



The Leading Edge

QUARTERLY REPORT • March 2018

In this edition of *The Leading Edge* we want to showcase some of the compelling investment ideas held across the portfolio.

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Justin Braitling
Portfolio Manager

Message from the CIO

It is pleasing to see an improvement in fund performance coming through in recent months, last year was a difficult one for Watermark. In hindsight the substantial investment we have made in building out our international equities capability stretched our resources, impacting performance. Having added to the investment team, it took longer than expected for the new members to settle in and contribute. We have also separated management of the Australian and International portfolios, bringing greater focus to the individual funds.

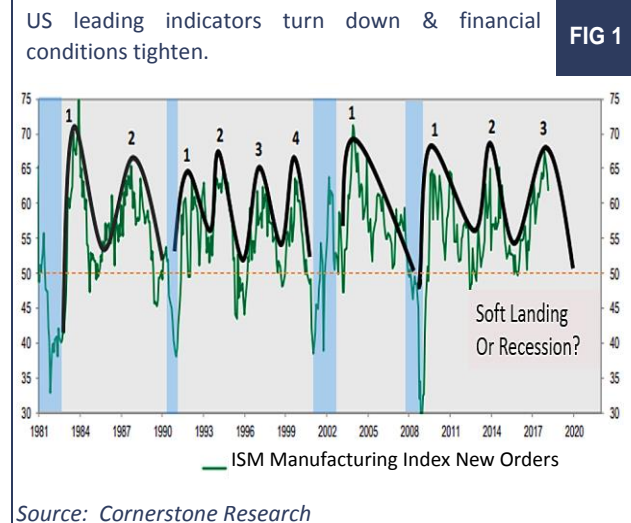
We are starting to see these changes bear fruit now and are confident we will be back achieving our target returns in future. I am particularly excited by the number and quality of good ideas in the portfolios. In this edition of *The Leading Edge* we want to showcase a handful of these ideas to you, so you can keep track of their progress.

Market Update

Volatility returned with a vengeance in the quarter, with the US share market falling by more than 10% in February. A correction was well overdue given overbought conditions at the start of the year. Survey data, sentiment and confidence measures had all risen to cyclical highs going into February, boosted further by large tax cuts announced late last year.

Synchronised global growth and accommodative policy settings were the backdrop for a surging share market in 2017. With many economies now operating at full employment, the risk of overheating in key industrial centres has become a concern for policy makers and investors. A more hawkish tone from the US Federal Reserve under new leadership and a deterioration in core inflation was all it took to send the market tumbling in February.

We are 9 years into this expansion. As leading indicators in the major economies look to have peaked with the euphoria of last year (Fig 1), investors are once again to consider the outlook as activity is set to slow, this time however with a backdrop of tightening financial conditions.



With shares having fallen, while profits have increased, key valuation metrics look reasonable for the first time in a long time. While this has comforted market bulls who can now point to reasonable valuations, one should bear in mind, valuations always contract at the end of cycle, particularly as policy tightens.

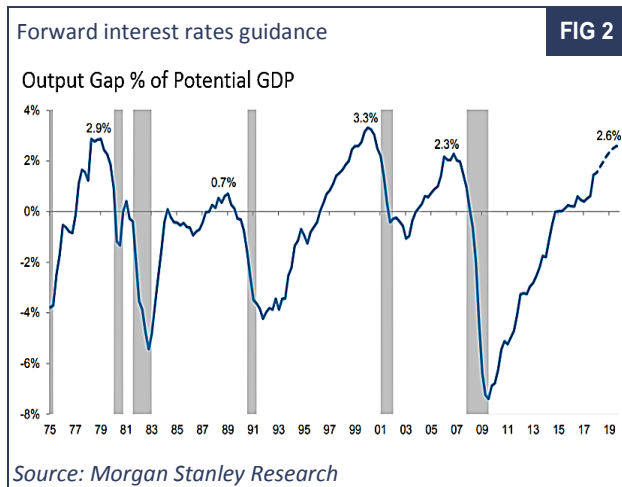
As we move toward late cycle, with interest rates increasing and activity set to slow, volatility will once again be a feature of shares going forward. As quantitative easing winds down, fiscal deficits increase, and inflation expectations rise, bond prices have fallen, and yields have surged higher marking the end of a golden age for bond investors. For the first time since a period briefly in the 1970's, US 10-year treasuries offer a higher yield than the equivalent Australian government securities. The reflation trade, where the US dollar and bond prices fall, and commodities rally has been the dominant theme for capital markets since deflationary forces abated in 2016. We would expect this trend to continue until we get closer to the next recession.

