



The Leading Edge

QUARTERLY REPORT • September 2017

In this edition, we examine the outlook for the Australian residential property market and look for lessons and early warning signs for a downturn from comparable markets abroad.

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Justin Braitling
Portfolio Manager

Message from the CIO

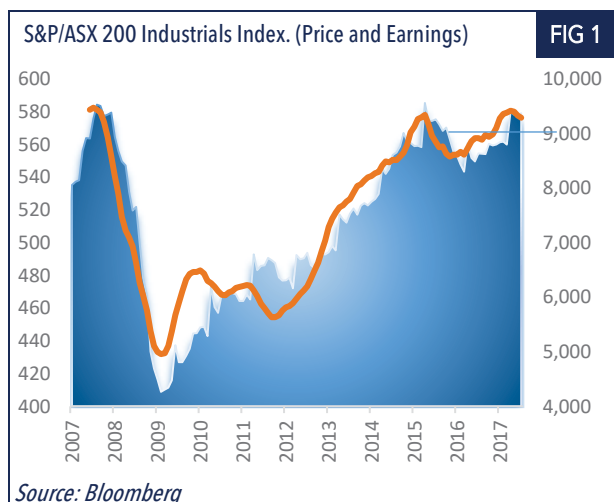
It has been a difficult year for our funds. Having been fully-hedged, we have not participated in the strong rally in shares. This has been further exacerbated by our failure to create value through security selection. In a typical year we would hope to achieve a 5-10% return for our investors across our funds, irrespective of what the share market delivers.

This return is derived internally through security selection and is unrelated to share market performance. Over 5 years we have achieved, and even exceeded this target while retaining little or no market exposure. So far in 2017 we have fallen well short.

Whilst we have not met the targets we set for ourselves, investors should keep in mind that there has been little, or no value lost in terms of the capital entrusted to us. Rather, we have struggled to create value in a period that has presented a myriad of challenges for many managers, including Watermark.

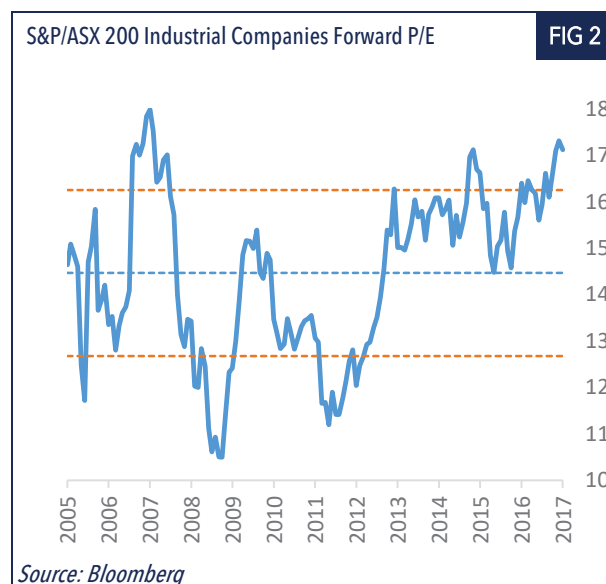
Unlike traditional funds that benefit from buoyant markets, our ability to deliver outcomes for investors depends entirely on the skill and success of our investment professionals. We have been busy in the last 18 months building out our investment team and are pleased to announce the appointment of Harvey Migotti in a new role as Head of International Equities. Harvey joins Watermark from Balyasny Asset Management in London. Having strengthened our international research resources, I have freed up my time to refocus on Australian equities, which remains a core focus for the business.

Turning to the market outlook. Shares have continued to grind higher as this cycle moves into its final phase. We have been cautious on the Australian share market for the last few years as profit trends have stalled and valuations have become quite stretched. In figure 1 below you can see earnings for Australian Industrial companies have been moving sideways for the last few years and shares have more or less followed.



Profit growth is likely to be subdued in the medium term given ongoing weak personal income trends, a low savings rate and elevated household debt levels. While the market continues to move higher, it is running ahead of underlying earnings, which is unsustainable. As valuations have moved well into extended territory, either profit trends improve (unlikely given the recent profit results were disappointing), or the market becomes even more overvalued, which cannot be sustained in the long term.

As is often the case toward the end of each cycle, valuations are once again looking stretched (*Fig 2*), with risks rising along with share prices.



In this edition of the Leading Edge we take a closer look at the property market and the important role it has played in sustaining this recovery. As the property cycle now looks to be rolling over, we consider the consequences for the broader economy.

This business cycle is shaping up to be one of the longest on record. As sure as night becomes day and product and labour markets tighten further, policy will eventually also tighten and this cycle, like all others will naturally end.

Our objective for each of our funds is clear: to achieve reasonable returns for our shareholders over time while avoiding major drawdowns. The value in this strategy can be easily grasped when one considers the Australian All Ordinaries Index is still well below where it was ten years ago. Most investors are yet to fully recover the capital lost from the last drawdown. If we can avoid these drawdowns while delivering reasonable returns year in year out, our investors will be well ahead in the longer term.

What's in store for the Australian property market?

It is well known that Australia has high house prices and elevated levels of household debt. Less widely discussed, but equally important in our view, is Australia's extraordinary level of speculative amateur investor activity in the housing market. In this report, we show that the participation of levered amateur investors in domestic housing is inflated in comparison to other countries, both currently and historically. We provide examples from the US to demonstrate that housing markets with significant investor participation tend to be more volatile – both in periods of boom and bust.

We also predict that Australia is near a peak in national house prices based on our learnings from countries that suffered housing-led economic downturns in the 2000s. Further, it appears that our economy is losing momentum quickly in comparison to four other countries with similar inflated levels of house prices and household debt – Canada, New Zealand, Norway and Sweden.

Our concerns however, extend beyond just house prices. Australia is demonstrating a unique combination of elevated house prices, high household debt and speculative housing investment; along with deteriorating underlying economic momentum.

Our analysis will be along the following lines:

1. **An overview of Australia's imbalances** – context for the level of Australian debt, housing prices and levels of investor participation.
2. **Lessons from the US on the effect of investor speculation on house prices** – demonstrating that markets with high participation from levered amateur investors exhibit more volatility, both when house prices are rising and falling.
3. **What to look for to time the peak in house prices** – observations from six countries that suffered housing-led economic downturns in the mid-2000s, supporting a conclusion that Australian house prices are likely nearing their price peaks.
4. **Evidence that Australia's economy is already slowing down** – comparing Australia's recent economic momentum to countries with similar household debt levels and house prices (Canada, New Zealand, Norway and Sweden) to conclude that Australia's downturn is likely to come first.
5. **How we are positioning the portfolio** – we draw on the experience of northern Europe in the last ten years to predict that in Australian financial services, mortgage lenders and P&C insurance companies will do relatively well. In contrast business banks and real estate companies may struggle.

An overview of Australia's imbalances

Australia's household debt levels are high

Depending on the measure, Australian households have either the second or fourth highest levels of debt in the OECD. Our general observations about the effects of household debt are:

- Extreme levels of household debt cause downturns to be deeper and more protracted than those entered when debt levels are lower.
- Rising household debt is associated with better growth, employment, and asset price outcomes, but these effects are generally reversed in 3 to 5 years.

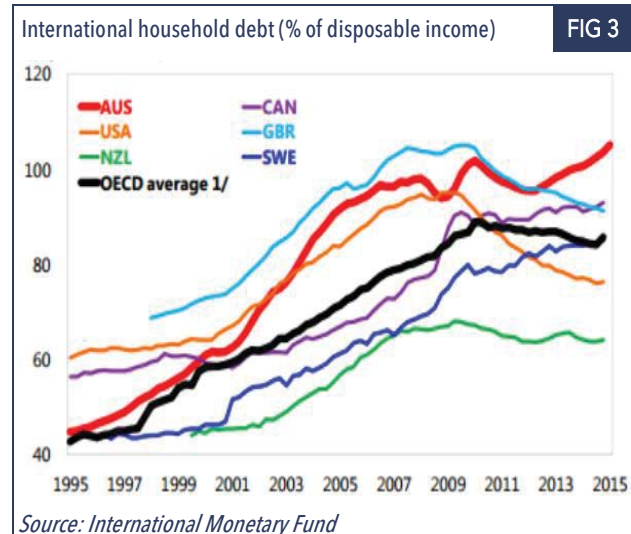
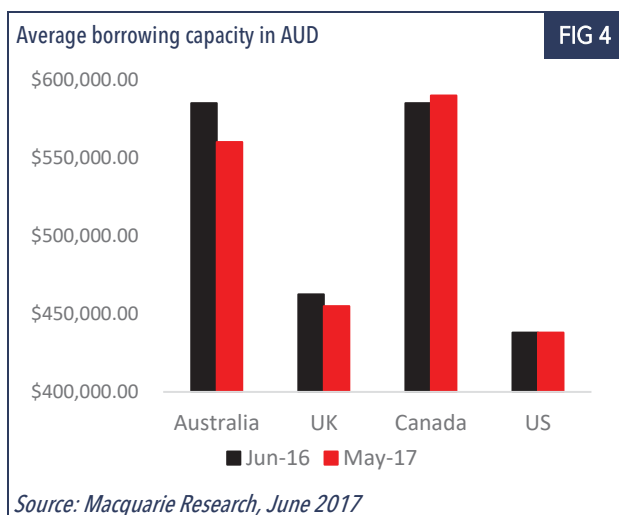


Figure 3 shows how Australian households have undertaken a recent borrowing boom which has left them with soaring levels of debt relative to foreign peers.

