WATERMARK
FUNDS MANAGEMENT

Agenda

- Asset Cycles
- Inflation/Deflation/Reflation where are we?
- Review of share market valuations
- Review of market risks
- Market Outlook
- Sector strategy
- Performance Update

Asset markets move up and down with inflation

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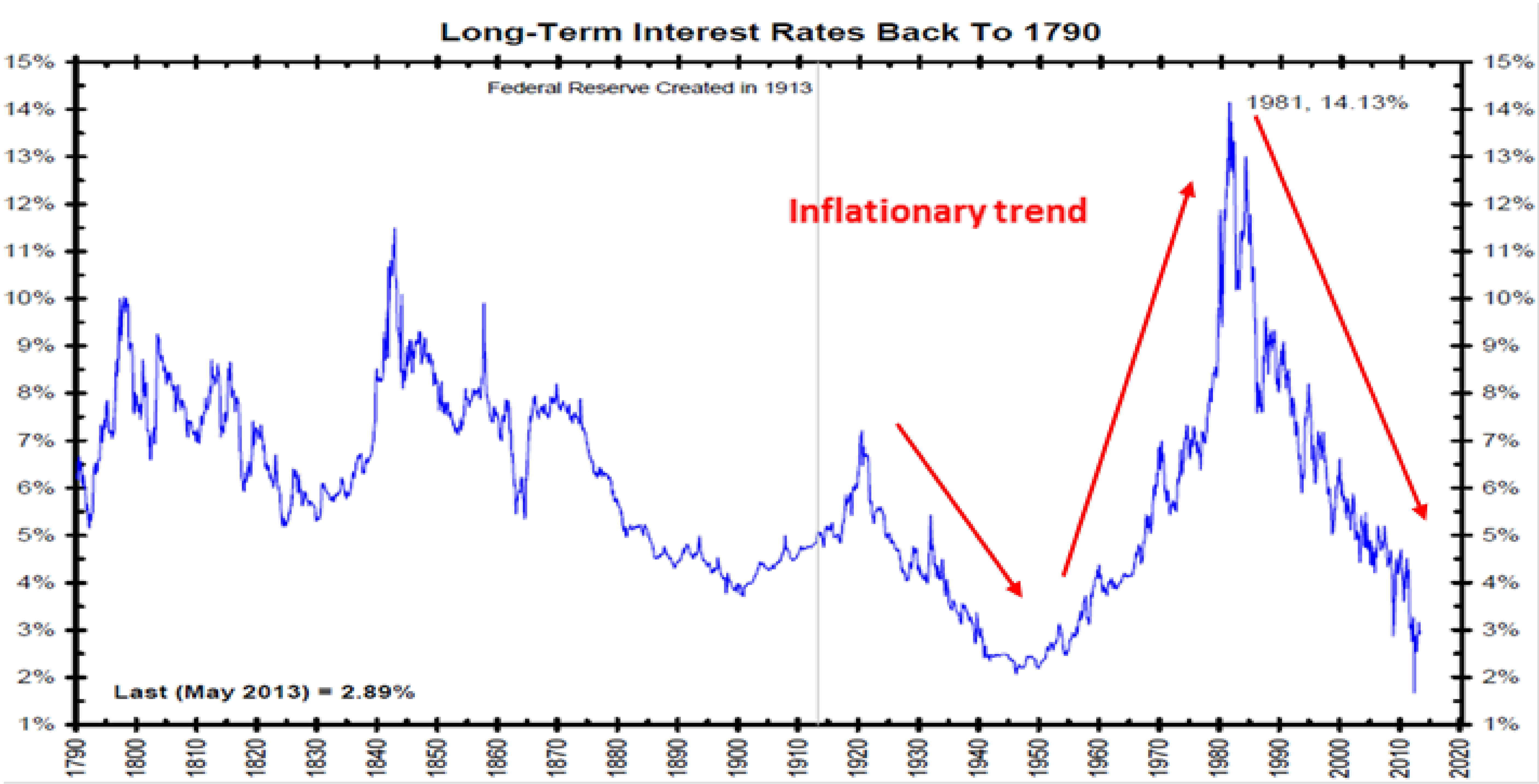
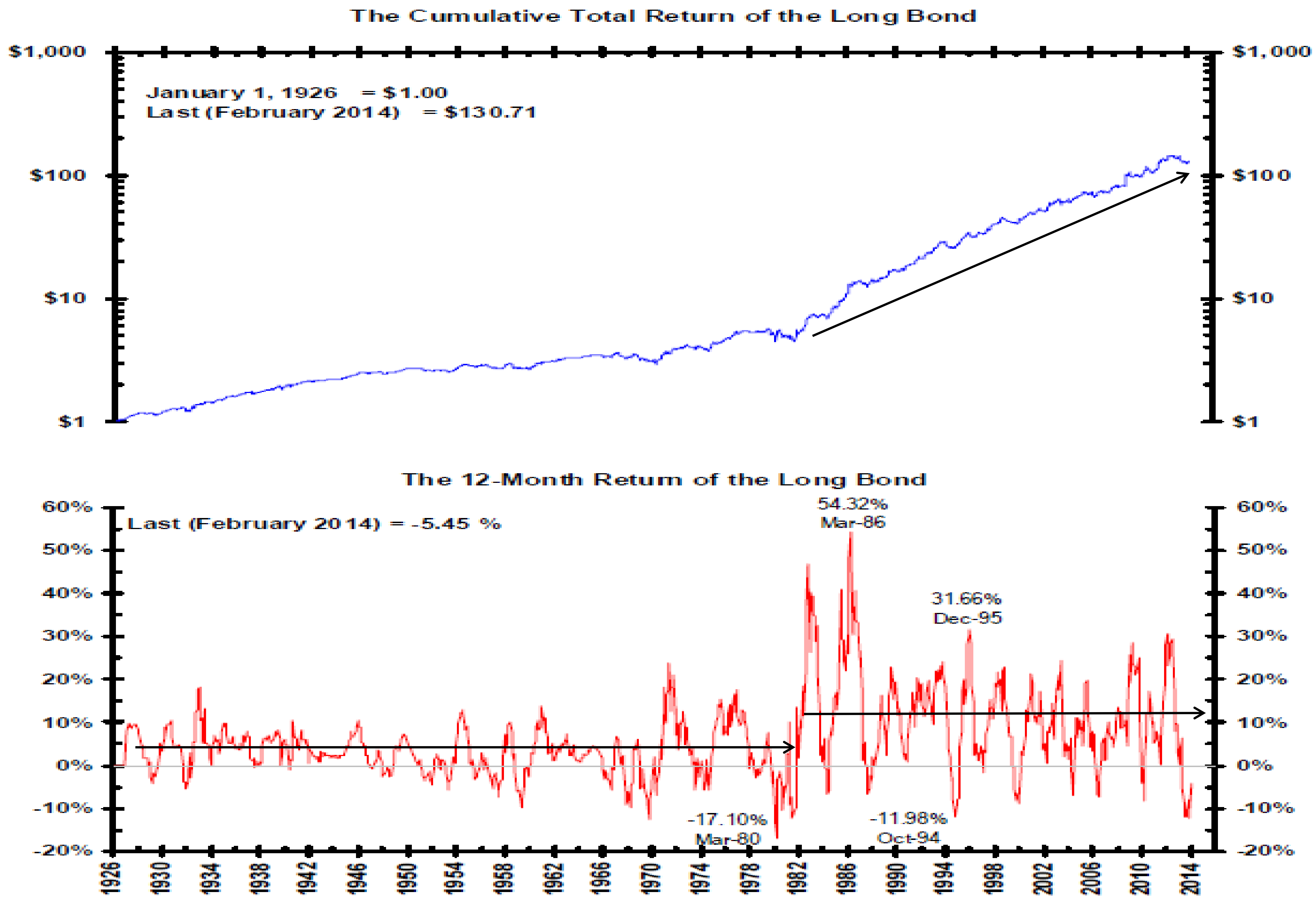