Real potential growth has been anaemic in major economies this cycle, given soft productivity and labour force growth. With employment and capital now fully utilised in many major economies, inflationary pressures are re-surfacing. Bond and equity markets are ill prepared if core inflation moves well beyond the 2% targeted by central banks. If this were to occur, financial conditions would tighten very quickly, and this cycle would come to an abrupt end. While this is not our base case, it is singularly the biggest risk for asset prices, a message that hasn't been lost on investors as US 10-year treasuries race toward 3%.

Assuming inflation is contained around targeted levels and interest rates rise in line with forward guidance, we can estimate the remaining life of this cycle based on the following measures:

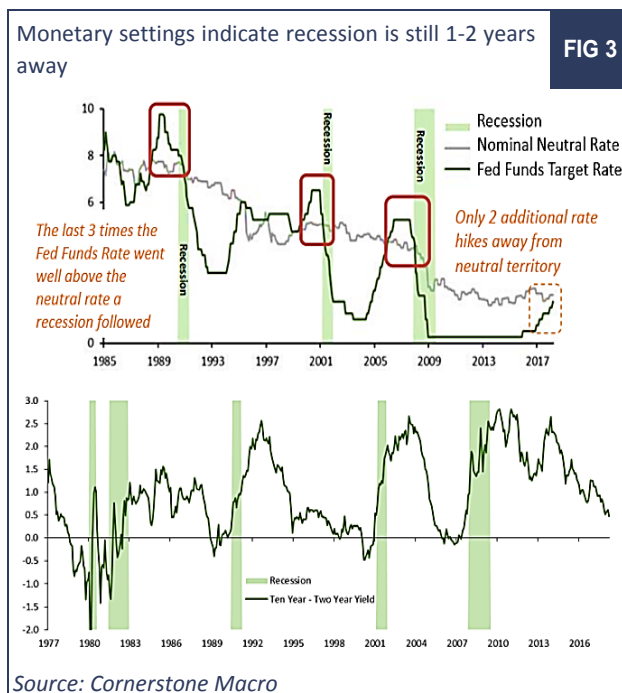
A) Available capacity: - Labour and capital are close to fully employed, further growth will tighten product and labour

markets creating inflation, this will force a faster than anticipated increase in interest rates. As this 'output gap' closes further we can guess when the cycle ends.



B) Forward interest rate guidance and the neutral interest rate - Fig 2 - once interest rates move beyond the neutral rate a downturn of some sort is not too far away. Based on forward guidance from the US Federal Reserve policy becomes restrictive from midway through next year.

C) Finally, the steepness of the yield curve Fig 3 (bottom panel) has been the most reliable indicator of the proximity of a recession, as policy rates rise, and long bond yields fall in anticipation of a slowing economy, the curve flattens and typically inverts, this is likely to happen in late 2019.

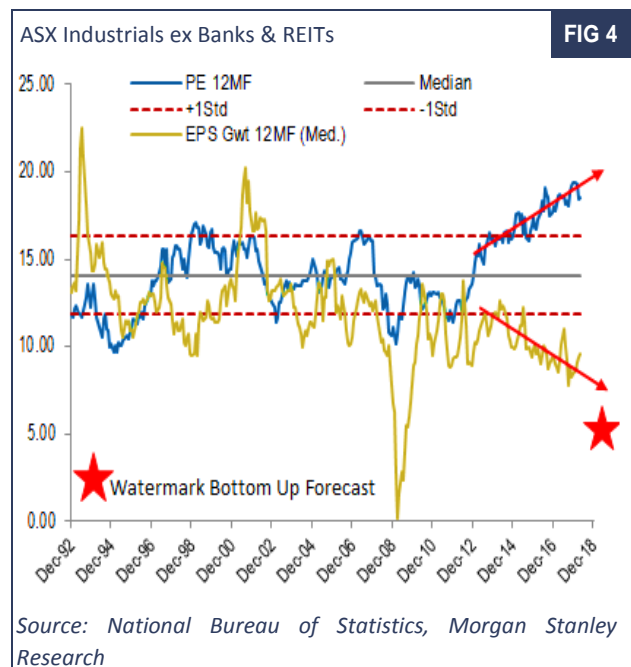


These reliable indicators would suggest the next downturn in the US economy is still at least 1 to 2 years away. The share market of course will anticipate this, with shares typically peaking 6 -12 months before the start of any recession which

