



WATERMARK
FUNDS MANAGEMENT

The Leading Edge

QUARTERLY REPORT • March 2015

In this edition we consider a number of highly profitable Australian industries under threat from new competition and the implications for listed companies that dominate them.

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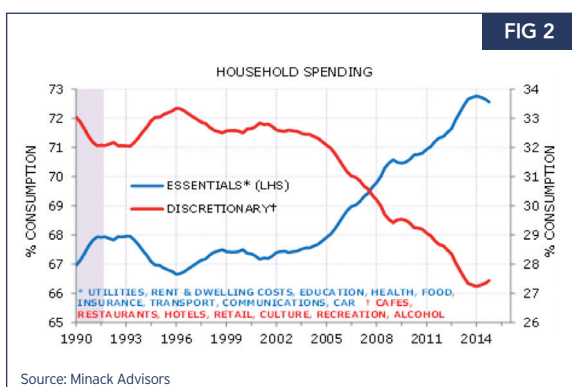
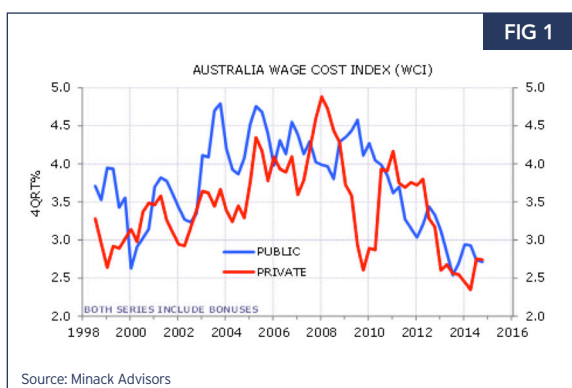
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Justin Braiting
Portfolio Manager

Softer income growth and persistent pressure on living expenses, coupled with fiscal consolidation and deleveraging is constraining spending in the economy. Households are being squeezed by softer income growth (see Figure 1) and an escalation in the cost of essential items which have been rising well ahead of inflation (see Figure 2).

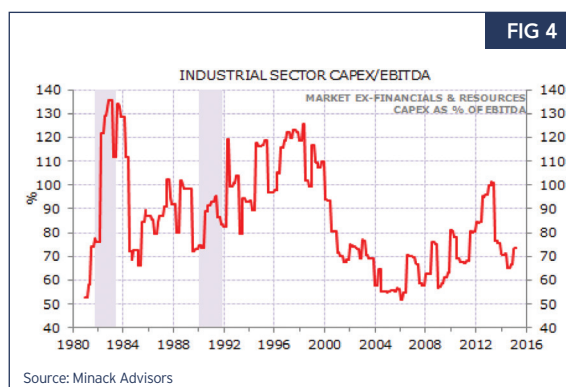
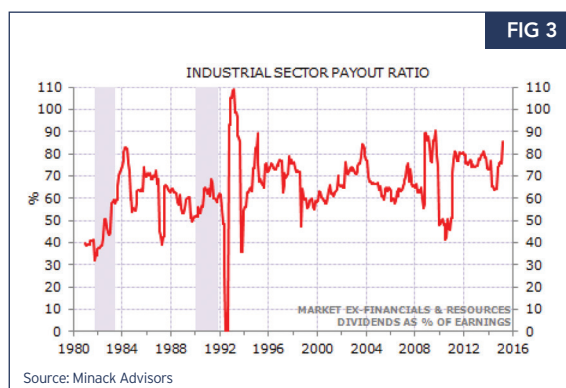


Following 25 years of uninterrupted expansion and a mining boom, Australia has become an expensive place to live and conduct business. With prices for most goods and services high by global standards and deflationary pressures a feature of most developed economies struggling with excess capacity, revenue

growth is proving hard to come by for many Australian public companies. It is not just the softer growth environment that is the problem, but affordability also is depressing activity.

A failure in competition policy has played a role here also. Companies in mature economies with few options for growth will inevitably look to expand through acquisition. The onus is on regulators to protect consumers and avoid unhealthy industry concentration. In recent times, we have seen further concentration across a number of important sectors of our economy such as banking, retail and utilities where we are left with oligopolies and regulated monopolies.

This has been a favourable development for shareholders as industry returns not surprisingly have also risen along with diminished competition. However with limited options for further growth, many of these companies have pushed the economic rents they are charging their customers to unhealthy levels. A corollary of the low growth/low interest rate environment we find ourselves in, is lower investment. Companies are not investing to sustain growth and are paying out more of their earnings to shareholders instead. Investors in their quest for income are pressuring companies to return more capital via dividends and buybacks. You can see this in Figure 3 and Figure 4, many of the companies we are referring to are investing less and returning these exorbitant returns to shareholders.



The prices of essential items such as general insurance, home lending and groceries in Australia are very high by global standards. In each of these industries publicly disclosed data reveals how industry leaders are generating returns in excess of 40% on every dollar invested. This is at a time when government bonds are yielding a paltry 2%. These usurious rents are a double edged sword however. While these businesses are incredibly profitable, their returns in many cases are attracting unwanted competition.

Investors need to consider the sustainability of these returns as new competitors try and get a piece of the action. We are seeing challengers emerge in a number of these attractive sectors, a development we believe will constrain profit growth in the medium term and in some cases put the incumbency at risk.

In this edition of the Leading Edge we review the outlook for a number of these industries. In many cases incumbents are over earning and under investing, a dangerous combination particularly for those exposed to disruptive technologies.

Industry Study 1: Retail Banking

How the Major Banks Became an Oligopoly

The banking industry in Australia has always been relatively concentrated and tightly regulated. Historically, the banks were divided into two groups: Savings Banks - which lent mortgages and collected deposits (paying almost no interest); and Trading Banks - which provided business and commercial banking activities. This regulated structure enabled a substantial non-banking sector of Building Societies and Credit Unions to flourish in the decades up until the 1980s.

Following the ground-breaking Campbell Report in 1981 (the first Financial System Inquiry) the banking system was deregulated and the Australian dollar was floated. Foreign banks were allowed to enter Australia for the first time. Many of the Savings and Trading banks were merged and rapidly expanded in an attempt to build barriers to potential new entrants. Many of the Building Societies were also demutualised, taking up banking licences.

In 1990, the Government introduced the "Six Pillars" policy which prevented mergers between the four major banks as well as AMP and National Mutual. However, during the severe recession of 1991-92 both Westpac and ANZ suffered heavy losses, mainly due to concentration risk in Commercial Property and large exposures to highly leveraged entrepreneurs. Subsequently, both ANZ and Westpac were privately

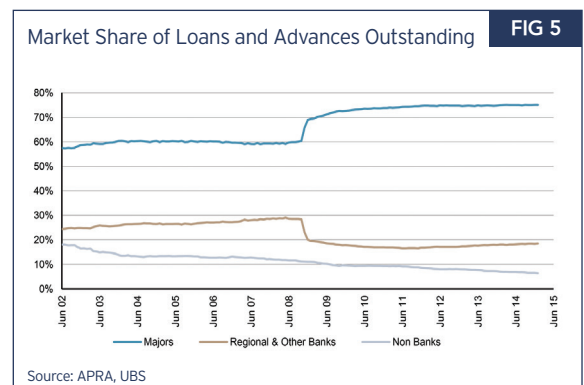
recapitalised and entered an extended period of de-risking, increasing their focus on retail banking. Westpac in particular undertook a number of regional bank acquisitions during the mid-1990s in order to rebuild its franchise. These transactions included the acquisitions of Challenge Bank, Bank of Melbourne and Trust Bank (New Zealand).