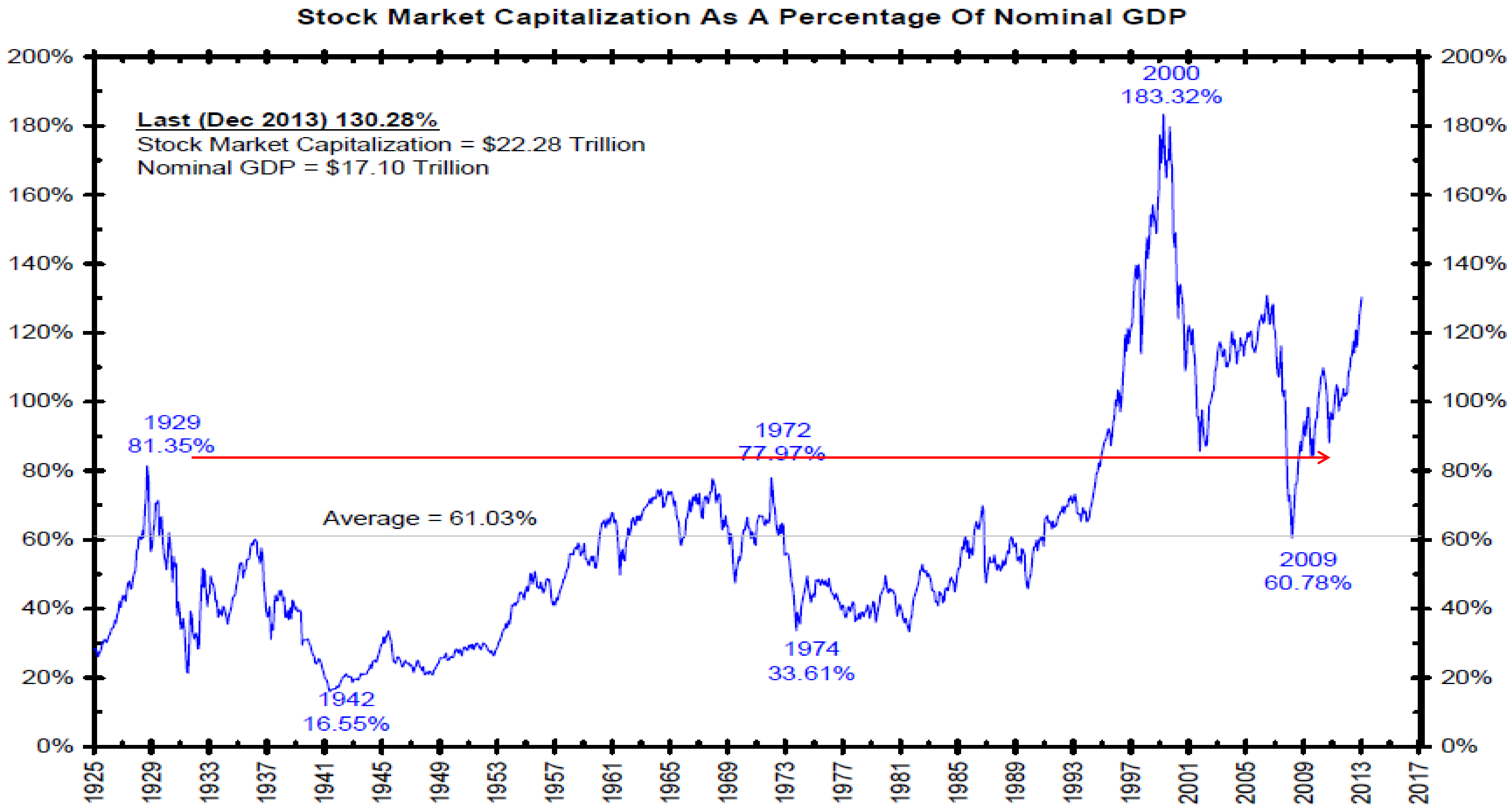
Source: Bianco Research

Asset returns will be low in the medium term



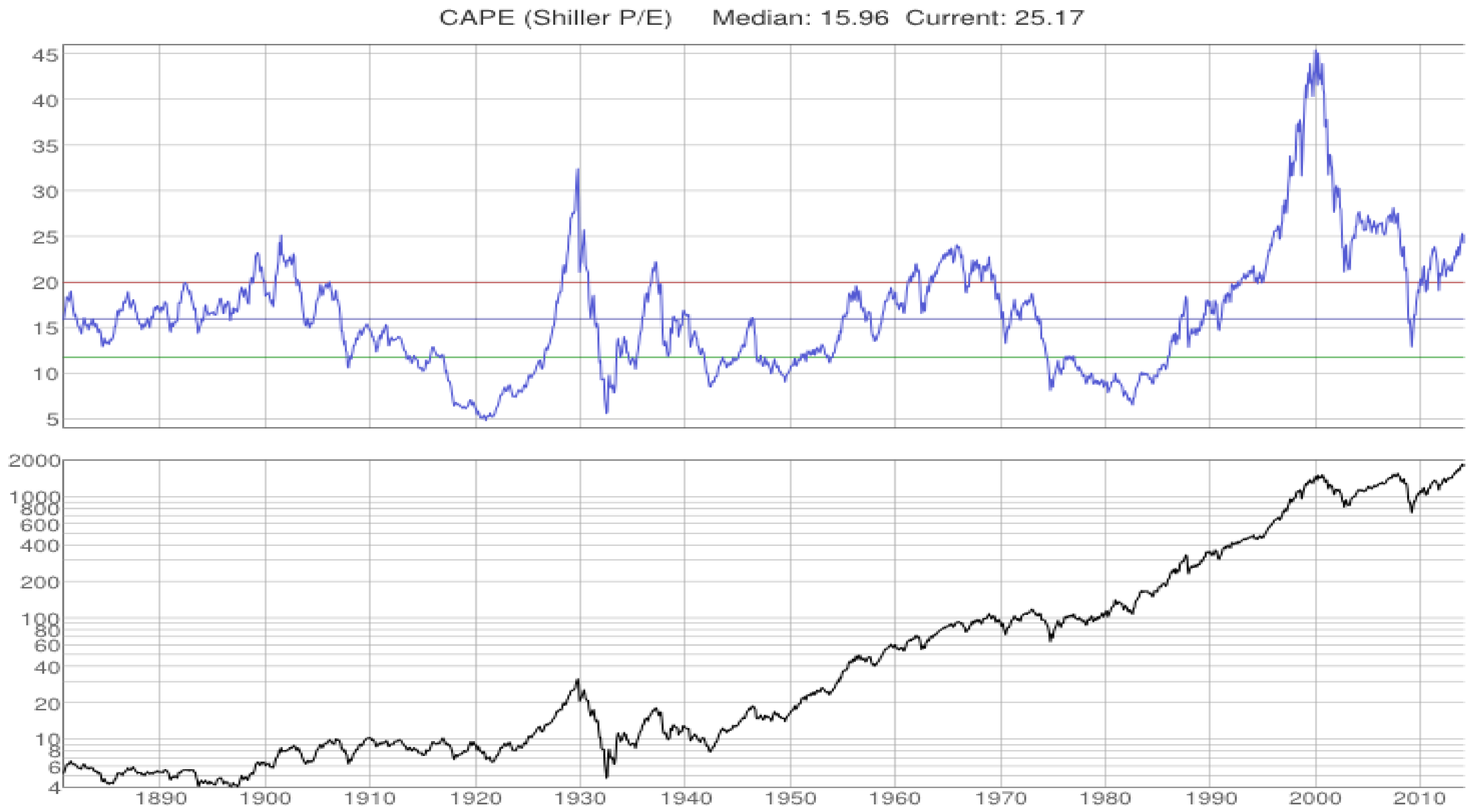
Source: Bia

Asset values are trading above historic levels given low yields

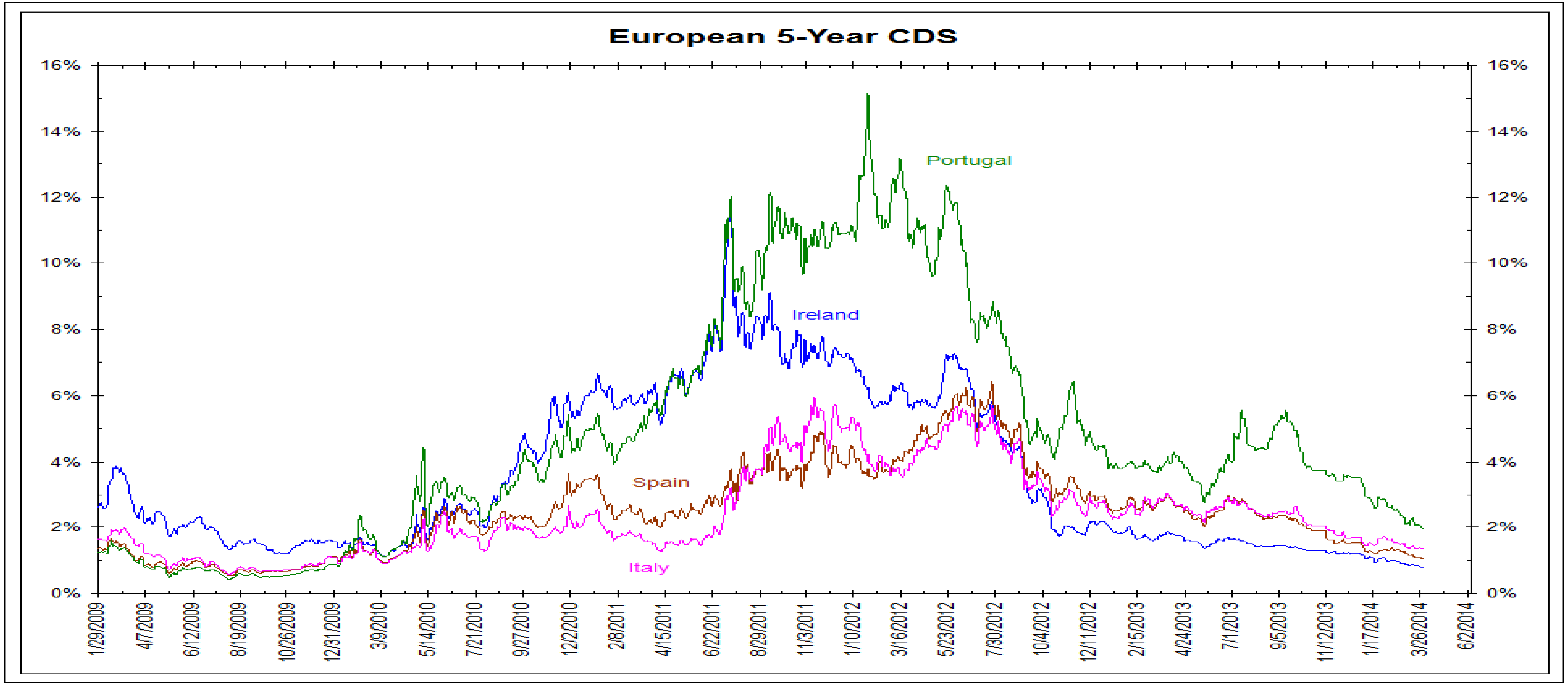


Source: Bianco Research

This is true of shares..........



Also for government bonds..........