would put us mid-way through next year at the earliest. This of course assumes share markets don't roll over in the meantime, which in itself could bring forward the timing of a downturn.

Where the market trades between now and then is anyone's guess. Some would have you believe the top is already in. Others would suggest there is one last leg higher, time will tell. All we can do is focus on the share market fundamentals- the profit outlook and valuations and position the funds accordingly. When we look at the Australian share market which has traded sideways now for 3 years since the first quarter of 2015, we continue to see limited upside.

While sections of our market are attractively priced, such as the Banks and Real Estate, the broader Industrials group of companies is overvalued. This is particularly evident when one considers the profit outlook which is soft Fig 4. In simple terms we are paying a very high price for industrial shares today (the blue line) while the outlook for profit growth (the grey line) is the weakest it has been for some time.



I suspect at best Australian shares will deliver modest gains from here if global markets stage one last rally in this cycle. The most likely scenario is a continuation of the pattern of recent years where shares grind sideways. Of course, the cycle will end at some stage in the next few years and shares will move lower.

It is hard to get too excited about the outlook for Australian shares given the challenges facing many key industries. Starting with the Major Trading Banks. While they are clearly cheap, and the funds are fully invested here, they are cheap for good reason. Investors in bank shares have the royal commission and a hostile Labor government to consider, these are formidable hurdles for the next 2 years. Furthermore, the banks are ex-growth – the debt supercycle is over, there is too much debt

held by Australian households, a structural problem that will take years to unwind.

The Australian share market also has an oversized exposure to defensive sectors given industry concentration, incumbency and low growth. Many of these mature businesses are priced as bond proxies and for us, it looks like the 36-year run in bonds is over. Like bonds these low growth securities will underperform as rates are now set to rise.

In Telecom, Retails Staples and Utilities in particular, new entrants in mobile communications, energy markets and groceries will put incumbents' profits under further pressure - there is little growth on offer in these sectors, so enjoy your dividends, that is all you will get from these shares.

While the Government and the Reserve Bank continue to talk up the economy, we are more circumspect. Many of the indicators that have the Reserve Bank excited, like employment growth and business confidence are backward looking. We see financial conditions tightening through 2018, even if policy rates are unchanged. Macro prudential measures to slow the property market and excessive lending to households are starting to bite.

Australian households are amongst the most indebted in the world and banks have been over lending based on collateral without proper regard to serviceability. Underwriting standards have slipped, and banks have not complied with responsible lending laws. In redressing this, lending standards will tighten marking the end of the property cycle - this has been a key source of growth aiding the economy in its transition away from the mining boom.

Cyclical shares are further challenged, not just by a weaker housing outlook but also from a fading fiscal impulse, as infrastructure spending peaks. Absent any further goodies in the May budget we have seen the best from the public purse. The prospect of tax cuts will support spending and confidence, but the scale of cuts in the Enterprise Tax Plan are modest and will be slow to come through.

Mining and Energy shares may be the one shining light in this market so long as global growth stays stronger for longer. Unlike the prior mining boom which was demand led, commodity markets are tight today as China and OPEC have managed the supply of industrial metals and oil. Miners are making super normal profits and are well capitalised, the longer this lasts the better the returns available for investors.

The growth segments of this share market, like Healthcare and Global Brands are extremely expensive. The equivalent healthcare peers internationally trade at a fraction of the price of the local listings. While Australian brands sold into China offer tremendous growth, the risks around trade with China are increasing, history has shown how quickly this channel can be disrupted.

While the outlook for the broader share market is less than inspiring at the moment, there are of course some exciting exceptions which we would like to share with you. In this edition of The Leading Edge we want to showcase some of the compelling investment ideas held across the portfolios. As usual we will focus on our investments given sensitivities around our short positions.