By 1997 the Wallis Inquiry (the second Financial System Inquiry) recommended the removal of the "Six Pillars" policy. The newly elected Liberal Government disagreed and although the two insurance companies lost their "pillar" status, the remaining four major banks were not allowed to merge. This created the "Four Pillars" policy which remains in place today.

However, regional bank consolidation continued unabated, with the Commonwealth Bank acquiring Colonial in 2000 and ANZ selling Grindlays, then acquiring the National Bank of New Zealand (the fifth major bank in NZ) in 2003. By the time the financial crisis hit in 2007-08 many of the regional banks were under pressure, especially those more reliant on structured debt and wholesale funding markets. St George was acquired by Westpac and BankWest was taken over by the Commonwealth Bank in the depths of the crisis. The non-bank mortgage securitisation model was no longer viable.

The financial crisis strengthened the competitive standing of the Major Banks as substantial deposits were withdrawn from the smaller players and stronger credit ratings enabled the Major Banks to return to the wholesale markets faster. In the first phase of the current housing boom, nearly all of the credit was written by the Major Banks (Commonwealth Bank and Westpac in particular).

Since the financial crisis, this situation has continued. We estimate the Major Banks now provide 75% of the total credit outstanding in Australia, a record high. This compares to 57% of outstanding credit in 2002 (see Figure 5).



Oligopolistic Powers Enable Banks to Maintain Profitability

The enormous stress placed on the financial system during the crisis led to the failure of many organisations. Although the Major Banks faced similar pressures, a public perception that these organisations were Too-Big-To-Fail along with cheaper access to the Government Guarantee ensured profitability was quickly restored.

A good example of this can be seen in the ability of the banks to reprice their Standard Variable Rate mortgage books above the RBA Cash Rate following the GFC. The banks were also able to reprice their business lending for higher risk and funding costs.

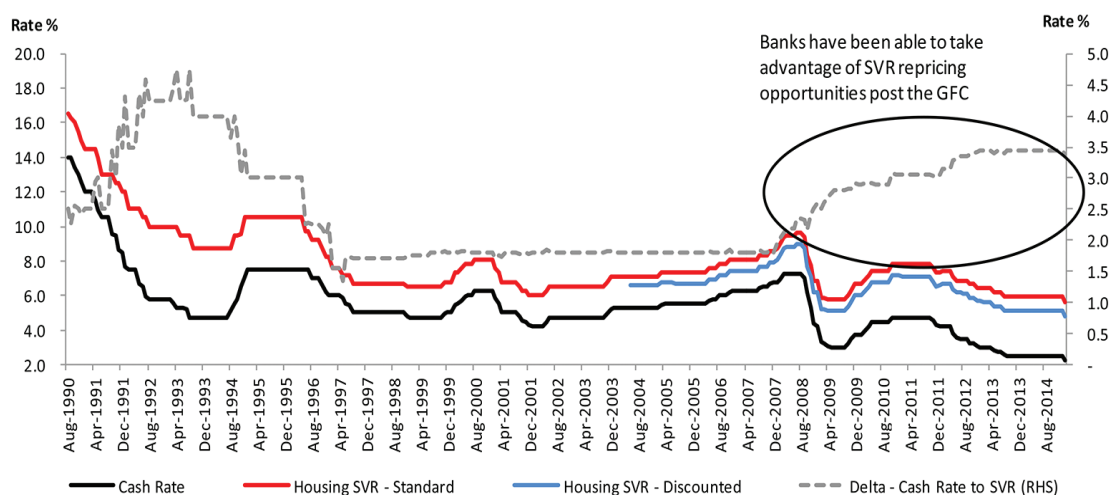
This enabled the additional funding costs to be passed straight through to customers (see Figure 6).

This repricing activity helped insulate bank earnings against the impact of the GFC with the Major Banks' Net Interest Margin (NIM), a key profit driver, bouncing from 2.12% in FY08 to 2.25% by FY11. This reversed a downward margin trend which had been in place since FY95 (see Figure 7). Although margins have recently fallen back to 2.06%, this reflects changes in business mix with rapid growth in mortgages.

Consolidation has also allowed the Major Banks to enjoy relatively high returns over the past 20 years, particularly compared to the Regional Banks where returns have fallen.

Banks' Discounted Variable Mortgage Rate vs. the RBA Cash Rate

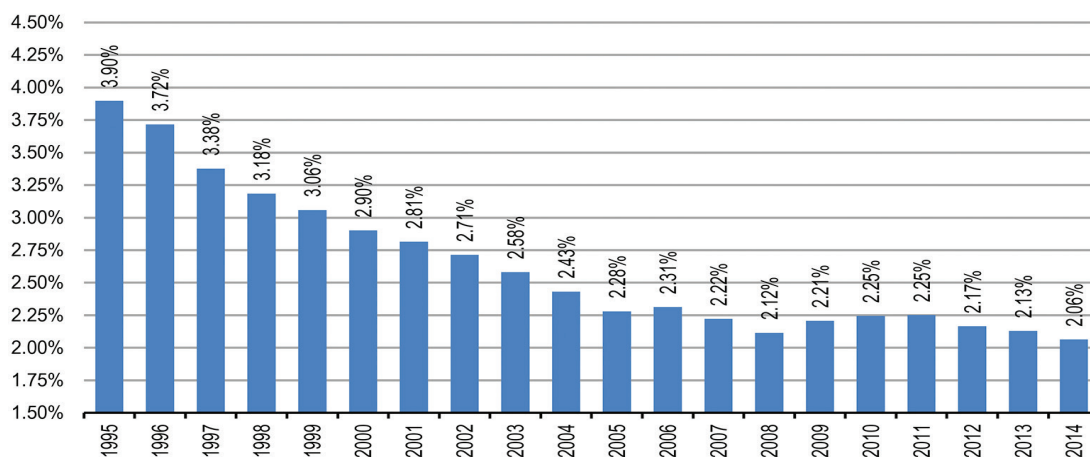
FIG 6



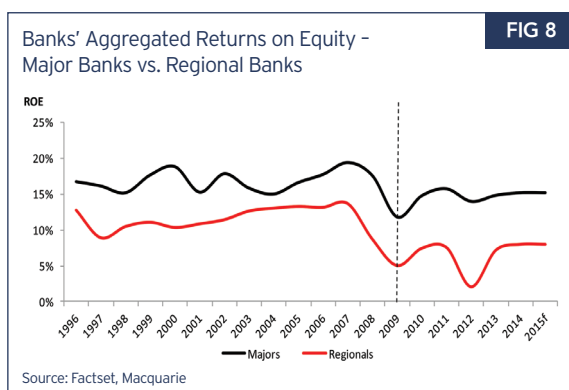
Source: RBA, Macquarie

GFC restored the net interest margins of the oligopoly

FIG 7



Source: Credit Suisse



Threats from Emerging Players

With industry profits at record levels and Return on Assets back at peak levels, there is a substantial risk of competition re-entering the banking sector. However, this is unlikely to come from traditional players. In particular, technology companies in the payments space and peer-to-peer (P2P) lenders in personal and SME lending may well disrupt the banks' oligopoly over time.

Within the technology space, the recent release of Apple Pay in the US highlights the desire of many technology companies to enter the payments system. PayPal and Google are other organisations which have the potential to become disruptive if the opportunity arises. As with other industries, once companies like Apple, Google, Facebook or PayPal gain critical mass within a market their ability to disrupt is substantial. The banks are aware of this threat and are investing heavily in technology to minimise this risk.

Another area of potential threat is from P2P lenders such as SocietyOneOne or Rate Setter. These businesses disintermediate the banks by enabling individual borrowers and savers to transact at a much narrower spread than is available via the banks. Although the P2P industry is in its infancy, better interest rates for personal and SME borrowers and higher yields for savers are likely to see it grow rapidly as has been the trend overseas. At present the banks have been reluctant to react to these threats given the risks to back-book profitability.