Source: Bloomberg

Ultra easy monetary policy to stimulate jobs

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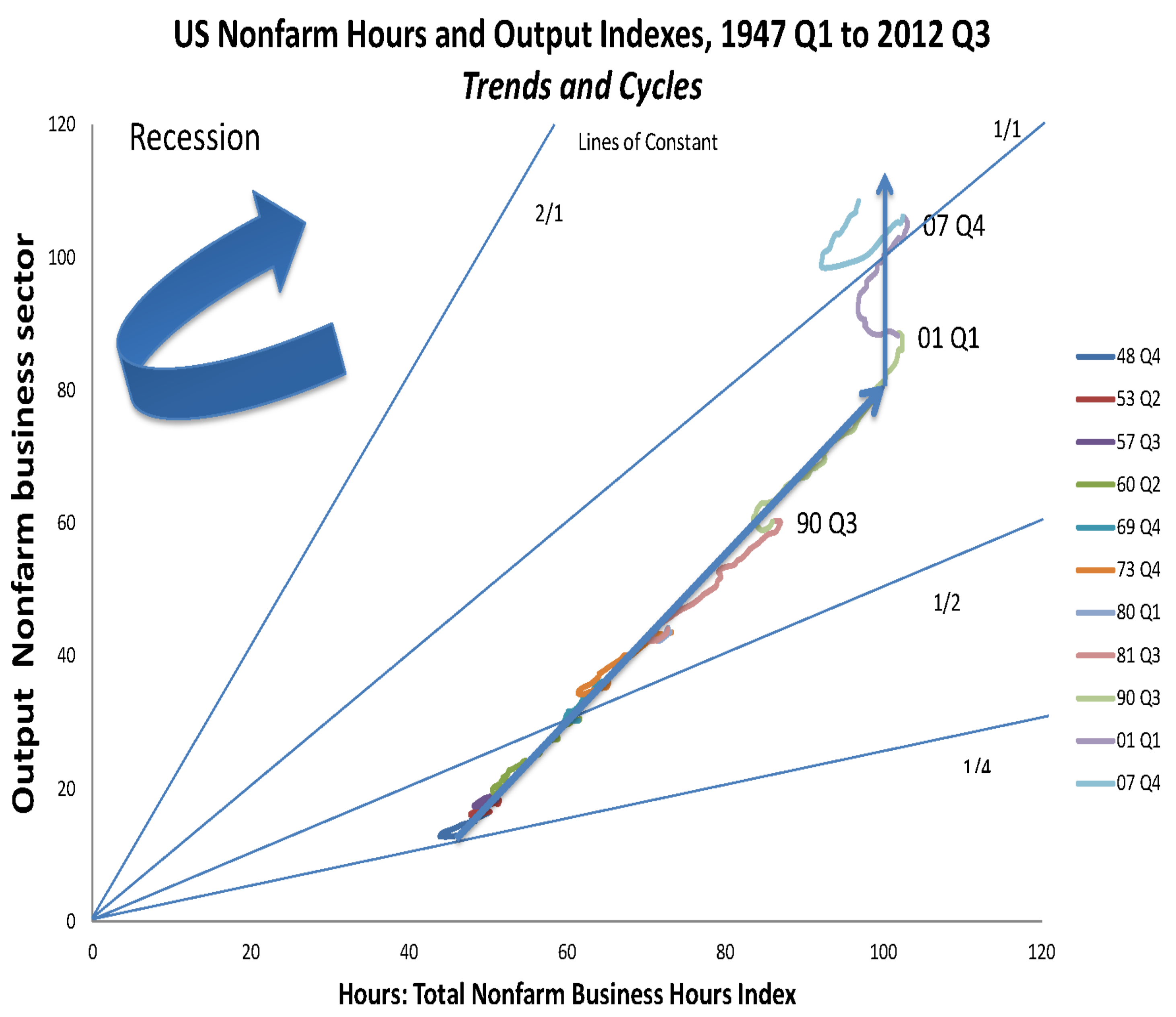
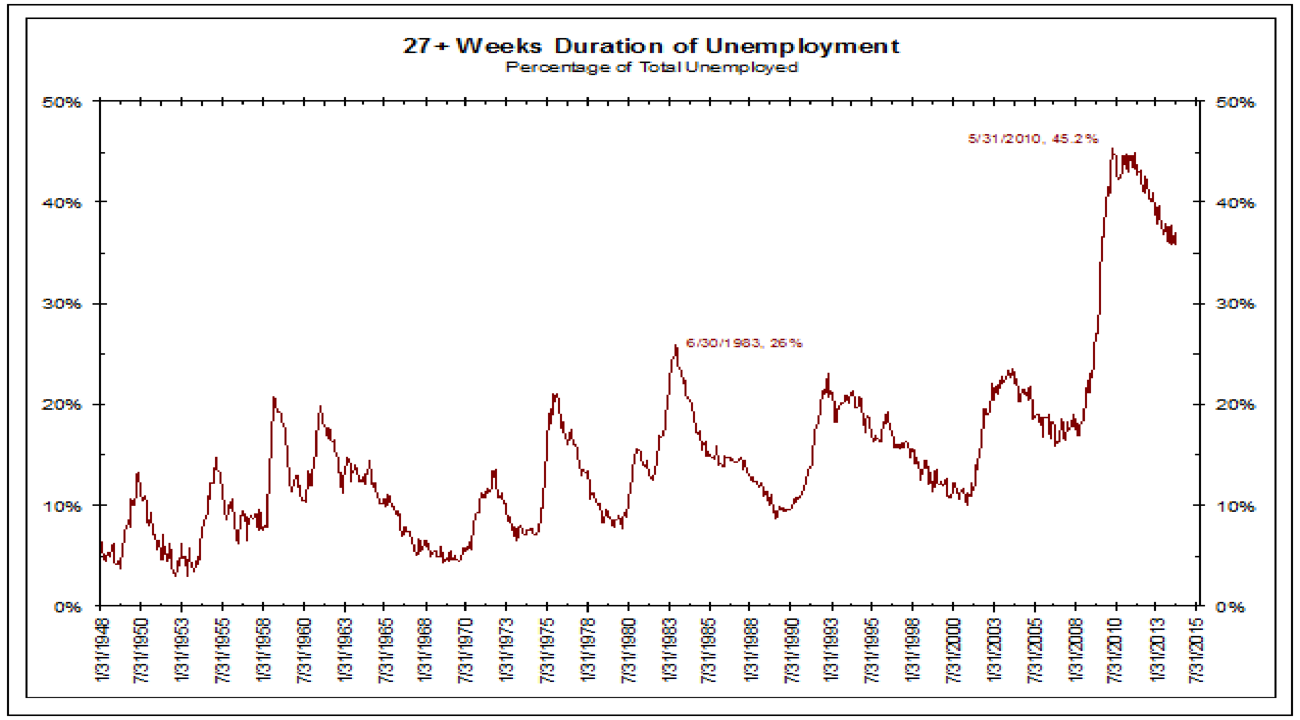
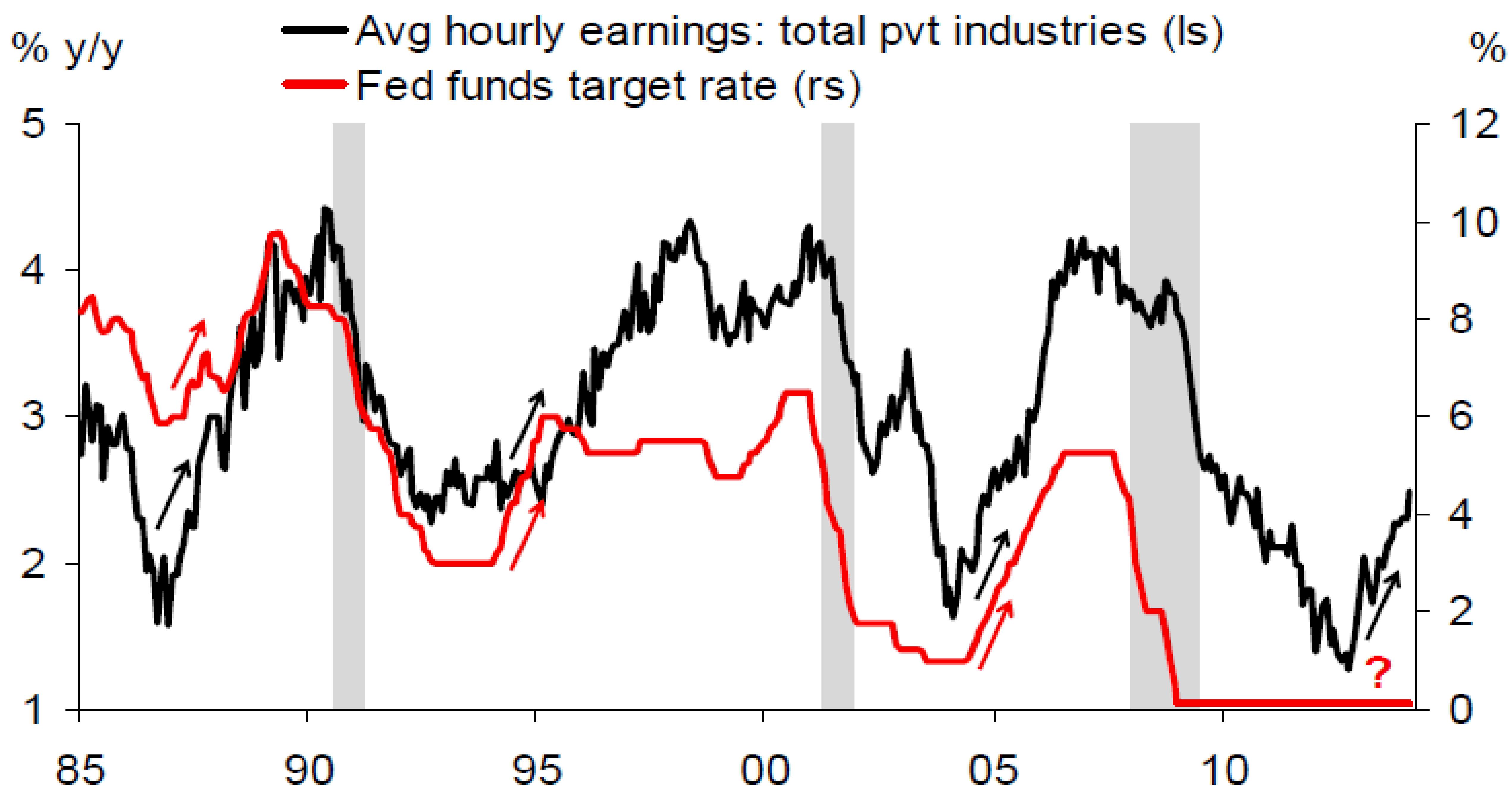