Technology, Media & Telecom

MYOB Limited

There has been a spotlight on the Australian technology sector in recent months and for all the wrong reasons. High-flying tech companies *Get Swift* and *Big Un* were caught misrepresenting results, while many companies across the sector trade at lofty valuation premiums to their offshore peers – which can end in bloodshed as seen with *Wisetech* falling 40% since disappointing on earnings. In this context, *MYOB* is a high-quality software business with recurring revenues. The company has historically been unloved for a variety of reasons and presents compelling value at 18x P/E (expensing all R&D) vs. peers at 40x+, with 38% upside to our DCF valuation.

MYOB sells desktop accounting and enterprise resource planning (ERP) software to accounting practices and to small-medium businesses (SMBs), on which the latter essentially operate their businesses. The company has been in business since the 1980's and has been listed in various iterations on the ASX over the years, most recently listing in 2015. Below we outline three primary reasons for its poor recent performance and why we believe they are misunderstood.

1) MYOB is the incumbent accounting software provider in Australia and New Zealand. However, it is holding share vs. challenger Xero.

One key concern around *MYOB* has been the emergence of a dynamic and aggressive industry competitor in *Xero*. *Xero* has experienced exponential growth in recent years and has been particularly successful in winning customers from new, tech savvy SMB's. Notwithstanding this competition, *MYOB*'s revenues are recurring through the subscription nature of its software, and its retention rate is high (82% for SMB, higher for enterprise) due to the crucial nature of the software. Before *Xero* entered the market, there was a duopoly between *MYOB* (70% share) and *Reckon* (30%). *MYOB* has certainly lost some of its market share; however, its revenues have grown strongly with industry growth (only 40% penetration of accounting software among SMBs) and transition from desktop to recurring sales. As compliance requirements increase and businesses realise the efficiency benefits, the addressable market will continue to grow. Sixty percent of *MYOB*'s churn is the natural life/death of small businesses –they are retaining a

high proportion (93%) of 'surviving' customers. Furthermore, *MYOB* is achieving close to 50% share in cloud customer net adds, the company is holding its own particularly as it catches up on product development. Finally, fifty percent of sales in the industry are referrals from practices to their clients, this is a big competitive advantage for *MYOB* which has incumbency in practice software.

2) MYOB has underinvested in developing its cloud product, and there are concerns that margins continue to compress.

We acknowledge that *MYOB*'s EBITDA margins of 45%+ are high relative to global peers, and the company has continued to guide down on this metric which has driven earnings estimates lower. We believe forecasts have been sufficiently rebased after *MYOB* announced an accelerated \$50mn investment with the *Reckon* acquisition. More importantly, *MYOB* is being punished for investing in their product but is not being rewarded for consistently exceeding expectations on cloud subscriber gains as an outcome. In fact, even though *MYOB* has guided to 1mn subscribers by 2020 most analysts are only forecasting 700k. Lastly, *MYOB* gets criticised as they capitalise half of their R&D spend – but this is standard practice for software firms globally.

3) Private equity (Bain Capital) still has a 25% stake and are looking to sell.

Bain have made their intentions to reduce their stake in *MYOB* very clear to the market, but not at the current market prices (*MYOB* listed at \$3.65 vs \$3.20 today). Once this overhang clears it will likely reduce the high arbitrage short interest of 6%. In the meantime, *MYOB* is buying back 5% of its shares. We also note with Bain being a potential exiting shareholder and trading at compelling valuation, *MYOB* could be a potential takeover target – in fact UK-based Sage (who are acquisitive) bid for the business at 13.5x EBITDA in 2011; or 30% upside to today's share price on current earnings.

Broadcom Inc.

Concerns around smartphone demand and inventory build at industrial customers has recently weighed on sentiment for semiconductor shares. We worry that many new-age developments which investors are relying on for the growth of the sector, such as autonomous driving and AI, may be longer dated than expected; and that the incremental cost of developing leading edge semis is increasing. This calls for selectivity in the sector as we approach the end of this cycle. Our highest conviction semiconductor investment today is *Broadcom*, which is a highly diversified mega-cap. It is 'fabless' which means it designs microchips but contracts out their production, avoiding the need to own factories or equipment. Most of *Broadcom*'s businesses relate to communications and storage, where it has leading market share.

