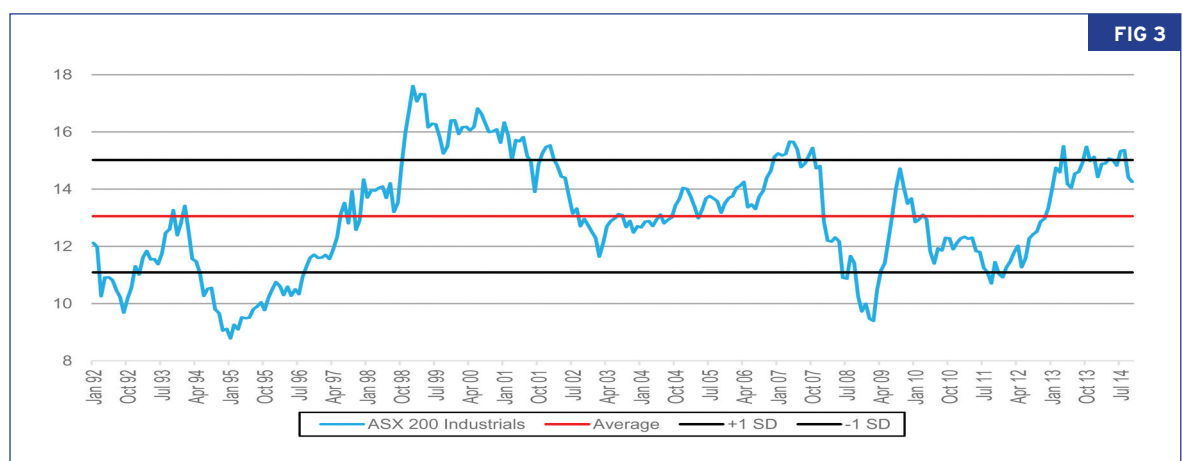
September Quarter in Review:

The September quarter saw divergence between global economies and share markets, characterised by continued momentum in the United States and a rapid softening in markets across the European Union. With the US Economy accelerating through the year following a weak first quarter, the US share market reached all-time highs in mid-September. The US Federal Reserve increased forward guidance on interest rates in September leading to a surge in the US dollar against other major currencies.

Weakness in European data returned, not just at the periphery but also in the core with softer German industrial production suggesting the recovery has stalled. Coupled with sharp falls in inflation, expectation of ECB intervention has increased, with the Central Bank openly talking of purchasing Greek and Cypriot bonds - a measure of how dire the situation has become. This uncertainty saw a sharp sell-off in most European share markets in the final weeks of the quarter.

On the domestic front, the quarter was a busy one for investors in shares, with the majority of listed companies reporting results for the 2014 financial year. Across the market, companies delivered earnings growth largely as forecast. With improved cash flow generation and stronger balance sheets, many companies were able to deliver dividend growth ahead of expectations, further nourishing investors' voracious appetite for yield.

Domestic shares were under considerable pressure as the quarter closed, largely on the back of offshore selling as investors exited Australian dollar assets. The two largest sectors felt the brunt of selling pressure with the Australian banks falling 7.7% and mining shares sliding on the back of weaker Chinese economic data.



Performance Review

Performance for the quarter was disappointing. Having enjoyed a prolonged period without a material draw down, the September quarter provided a reminder that while exposure to market movements can be effectively hedged, the random nature of markets will bring volatility to returns from time to time.

Despite our conservative portfolio settings in respect of market exposure, significant adverse movements in three core short positions during the month of July resulted in negative absolute returns for Watermark's funds.

August too proved a difficult month for portfolio returns, with negative attribution coming from both the long and short portfolios. Pleasingly, the portfolios fared better in September with weakness in the performance of the domestic share market vindicating our defensive portfolio settings. Some of the key shorts positions that cost us dearly in July also reversed in September. The companies we are selling short are often by their nature highly volatile. We are convinced these shares will move lower over time.

Portfolio Review

Shares in the Defensives sector were mixed through the quarter. Gaming was weak as a clamp down in China on corruption weighed heavily on Macau gaming revenues, hitting Crown Resorts through its exposure to Melco Crown. In contrast to the raft of mergers and acquisitions and high valuations for international slot-machine manufacturers, Ainsworth Gaming fell significantly as the market digested softer expectations for the 2015 year. Healthcare was the standout industry, a falling currency and strong results in August reinforced the growth qualities of the industry. Telecom was also strong as Telstra focused on capital management rewarding yield-hungry investors. Utilities, Infrastructure and Consumer Staples were largely unchanged for the period, while Food and Beverage was soft with Treasury Wine Estates dropping 15% after discussions with private equity ended.

The Financial sector was stronger over the quarter. The Banks were the weakest industry falling 3% in contrast to the broader sector which rose by 3%, led higher by general insurers who are benefiting from favourable trends in claims. The Banks came under pressure after the release of the Financial System Inquiry Interim Report (FSIIR). We maintain a cautious view on the major banks as bad debt charges are at cyclical lows and margin pressures are building. It is also clear in light of the FSIIR that regulatory

uncertainty remains high and further capital imposts are being considered. The recent reporting season has reaffirmed our thesis on the banks, with the Commonwealth Bank reporting a marginal increase in bad debt charges and flat net interest margins for the second half of the 2014 fiscal year.

During reporting season, the Wealth Management firms delivered results that were largely above or in line with expectations as capital inflows continued. The fund has short exposures in some of these companies given their full valuations and the uncertain outlook for the share market. As a result of the broader market sell-off in September, the Wealth Managers came under pressure.