Source: UCLA

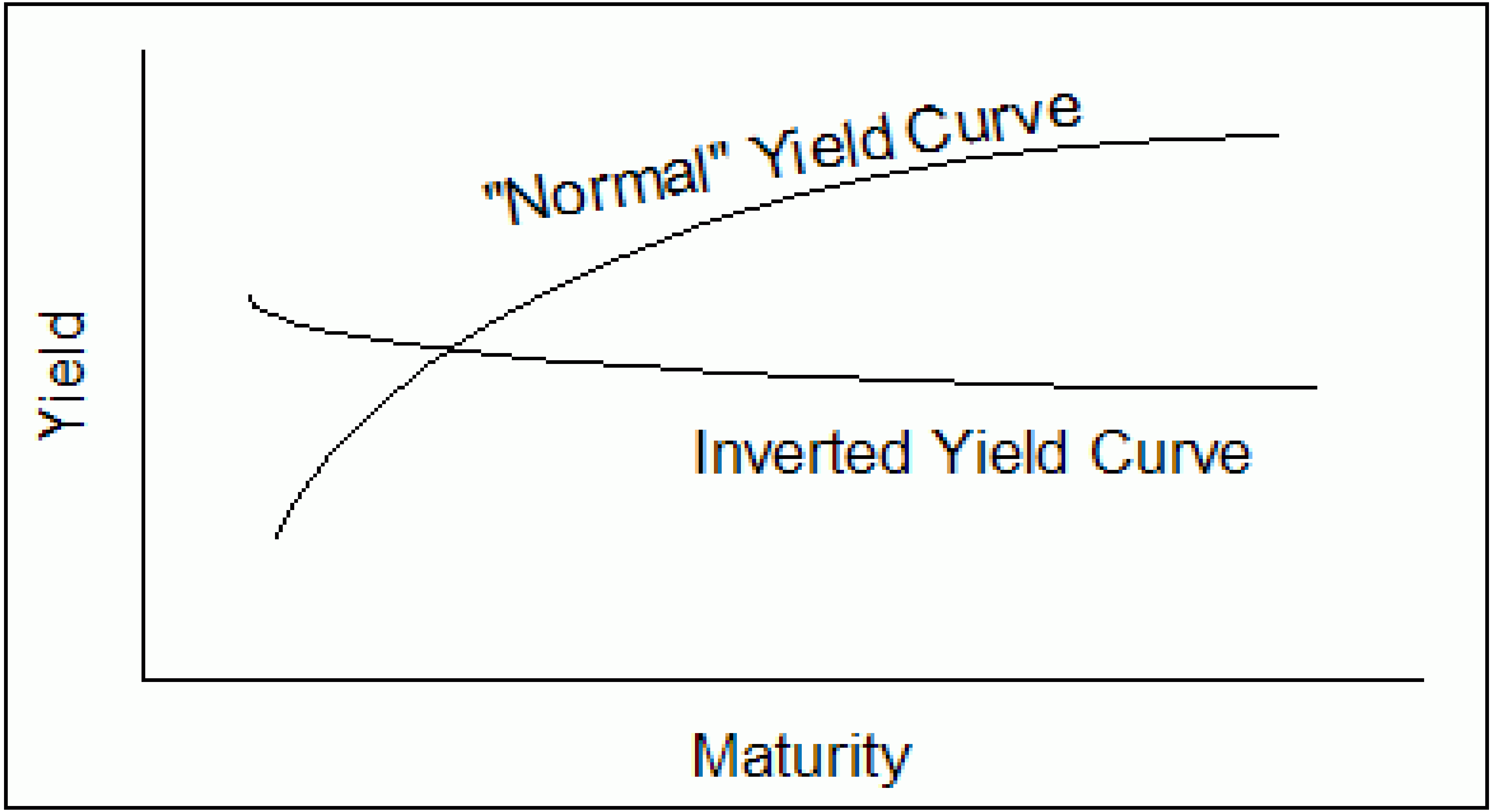


The tightening cycle has begun, a headwind for shares



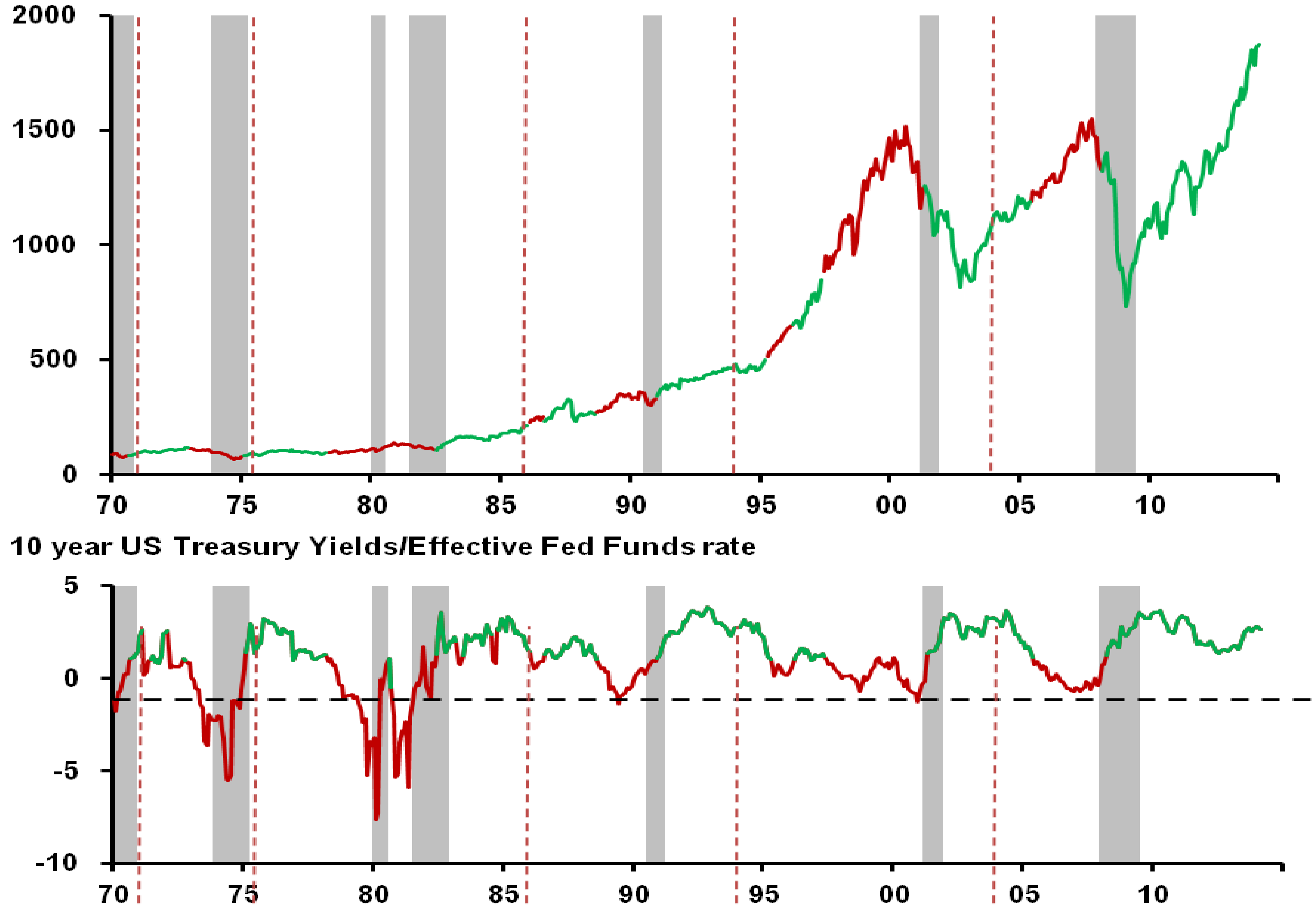
Source: Deutsche Bank

Yield curve reflects outlook for financial conditions

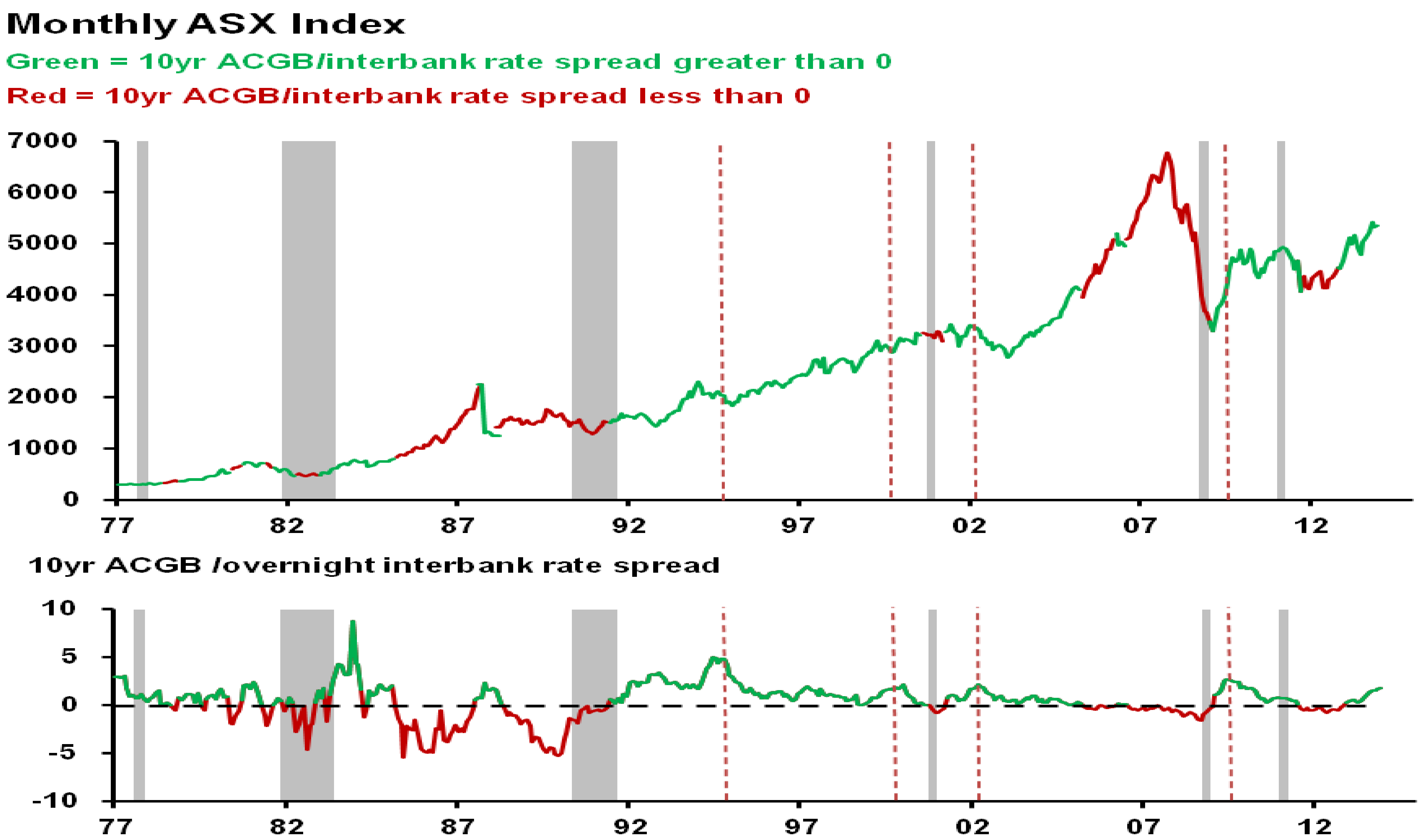