How did Australian households become so leveraged?

Australia's debt predicament is largely due to it not having a significant economic, house price or credit contraction in 25 years. ABS statistics going back 40 years indicate Australian households have increased their mortgage debt every year. These factors have produced what the Bank of International Settlements recently described as the longest bull-market in house prices ever recorded (55 years – see <https://www.bis.org/publ/work665.pdf>).

Following this unprecedented expansion, we believe hindsight will reveal Australian banks have simply over-lent to households. Macquarie Research frames this argument well (*Fig 4*), showing that an Australian earning \$100,000 can borrow \$575,000 at 4.5% from an Australian bank, while a Brit with the same income can only borrow \$450,000 at 1.6%. Why can an Australian borrow 30% more than a Brit despite a significantly higher interest rate? We believe that British bankers can recall a recession and house price declines while Australian bankers cannot (*Fig 5*).



Ten least affordable cities in 2017 **FIG 6**

Least Affordable	Nation	Housing Market	Median Multiple
1	China	Hong Kong	18.1
2	Australia	Sydney	12.2
3	Canada	Vancouver	11.8
4	NZ	Auckland	10
5	US	San Jose	9.6
6	Australia	Melbourne	9.5
7	US	Honolulu	9.4
8	US	Los Angeles	9.3
9	US	San Francisco	9.2
10	UK	Bournemouth & Dorset	8.9

Source: Demographia International Housing Affordability Survey



Ten least affordable cities in 2006 **FIG 7**

Least Affordable	Nation	Housing Market	Median Multiple
1	US	Los Angeles	11.5
2	US	Salinas	10.9
3	US	San Francisco	10.8
4	US	Honolulu	10.3
5	US	San Diego	10
6	Australia	Mandurah	9.5
7	US	San Jose	9.3
8	Australia	Sunshine Coast	9.3
9	UK	Bournemouth & Dorset	8.9
10	UK	Belfast	8.8

Source: Demographia International Housing Affordability Survey

Australia has elevated house prices

Australia's cities are home to some of the world's most expensive houses as measured against local incomes. According to Demographia, Australia has two of the ten least affordable housing markets in 2017 (*Fig 6*) ranked across 406 metropolitan centres in Australia, Canada, Hong Kong, Ireland, Japan, New Zealand, Singapore, UK and US. This annual survey grades cities by their 'median multiple' - the median house price divided by the median household income in that area. For example, Sydney's median multiple of 12.2x is the ratio of the Sydney median house price of \$1.1million and the Sydney median income of \$88,000.

Interestingly, the least affordable cities in 2006 (*Fig 7*)—before the financial crisis and US/European housing market downturns— reveal a striking similarity in price-to-income multiples.

Speculative investors are key players in the Australian housing market

Amateur investors are those operating outside of professional investment companies and not-for-profit institutions (i.e. councils, housing associations, etc.). Speculative investors are those purchasing assets where the income produced by the asset is insufficient to cover ongoing expenses and debt servicing costs. For speculative investors, an investment profit can only be reasonably expected from an appreciation in the asset's price. This is currently the case for Sydney and Melbourne investment properties, if purchased with leverage.

The level of leveraged amateur investor participation in the Australian residential real estate market is possibly its most worrying feature. Australian home ownership rates in the high-60s (%) are not unusual relative to other advanced economies. The anomaly in Australia is the residential rental sector, which is almost exclusively dominated by non-institutional landlords (i.e. 'mums and dads'). Whereas in other countries residential rental stock is predominately owned by state institutions (i.e. UK council houses) or institutional investors (i.e. Blackstone's

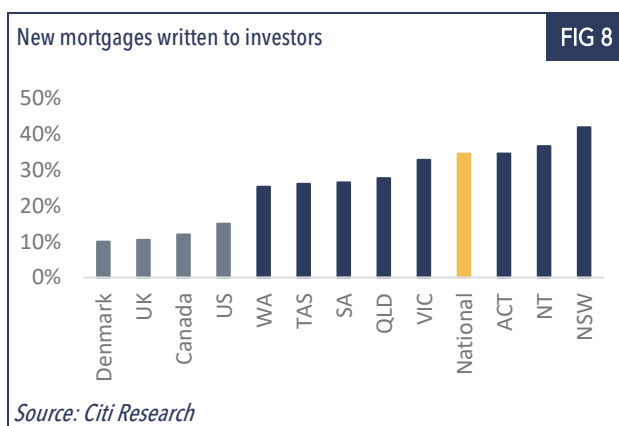
Invitation Homes in the US or Vonovia in Germany). Public housing has never been popular in Australia and rental yields are far too low to entice institutional investors.

What the US teaches us about investor speculation

With regard to the involvement of investors in Australia, we provide data to support the following points:

1. Amateur (i.e. non-institutional) investor participation in the Australian residential real estate market is extreme by international standards.
2. The US experience in the 00's suggests that housing markets with high participation of leveraged speculators tend to exhibit increased volatility in both booms and busts.
3. There is evidence that investors, and not owner-occupiers, are increasingly setting the marginal price for Australian houses. This is a concern to the extent that recent macro-prudential measures and possible future tax changes are being specifically designed to reduce investor activity in the Australian housing market.

To compare Australia's position with other global economies in terms of property market investor participation, figure 8 identifies the proportion of new mortgages written to non-professional property landlords. At 35%, Australia is approximately three times higher than the US, UK and Canada; with Sydney far exceeding all markets at 42% (down from the 50% in 2015-16).

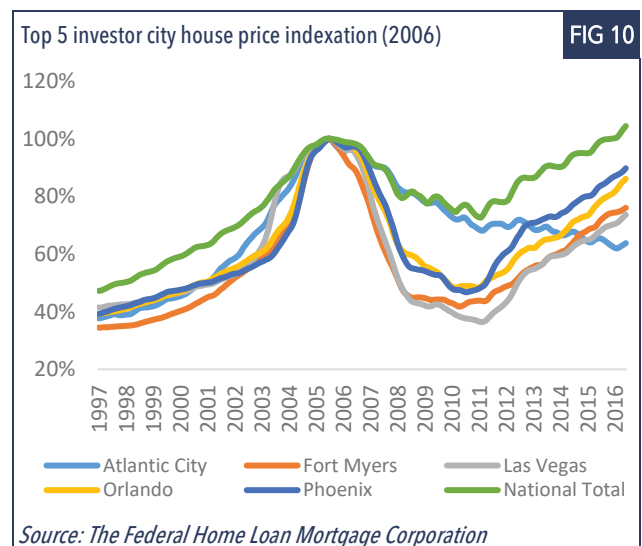
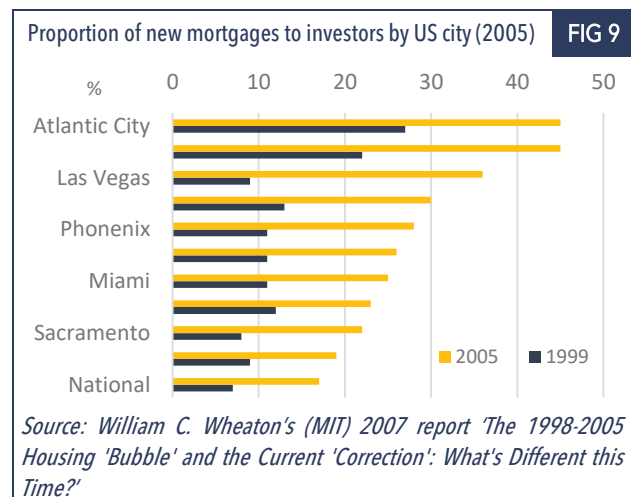


To understand the effect that investors can have on local property markets, we reviewed a report by MIT's William C. Wheaton: 'The 1998-2005 Housing 'Bubble' and the Current 'Correction': What's Different this Time?'. It analyses US cities where investors accounted for the largest proportion of new mortgages.