Threats from increased regulation

Regulation and supervision has risen exponentially since the financial crisis across the global banking industry. This scrutiny will continue, with the recent Financial System Inquiry (Murray Inquiry) and proposed changes to asset risk weightings under Basel IV remaining front of mind.

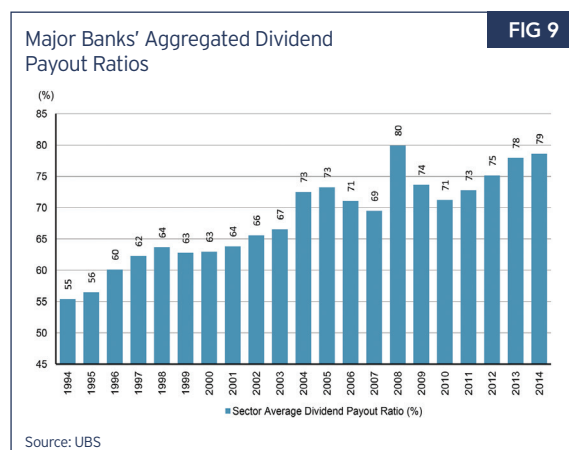
If adopted, these proposals could materially increase the level of capital banks would be required to hold, to ensure their balance sheets are "unquestionably strong". Although there is still much water to pass under the bridge, and final standards are unlikely before the end of the year, substantial capital raisings may be required by the banks to comply with the proposals.

While some of these costs are likely to be passed down to customers, stronger capital ratios may pressure returns over time and bring into question the sustainability of dividends. In the medium term, increased regulatory scrutiny of capital adequacy is the biggest issue facing the banks.

Retail Investors' Desire for Dividends vs Higher Regulatory Capital Charges

In the current ultra-low interest rate environment as retail investors search for yield, we continue to see P/E expansion in the banking sector. Retail investors currently make up 48% of the banks' share registers.

With a more subdued growth outlook and a push for higher dividends, the banks have obliged with increasing dividend payout ratios. During the late 1990s and early 2000s the banks generally maintained payout ratios in the mid-60s. This rose into the 70s pre-GFC



Since the Financial Crisis the banks have been steadily increasing their payout ratios as the outlook for credit growth has been subdued and investors have rewarded higher dividends. This has led to questions about whether payout ratios at this level are sustainable.

With regulators pushing for higher risk weights (given Basel IV) and increased capital ratios, the capital intensity of banking is likely to rise substantially. Not only will this force the banks to

raise further capital to meet these new targets, any future growth in loans or Risk Weighted Assets will require a higher level of equity funding. Therefore, unless profitability levels rise materially (via repricing), sustainable payout ratios will be lower in a post Murray/Basel IV world.

As the threat of new disruptive players increases over time, it is possible that the banks will have to reinvest more of their profits to protect their deposit and lending franchises, leading to further pressure on the payout ratios. Any deterioration in asset quality would further pressure dividend sustainability.

Industry Study 2: General Insurance

How General Insurance Became an Oligopoly

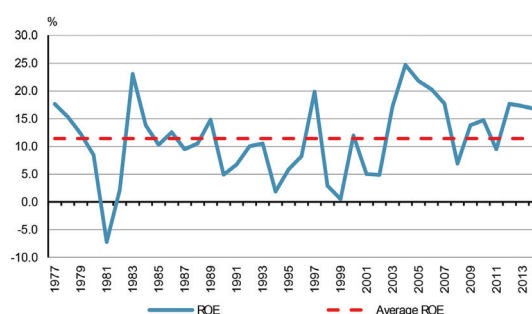
The antecedents to today's insurance oligopoly lay in the explosive growth in claims inflation in long-tail classes in the late 1990s. It was the collapse of the number two insurer at the time, HIH that was the catalyst for significant market consolidation and strengthening of capital standards.

Over a five year period, NRMA acquired a number of insurers and demutualised, AMP bought GIO which was subsequently sold to Suncorp, Wesfarmers' bought Edward Lumley Holdings, and QBE bought out its JV partner in Mercantile Mutual.

Prior to this consolidation, there were seven insurers that each held between 5% and 15% of the market, with the top five holding 54%. Today the top five control 75% of the market (top two 48%).

Australian General Insurance Industry ROE (Direct only, year to 31 Dec)

FIG 11



Source: UBS, APRA, Office of the Insurance Commissioner, Insurance and Superannuation Commission, Australian Bureau of Statistics

After tort law reforms in 2002 to address spiraling long-tail claims, industry profitability improved. Following these reforms and consolidation, industry returns have surged (see Figure 11).

It was at the tail-end of this period that Suncorp acquired Promina. The landscape has remained broadly similar since then, with the exception of the recent acquisition of Wesfarmers' insurance underwriting operations by IAG, which consolidated the number two and five players.

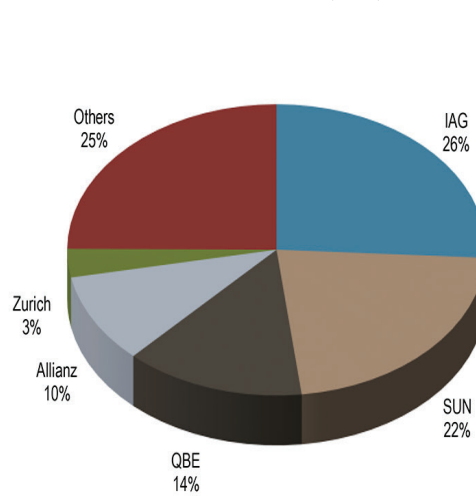
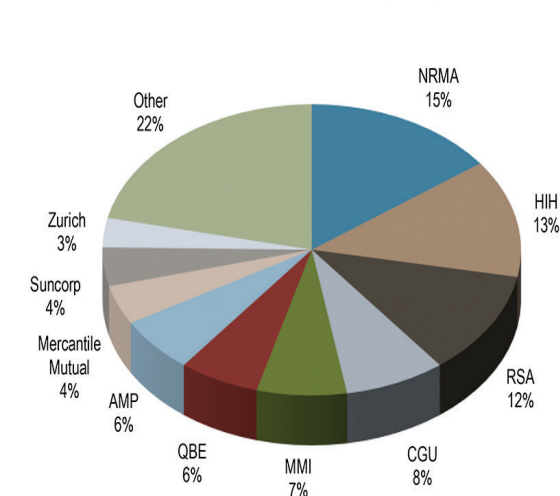
The direct distribution model of home and motor insurance in Australia and the benefit of scale and diversification inherent in the provision of insurance have been important in the establishment of the current market structure.

The prevalence of direct distribution has enabled IAG and Suncorp to reduce customer acquisition costs, reduce pricing transparency for consumers

Australia General Insurance market share (1999)

Australia General Insurance market share (2014)

FIG 10



Source: UBS, APRA

and reduce competition for customers. These issues have plagued other markets such as private health insurance, where intermediaries and aggregation sites have gained a dominant position.

Scale and diversification have allowed IAG and Suncorp to pool customer risk (particularly important when data analysis was less sophisticated), minimise customer acquisition costs and better manage claims.

However, the structural factors that have supported this new oligopoly may be less supportive going forward. We consider the drivers of change below.