Monetary policy is still highly supportive for shares

S&P 500 and the Yield Curve

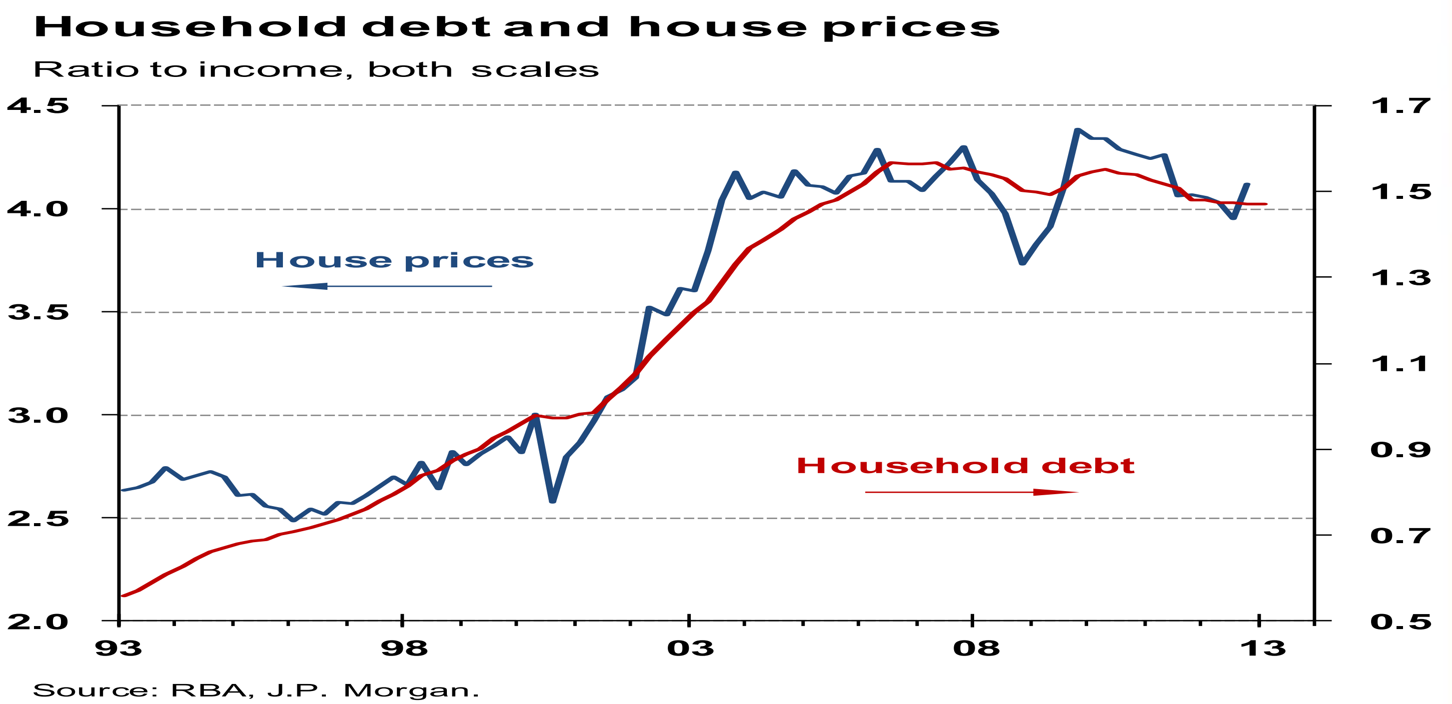


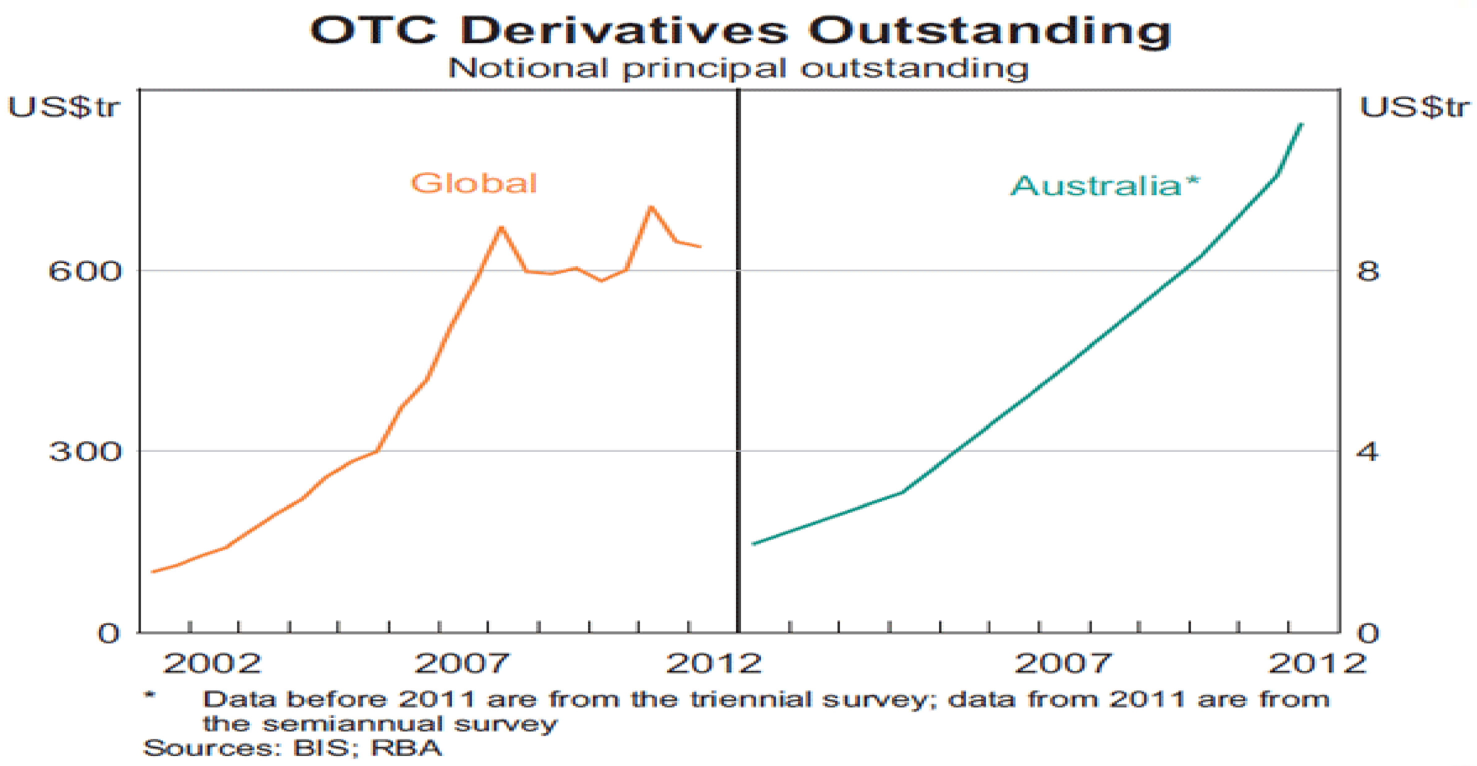
This is true also for Australian shares



Risks and imbalances are building again….