The highest investor borrowing activity in 2005 (**Fig 9**) was in Atlantic City, Fort Myers and Las Vegas where investors accounted for greater than 40% of total new mortgages. Analysis of data from The Federal Home Loan Mortgage Corporation (**Fig 10**) shows how house prices behaved in those

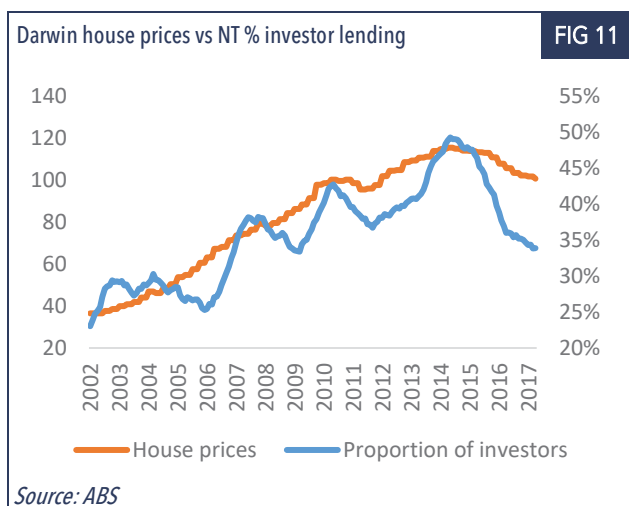
top three cities for investor activity, with figures indexed to 100% at the price peak in 2006. These 'investor cities' had greater than 50% appreciation in the housing boom and a 50% larger correction when the market declined, compared to the US national average (the green line - **Fig 10**).

This would suggest that markets with above average leveraged investor activity demonstrate above average price volatility. Given that the Australian national average is currently 35%, similar to Las Vegas at its peak, we expect that the behaviour of Australian property investors will be a crucial driver of house price volatility going forward.



What evidence do we have of investors driving house prices in Australia?

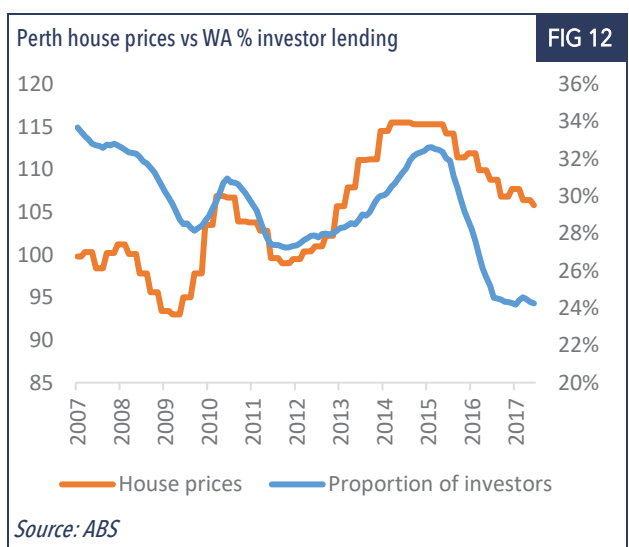
Recent house price trends in Australian cities suggest investors are playing a meaningful role in setting the clearing price for houses. We have observed two recent house price corrections in Australian capital cities: Perth and Darwin. In both cities, prices rose as investors became more active in the market (as measured by the proportion of new loans being drawn by investors) and declined as investors stepped back (**Fig 11 & Fig 12**).



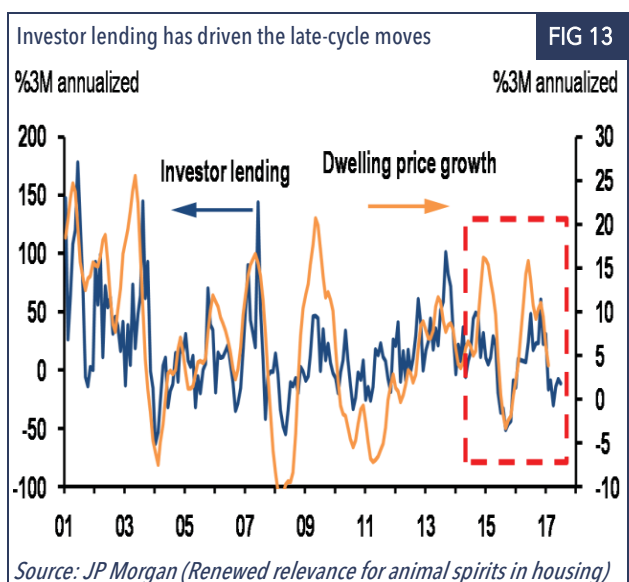
Why do we think Australian house prices are close to peaking?

We looked at dozens of indicators in six countries that experienced housing-led economic downturns in the 2000s—UK, US, Ireland, Spain, Denmark and the Netherlands. Our analysis found at least six indicators that reliably started declining before house prices started to fall. We consider these as valuable early warning indicators that housing prices are close to peaking:

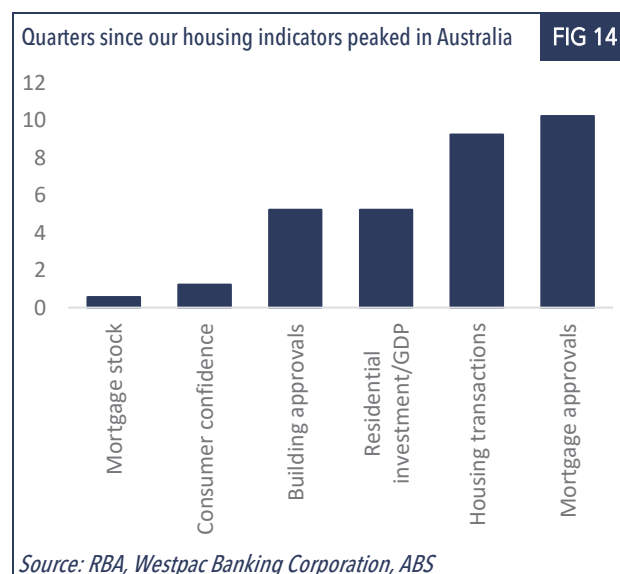
- Growth rate in mortgage credit stock
- Mortgage approvals
- Building approvals
- Housing transactions
- Residential investment as a percentage of GDP
- Consumer confidence



Looking broadly across Australia, JP Morgan analysts have identified that investor lending appears to be increasingly important to the setting of house clearing prices (*Fig 13*). The report states: “investors have dominated the housing cycle more recently, driving upswings in 2014 and 2016, and the subsequent slowdowns following macro-prudential tightening”.



All indicators mentioned above have peaked in Australia. Furthermore, Australia is the only country out of our high-debt/house price sample (Australia, Canada, New Zealand, Sweden, Norway) where all six factors are declining. The chart below (*Fig 14*) shows how many quarters have passed since each indicator last peaked in Australia. While our research found no perfectly consistent timing between indicators peaking and house prices falling, an approximate lead time appears to be between two to four quarters. Considering this, and given the data below (*Fig 14*), we estimate that Australian national house prices are likely to peak in the first half of 2018 (Sydney, Perth and Darwin are already falling).



Australian regulators are aware that property speculation has become too widespread. This recognition prompted the implementation of macro-prudential policies in 2015, which

targeted investor lending, limiting year-on-year growth rates to 10%. When the RBA cut rates in 2015 and 2016, prompting a shift by investors back into housing, APRA acted to limit growth in investors' product of choice: interest-only loans. The question from here is what do investors do in response to:

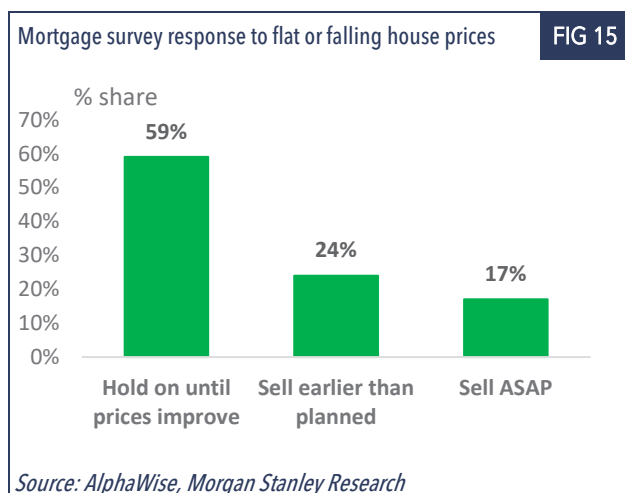
- **Ongoing tighter credit conditions from macro-prudential squeezing and new responsible lending rules?**

- **Poor prospective investment returns?** A Sydney or Melbourne property investor with an 80% LTV mortgage is likely to incur negative cash carry (i.e. before tax) costs of 2% to 4% of the value of the property. Furthermore, it can cost between 6% to 7% of its value to buy and sell a property. Therefore, an investor needs 3% to 5% compounding house price inflation (depending on the holding period) just to break even.

- **Possible changes to tax laws?** The recently elected Labour government in New Zealand is likely to scale back property investing tax concessions and we believe a Labor government in Australia would likely take similar action.

If a combination of the aforementioned factors were to drive investors out of the market, the relationships explained above suggest a material negative impact on house prices.