Shares in the Resources sector were sharply lower through the quarter largely in response to falling commodity prices. The price of a tonne of iron ore dropped below \$80 as Chinese steel consumption fell for the first time since 2000. We have long maintained a strong preference for producers of industrial metals while avoiding the higher cost iron ore miners. The price of oil, gold and industrial metals all fell in the quarter as a rising US dollar impacted the commodities complex at a time when global demand is softening. The fund has a modest exposure to Gold Mining companies where we believe the medium term fundamentals are sound. While this position detracted from performance in the quarter, we used the volatility to add to our position. We will outline our investment case for gold in our feature article to follow. BHP Billiton announced a strong profit result; however a failure to implement capital management initiatives was received poorly and weighed on the share price. The resulting fall presented an attractive entry point and we accumulated a sizable position in the name.

Cyclical shares are challenged by a weak domestic economy. The one bright spot - residential construction is becoming overheated. In the RBA's semi-annual Financial Stability Review, the bank flagged "additional steps may be taken to reinforce sound lending practices, particularly to investors in housing." The fund has been short the shares of Building Materials companies for some time as valuations have become stretched. We have covered this position through the quarter on weakness. Cyclical shares were generally volatile through the quarter, rising strongly in July only to give back that performance in September. We increased our exposure to Mining Services having taken profits on a number of short positions. While these companies are facing headwinds, deep value has emerged in this unloved segment with the shares of some companies trading near salvage value.

Are Low Interest Rates Creating Asset Bubbles?

With unprecedented levels of liquidity support for asset markets, the debate rages as to whether ultra-low interest rates are creating asset bubbles which could undermine financial stability. The Bank for International Settlement (BIS) has been particularly vocal on this issue. Central banks in turn acknowledge their complicity in driving asset values higher as they try to raise demand via the “wealth effect”.

Hedging strategies such as those employed by Watermark offer advantages over traditional funds in managing these risks. Unlike a traditional fund, we are able to hedge our investments through short selling, reducing or eliminating our exposure to the underlying, industry, sector or asset class. The only way a traditional fund can circumvent these risks is to avoid investing in the asset class altogether.

There are always opportunities to capitalise on good investment ideas. We are able to pursue these opportunities while at the same time, laying off the risks associated with excessive valuations by short selling securities that we don't like in the same industry or sector.

Take gold for example. With the gold price having tripled over the last decade many think the precious metal is on a path back to where it has come from. Gold bulls on the other hand expect the gold price to move higher as central banks move away from sound money principals by printing money.

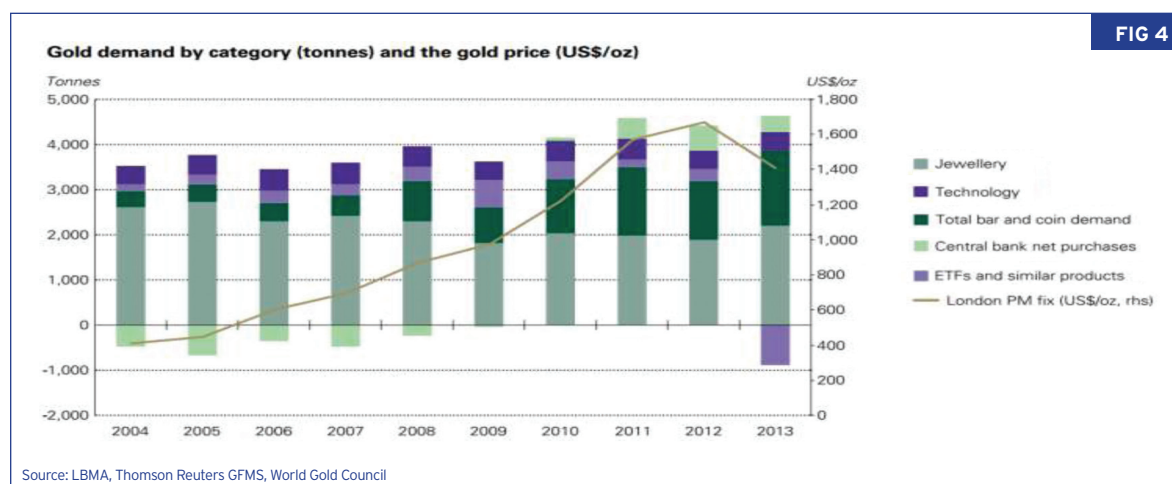
While we will outline the case for a higher gold price shortly, no one can say with conviction which way the price will go. The outcome is highly uncertain, and given this uncertainty, it is nearly impossible to separate the success of any investment in the gold sector from the gold price.

As a long-short investor we are able to manage these risks, buying gold companies we like while laying off the gold price risk by short selling gold companies we don't like in a fully hedged structure. Our exposure is to the individual companies and not to the gold price which has been hedged out of the equation. This can reduce overall risk, as we are able to hedge out the factor risk in the gold price which is highly uncertain while still being able to capitalise on the fundamental research we have completed on the Gold sector. In every industry, there are strong and weak players. We want to be able to capitalise on these differences without exposing our investors to factor risks that we are less clear about. We do think the gold price is likely to move higher in the medium term but the timing is highly uncertain. This strategy allows us to participate in the sector, and to capitalise on mispricing opportunities until such time as we are more confident in the price rising. We can then reduce the amount of hedging in place and increase the exposure to the underlying metal price.