- Volatility is likely to return as most of the imbalances that contributed to the financial crisis are still in place:
  - global trade imbalances
  - shadow banking
  - financial leverage
  - household leverage
  - government debt





Junk Bond Issuance at record levels

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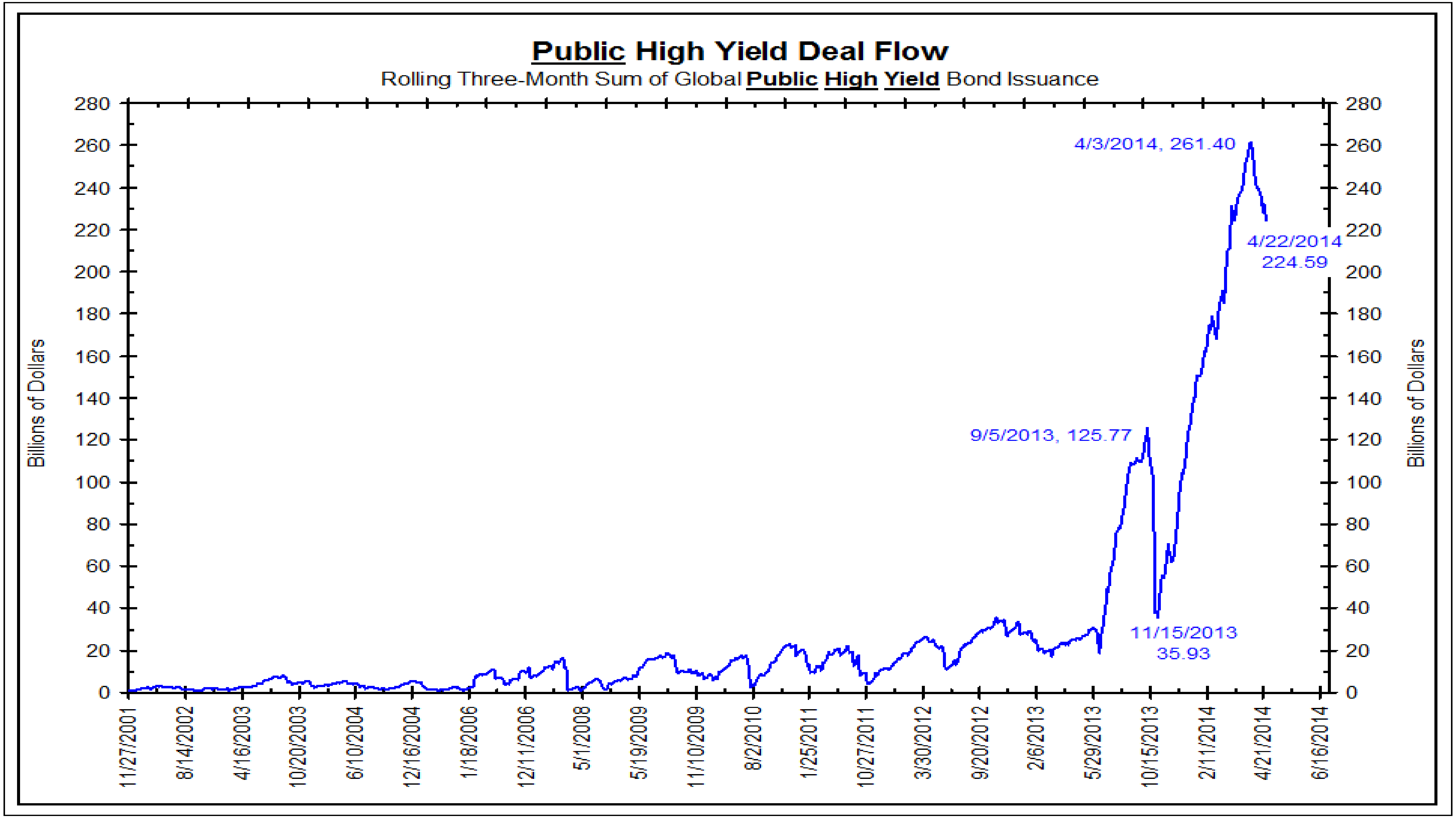
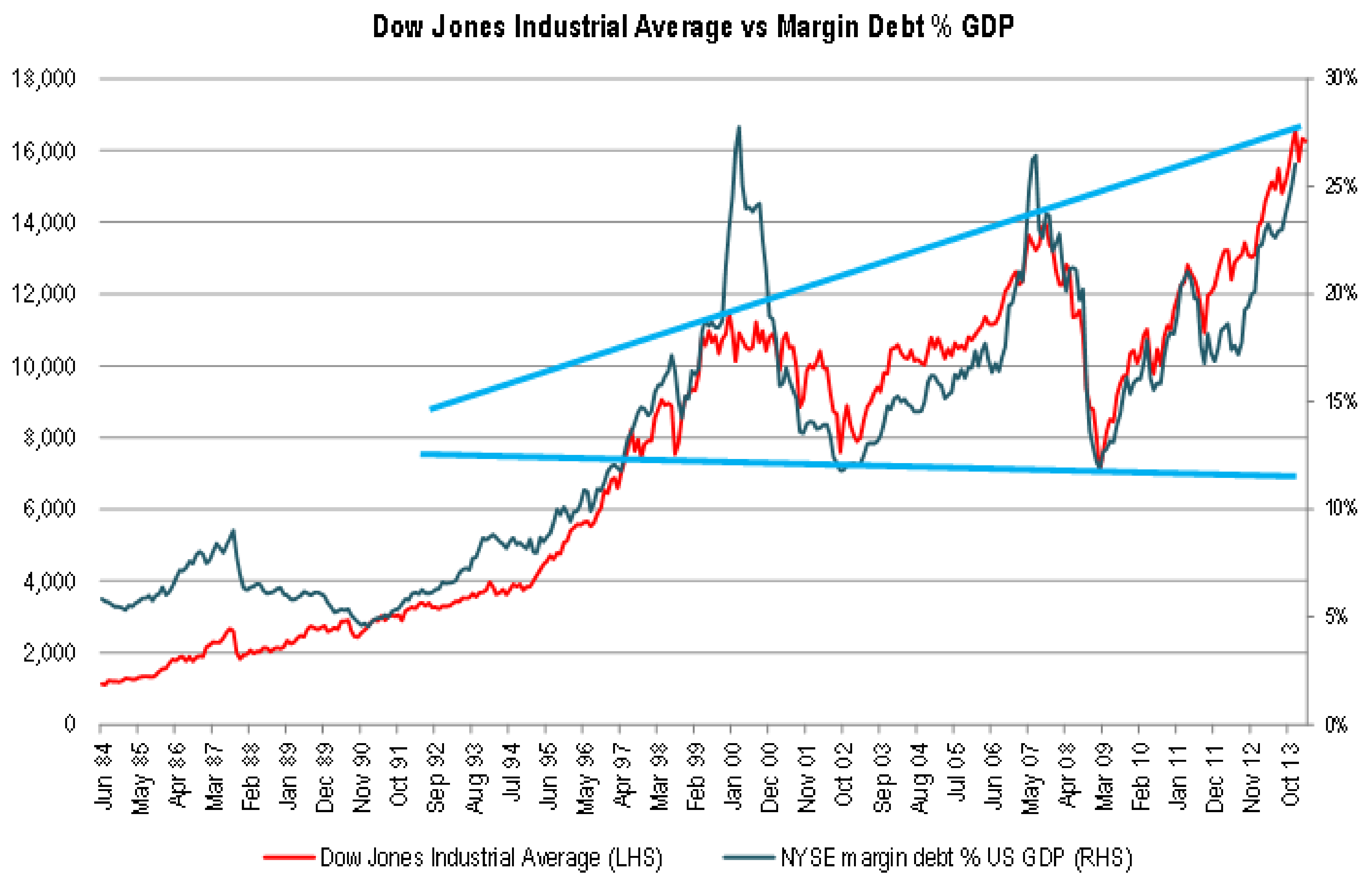


Risks and imbalances are building again....



Market Outlook

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- Risks are building in a liquidity driven share market that is looking tired. We have not had a proper correction in almost 2 years.
- With policy settings still at such accommodative levels however, this bull market may have further to run and asset values may overreach in the short term before inevitably falling.
- With shares now looking fully valued, returns are likely to be quite poor over the medium term.
- Given this backdrop we believe it is prudent to maintain high levels of insurance in our variable beta funds (ALF:ASX) with current cash levels at 70% of shareholders funds.
- Investors in the market neutral funds are fully hedged against any market set back.