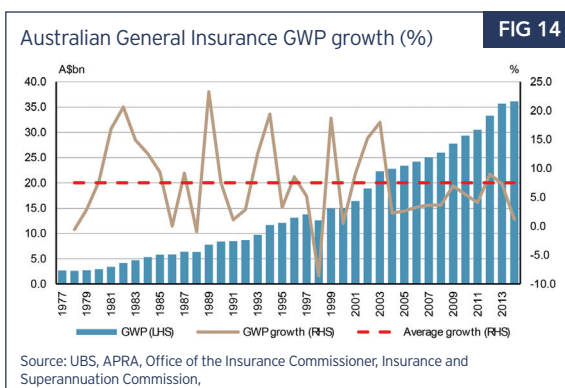
Current Competitive Situation

Between 2007 and 2011, there were six separate extreme weather events in Australia, each resulting in industry losses of over A\$1bn. Earthquakes in New Zealand also caused significant losses. This led to an extended period of rate increases in property classes, driving double-digit top-line growth and improving margins over 2010-2014.

The major insurers took full advantage of these catastrophe events to enhance profitability in Householder and Commercial Property portfolios,

enticing smaller start-up insurers to gain a foothold in the market. This group which we term "Challengers" (Youi, Real Insurance (backed by Hollard), Budget Direct (backed by Auto & General), Progressive and Coles) have grown their share of the motor insurance market from 4.6% to 12.4% in four years, at the expense of the majors (see Figure 12).

With improved levels of profitability, a lack of claims inflation, and benign natural perils, the need for rate increases has now abated. At the same time, competition in the motor and home insurance markets has intensified. The confluence of these factors has arrested premium growth in personal lines. We would be surprised to see any growth in premiums for years to come while the incumbents will continue to lose share to Challenger brands.



Motor GWP and market share changes (FY10 - FY14)

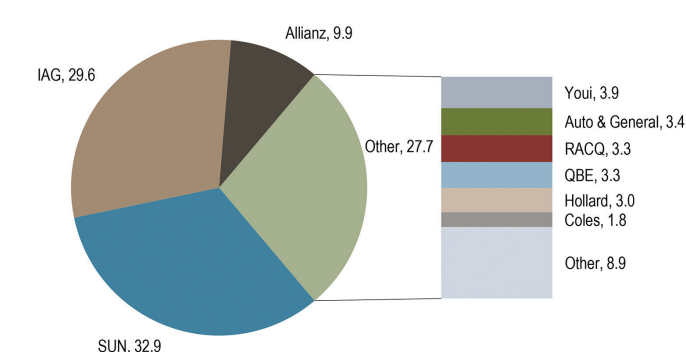
FIG 12

	FY10		FY14		4-year GWP CAGR (%)	Market share change (%)
	GWP (\$m)	Mkt shr (%)	GWP (\$m)	Mkt shr (%)		
SUN	2,320	35.4	2,597	32.9	2.9	-2.5
IAG	2,138	32.6	2,446	31.0	3.4	-1.7
Mid-tier	1,272	19.4	1,486	18.8	4.0	-0.6
Challengers	304	4.6	979	12.4	33.9	7.7
Other	515	7.9	390	4.9	-6.7	-2.9
Total	6,549	100.0	7,898	100.0	4.8	

Source: UBS estimates, Company data, APRA

Motor market shares by GWP (year to 30 Jun 2014)

FIG 13



With some of the highest insurance margins in the world, the Challengers are pursuing price led strategies to gain share and IAG and Suncorp are now being forced to respond.

In the six months to December 2014 Suncorp's premiums contracted by ~6% in NSW and Victoria. Suncorp has had to increase discounting at renewal to retain customers and marketing from both IAG and Suncorp has become increasingly price orientated.

To illustrate the risk of price led strategies and the importance of customer retention, as customer loyalty is potentially breaking down, we note that the level of customer retention in the UK motor insurance market has in some cases fallen to 50%. The UK has become an inherently unprofitable motor insurance market coinciding with the increased use of comparison sites as a distribution channel.

These pressures are now manifesting in declining GWP for the two majors, with both cutting average premiums in motor and home insurance in an attempt to stimulate growth.

Threat of Emerging Players

While pooling of risks is central to a successful insurance company, reduced acquisition cost, information transparency and accurate risk segregation made possible with modern technology has enabled the Challengers to profitably target certain customer segments. If they continue to execute successfully, the Challengers may undermine the profitability of the major players. It is unusual for a new entrant without scale in any industry to be writing such profitable business.

While IAG and Suncorp continue to develop more sophisticated insurance pricing aimed at retaining better risks, this can only help defend market share rather than grow share and expand margins.

On the other hand, new entrants are able to adopt strategies that selectively target risks rather than trying to cater for the whole market. This could negatively impact margins of the leading insurers. We consider some of the observable strategies below:

- **Geographic strategies:** New entrants are able to avoid regions impacted by natural disasters and where there their claims infrastructure does not extend (e.g. far north Queensland).
- **Product strategies:** New entrants are able to adopt a more focused strategy and avoid certain car types (e.g. luxury European cars that impact claims efficiency).
- **Underwriting strategies:** New entrants are able to avoid certain risks in the underwriting process (e.g. large tree within 10 metres of home).

Although it is early days, if successfully executed, the new entrants have the potential to capture the “good” insurance risks. The consequence is that, as new entrants capture more market share, the new entrants may disproportionately capture the “good” insurance risks and this may require a price response from larger incumbents to protect their position or they will be left with a book impacted by adverse selection which impacts margin.

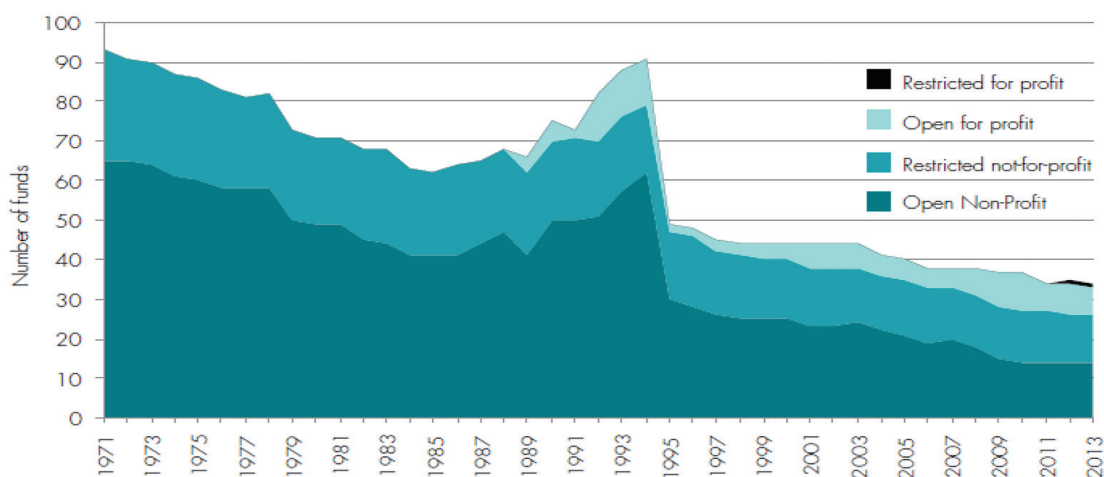
Industry Study 3: Private Health Insurance How Private Health Insurance Became an Oligopoly

The Private Health Insurance industry has seen considerable consolidation over time, evolving from 93 insurers in 1971 (pre-Medicare) to 35 today. The number of for-profit insurers has increased from zero in 1971 to eight today.