In the section that follows we look at Gold, Technology and Bio-technology – three sectors many believe are either in asset bubbles or breaking down from past bubbles. We consider the opportunities in each sector and outline how we can employ hedging strategies to reduce the funds exposure to a correction in these sectors.

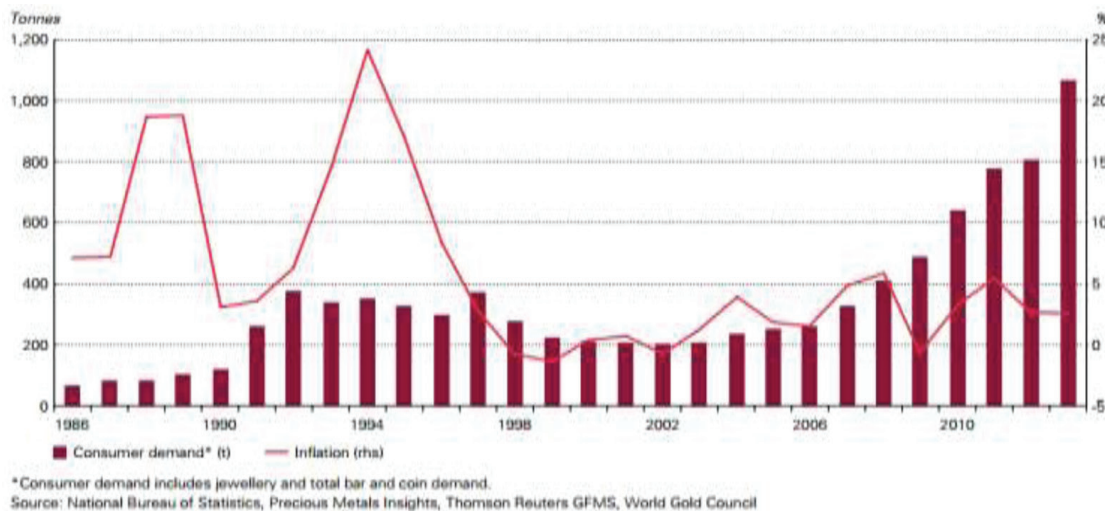
Has the Gold Bubble Burst?

The price of gold peaked at \$1,921/oz in September of 2011. It has since fallen over 30% to be roughly \$1,200/oz. Despite the high levels of volatility in the price of the commodity, we believe the underlying fundamentals for gold are sound (Fig4).



Chinese Gold Consumption

FIG 5

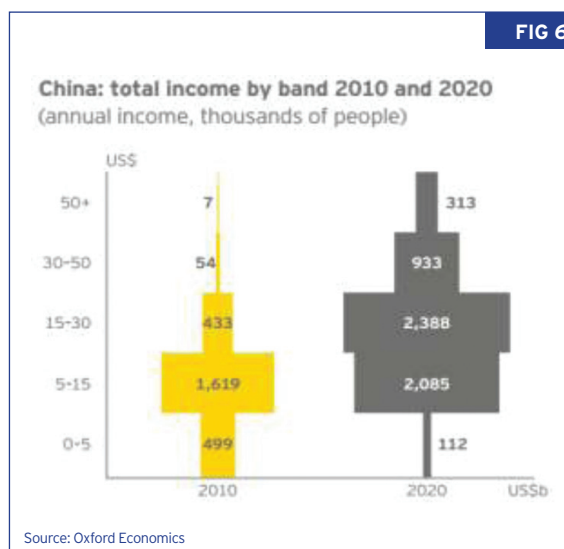


Consumer Demand - China and India Dominate

China has grown rapidly to be the world's largest consumer and producer of gold. Economic reforms that began in 1978 have seen the re-establishment of a gold market in China. In 2001 the People's Bank of China (PBoC) ceased setting a domestic price and the Shanghai Gold Exchange (SGE) was formed shortly thereafter. Liberalisation continued, and in 2004 private persons were permitted to own and trade bullion - the first time since 1950. This de-regulation has driven a rapid increase in demand (Fig5).

Constituting less than 8% of global jewellery demand in 2003, China has quickly become the dominant force accounting for over 30% of demand in 2013. It is important to note that this increase has occurred through a period of significant price appreciation, with the value of Chinese demand increasing 10 times over the last decade.

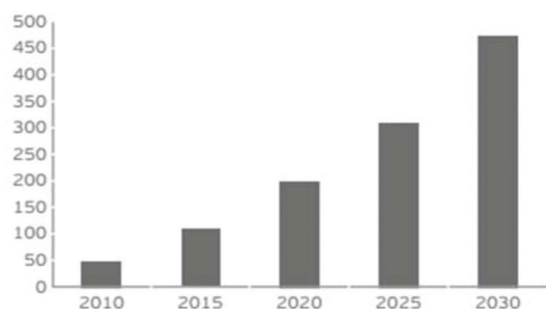
As we have written in prior editions of The Leading Edge, the Chinese economy is pivoting from being investment to consumption led. This is having a noticeable effect on many commodity markets as the demand for bulk materials begins to wane. Gold on the other hand is emerging as the preferred play on the growing Chinese middle class. As the middle class of China (defined as those households with incomes greater than RMB50,000) rapidly expands, the amount spent on non-essential items such as jewellery and luxury goods will rise (Fig6).