The *Broadcom* of today is the by-product of many M&A transactions through the years. Current CEO Hock Tan was CEO of *Avago* and led that business through a wave of acquisitions culminating in the largest tech acquisition ever – that of *Broadcom* in 2015. Many investors have thus penned it as a 'roll-up' story reminiscent of the train wreck *Valeant Pharmaceuticals*. We see such a comparison as misguided. *Broadcom* and its constituent businesses all hold their roots in the very birth of the semi industry – including Bell Labs and HP. The *Broadcom* M&A strategy is to acquire companies that are leaders in their field with a high degree of IP differentiation and a competitive moat – but that have been inefficiently managed. Acquired companies are streamlined with any non-core businesses divested, resulting in what are industry-leading margins for the combined group. Semi analysts popularly characterise this approach as 'slashing and burning R&D' but the reality couldn't be further from the truth. *Broadcom* invests 20% of its revenues into R&D, which is in line with peers and double that of *Texas Instruments*.

The company has been disciplined in its M&A approach and is not reliant on M&A to drive its targeted GDP-plus growth. Its largest segment; wireless, is still growing strongly. Here it designs radio frequency (RF) chips which smartphones use to communicate with mobile networks. *Broadcom* is the market leader and is dominant in high-frequency RF filters; this is important as most low-frequency mobile spectrum has already been exhausted (future mobile investments are in high-frequency) and higher frequency signals generate more interference so require higher performance filters. Its other large businesses are designing controllers for networking equipment (like switches and routers) and for enterprise-grade storage devices (like SSDs) – here *Broadcom* is also the dominant player, where growth is slower but more predictable. *Broadcom*'s diversification is an attractive feature to Watermark.

Broadcom has underperformed its semi peers by 15% since mid-last year, primarily due to uncertainty around its M&A strategy. The company was a rumoured bidder for Toshiba's memory division (a commodity business less in line with *Broadcom*'s stated strategy) and earlier this year, made a high-profile, highly levered bid for *Qualcomm*. We believe the rationale in both instances was sound, and the company showed discipline in not proceeding at any cost. CEO Hock Tan is singularly focussed on driving best use of free cash flow (FCF) – and in the absence of M&A, the company is paying a 2.5% dividend yield (doubling its dividend last year and likely to be raised substantially again) and is buying back \$12bn or over 10% of its shares. On a 9% FCF yield and above-sector earnings growth, the shares are too cheap at current levels.

Financials

Genworth Mortgage Insurance Corp

Genworth Australia is Australia's largest provider of lenders' mortgage insurance (LMI). Banks require that highly levered borrowers take out LMI on mortgages where the loan to value ratio (LVR) is greater than 80%. In return for an insurance premium, *Genworth* promises to pay the lender for losses incurred if the borrower defaults and the property against which the loan is secured is sold for less than the remaining loan balance. Originally conceived to help people with limited savings secure a mortgage in order to buy a home, demand for LMI has waned in recent years as the proportion of high LVR loans has fallen. This has largely been a result of macroprudential controls imposed by the local regulator to curb lending to highly levered investors, thereby reducing the stock of mortgages over which *Genworth* can write LMI. In addition to concerns about the potential effects of falling house prices, *Genworth* has also fallen out of favour with investors due to the perceived risk that its US parent company and 56% shareholder will be forced to divest its holding in *Genworth Australia*.

We believe these conditions have given rise to an opportunity to buy *Genworth Australia* shares, well below fair value. Furthermore, we see several potential catalysts for the company to create significant value for shareholders through the return of excess capital. To understand these catalysts, it is necessary to understand how capital requirements work for an insurance company such as *Genworth*. Insurance companies such as *Genworth* have a statutory requirement to hold sufficient capital to fund losses on policies it has written. Capital requirements are a function of the value of policies written and the ages of the loans. As loans age, the regulator (APRA) requires *Genworth* to hold less capital on the assumption that older loans are less risky and that the potential liability is falling. Given falling demand for new LMI policies (more risk) and ageing vintages of *Genworth's* book, *Genworth's* statutory capital requirement is falling. The company currently holds excess capital of around \$600m, with a total market capitalisation of \$1.1b. At its recent investor briefing, *Genworth* reported \$2.1b of 'regulatory' capital supporting a capital requirement of \$1.1b, giving a coverage ratio of 193%. The company has also stated that it has a target coverage ratio of between 132-144%, implying an excess capital position of \$600m at the mid-point of management's capital ratio guidance.