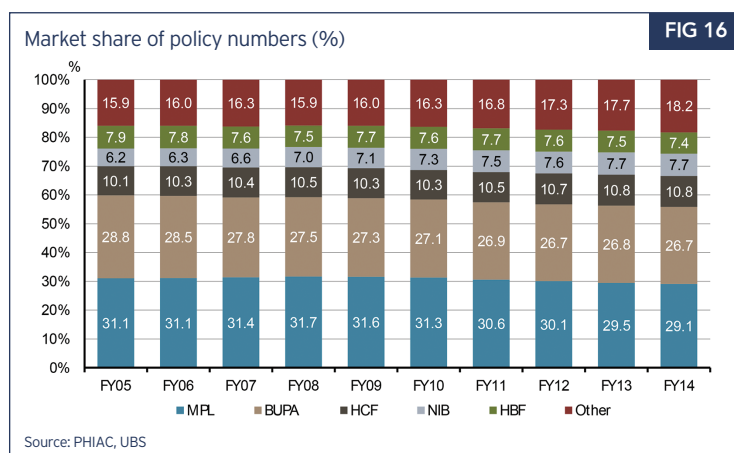
The year 2008 was the tipping point, Bupa acquired MBF in February 2008, and in December that year Medibank Private (MPL) acquired Australian Health Management. HCF acquired Manchester Unity shortly after that. This left the top five health funds controlling 84% of the market, with Medibank Private at 31.7% and Bupa at 27.5%. There is a long tail of 30 smaller health funds beyond this. Much of the consolidation activity was driven by the Liberal Government's intention to list Medibank Private in 2008, a policy which changed under Labor but then subsequently changed again in 2013 under the Liberals.

Number of registered funds in the Australian PHI market 1971 to 2013

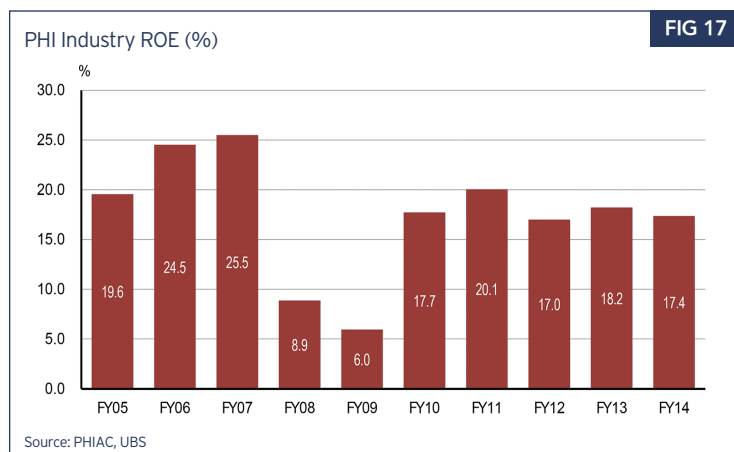
FIG 15



Source: PHIAC



Since this time, the industry has delivered consistently high returns (see Figure 17).



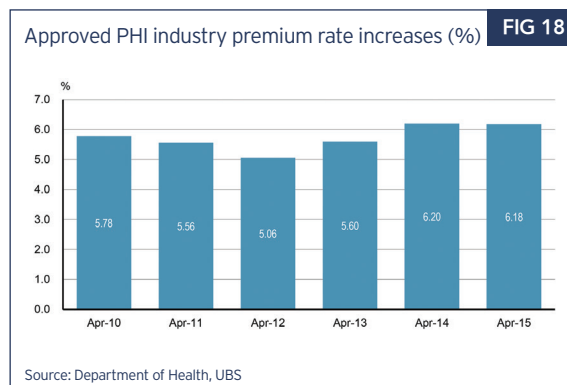
Current Competitive Situation

Health insurers do not compete on price in a typical free market as premium rate increases are approved by the Government every year and announced simultaneously by all funds before 1 April. While funds with slightly lower increases will often highlight this in campaigns around this time, most competitive activity in the industry revolves around marketing activity and tailoring “extras” to offer the best cover. Extras (often referred to as General cover) are sold mostly on a bundled basis with hospital cover, but either product can be purchased separately.

Given closer Government oversight, market shares have remained relatively stable, but there is clear evidence that the major players have gradually been shedding share. Medibank Private and Bupa’s combined share has slipped from 59.2% in 2008 to 55.8% in 2014.

One of the significant drivers behind market share changes has been affordability. Fairly consistent 5-6% price increases in recent years have significantly

increased the cost of health insurance, especially when expressed as a proportion of household income. Online aggregators like iSelect and Compare The Market are contributing to price transparency, allowing consumers to shop around for the best deals on price and extra features. This has been somewhat accentuated by the marketing campaigns of the aggregators which have highlighted affordability issues and encouraged churn as they get paid commissions for new business and benefit from this churn.



PHI industry premium rates increased a further 5.9% p.a. from June 2003 to June 2014. While this premium rate growth has supported industry revenues, policyholders have responded by downgrading cover.

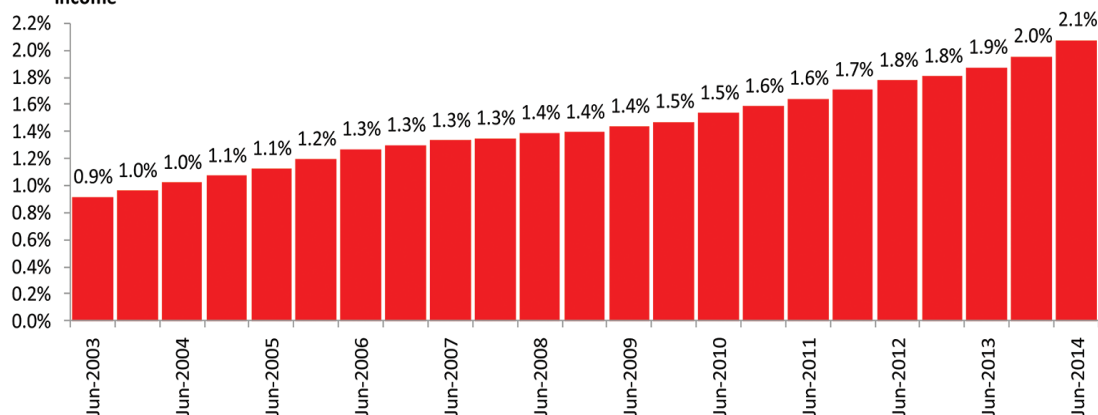
Accentuating affordability concerns was the removal of the 30% PHI rebate in July 2012 (for the ~20% of holders whose income is above the new limits imposed) and indexation of the rebate going forward for those who still receive it, among other PHI policy changes. Indexation will accentuate any price increases above CPI for policy holders, i.e. if a policy increases by 6% in total, but the rebate proportion only increases by 2.5%, the proportion paid by the policy holder increases by 7.5%. This level of price increase is unsustainable in the long term.

This has had limited impact on the absolute level of affordability for most policyholders to date (outside of policyholders on higher incomes who were means tested out of part or all of the rebate) but is expected to drive continued downgrading. Whilst rebate means-testing (which increased the effective policy price by up to 43%) has driven downgrading, PHI costs (after the rebate) as a proportion of after tax income in Australia have increased to 2.1% (see Figure 19) for the average premium per policyholder (\$1,237 p.a. post the rebate) and the average after tax income (\$59,492). While premiums have clearly increased materially as a proportion of incomes, the absolute magnitude of PHI premiums is still low on average.

PHI Premiums on Average are Now ~2% of After Tax Income

FIG 19

PHI % of est. post tax income



Source: Macquarie, Department of Health, ABS, ATO

Threat of Emerging Players

With the Private Health Insurance Administration Council (PHIAC) – the main regulatory body – being disbanded from 1 July, we feel the environment will become more conducive to new entrants. The Australian Prudential Regulation Authority (APRA) will regulate capital and other prudential matters, with other functions transferred to the Department of Health. Although the Government will maintain a firm regulatory hand on the industry, without direct ownership of a fund we believe its attitude to new entrants and competition could be more welcoming.

Given high returns and low capital requirements, we feel it is quite possible that life or general insurers may start selling health insurance. The ease with which customers can switch funds without being penalised is likely to be an attraction for a start-ups in this area, particularly if they already have an established financial services brand in Australia.