Chinese demand for jewellery has grown strongly over the last decade and 2013 was the first year it usurped India as the world's largest consumer. While India's insatiable demand for gold has moderated as the country struggles with lower growth and high inflation, this is set to change. The Bharatiya Janata Party (BJP) led by Narendra Modi recently secured an emphatic win at the Indian national elections with a clear mandate for change. With a strong reform mandate, India's growth will hopefully move back to its potential further supporting gold demand (Fig7).

India's global middle class (millions of people)

FIG 7



Source: IEMS

Supply Side - Rising Production Costs

The average cost of producing an ounce of gold has risen significantly over the last decade along with the cost of labour, energy and consumables. As can be seen in Fig8, mine production has increased by a mere 500 tonnes over the last five years to meet rising demand. This has come from high cost ounces drawn into the market through higher prices. With a 30% fall in the gold price, many of these operations are now unprofitable.

With lower prices the industry is investing less in new supply. The previously popular notion of “cash costs” is widely being replaced by “all-in sustaining costs”. New management at industry leaders Barrick Gold Corporation and AngloGold Ashanti are singularly focussed on cost reduction and capital management limiting new supply. Combined with a dearth of new discoveries, production is likely to decline in the medium term.

Wafi-Golpu, a Newcrest Mining project is the largest copper-gold discovery of recent years. However, in spite of the size of the resource, and its high grade, the project economics are marginal at current prices due to the large upfront capital requirement. As such development work has ceased and engineering alternatives are being contemplated. Ongoing grade declines across the industry are making it tougher to get new projects over the line.

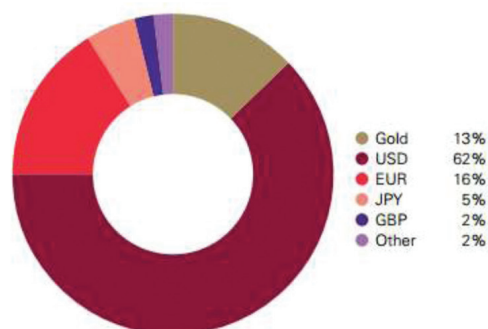
Investment Demand - Central Bank Diversification

Between 2000 and 2012, central banks globally shifted away from US dollar assets. The key beneficiaries of this rebalancing were euro-denominated assets, explaining the rise of the euro over this time. However euro allocations have plateaued following the European sovereign debt crisis.

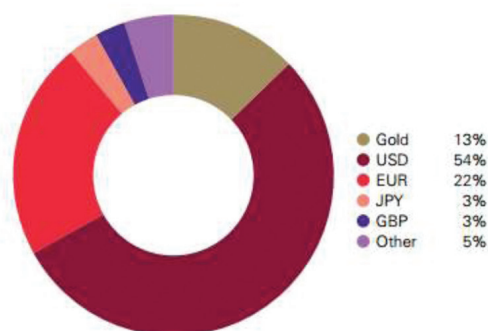
Central banks have pursued a more diverse asset allocation with the share of “other” currencies increasing from 2% to 5% over that decade. The Australian dollar, Canadian dollar and Chinese renminbi are the currencies emerging central banks are investing in. This demand has supported the Australian dollar causing ongoing challenges for our central bank and the economy (Fig9).

Breakdown of total official reserves (as of 2000 and 2012)

FIG 9



Note: Totals may not equal 100% due to rounding.



Source: IMF COFER statistics, Q2 2000 & 2012

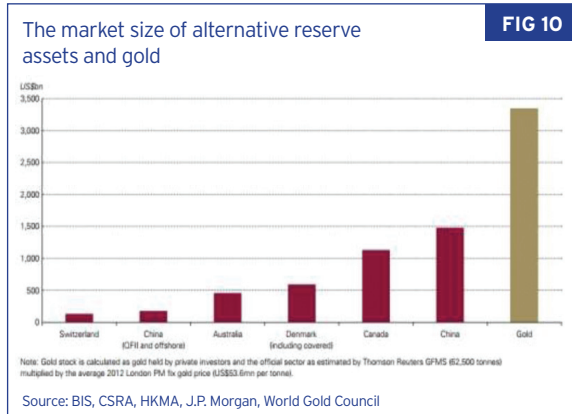
Gold Supply

FIG 8

GFMS Reports													RBCCM Estimates	
Metric Tonnes	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014E	2015E	
SUPPLY														
Mine production	2,631	2,504	2,560	2,495	2,498	2,430	2,612	2,739	2,838	2,861	2,982	3,050	3,025	
Net official sector sales	620	479	663	365	483	235	34	-	-	-	-	-	-	
Old gold scrap	991	881	902	1,133	1,005	1,350	1,735	1,723	1,669	1,616	1,371	1,250	1,275	
Net producer hedging	-	-	-	-	-	-	-	-	11	-	-	25	25	
Implied disinvestment	-	-	-	-	-	-	-	-	-	-	184	95	-	
Total Supply	4,242	3,864	4,125	3,993	3,986	4,015	4,381	4,462	4,518	4,477	4,537	4,420	4,325	

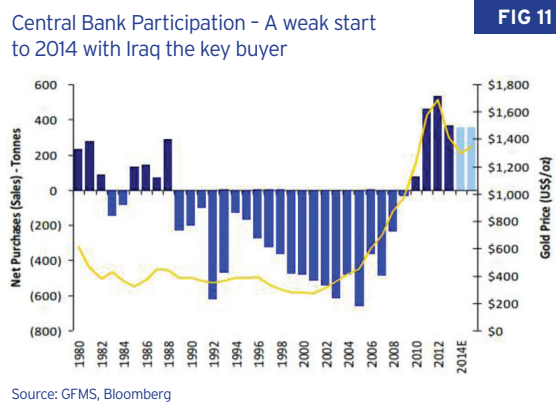
Source: GFMS, RBC Capital Markets

Gold has an integral role to play in central bank reserve diversification. Due to the large pools of official reserves managed by central banks, liquidity is of the upmost importance. Fig10 shows that the gold market remains by far the largest of the alternative assets.