Morgan Stanley Research (*Fig 15*) recently surveyed Australian mortgagees and found 40% intend to sell if house prices are flat or falling. Interest-only borrowers (mostly investors) were three times as likely to sell in response to flat or falling house prices compared to principle and interest borrowers.

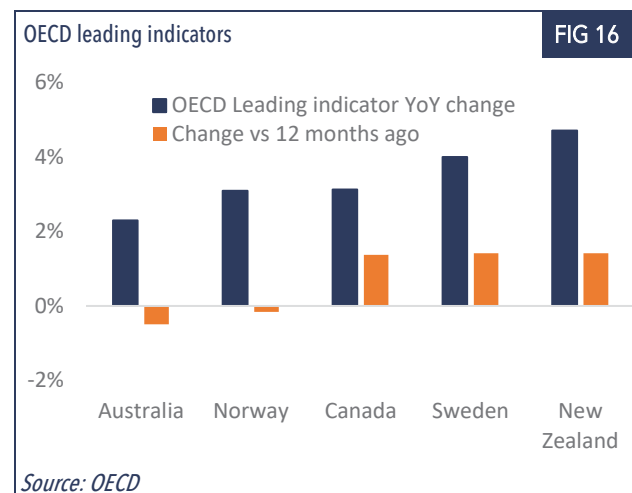


The Australian economy appears to be losing momentum

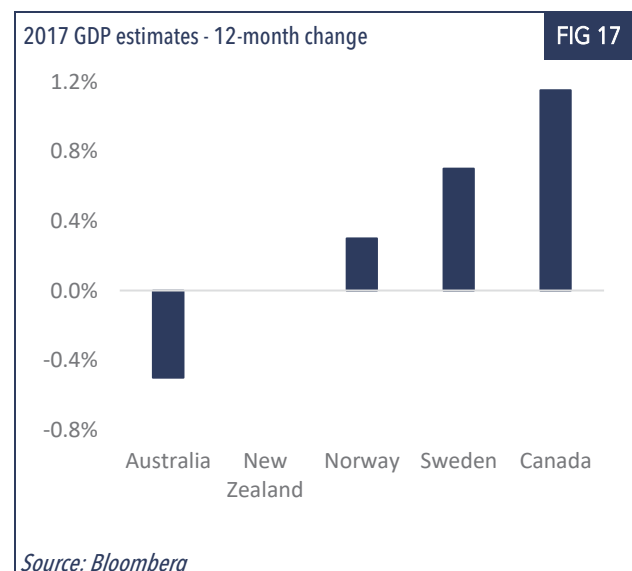
We compared the Australian economy to other global economies that exhibit similar characteristics of high prices and debt (Canada, New Zealand, Sweden and Norway). This reveals that the Australian economy appears to be losing momentum most rapidly out of the five nations. To provide evidence of this slowdown we show:

- OECD leading indicators
- 2017 GDP estimates
- 2017 unemployment estimates
- The number of building approvals
- The amount of residential investments

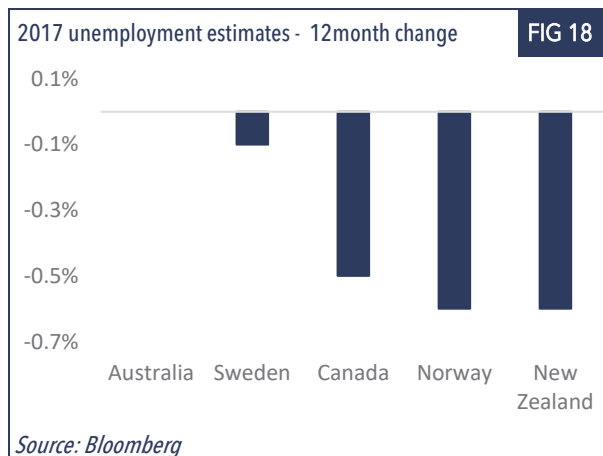
The chart below presents the year-on-year percentage change in the OCED lending indicator. The blue bar is a proxy for the rate of growth in the economy, and the orange indicates if that growth is accelerating or decelerating compared to twelve months ago. As can be seen, Australia has the lowest rate of growth and that growth is declining, while other economies have improved (a positive orange bar).



The following chart illustrates the change in economists' 2017 GDP estimates in the last 12 months (*Fig 17*). It takes economists' estimates for 2017 GDP growth today and subtracts what that estimate was 12 months ago. A positive reading indicates economists' expectations for 2017 GDP are higher presently than they were 12 months ago, and a negative reading indicates those expectations are lower today. Australia is one of the few countries for which GDP developments have been disappointing in the last 12 months.



When we review changes in expectations for unemployment (*Fig 18*), we observe that economists' unemployment rate expectations fell over the last 12 months across our sample markets – a positive development. Australia's unemployment rate is static compared to other nations – a concerning indicator.



Australia stands out as the only country in our sample pool where building approvals are lower now than they were 12 months ago (*Fig 19*). This may suggest that the Australian home-building cycle has passed its peak, whereas other economies are still experiencing growth.

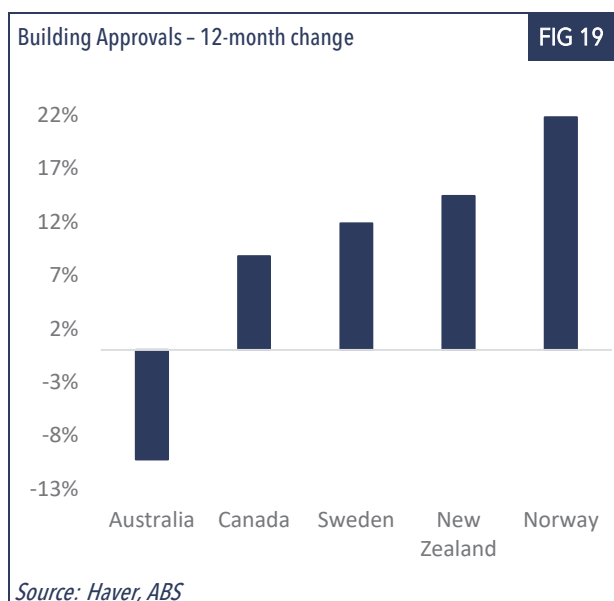
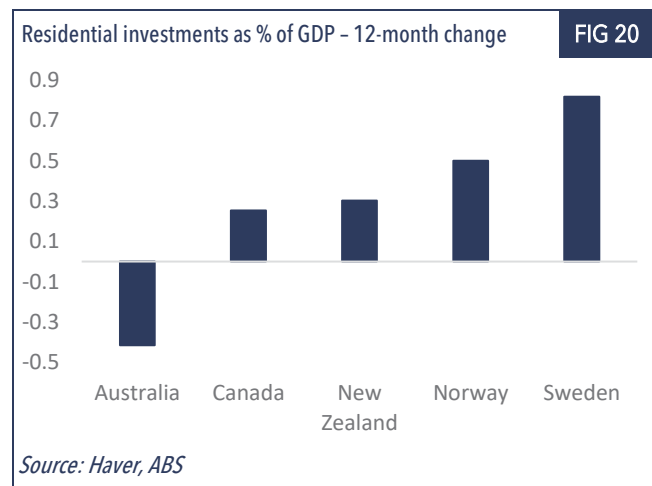


Figure 20 paints a similar picture, it shows the 12 month change in the contribution of residential investment to GDP. Residential investment consists of building new houses, renovating existing houses and dwelling transfer costs..

Australia's residential investment is between 6% and 8% of GDP. A positive reading (*Fig 20*) reveals that residential investment is growing faster than overall GDP, and is therefore a tailwind to GDP growth. This negative reading for Australia shows the residential investment cycle has passed its peak and has turned

into a headwind to GDP growth. Building approvals suggest this downward trend is likely to continue.

This is an important point. There is a large body of academic research that argues a peak in the contribution of residential investment to GDP is a statistically significant recession indicator. This is primarily due to the large multiplier effect that housing construction and investment has on employment and other parts of the economy.



The four key insights

1. Australia suffers from several well-known imbalances, specifically excessive levels of household debt and house prices. These preconditions generally result in economic downturns being more severe than if those conditions were not present.
2. High levels of speculative investor participation in Australia suggest house prices are likely to exhibit more volatility than might be explained by 'fundamentals' alone. We can see that investor demand is currently falling.
3. Australian housing indicators are showing trends like those observed in the UK, US, Netherlands, Denmark and Spain before their housing-led economic contractions in the mid-2000s. The behaviour of our chosen housing indicators in Australia suggest that national house prices will peak in the first half of 2018.
4. The Australian economy appears to be losing momentum relative to Canada, New Zealand, Norway and Sweden.

What's the prognosis for Australia?

International experience tells us that falling housing activity has a depressing impact on employment and economic activity, and falling house prices have a negative impact on consumption via the wealth effect. Given the evidence provided above, we have a cautious outlook for the Australian economy.