The potential for vertical integration to become more prevalent in the industry is also a source of emerging competition. The purchase of Transport Health by Primary Health Care in September 2014 represented a step in this direction, and is unlikely to be the last transaction of this nature.

Industry Study 4: The Australian Supermarket Industry

The landscape today

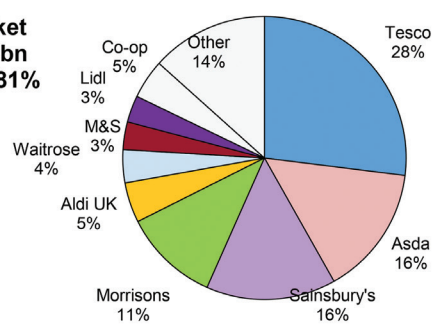
Woolworths and Coles dominate the \$112bn grocery channel with a combined 63% market share, a unique duopoly structure in comparison with other

Western countries. The Australian marketplace has a high proportion (10-15% and falling every year) of independent ‘mom and pop’ stores and a weak third player in IGA, which operates as a franchisee system. Until the entry of Aldi and Costco, Woolworths and Coles (which was in disarray until Wesfarmers acquired it 7 years ago) have enjoyed a relatively benign competitive environment. This cosy duopoly has enabled Woolworths in particular to grow sales above GDP for many years, entrenching its position in the share-market as a defensive blue-chip investment.

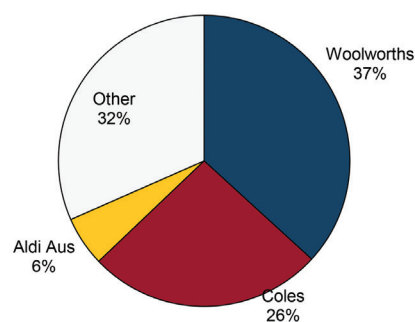
Supermarkets Shares UK vs. Australia

FIG 20

UK market
GBP155bn
Chains 81%

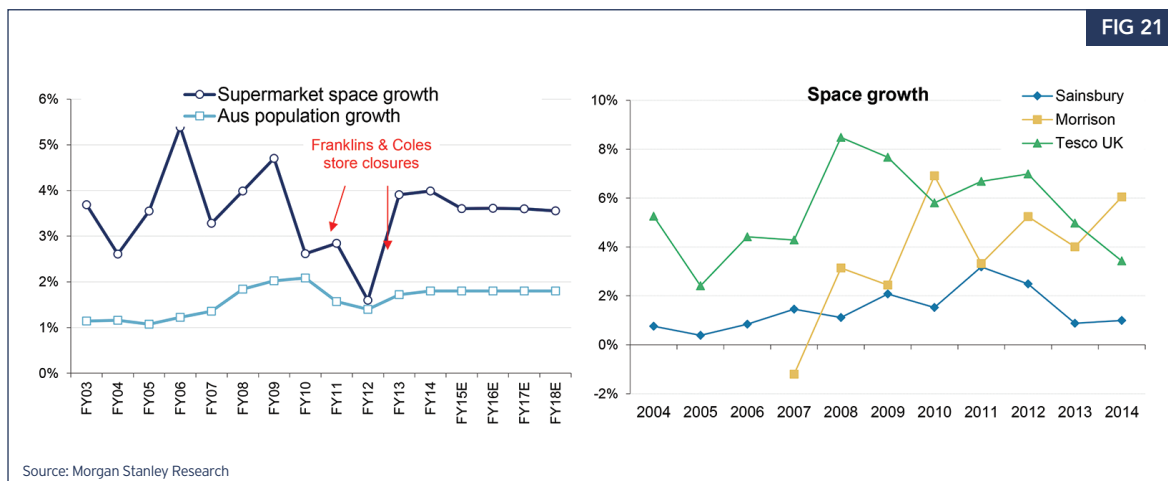


Australian market
AUD112bn



Source: XXX

FIG 21



The story however is changing, with Woolworths' recent trading update indicating it is lagging its peers. Our challenge in evaluating Woolworths is to determine whether this is a short-term setback in performance, or whether it is indicative of deeper issues. Systemic issues such as increased competitive intensity; excessive store roll-out; and an increased acknowledgement by consumers and regulators that Australian customers are being gouged on grocery prices all suggest that the challenges for Woolworths and Coles are more than transitory. In the UK, incumbents with high price points are losing share to discount chains Aldi and Lidl. This has been further aggravated by excessive growth in store space over the past decade, resulting in a blood bath for Tesco, a disaster scenario which could conceivably face Woolworths if similar forces come to bear on the Australian market.

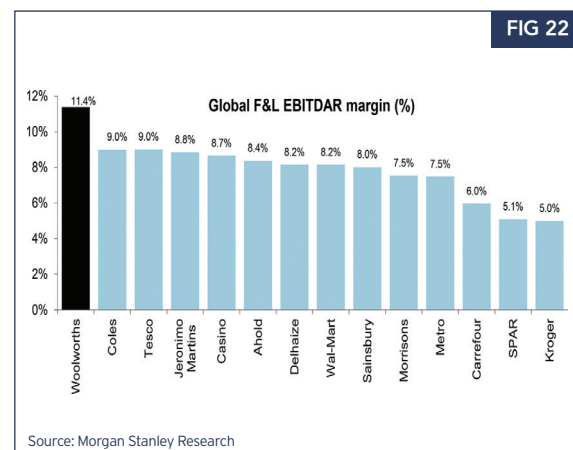
Industry profitability is under considerable pressure in the UK, will Australia's incumbents follow?

As illustrated in Figure 21, Australia has experienced supermarket space growth well in excess of population growth for the past decade, which has been led by Woolworths. One of the key criticisms of Woolworths in recent years has been its limited ability to grow sales per square metre, suggesting the underlying business is losing momentum.

One of the key elements in Tesco's fall from grace was its price points for consumers. It's hard to compare pricing across countries for numerous reasons, but when considering the profitability of Australian retailers with international peers, it is obvious margins are excessive (see Figure 22). On closer inspection, we can rule out labour and supply-chain as competitive advantages, so it is not the cost of doing business. This leaves gross margin where Woolworths and Coles are pricing the basket too high, not surprising given the weak competitive dynamics in Australia.

While Lidl are yet to launch in Australia, Aldi has grown its market share on the East Coast to 10%, surpassing its success in the UK, with plans to expand into South Australia and West Australia. Costco, while at present smaller, is also expanding and gaining traction.

FIG 22



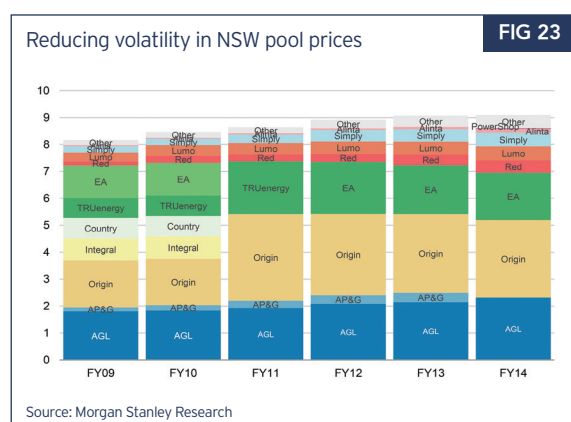
Woolworths and Coles are faced with a tough choice to either continue overpricing groceries drawing further interest from challengers or lower prices at the expense of short-term profitability. Until very recently Woolworths has resisted the tough decisions, but trading performance has become such an issue that earlier this year the company replaced its head of supermarkets and announced a price reinvestment program worth \$500 million.