Emerging market economies are moving away from US dollar dependency, their central banks are accumulating alternate reserves, and gold will play an important role here. You can see in Fig11 how central banks have started accumulating gold again - this is being driven by surpluses in emerging market economies and China in particular, another strong positive for gold demand.

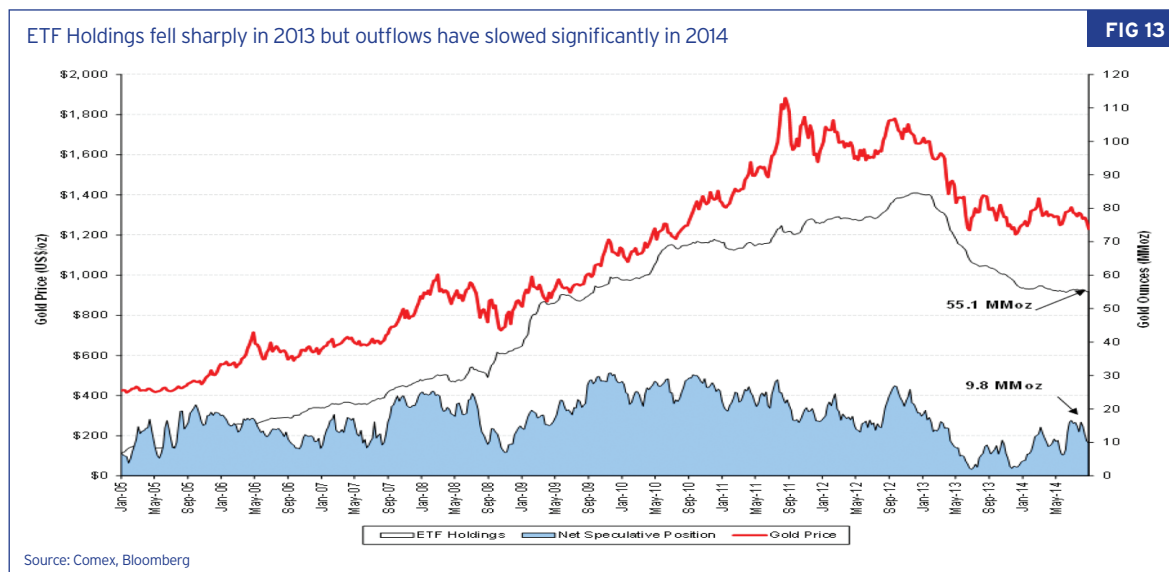
Another important component of investment demand is the holdings of Exchange Traded Funds (ETF). Fig13 shows the level of ETF holdings has swung considerably and can be difficult to predict. From the peak in early 2013, gold ETFs have seen large liquidations, resulting in roughly 800 tonnes of gold being sold in 2013. While the outlook for ETF demand is uncertain selling pressure has stabilised in 2014.



We like gold because of the strong demand coming from the emerging Chinese and Indian middle classes. The supply side is also supportive given the absence of new production in the pipeline at current prices. If increasing demand is to be met by supply, the price of gold will have to move higher. While the underlying fundamentals are strong, there maybe short term volatility with a rising US dollar weighing on the price. Given our favourable outlook, we will be utilising these periods of weakness to add to our position.

Biotech

As billionaire investor George Soros once said of stock market bubbles, they "don't grow out of thin air. They have a solid basis in reality, but reality as distorted by a misconception". We wrote in December 2013 of Australia's biotechnology bubble, clearly evidenced through the spectacular rise in the share prices of emerging healthcare companies, most of which had never generated a dollar of profit. Notwithstanding the opportunities that remain present in the sector, it was clear that euphoria had taken hold and that



the market was mispricing the risk associated with unproven technologies, business models and management teams.

Our attention was first piqued in regards to this sector by North American biotechnology companies opting to raise capital in Australia. What became clear upon a deeper examination of the sector domestically and abroad, was that Australia is a relatively immature market in comparison to the US, with local investors excepting company forecasts rather than scrutinising the clinical data.

For a long/short equity investor, such extremes in mispricing can provide some of the most compelling investment opportunities. We are able to capitalise on such distortions and profit when sense and reason prevail or in an extreme case, where fear overcomes euphoria and bubbles burst.

The performance of Australia's emerging healthcare index has diverged from offshore trends and is actually struggling after a spate of overpriced companies came crashing back to earth, including QRxPharma, Pharmaxis and Prana Biotechnology. Our portfolios have been beneficiaries of this recent divergence.