Consensus estimates for earnings on the company's excess capital in the next three years ranges from \$109-136m. Assuming earnings of \$100m per annum over the next 3 years, during which time the capital requirement will also fall,

Genworth's excess capital position would increase to \$1.2-1.3b. At that point, we would expect that the company could continue generating net income of \$100m pa, which we would value conservatively at \$700-800m (assuming a P/E of 7-8x). Should this scenario eventuate, *Genworth* has an implied value today of roughly twice the current market capitalisation of \$1.1b (i.e. excess capital of \$1.2-1.3b plus \$700-800m). If excess capital is returned to shareholders via buy-backs of the company's shares, the potential upside is even greater, given the company would be buying back shares at a 35% discount to tangible book value, which is highly accretive.

Falling house prices are clearly a risk for *Genworth*, although our analysis would suggest that there is limited downside for the company. To put this in perspective, loss ratios for LMI policies peaked at 70% for the *Genworth's* 2008 vintage. This is to say that in the company's worst year on record, after expenses *Genworth* made no profit on new business written in that year but did not suffer a loss. Our own internally generated stress-test suggests that in the event of an 'orderly housing market downturn' (i.e. 10-15% falls in national property prices), we would expect *Genworth* to deliver a similar result – no profit, with no material reduction in the company's capital base. In any event, the market currently prices *Genworth* under the assumption that it will lose half its regulatory capital in the next few years – an unlikely scenario in our assessment.

Clydesdale Bank PLC

Clydesdale Bank (CYBG) is a British retail business focused bank based in the North of England and Scotland which was spun-out of the National Australia Bank in 2016. We view CYBG as being fairly valued based on consensus earnings expectations, however there are several levers available to the company, to boost its return well above 12% in the medium term. This implies more than 30% upside to the current share price. These levers are:

1) **Government initiative in business banking.** Currently the UK government is focused on improving competition within the small/medium banking market. As a result, Williams & Glynn (owned by RBS) is being forced to introduce its customers to competitors, including CYBG. As one of the largest UK "challenger" business banks, CYBG is hopeful that it will be a primary beneficiary of this process. The potential prize is likely an upfront payment of c. GBP100m (4% of the company market cap) and incremental assets and liabilities that should contribute c. 5% to earnings.

2) **The company's efficiency should improve.** The company was not efficiently managed under *National Australia Bank*. Benchmarking exercises suggest that the cost/income ratio of

the bank should fall below 60%, providing another 10% uplift to earnings vs. current expectations.

3) **There is excess capital which should be released this year.** CYBG has the capacity to reduce the regulatory capital it is required to hold by obtaining advanced internal model approval for its lending portfolios. This will liberate capital within the business and enable the company to return capital to shareholders or accelerate growth. We believe neither of these scenarios are captured in consensus earnings forecasts and that the possible capital release could be as much as 20% of the company's market capitalisation (although there are likely to be offsets which may reduce this number to 12-17%).

4) **UK banking margins appear to be stabilising.** Recent data from the Bank of England suggests that the mortgage lending margin pressure that has characterised the UK market for the last three years appears to be settling. In addition, the Bank of England has started to raise interest rates, which is a positive for banks' margins.