The magnitude of house price falls and the impact on consumption and the economy, will depend most on the reaction function of three groups:

- Governments and regulators, and their the macro prudential, fiscal and monetary response.
- Banks and their appetite to expand or ration credit.
- Property investors and their propensity to sell in response to flat or falling prices.

Australia's housing banks will trade relatively well

We believe the experience of northern Europe in the last 10 years will be instructive if Australia experiences a housing-led economic downturn. When the UK, Denmark and Netherlands had their recessions in the last decade, losses in mortgage loan portfolios were very low despite high household indebtedness and house prices falling around 20% from peaks. This is because, unlike the US, creditor protections in these countries are strong and people do everything they can to pay their mortgages.

The Australian legal system has more similarities to northern European countries than to the US, and as such, the Australian experience will likely follow Europe, with very low loss rates in mortgage portfolios. Therefore, we believe the Australian mortgage banks will do relatively well in a downturn. As in Europe, we expect business banks will suffer most of the system credit losses, as companies struggle under lower aggregate demand and the commercial real estate market deteriorates.

Commercial property landlords will have only poor choices

Australian retail landlords, while not over-gearred, will probably encounter falling rents and more tenancy bankruptcies. Office landlords will suffer from increased vacancy rates with an already looming oversupply forecast for Sydney in 2019 and Melbourne in 2020. Meanwhile, apartment developers will be confronted with lower volume demand and lower price expectations for their product. We are somewhat perplexed by the share market's lack of concern about the increasing evidence that Melbourne and Sydney apartment prices are falling.

Defensive P&C insurers will trade relatively well

Property and casualty insurers should trade reasonably well due to the non-discretionary nature of their product and low-risk balance sheets. While economic contractions tend to be associated with lower frequency of insurance claims, they also tend to drive more switching of products and shopping around as customers become more price sensitive.

International exposures

Internationally, we are positive on banks in Sweden, where fears of a housing-induced reduction in bank profitability are premature. Within our portfolio we support banks in Ireland where we see a vigorous economic and asset price recovery after a deep recession. We have an unfavourable view on Spanish banks due to general industry overcapacity and ongoing household and corporate de-leveraging, despite a strong economic recovery. We see certain legacy US life insurance business models as structurally challenged. Lastly in Asia, we are positive on selective opportunities in consumer credit providers.

PORTFOLIO REVIEW

BASIC INDUSTRIES

The Chinese economy continues to reap the benefits of last year's credit boom, with nominal GDP growth above 10% in the quarter – a level not seen since 2012. This has been evident in commodity prices, with aluminium, steel and coal further supported by the Government's supply-side reform agenda. We remain neutral mining shares however, as the credit impulse in the economy has turned negative, which should see a slowing in activity in 2018.

We entered the quarter with an overweight position in oil and gas companies, which had significantly lagged the price of crude oil. September saw an unseasonal draw on global crude inventories suggesting the market is rebalancing. Coupled with comments from Nigeria's oil minister that "OPEC members are trying to target a figure of close to \$60 a barrel", this pushed the price of oil to its highest level in over two years. We have now neutralised our position, as new projects are economic below \$60/barrel, giving rise to an expectation that the commodity will be range bound for the next few years.

The Governments of UK and France both announced their intentions to ban internal combustion engines (ICE) by 2040, transitioning their fleet of cars to electric vehicles. Soon thereafter, the Chinese government made a similar announcement with an undetermined time frame. While this is clearly positive for lithium and cobalt producers, investors' enthusiasm extended to nickel and copper where small, but growing volumes are required in batteries. We exited our position in *Orocobre* as this exuberance pushed the shares to record highs. *Independence Group* also performed well after a positive update for their new nickel mine Nova.

Anadarko Petroleum announced a \$2.5 billion share buyback resulting in the share price increasing by 25% in the month. Investors welcomed the announcement, signalling a balance between capital spending on growth and shareholder returns. We have reduced our position, however in our view, the company is well placed for potential transactions in the future.

Utility companies delivered mixed returns, as US names continue to perform strongly while European counterparts were volatile as a result of regulatory overhang. We increased our holding in *E.On* which simplified its business, disposing of its *Uniper* stake, having accepted a bid from *Fortum* for the asset. Combined with a €3.3 Billion nuclear tax refund, this will significantly reduce *E.On's* net debt and allow for an increase in

dividend payments. *E.On* performed well this quarter, with more upside expected as the story unfolds.

The domestic utilities sector remained under the microscope this quarter as the AER continued to investigate high electricity and gas prices. The ACCC released details following its own investigation into high electricity prices, which highlighted excessive network charges in the past decade. All of this weighed on our investment in *Origin Energy*, providing an opportunity to add to our position.

INDUSTRIALS

Global industrials performed in line with the market over the past quarter with leading indicators continuing to show strength in most regions, offset by fears around high valuations relative to the sector's history. Australian industrial shares were mostly weak due to disappointing results in several transportation and logistics companies, despite continued traffic growth. Overall, this meant infrastructure names remained relatively resilient. Most industrial companies in Australia (primarily transportation, logistics and infrastructure) have seen relatively muted fundamental improvement in earnings in recent times, though these companies have tended to pay attractive dividends. Our strategy is to arbitrage valuation discrepancies across this group, taking advantage of significant divergences that arise periodically in the market.

In this vein, we have established a position in *Brambles* – a pooling solutions company specialising in the provision of reusable pallets, crates and containers and associated logistics services. With a significant pull-back from its highs last year on fears of competitive pressures in its US business, it should be remembered that *Brambles* retains a strong position globally in pooled pallet systems. In fact, many countries still see growth in outsourcing pallets to companies like *Brambles* – and the shares now trade at a significant discount to historical levels.

We hold a core investment in *Honeywell*, a global leader in aerospace components and various industrial end-markets including building and plant automation. *Honeywell* has a strong track record of cost reduction and capital allocation, which should be maintained under its new CEO.

Deutsche Post is another core holding. The company is a global leader in logistics via its DHL network and has been gaining market share in international time-definite shipping. This is an attractive market owing to high barriers to entry (cost of establishing a comprehensive network), and relatively few players.

With less favourable competitive dynamics, the automotive sector is out of favour and cheap. Given the value on offer, we

initiated a position in *the Volkswagen Group* during the quarter. With vehicle sales largely unaffected by the recent emissions scandal (the financial impact of which has been provisioned), and a portfolio of successful brands including Porsche, Audi and Scania, we expect a recovery in the shares as it rebuilds credibility with investors.

Short positions include companies facing structural pressures, such as manufacturers of more commoditised products, facing low cost Chinese competition, and traditional distributors facing competition from e-commerce.

CONSUMER

Overall, we are seeing improving consumer trends in Europe and Asia while the picture in the United States is more uneven. Australian consumer demand appears to have weakened somewhat over the quarter as non-discretionary expenditure on energy, healthcare and housing takes an increasing share of the household wallet in an environment of muted wage growth.

Despite accelerating store closures, there remain too many retail stores in the United States given the channel shift to ecommerce. Although the starting points in Australia, continental Europe and Asia look more favourable, retailers in these regions should not assume they will be immune. This quarter was most notable for the underwhelming results produced by the branded suppliers to the US grocery sector. This has occurred as retailers pressed for better terms from suppliers in response to the increase in competitive intensity triggered by the expansion of the hard discounters (Aldi/Lidl).

The investable consumer universe can be roughly divided into retailers and brand owners. Finding retailers that i) don't have structural problems and ii) aren't consensus positions, is not without its challenges. As such our strategy is to implement a diversified long portfolio offset by concentrated short positions with idiosyncratic problems not currently reflected in share prices. When investing in brand owners we are looking for sustainably managed brands in growing categories, balanced with short positions in overpriced securities which do not properly reflect the structural challenges that we have identified.

During the quarter a new position was established in the domestic agribusiness company *GrainCorp* which sold off in anticipation of a weaker east coast grain harvest. While we don't disagree that the size of the FY18 harvest will be below average, the value of the company will ultimately be determined by the results of future harvests, not just the next one. *GrainCorp* has also diversified its business into specialty malts and oils which reduces the sensitivity of overall results to the east coast harvest,

making the current share price attractive to investors with a medium-term investment horizon.

New international positions added during the quarter included the snacking/confectionary company *Mondelez* and the global brewer *Anheuser-Busch InBev*. *Mondelez* was sold down in sympathy with others in the grocery channel but this is at odds with their favourable categories and geographical exposure (75% of sales outside of USA). *Anheuser-Busch InBev* has had a difficult eighteen months as a challenging environment in Brazil has hindered beer and soda sales in this important market - however our assessment is that an earnings inflection looks likely in the next six months.