While Coles holds price leadership in the eyes of the consumer, somewhat mitigating the risks with discounters, a more aggressive Woolworths is negative for all competitors. Early signs of a price war are emerging from suppliers, and while Coles has momentum which Woolworths doesn't, Wesfarmers share price does not reflect this increased level of competition. Given this uncertain outlook we are very cautious on the Australian Grocery sector.

Industry Study 5: Energy Retailers

The landscape today

Origin Energy, AGL and Energy Australia dominate the retail energy industry with a combined share servicing the majority of Australian homes. Until recently all states except Victoria had regulated prices, limiting returns to retailers and discouraging competition. South Australia and New South Wales have recently deregulated, and Queensland is soon to follow suit. The three incumbents are all vertically integrated owning combinations of gas and coal-fired generation. There is a raft of second tier retailers, mostly active in Victoria, which are typically more aggressive on pricing and offer more innovative products.



The industry dynamics are increasingly less attractive, will the incumbents adapt in time or are new entrants with lower cost structure's better placed?

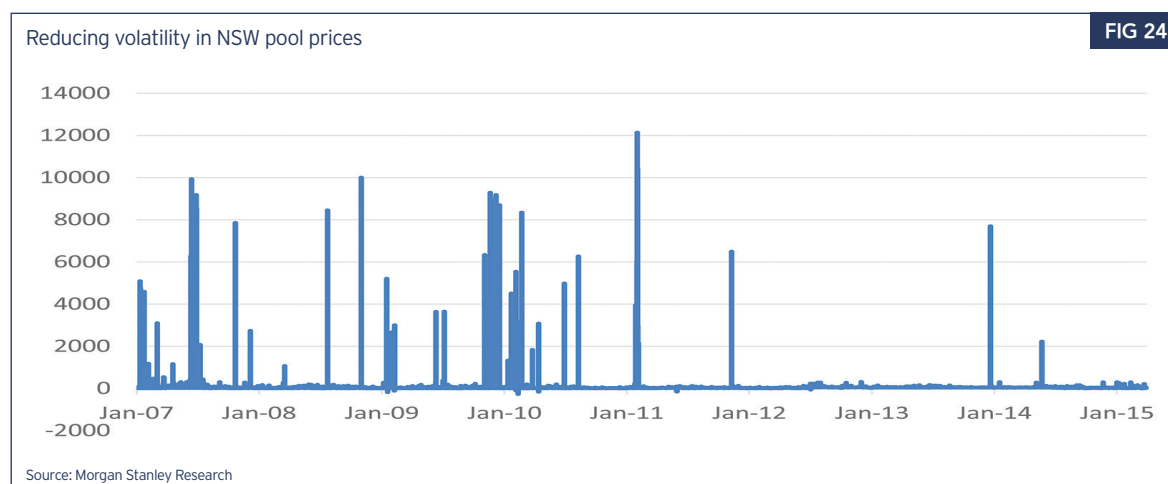
There are a number of structural factors undermining the economics of the incumbents. Firstly, generation capacity exceeds supply which is detrimental to merchant returns. Demand is falling each year as manufacturing and industrial sectors consume less energy and households become more energy efficient. The excess in generation

capacity has been further distorted by the installation of solar panels in the residential market, which allow homes to become energy self-sufficient. Approximately 15% of households have already installed solar, closer to 25% in South Australia, with this number increasing every month. The generation businesses of AGL, Origin and Energy Australia are struggling.

The second headwind with excess generation is the creation of cheap hedging for retailers which are not vertically integrated. An environment with low wholesale energy prices and cheap hedging de-risks the businesses of new entrants and second tier retailers.

While the incumbents are supportive of deregulation and the removal of price caps on retail electricity prices, these steps will naturally enhance competition. New market entrants will inevitably be attracted by low wholesale prices and hedging costs and higher retail prices. It isn't clear whether higher margins will provide sufficient compensation to offset incumbents' loss of market share to new competitors. We know that margins are not fully competed away - Victoria is the most profitable market even though prices have been deregulated, but we also know the incumbents have lost market share in Victoria where they hold proportionally less of the market than anywhere else in the country.

Technological change is reshaping the industry and over the next two decades, improvements to solar and battery storage will further disrupt the profitability of traditional coal and gas-fired generation. The National Broadband Network, smart-meters and wireless technologies will increasingly change the dynamics through which consumers interact with businesses, including their retailers. Whether the slow-moving incumbents can hold ground in an increasingly innovative world is far from proven, it is easy to see where they can lose and harder to imagine how they may benefit.



Performance Review

In absolute terms and given the funds' conservative positioning, the portfolios performed reasonably well during the quarter. With no net exposure to a market that delivered 8.72% for the quarter, total returns were derived almost exclusively from stock selection. Stimulatory Central Bank action here and abroad sparked a share market rally in mid-January which peaked early in March. The long portfolios provided strong absolute returns through this period, outperforming the rising market while the short portfolios performed largely in line with the market, detracting from total returns but broadly meeting our objectives.

March saw the market give back some of the gains made earlier in the quarter and provided a good example of the type of prevailing share market conditions that suit absolute return investing. With the market delivering a small negative return for the month, effective stock selection, sensible portfolio positioning relative to several key macroeconomic themes and some good fortune in respect of M&A activity, saw broad based contributions to the funds' total returns which were well in excess of both cash and equity benchmarks. Performance attribution from the short portfolios was particularly strong in March, demonstrating the benefit of an investment strategy that can generate significant value, independent of market momentum.

The funds were variously beneficiaries and victims of corporate actions through the quarter, demonstrating

the risks and opportunities that arise during periods where M&A activity is elevated. Interestingly, while the bid for Toll Holdings (a core short position for the funds) came very much out of left field, bids for iiNet and PanAust were not unanticipated and were based on clear value or business synergies as recognised by bidders and shareholders alike. This demonstrates the random element to investing that is introduced through short selling, whereby corporate transactions are not always based on economic fundamentals, but may be driven by strategic or other motives that are less evident on a fundamental analysis. We have spent many years developing our research process to take account of all such factors and have avoided many potentially difficult situations in the past as a result. Nevertheless, we will invariably be taken by surprise from time to time and can only hope the ledger of wins and losses tallies in our favour over the long term.

Given our outlook for equity markets outlined in this and previous quarterly reports, we believe that fund performance in Q3 of FY15 bodes well. The dual benefits provided through absolute return investing; being portfolio returns which are not dependent on a rising share market and the hedging of share market risk, will be particularly important going forward given the low forecast returns for shares and an environment where risks to the market are elevated. We have been particularly diligent in recent months, ensuring that the portfolios are balanced and well-positioned to withstand periods of share market volatility while continuing to introduce new investment ideas and themes.