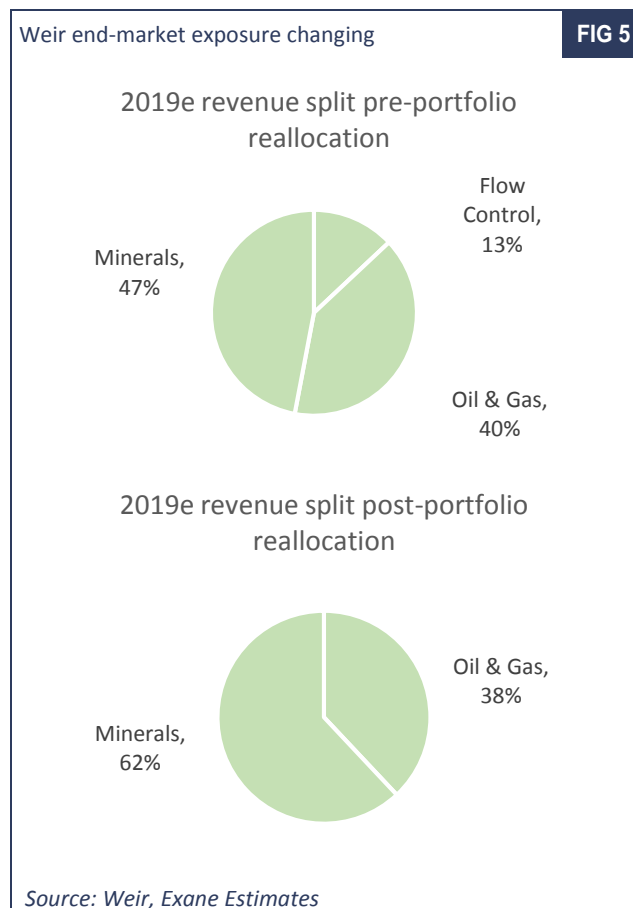
Considering these four factors, our valuation suggests CYBG has at least 30% upside. The downside risks for CYBG is another increase in the capital provision required to fund customers' payment protection insurance claims. The company recently announced an additional GBP200m of provisions for PPI payments, and there is a possibility that provisions are increased again as the 29 August 2019 claims cut-off date approaches. Our analysis suggests any additional provision is likely to be lower than the GBP200m recently announced and our c. 30% upside target implies roughly GBP800m of additional market cap for CYBG. Overall, we believe there is an adequate buffer in the valuation for PPI payments.

Industrials

Weir Group

Across much of the European industrial sector, companies are currently trading on high valuation multiples. Given this backdrop, *Weir* – a mining and oil & gas fracking equipment and services manufacturer – screens attractively given it trades on 15x 2019E P/E despite having one of the highest quality mining aftermarket businesses in the world, two end markets with potential for further recovery, and >75% recurring aftermarket revenues. Recent trading has been robust, with group orders growing 21% YoY and a book to bill of 1.15x. Moreover, a Sum-of-the-Parts analysis of the key divisions indicates fair value over 2,600p.

Portfolio Change. In April *Weir* announced the \$1.3bn acquisition of *ESCO*, a seller of lip systems for mining excavators that see a high amount of wear and tear. The business model looks very solid given the company generates 90% of its revenue from aftermarket activities while its proprietary locking systems for consumables drive a capture rate close to 100% of initial original equipment ("OE") sales. The transaction is set to boost the overall group's aftermarket exposure to over 75% and is set to be 7-8% accretive. Furthermore, management has finally decided to divest the underperforming and sub-scale flow control division which has been a long-term laggard within the group.