FINANCIALS

Global financial shares performed in line with broad share market indices in the third quarter of 2017. In July and August financials lagged the broader market, as a series of inflation misses—particularly in the US—saw yield-curves flatten across developed markets. However, from mid-September financial shares rebounded relative to the market and yield curves steepened, principally because of the release of US President Donald Trump's tax reform proposals.

Our strategy in Australian financials is to increase exposure to less economically sensitive industries, particularly non-life insurance and maintain short exposures in those parts of the market that look over-valued and where the fundamentals are challenging, for example wealth managers. We benefitted from a new position in *Suncorp*, which was accumulated following the poorly received full-year 2017 earnings release. We did, however, suffer losses elsewhere in the insurance sector driven by several results announcements that surprised us.

Within the banking sector we are positioning the portfolio for ongoing weak consumer demand and its knock-on effects for businesses, which implies a preference for the retail banks over business banks. In real estate we added to short positions in companies that will suffer from a slowing residential property market. We initiated a new position in *CBA* following the announcement of its AUSTRAC investigation. On reflection we were too early to buy the recovery story for this world-class retail bank.

We reduced our position in *Unicredit* as the shares have performed well and we anticipate an increase in risk premiums in Italy due to the Italian general election. We entered a position in British consumer credit provider *Provident Financial*, where we see significant value emerging because of the heavy sell-off following two profit warnings in their home credit division.

Looking abroad we benefitted from a position in Dutch insurance company *NN Group* which reported strong results in the period. Our portfolio also benefitted from a short position in *Deutsche Bank*, which continues to compete poorly against better-capitalised US investment banks.

HEALTHCARE

Australian healthcare shares underperformed offshore peers in the September quarter albeit with valuations pushing towards record levels. We believe this was due to the poor quality of 2017 financial year results; continuing the trend we've highlighted previously. *Healthscope*, *Mayne Pharma Group* and *Primary Health Care* reported disappointing financial results impacted by "one off" items which are becoming more the norm for these challenged businesses. *Ramsay Health Care* shares languished and were a drag on fund performance despite what we viewed as solid results, with Australian hospitals margins hitting 20%. We took advantage of this pullback to add to our investment.

Our investment strategy for international markets through the cycle is to be net short biotechnology and pharmaceutical drug manufacturers while building larger investments in medical device manufacturers, life science businesses and managed care organisations. In our view, it is becoming more challenging for pharmaceutical and biotechnology businesses to build long-term defensible franchises given patent protection is short-lived and as the rapid pace of innovation in biotechnology is driving faster drug development. In the US, a more accommodative drug regulator (FDA) and consolidation of drug buying groups will add further pressure. Investments in medical devices, life sciences and managed care companies, however, provide less exposure to pricing and competitive headwinds that face drug developers. We believe that these businesses are more likely to generate and defend value over a longer period.

During the quarter biotechnology shares outperformed as clinical trial results continued to deliver positive outcomes and as M&A speculation remained high following *Gilead Sciences* US\$12 billion bid for cancer cell therapy company *Kite Pharma*. A new attempt by Republicans to repeal Obamacare in the US ultimately failed but not without causing significant volatility in healthcare service providers and managed care share prices.

Our international healthcare investments delivered negative returns in the quarter. While investments in *Galapagos*, *Nevro Corporation* and *Spark Therapeutics Inc* were positive contributors, our investment in *Allergan* was a detractor. After a period of decent performance, renewed fears of more imminent generic competition for its key dry eye drug Restasis caused the shares to decline materially. Notwithstanding, *Allergan's*

leading aesthetic business is uniquely positioned with no exposure to drug pricing pressures, strong brands and above industry growth; the value in *Allergan's* aesthetics business is underappreciated at these levels.

Overall, we made only modest changes to our international healthcare investments in the September quarter. While performance was disappointing, we see significant value accumulating in our core positions.

TECHNOLOGY/MEDIA/TELECOMMUNICATIONS

Global technology shares performed strongly in the September quarter. The semiconductor sector caught a bid as demand from industrial and automotive end-markets remained resilient, while software and internet shares were supported by positive earnings.

It was a different story in media. Globally, the sector was in meltdown as large advertisers (particularly FMCG) reined in their spending amid a focus on zero-based budgeting. We saw numerous profit warnings across advertising agencies and broadcasters as a result. To make matters worse, the US cable networks had a challenging quarter, as cord-cutting continues, and as streamed video services accelerate - value is clearly moving into the internet sector, in particular *Netflix*, which reported blowout results.

US telcos performed well after reporting better than expected results driven by the launch of unlimited plans across all carriers and amid re-surfacing rumours of imminent consolidation between *T-Mobile* and *Sprint*. Asian telcos also caught a bid amid positive earnings revisions, while European telcos tracked sideways despite an initially well-received reporting season.

Across the technology, media and telcos (TMT) space we are slightly long. However, we are conscious of the sector's strong performance and have been selective in identifying companies with a structural runway for growth. Within the semiconductor sector, we are long analogue semis with particular exposure to content growth in industrial automation and connected devices, while shorting manufactured logic circuits where returns are under pressure as workloads migrate to the cloud.

Cyber security investment has consistently outpaced broader IT spending. We maintain a long exposure here given recent malware attacks, highlighting the increasing complexity in enterprise networking environments and the security difficulties.

Growing penetration of high speed internet access is becoming all-consuming for consumers craving content in various forms from *Netflix* to *Facebook*, and while the demand for premium video content is well understood by the market, we have sought

to capitalise on undervalued content such as video games and music. Meanwhile, the role of TV networks in distributing video remains vulnerable given declining audiences. This has led us to sell short, broadcasters in markets where TV still commands a large portion of overall ad spend (i.e. France and Spain) and invest in broadcasters that have diversified into digital avenues, giving TV, a much smaller share of advertising spend (i.e. Germany). Given the challenges across the sector, we are short telcos that are over-earning or under competitive threat, while selectively investing in markets that are either recovering or growing.

During the quarter, our shorts in the Australian telco sector contributed strongly to performance as a number of these shares reported disappointing results. Our core holding in *MYOB* also performed well with a strong first half earnings release and implementation of a share buyback. Conversely, our biggest detractor from performance was our holding in *Fairfax*, where both private equity bidders withdrew on the first day of the quarter – however, the company's shares rallied through to September.

Our shorts in the domestic internet sector also detracted from our performance despite lacklustre results. Weakness in *Trade Me* provided an opportunity to increase our position as the company reported robust results, while unfounded concerns around *Amazon's* entry into Australia took their toll on the shares.

Just after the end of the quarter, a loss of the key Melbourne outdoor contract for Yarra Trams presented an opportunity to invest in the domestic outdoor companies' *oOh! Media* and *APN Outdoor*. Digital and outdoor are the only two media formats taking share of advertising for three key reasons. Firstly, outdoor is going digital as most of the higher-yielding boards have been digitised allowing for more responsive and targeted campaigns while outdoor companies benefit from a higher number of faces being shown on a single board. Secondly, outdoor is complementary to other formats that capture consumers when stationary; and thirdly, it still only represents a small (but growing) share of most ad budgets at mid-single digits.

Our funds had a challenging quarter across TMT with the biggest detractor being two short positions within the semiconductor sector. Firstly, *Intel's* near 100% share in server and data centre processors is under threat from emerging architectures such as GPUs and FPGAs particularly for machine learning; and its 90% share in desktop CPUs is also under threat from a resurgent AMD that has lacked a competitive product for many years. *Intel's* successive developments in chip architecture is also becoming more capital-intensive, delaying their

technological progression, further eroding its competitive advantage.

Secondly, *STMicro* (supplier of commoditised sensors) shares have run up due to excitement around their participation in 3D-sensing for the new iPhone; however, initial impressions indicate the opportunity isn't as significant as expectations indicate, and the price of iPhone sockets tend to be competed away rapidly. Unfortunately, both positions rallied along with the rest of the semiconductor sector despite no share-specific news. We've taken action to manage this portfolio risk going forward.

Elsewhere, our investment in the European broadcaster *Prosieben* also detracted from our performance as the company announced a surprise (third successive) earnings downgrade. However, our offsetting shorts in European broadcasters offset this fall as broader media weakness became evident; and as the structural growth in music and video games gained appreciation, our biggest performers were our core positions in content companies *Vivendi* and *Activision Blizzard*.

Performance Review

Performance in the quarter again represented a mix of wins and losses across the portfolios. In aggregate, all the funds posted modest falls after fees, ranging from 0.8% to 1.6%.

Domestic results

In the domestic portfolio, strong performance in Basic Industries and Consumer was offset by losses in Healthcare, TMT and Financials. The August reporting period again posed challenges, with several companies announcing weaker than expected profit results or providing sanguine outlook statements suggesting risks to earnings growth. For a skittish market willing to pay high P/E multiples for earnings certainty, any inking of weakness has been brutally punished, with companies' shares quickly de-rated. *Ramsay Health Care* and *Mayne Pharma* were two such culprits during reporting season, which detracted from returns.