In the United States, the biotechnology and digital technology sectors are showing all the signs that they are already in, or rapidly heading towards bubble territory. In response to the increasingly stratospheric valuations for US companies in these sectors, Federal Reserve Chairwoman Janet Yellen

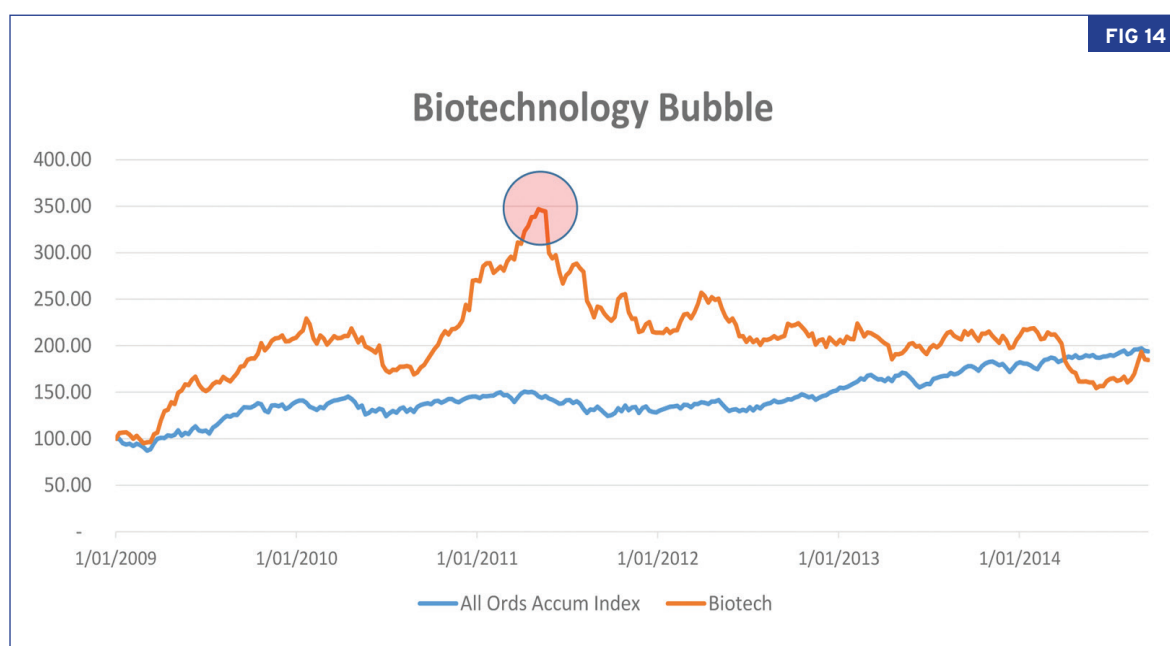
took the extraordinary step of singling out these sectors as areas of concern during her testimony to Congress in mid-July, stating that: "Valuation metrics in some sectors do appear substantially stretched - particularly those for smaller firms in social media and biotechnology industries, despite a notable downturn in equity prices for such firms early in the year".

Dot-com Bubble 2.0

Digital disruption is changing the Industrial landscape at a rapid pace. A recent study by Deloitte estimates 65% of the local economy is facing significant disruption over the next three years. For entrepreneurial start-ups this presents opportunities as new technologies create innovative solutions for customer problems in affordable and convenient manners. For established corporates, this presents both opportunities and risks, with new opportunities and channels to customers along with the threat that their established businesses could be superseded.

Some of the key themes we've observed in the technology sector include "The Cloud", "Micro-transactions", "Mobility", "Big Data" and "Social Gaming". While each new thematic encompasses a raft of opportunities, many of the recent start-ups have little or no corporate history and seem to have done little more than capitalise on the right buzzwords.

One clear lesson from the first dot-com bubble was that investors bought the blue-sky but failed to fathom the difficulty in monetising new products and the speed



in which pricing power is eroded. It would seem that investors may have forgotten this lesson in dot-com 2.0.

The cloud is changing the economics of technology companies in three key ways; firstly monetisation is driven by consumption with low switching costs, secondly the risks have skewed more to the vendor with the consumer now expecting to pay lower up-fronts and more in recurring fees. Lastly, the growing “consumption gap” is limiting the ability of technology companies to grow profits as consumers and businesses are pushing back on paying for features they don’t require.

The behaviour of the consumer has changed considerably, with the iPhone and App Store proving to be highly disruptive forces. Apple led the market in empowering its end users to make their own decisions and pay only for the applications they want. It hasn’t taken long for this mindset to filter through to enterprise.

While some of the opportunities in these sectors are undoubtedly exciting, we are now witnessing what we believe is a bubble in stock prices. As seen in figure 15 below, when margin debt on the tech-heavy NASDAQ as a percentage of GDP reaches 25-30%, it delivers a negative signal to the market. There is probably no better indicator of herd behaviour than margin loans, which indicate this cycle is peaking.