Outlook for the Australian Economy

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- Three phases to mining downturn:
  - -Income shock as commodity prices normalise (2013-2015)
  - -Mining investment contracts as projects are completed (2015)
  - -Exports expand as new projects start to contribute (2016)
- Offsetting benefits of an easing in financial conditions (interest rates and softer $A) and a stronger housing market.
- Fiscal consolidation and deleveraging to weigh on household spending.
- Poor productivity trends will see further restructuring in the private sector and rising unemployment.
- <u>Summary: subpar growth trends to continue</u>

Weakness in Australia's key trading partners…

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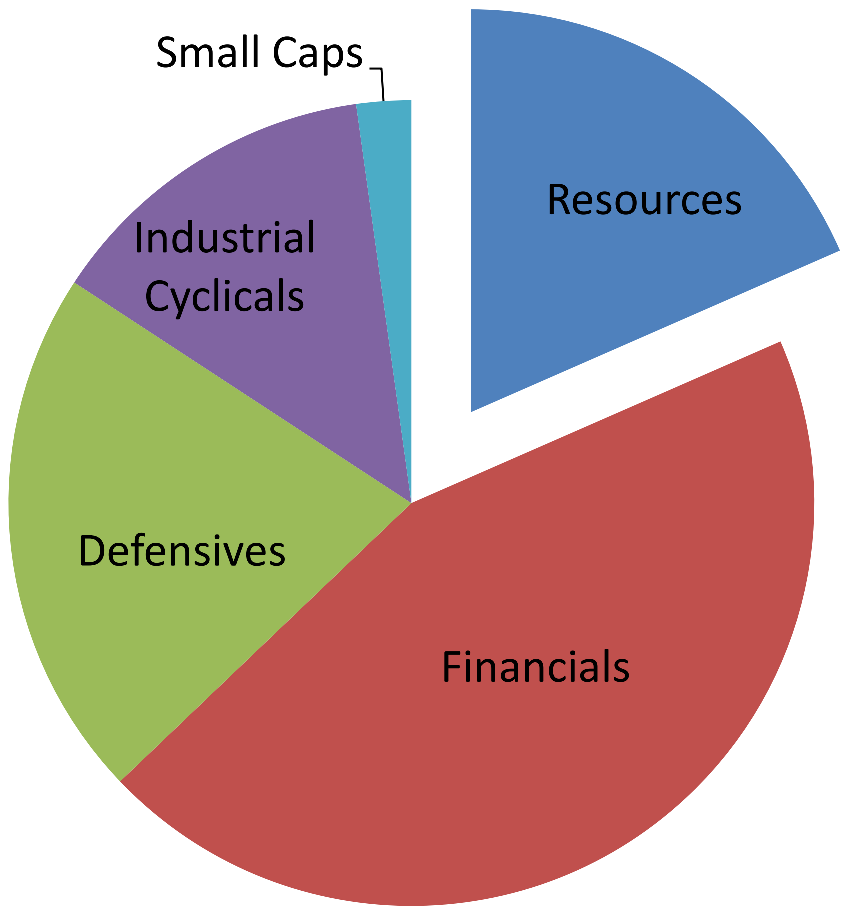
China

- Strong new leadership attempting to reign in shadow banking – further defaults expected
- Weakness in property markets will continue due to huge overbuild in Tier 3 and 4 cities
- Environmental concerns have become a major policy initiative weighing on many sectors
- Government unlikely to pursue stimulus package
- News flow likely to remain negative for the next 6-12 months

Japan

- Abenomics is not working, cost of living is going up without any commensurate improvement in household income.
- Trade deficit has not improved with weakening Yen (J Curve). Japan continues to run deficits which will have to be funded externally.
- Sovereign debt is looking unsustainable given poor demographic trends and persistent external deficit.

"Where to from here for mining shares?"



Tom Richardson
Portfolio Manager

Resources

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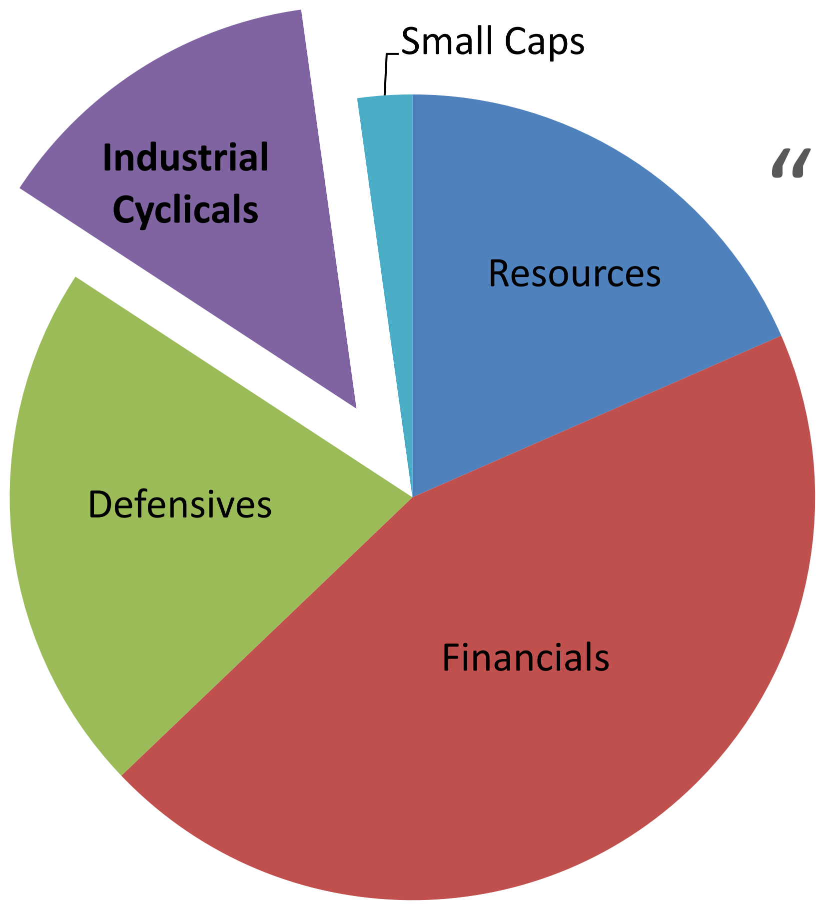
- While growth in China is slowing, we are unlikely to see a collapse as the new leadership has articulated growth targets.
- After a ten year boom, the fundamentals for individual commodities are now vastly different.
- We will selectively invest in those commodities with stronger outlooks. Base metals, industrial minerals - lithium, renewable energy. We are short Bulk commodities
- Cost out focus will remain entrenched for many years.
- The resources sector is in a bear market trading range. Growth will be more modest and some commodities look oversuplied.
- Preference is for Tiger Resources and Alumina

Cyclical Industrial Sectors



"Have cyclical shares had their run? "

Justin Braitling
Portfolio Manager

Cyclicals

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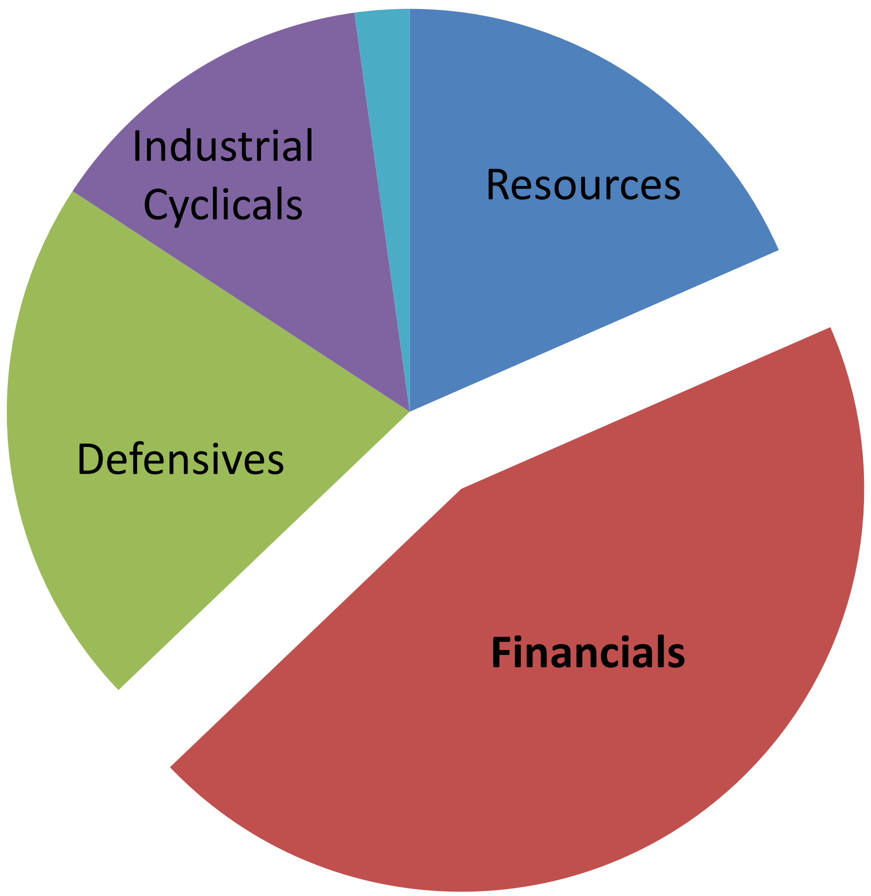
- **Media:** New media continues to take share from old media though this is fully captured in valuations. Digital businesses looking very expensive.
- **Discretionary retail:** Challenging retail trends continue. We are picking winners and losers. (Super Retail Group and Beacon Lighting)
- **Developers & contractors:** It's an extremely tough operating environment where management are the key differentiators. We are witnessing an enormous divergence in performance. (RCR Tomlinson)
- **Transport:** Preference for companies with cost-out potential as top line remains muted. (Aurizon and Asciano)
- **Building materials:** We are seeing a strong housing recovery but this is well and truly priced in. Significant risks of overbuilding in apartment sector. (GWA and Brickworks)

Financials

"Should you still own Australian Bank shares?"