Fund Snapshot – 31 March 2015

Fund at a Glance

ASX Code	ALF
Fund Size	AU\$332m
Fund Strategy	Variable Beta
Share Price	\$1.25
NTA Before Tax	\$1.34
Shares on Issue	254.8m
Dividend (1H15)	5 cents
Dividend Yield	8.8%

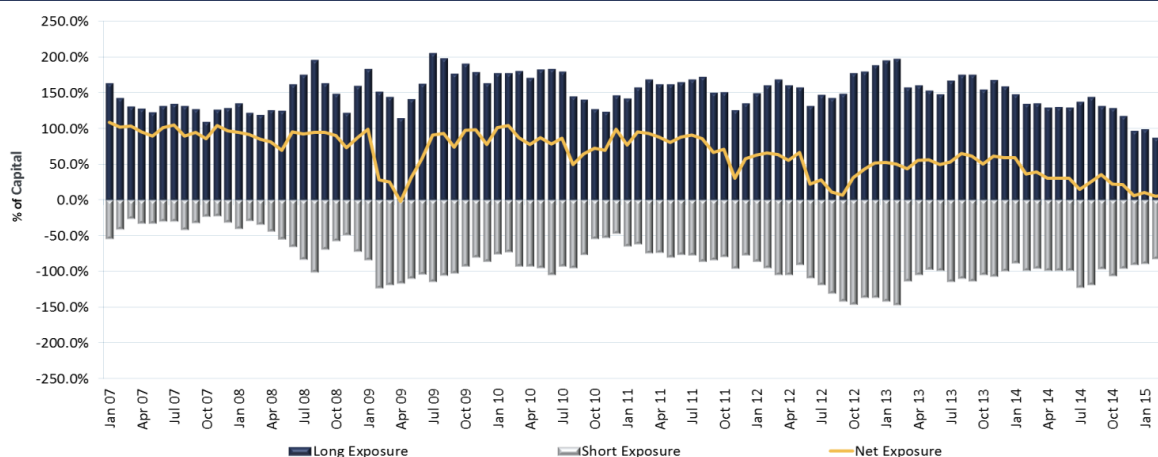
Net Tangible Asset (NTA) Backing

	Feb 15	Mar 15
NTA Before Tax	\$1.29	\$1.34
NTA After Tax	\$1.31	\$1.34
Dividend Declared	(\$0.05)	(\$0.05)
NTA After Tax & Dividend (5¢)	\$1.26	\$1.29

Performance¹

Period	Contribution				ALF Net Return
	S&P/ASX All Ordinaries Accum. Index	Net Equity Exposure	Market ²	Security Selection ³	
1 Mth	0.0%	4.6%	0.00%	3.0%	+3.0%
6 Mths	13.0%	14.3%	1.6%	-3.7%	-2.1%
Fin. YTD	12.7%	17.3%	1.0%	-7.7%	-6.6%
1 Yr	13.2%	21.3%	1.3%	-4.1%	-2.8%
3 Yrs p.a.	14.7%	37.7%	4.1%	10.7%	+14.8%
5 Yrs p.a.	8.2%	52.9%	1.6%	8.5%	+10.2%

Net Equity Exposure



¹ Performance data is net of all fees and expenses. The Fund's inception date is January 2004

² 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 and an adjustment for cash holdings, the contribution is not necessarily the same as the average equity exposure for the period multiplied by the market return.

³ All fees and expenses are netted off against stock selection.

Fund Snapshot – 31 March 2015

Fund at a Glance

Fund Size	AU\$38.5m
Firm Assets	AU\$455.6m
Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

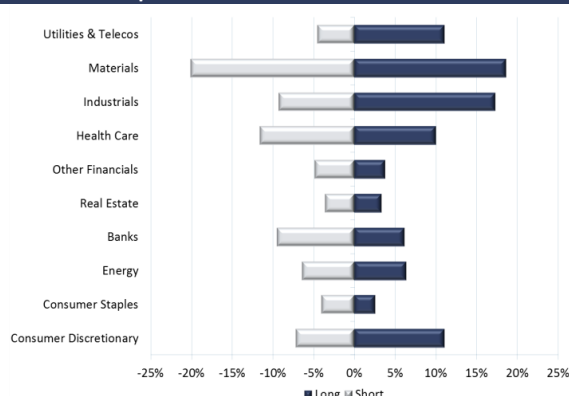
Return Characteristics¹

Positive Months	69%
Maximum Drawdown	-9.04%
Sharpe Ratio	1.13
Sortino Ratio	3.83
Standard Deviation	9.03%
No. Long Positions	68
No. Short Positions	57
Gross Exposure	171.7%

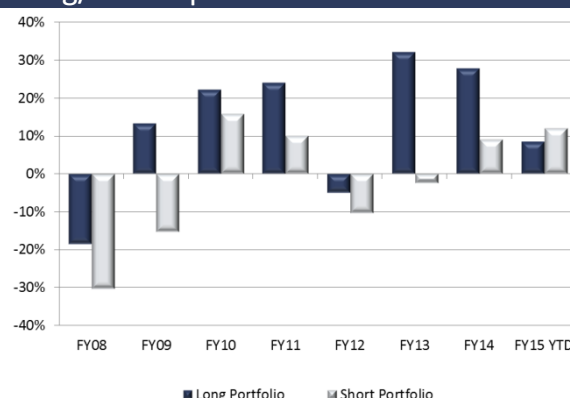
Monthly Net Performance

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	-4.4	-1.8	2.5	-1.57	-1.58	-1.32
2015	-1.18	0.70	3.23									

Sector Exposures



Long/Short Spread²



Gross Portfolio Structure

Investment Type	February 2015		March 2015	
	\$m	%	\$m	%
Listed Securities - Long	34.5	93.6	34.8	90.3
Listed Securities - Short	-33.9	-92.6	-31.3	-81.4
Net Exposure	0.6	1.0	3.4	8.9
Cash	38.4	99.0	35.1	91.1

¹ Return Characteristics are in relation to the market neutral strategy using data recorded from April 2008

² Long/Short attribution is before fees. Portfolio returns prior to inception are calculated using the returns of the long and short portfolios of the Australian Leaders Fund Ltd.

Fund Snapshot – 31 March 2015

Fund at a Glance

ASX Code	WMK
Fund Size	AU\$85.1m
Fund Strategy	Equity Market Neutral
Share Price	\$0.86
NTA Before Tax	\$0.98
Shares on Issue	87.4m
Dividend (1H15)	2 cents
Dividend Yield	5.2%

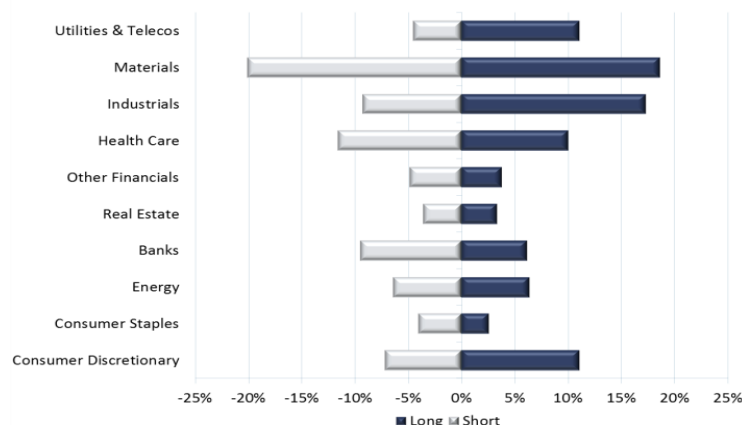
Net Tangible Asset (NTA) Backing

	Feb 15	Mar 15
NTA Before Tax	\$0.95	\$0.98
NTA After Tax	\$0.96	\$0.98
Dividend Declared	(\$0.02)	(\$0.02)
NTA After Tax & Dividend (5¢)	\$0.94	\$0.96

Performance¹

	1 Mth	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I (pa)
WMK (net return)	3.2%	-1.8%	-5.1%	-0.5%	N/A	3.6%
RBA Cash Rate	0.2%	1.2%	1.9%	2.5%	N/A	2.5%
Outperformance	3.0%	-3.0%	-6.9%	-3.0%	N/A	1.1%

Sector Exposures



Gross Portfolio Structure

Investment Type	February 2015		March 2015	
	\$m	%	\$m	%
Listed Securities - Long	34.5	93.6	34.8	90.3
Listed Securities - Short	-33.9	-92.6	-31.3	-81.4
Net Exposure	0.6	1.0	3.4	8.9
Cash	38.4	99.0	35.1	91.1
Capital	39.0	100	38.5	100

¹ Performance data is net of all fees and expenses. The Fund's inception date is July 2012



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