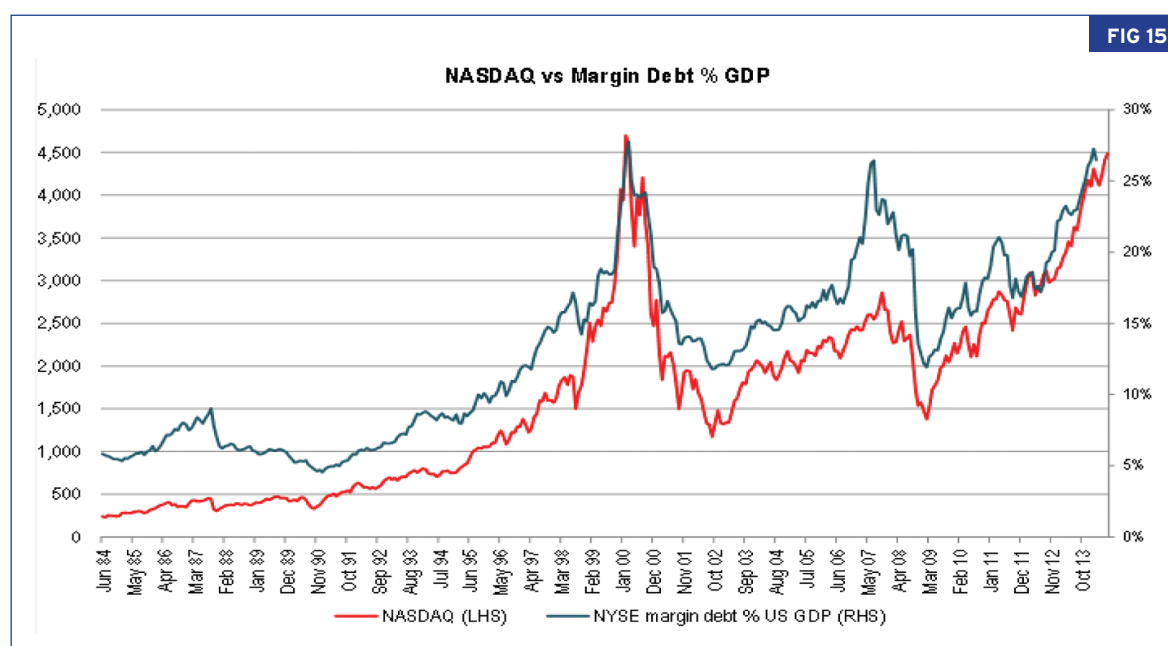
Providing further evidence that investor enthusiasm is becoming irrational, the flurry of private companies taking advantage of lofty valuations by floating on the share market is culminating in an

Initial Public Offering (IPO) boom not dissimilar to that which occurred during the last dot-com bubble. In the past 12 months, Australia and New Zealand have digested roughly \$15bn in new floats, with more coming to market in the next few months. To put that in context, in the four years leading up to 2013 there was roughly \$3.5bn per annum in new issuances.

Valuations for tech companies are justified on the promise of potential growth from online services that are building huge audiences, while consideration of the risks is often overlooked. While investors grasp the opportunity very quickly, they struggle to temper their enthusiasm given technology companies can become extinct just as quickly as they emerge, and that monetising an opportunity can be harder than winning the audience.

The excessive valuations we are seeing offshore are spilling over into some local industries. For instance, segments of the Telecom, Education and Media industries maybe moving into bubble territory. The market for Initial Public Offerings is overheating with many low-quality businesses listing on high valuations, most trading above their issue price.

At Watermark we scour new issues looking for situations where sponsors have fully exploited opportunities and investors are clearly mispricing the risks. Having profited from the demise of an overheated biotech sector last year, we are monitoring with interest what appears to be an echo of the dot-com boom 15 year on.



Fund Snapshot

30 September 2014



Net Tangible Asset (NTA) Backing

Month	Aug 2014	Sep 2014
NTA before tax on unrealised gains	\$1.35	\$1.37
NTA after tax	\$1.34	\$1.36

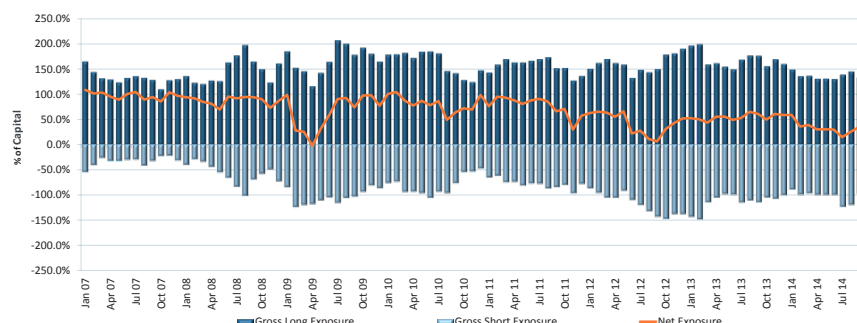
Performance (Net of all Fees and Expenses)

Period	S&P/ASX All Ordinaries Accum. Index	Net Equity Exposure	Contribution Market ¹	Security Selection ²	ALF (net returns)
1 Mth	-5.2%	29%	-1.5%	2.8%	+1.3%
6 Mths	0.2%	29%	-0.3%	-0.4%	-0.7%
Fin. YTD	-0.3%	24%	2.6%	-7.3%	-4.7%
1 Yr	5.9%	40%	2.6%	2.4%	+5.0%
3 Yrs p.a.	14.0%	45%	6.5%	16.4%	+22.8%
5 Yrs p.a.	6.7%	61%	2.5%	8.9%	+11.3%
Since Inception p.a.	9.1%	68%	-0.7%	15.8%	+15.1%

¹ 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.

² 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			

Australian Leaders Fund

ASX Code	ALF
Listed	Feb 2004
Capital	\$358.2m
Market capitalisation	\$434.3m
Share price	\$1.66
NTA before tax	\$1.37
Shares on issue	261.7m
Fully franked dividend (FY14)	12.0¢
Dividend yield (fully franked)	7.2%

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 Braitling

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

30 September 2014



Net Tangible Asset (NTA) Backing

Month	August 2014	September 2014
NTA before tax on unrealised gains	\$0.97	\$0.99
NTA after tax	\$0.97	\$0.99

Performance (Net of all Fees and Expenses)