Shorts again proved challenging through the quarter, and the domestic short book rose marginally more than the All Ordinaries Accumulation Index, which finished a volatile period up 1%. With continued exuberance in selected commodity markets, mining shorts have posed difficulties, with two shorts in this part of the domestic portfolio also amongst the biggest detractors.

International results

The international short portfolio also rose in excess of the MSCI AC World Index, detracting from returns. Losses were felt most heavily in the TMT sector, where two core short positions in semiconductor manufacturers, which rallied along with the broader sector, were the most notable.

Standout performers

Highlights for the quarter included strong performance from exposures in telecommunications and solid contributions from energy and industrial names. The top contributors for the period included investments in *BHP Billiton*, *Westpac Banking Group*, *National Australia Bank* and lithium producer *Orocobre Ltd*. Amongst the international names; *Royal Dutch Shell*, *Nevro Corp*, *Vivendi* and *Galapagos* were the top performers, while shorts in *Mediaset Espana* and *IBM* also did well.

Quarterly Performance by Sector

Sector	Domestic Portfolio *	International Portfolio **
TMT	-0.24	-0.87
Healthcare	-0.53	0.20
Consumer	0.17	-0.29
Industrials	0.04	0.32
Basic Industries	0.34	-0.08
Financials	-0.44	0.15

*Domestic portfolio data is for Australian positions in Watermark Market Neutral Trust. ** International portfolio data is for international positions in Watermark Market Neutral Fund Ltd.

Performance Attribution for the Quarter

Contributors

Domestic Positions	International Positions
BHP Billiton Limited	Nevro Corp
Westpac Banking Corp.	Galapagos NV
Independence Group	Vivendi SA
Sims Metal Management Ltd	Anadarko Petroleum Corp
National Australia Bank	Airbus SE

Detractors

Domestic Positions	International Positions
South32 Ltd.	STMicroelectronics NV
Ramsay Health Care Limited	Glencore
Mayne Pharma Group Ltd	Allergan
James Hardie Industries	Repsol SA
CSR Limited	Gap, Inc.

Fund at a Glance - October 2017

ASX Code	ALF
Fund Size	AU\$317.8m
Fund Strategy	Variable Beta
Share Price	\$1.07
Shares on Issue	272.5m
Return on Capital (2HFY17)	4 cents

Net Tangible Asset (NTA) Backing

	Sep 17	Oct 17
NTA Before Tax	\$1.24	\$1.21
NTA After Tax	\$1.25	\$1.23
Return of Capital	(\$0.04)	(\$0.04)
NTA After Tax & RoC	\$1.21	\$1.19

Gross Portfolio Structure

	Sep 17	Oct 17
Long Exposure	122.5%	97.2%
Short Exposure	-119.2%	-89.6%
Gross Exposure	241.7%	186.8%
Cash	96.7%	92.5%

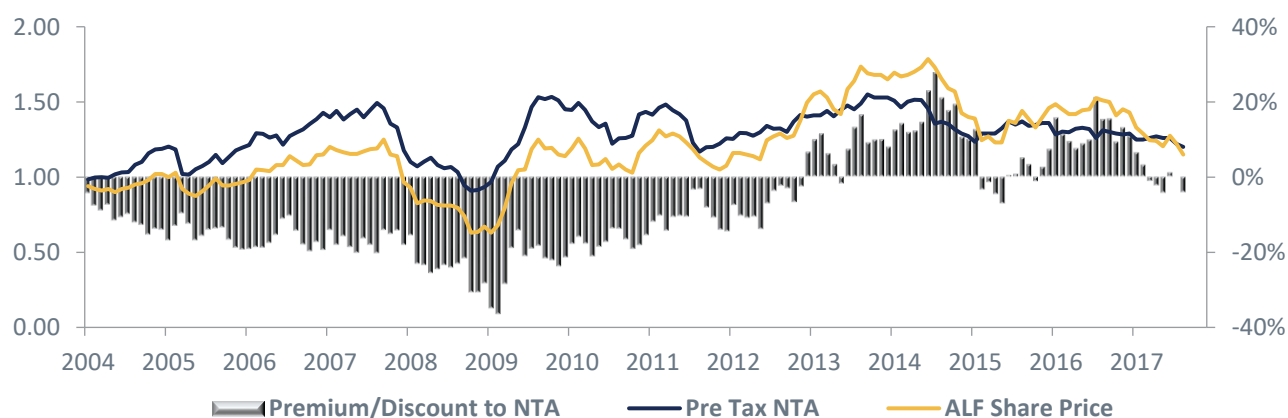
ALF Performance

	1 Mth	6 Mths	2 Yrs (pa)	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	S.I (pa)
Portfolio Return (net)	-3.1%	-4.8%	0.5%	3.4%	9.8%	10.5%	12.2%
All Ords Accum Index	4.1%	2.7%	10.9%	7.3%	10.3%	8.0%	9.0%
Outperformance (net)	-7.2%	-7.5%	-10.4%	-3.9%	-0.5%	2.5%	3.2%

Net Equity Exposure



Historical Premium/Discount to NTA History



Fund at a Glance – October 2017

Fund Size	AU\$235m
Strategy FUM	AU\$280m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

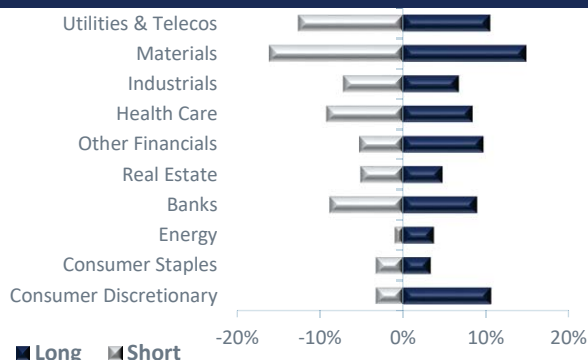
Return Characteristics¹

Positive Months	68%
Portfolio Beta	-0.2%
Sharpe Ratio	1.3
Sortino Ratio	3.9
Standard Deviation	6.9%
No. Long Positions	64
No. Short Positions	54
Gross Exposure	154%
International Exposure (% of Gross)	19%

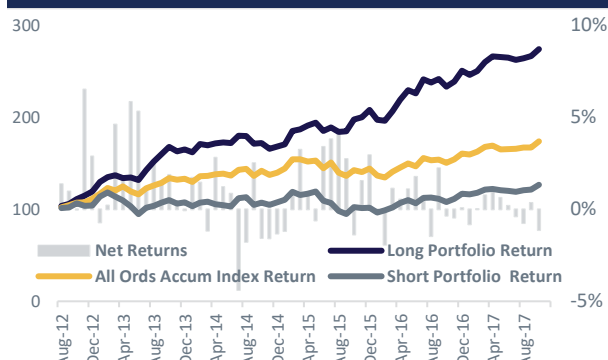
Performance²

	1 Mth	1 Yr	2 Yrs (pa)	3 Yrs (pa)	4 Yrs (pa)	S.I (pa)
WMNT (net return)	-1.1%	-0.4%	3.7%	6.8%	5.5%	11.2%
RBA Cash Rate	0.1%	1.5%	1.7%	1.9%	2.0%	2.2%
Outperformance	-1.2%	-1.9%	2.0%	4.9%	3.5%	9.0%

Sector Exposures



Long/Short Spread³



Monthly Net Performance (%)

Cal. Yr	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2012	-	-	-	-	-	-	-	1.36	0.97	0.00	6.51	2.88	11.72
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	24.05
2014	1.71	1.45	-1.17	2.80	1.21	0.84	-4.38	-1.77	2.52	-1.57	-1.58	-1.32	-1.26
2015	-1.18	0.70	3.23	0.96	-0.61	3.39	3.82	4.04	2.73	-1.36	1.53	2.93	20.19
2016	-0.14	-1.92	1.13	0.53	1.08	1.76	0.60	-1.46	2.23	-0.34	-0.46	0.07	3.03
2017	-0.81	0.02	0.76	1.13	0.61	0.19	-0.39	-0.75	0.34	-1.14			-0.03

¹ Return Characteristics are in relation to the market neutral strategy using long/short return series recorded from April 2008.

² Performance data is net of all fees and expenses. The Fund's inception date is August 2012.

³ Long/Short spread shows the gross performance of the long and short portfolios. The Fund makes a profit where the long portfolio outperforms the short portfolio, after the payment of fees. Returns prior to the Fund's inception date are based on return series from the long and short portfolios of the Australian Leaders Fund Ltd in a market neutral structure.