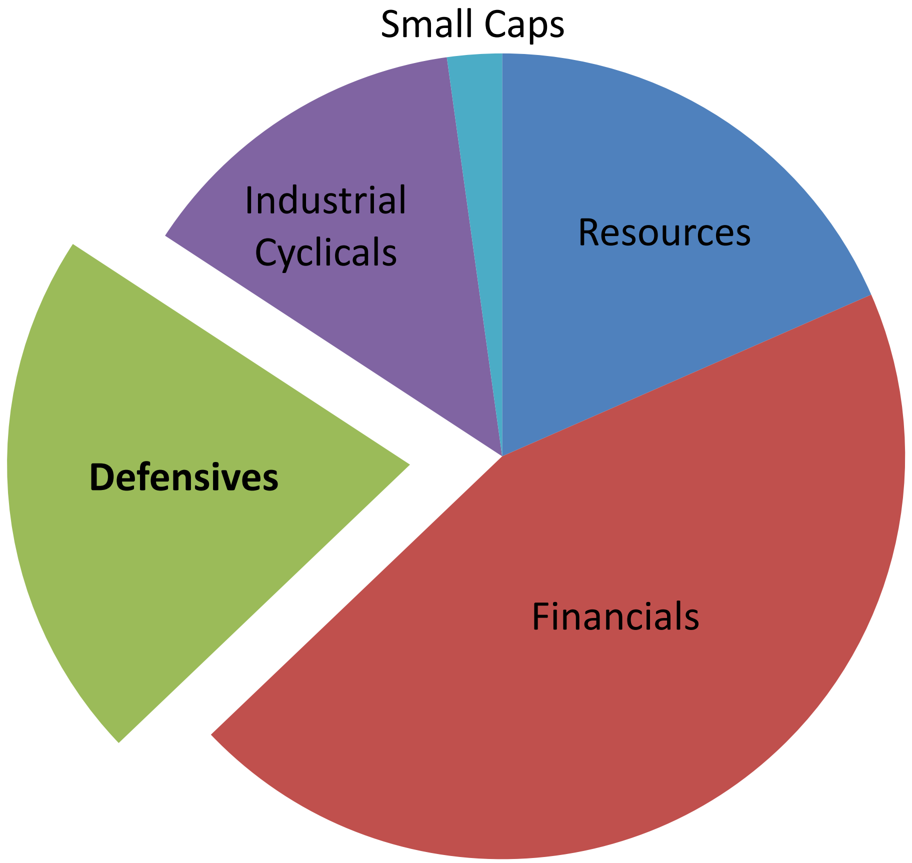


Omkar Joshi
Investment Analyst

Financials

- Margin pressures building with lower cash rates and limited ability to claw-back margins given the Financial Services Inquiry
- Competition building in business banking as credit growth remains at historically low levels
- 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 with APRA still to announce its final position regarding further capital requirements
- Banks look expensive compared to their historic trading range and long-term average P/E multiples
- Preference is for ANZ and Commonwealth Bank

Defensive Sectors



"Is it time to switch back into defensive shares?"

Joshua Ross
Investment Analyst

Defensives

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- **Infrastructure/Utilities:** Valuations look expensive due to low global interest rates.
- **Telecom/IT:** Traditional fixed line services under pressure, mobile industry successfully transitioning to monetization of data services, new opportunities emerging with NBN Co and structural separation.
- **Retail Staples:** Coles and Woolworths continue to gain share at the expense of independents (Metcash). Coles sales density now comparable to Woolworths, next leg in the turnaround will be increased focus on supply chain and fresh offering.
- **Gaming:** Slot manufacturers look stretched on valuation, wagering operators face increasing competition from corporate bookmakers, Crown continues to benefit from strong mass-market growth in Macau.
- **Healthcare:** Underlying growth thematic persists, plenty of opportunities to pick winners and losers, increasing risks regarding federal budget and healthcare funding.

Australian Leaders Fund Returns

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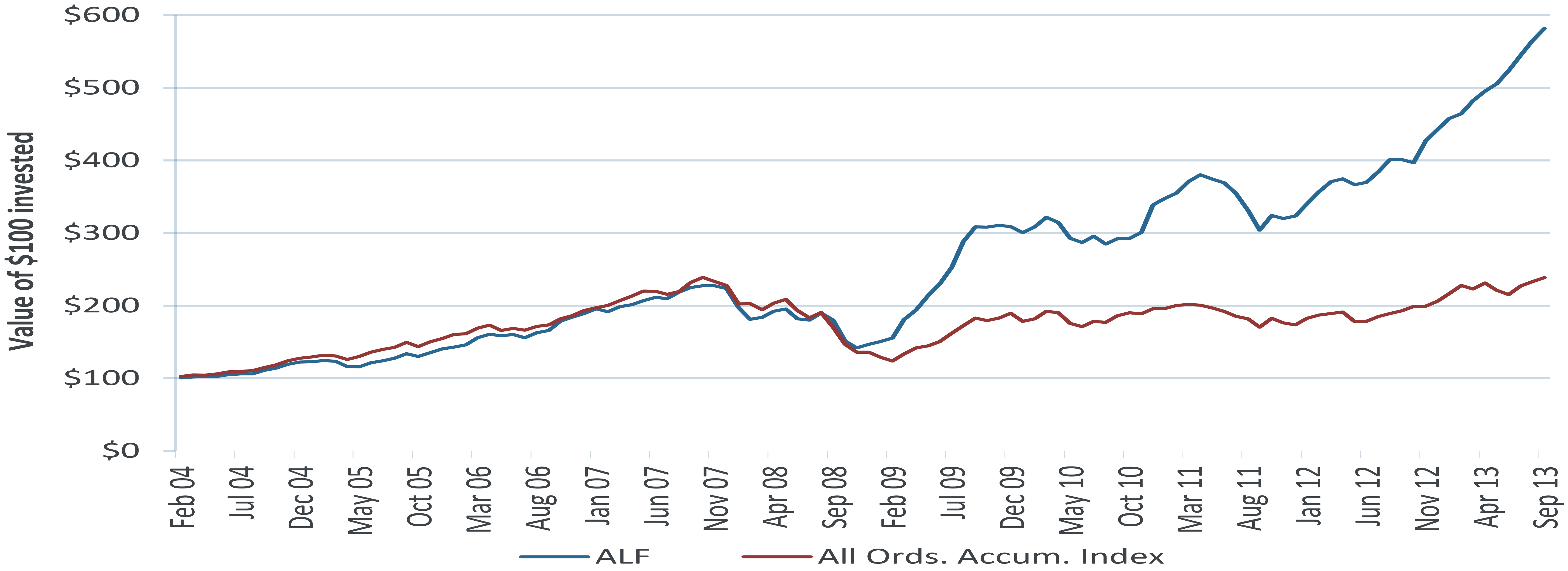
Performance at 31 March 2014	6 Months	1 Yr	3 Yrs %pa	5 Yrs %pa	Since Inception %pa
ALF (net return)	5.7%	23.2%	14.4%	22.6%	16.0%
All Ordinaries Accum.	5.7%	13.2%	7.7%	13.6%	9.6%
Outperformance (net)	0.1%	10.1%	6.7%	9.1%	6.4%



Watermark Market Neutral Fund Returns

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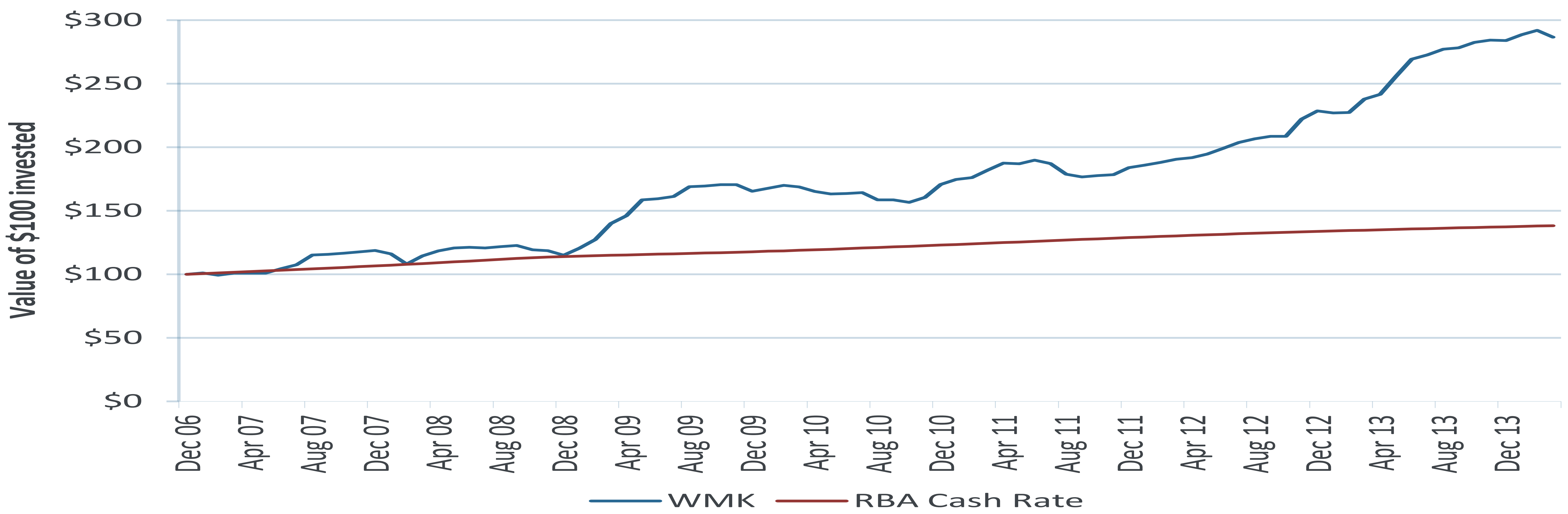
Performance at 31 March 2014	6 Months	Fin. YTD	1 Yr
WMK (net return)	3.5%	6.9%	N/A
RBA Cash Rate	1.3%	1.9%	N/A
Outperformance (net)	**2.2%**	**5.0%**	**N/A**



*Pre July 2013 returns calculated from ALF portfolio in market neutral structure

QUESTIONS