Performance at 30 September 2014	1 Mth	6 Mths	Fin. YTD	1 Yr	3 Yrs %pa	5 Yrs %pa	Since Inception %pa
WMK (net return)	2.8%	0.7%	-3.7%	4.2%	N/A	N/A	6.1%
RBA Cash Rate	0.2%	1.3%	0.6%	2.5%	N/A	N/A	2.5%
Outperformance (net)	2.6%	-0.6%	-4.4%	1.7%	N/A	N/A	3.6%

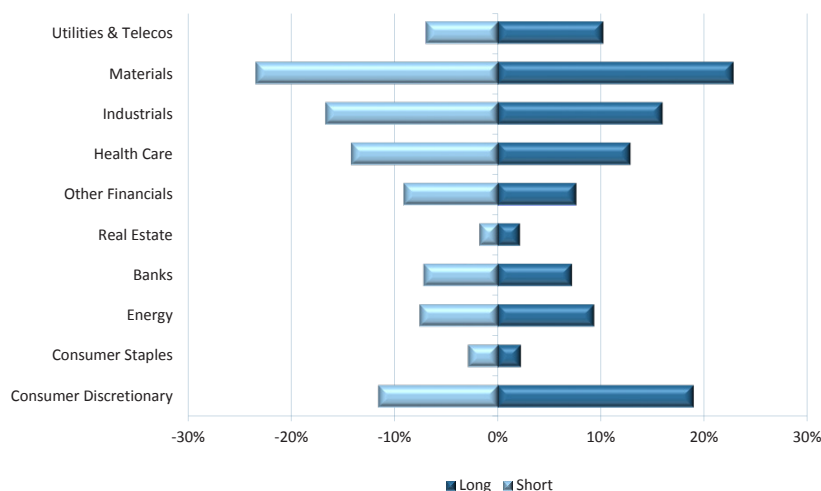
Monthly Net Returns

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	2.70	1.11	0.73	-4.34	-2.10	2.81			

Gross Portfolio Structure

Investment Type	31 August 2014		30 September 2014	
	\$m	%	\$m	%
Listed Securities - Long	90	99%	98	110%
Listed Securities - Short	-87	-96%	-91	-102%
Net Exposure	3	-3%	7	8%
Cash	88	97%	82	92%
Capital	91	100%	89	100%

Sector Exposures



Watermark Market Neutral Fund

ASX Code	WMK
Listed	Jul 2013
Capital	\$88.9m
Market capitalisation	\$87.6m
Share price	\$0.98
NTA before tax	\$0.99
Shares on issue	89.8m
Fully franked dividend (FY14)	5.0¢
Dividend yield (fully franked)	5.1%

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

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Investment Analyst

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Investment Analyst

Delian Entchev

Investment Analyst

Tim Bolger

COO & Head of Distribution

Shannon Wells

Office Manager

Fund Snapshot

30 September 2014



Net Asset Value (NAV)

Month	August 2014	September 2014
NAV per unit	\$1.244	\$1.275
Increase/Decrease	-1.77%	+2.52%

Performance (Net of all Fees and Expenses)

Performance at 30 September 2014	1 Mth	6 Mths	Fin. YTD	1 Yr	3 Yrs %pa	5 Yrs %pa	Since Inception %pa
WARF (net return)	2.5%	1.0%	-3.7%	5.2%	19.1%	11.9%	15.1%
RBA Cash Rate	0.2%	1.3%	0.6%	2.5%	3.2%	3.7%	4.4%
Outperformance (net)	2.3%	-0.2%	-4.3%	2.7%	15.9%	8.2%	10.7%

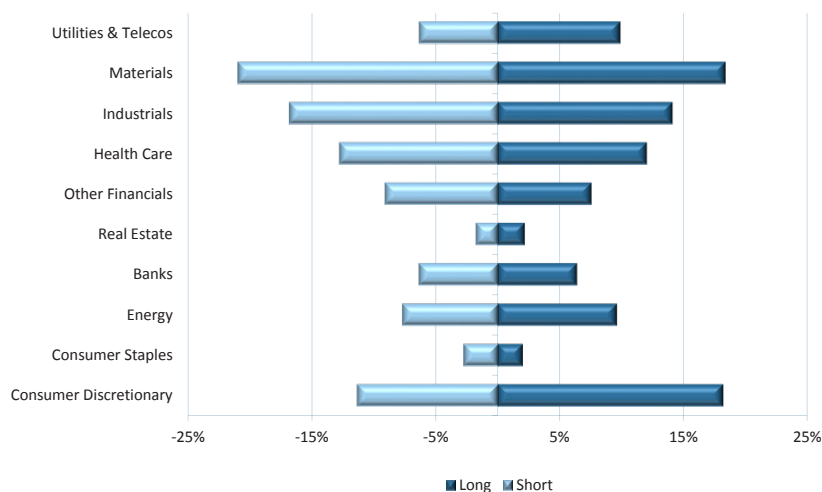
Monthly Net Returns

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	2.96			

Gross Portfolio Structure

Investment Type	31 August 2014		30 September 2014	
	\$m	%	\$m	%
Listed Securities - Long	23.5	91.7%	41.3	100.4%
Listed Securities - Short	-23.0	-89.9%	39.7	-96.3%
Net Exposure	0.5	1.8%	1.7	4.1%
Cash	25.1	98.2%	39.5	95.9%
Capital	25.6	100%	41.2	100%

Sector Exposures



Watermark Absolute Return Fund

Firm Assets	\$488.3m
Fund Assets	\$41.2m
Inception Date	Aug 2012
Strategy	Equity Market Neutral
Fund Domicile	Australia
NAV per unit	\$1.275
Redemptions	Monthly
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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