Fund at a Glance - October 2017

ASX Code	WMK
Fund Size	AU\$80.0m
Fund Strategy	Equity Market Neutral
Shares Price	\$0.91
Shares on Issue	87.6m
Dividend (FY17 Annual)	2.5 cents
Dividend Yield (annualised)	6.0%

Net Tangible Asset (NTA) Backing

	Sep 17	Oct 17
NTA Before Tax	\$0.99	\$0.94
NTA After Tax	\$1.00	\$0.95
Dividend Declared (2.5c)	(\$0.025)	\$0.00
NTA After Tax \$ Dividend (2.5c)	\$0.97	\$0.95

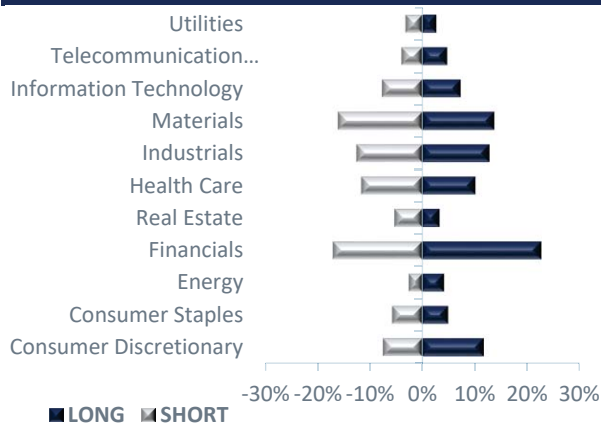
Gross Portfolio Structure

	Sep 17	Oct 17
Long Exposure	122.4%	99.5%
Short Exposure	-116.5%	-94.0%
Gross Exposure	238.9%	193.5%
Cash	94.1%	94.5%

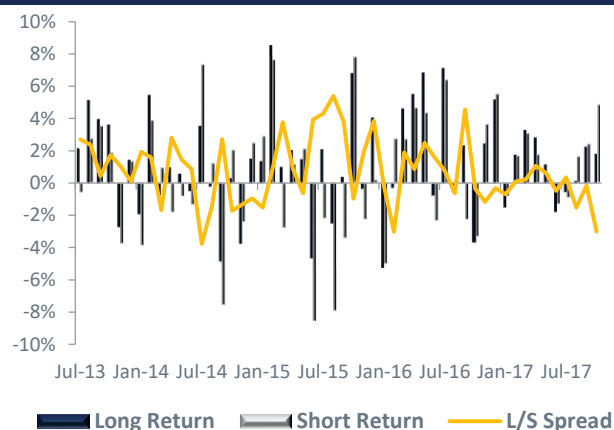
WMK Performance

	1 Mth	3 Mths	1 Yr	2 Yrs (pa)	3 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	-3.0%	-4.9%	-5.4%	1.5%	5.1%	5.0%
RBA Cash Rate	0.1%	0.4%	1.5%	1.7%	1.9%	2.1%
Outperformance (net)	-3.1%	-5.3%	-6.9%	-0.2%	3.2%	2.9%

Sector Exposures

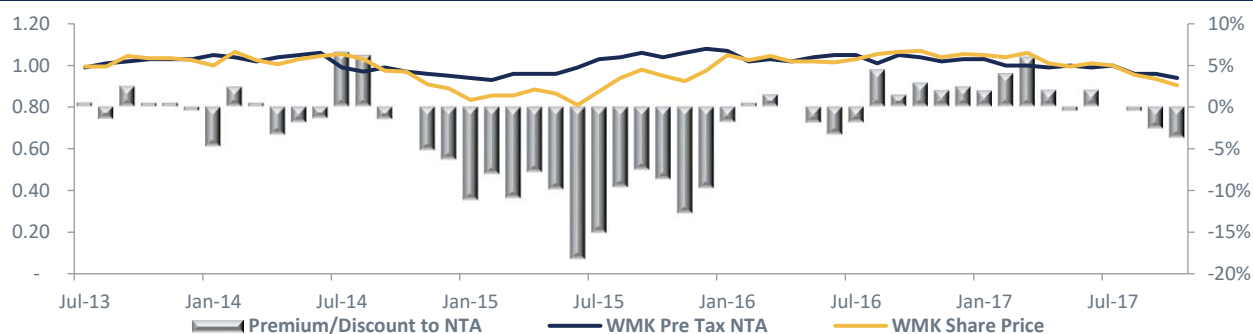


Long Short Spread*



* Long Short spread shows the gross monthly performance of the Company's long and short portfolios. The difference between the two represents the gross performance of the portfolio as a whole. The company will make a profit where the long portfolio outperforms the short portfolio, after the payment of fees and expenses.

Historical Premium/Discount to NTA



Fund at a Glance - October 2017

ASX Code	WGF
ASX Code Options	WGFO
Fund Size	AU\$85.4m
Fund Strategy	Global Market Neutral
Share Price	\$0.94
Shares on Issue	82.5m
Option Price	0.4 cents

Net Tangible Asset (NTA) Backing

	Sep 17	Oct 17
NTA Before Tax	\$1.08	\$1.05
NTA After Tax	\$1.07	\$1.05

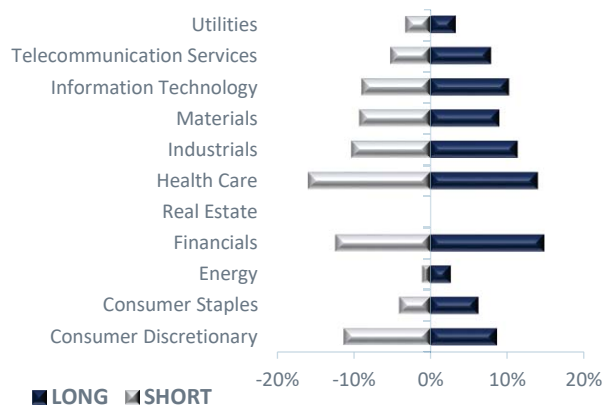
Gross Portfolio Structure

Long Exposure	114.6%	88.7%
Short Exposure	-106.9%	-82.0%
Gross Exposure	221.5%	170.7%
Cash	92.3%	93.3%

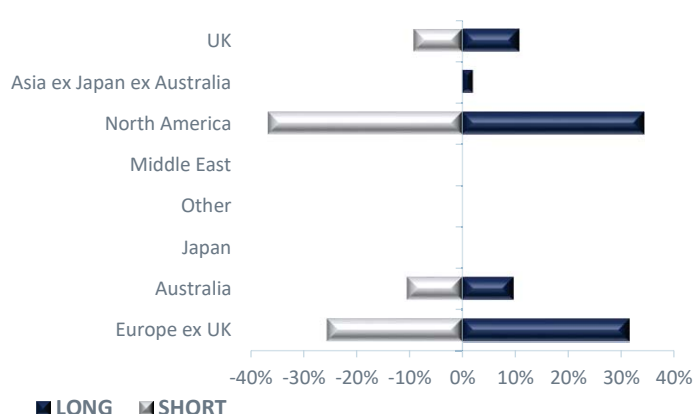
Performance

	1 Mth	3 Mths	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I. (pa)
Portfolio (net return)	-3.2%	-4.2%	-3.8%	-4.0%	-	-	-3.1%
RBA Cash Rate	0.1%	0.4%	0.8%	0.5%	-	-	1.4%
Outperformance	-3.3%	-4.6%	-4.6%	-4.5%	-	-	-4.5%

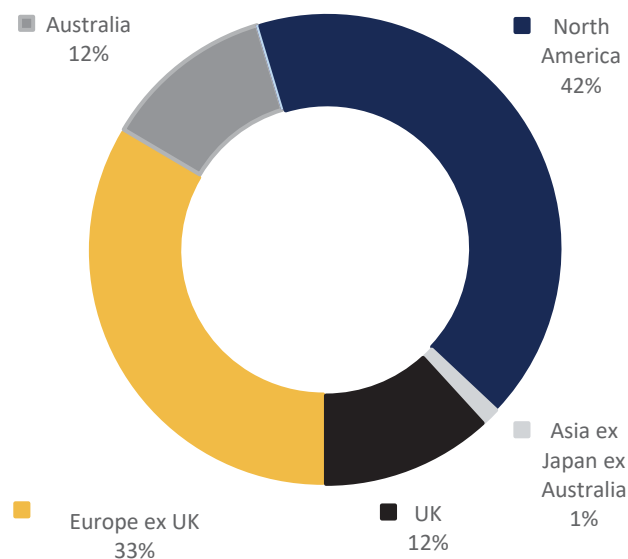
Sector Exposures



Regional Exposures (Net)



Regional Exposures (Gross)



Contributors/Detractors

Top 3 Contributors	
Fortinet, Inc.	0.3%
Volkswagen AG	0.3%
Royal Dutch Shell	0.2%
Top 3 Detractors	
Celgene Corporation	-0.7%
Intel Corporation	-0.6%
STMicroelectronics NV	-0.4%

Notes

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WATERMARK
FUNDS MANAGEMENT

Level 6, 139 Macquarie Street, Sydney NSW 2000

TEL (02) 9252 0225 • FAX (02) 9252 1220 • info@wfunds.com.au • www.wfunds.com.au