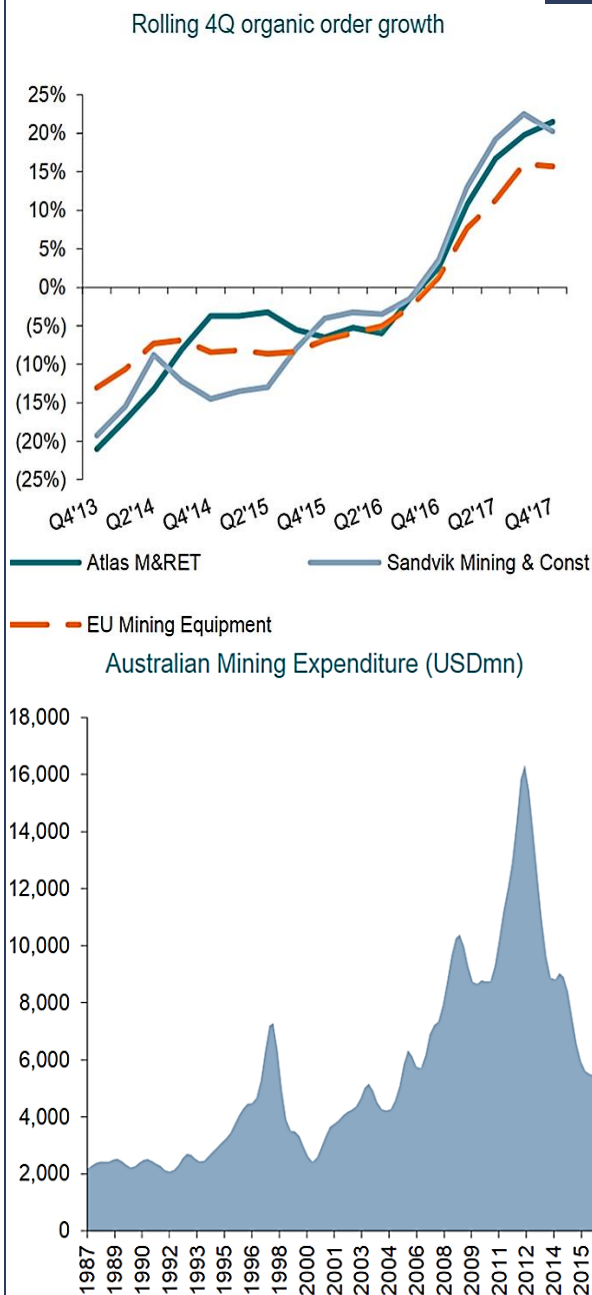


Mining Equipment Has Room to Run.

The mining recovery remains in its early stages with past investment/capex austerity having created some supply constraints, while solid demand growth from China and the West has helped create upward pressure on commodity prices. Over the past six months most mining companies have announced new capital programs at both existing mines and new locations – their balance sheets and FCF generation remain at the healthiest level seen over the last decade. In addition to this dynamic, structural aftermarket/consumable growth is set to continue given that declining ore grades and deepening mines are resulting in a higher amount of material that must be mined/removed to keep production volumes flat.

Mining equipment growth vs mining expenditure

FIG 6

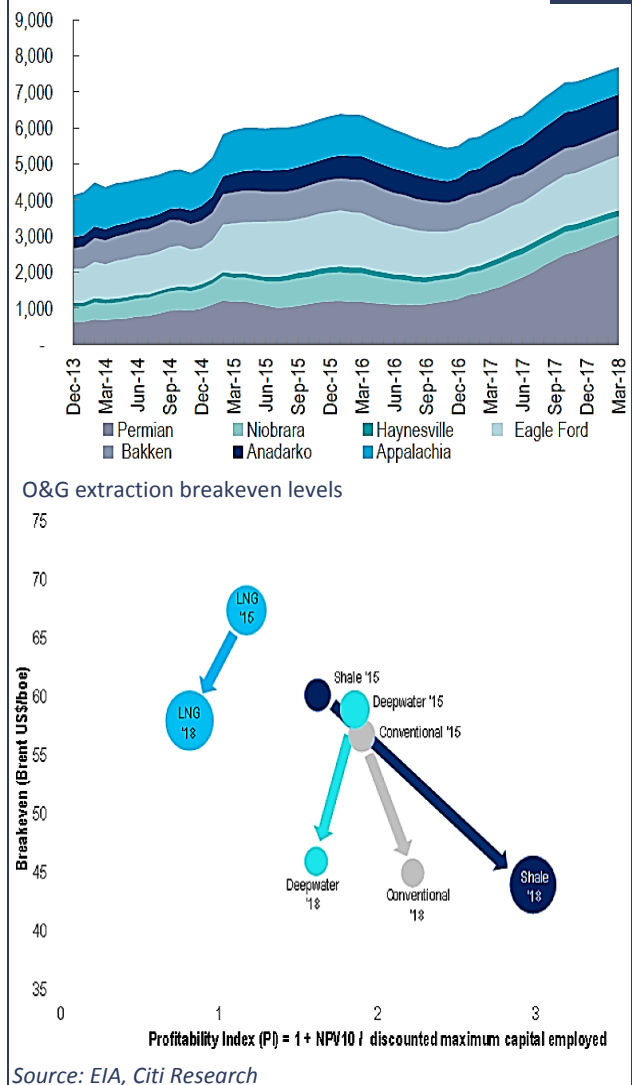


US Onshore Recovery Helping Support Momentum.

Key indicators of shale oil activity have bottomed, and 2018 North America upstream capex growth helps support earnings momentum. Competitive economics continue to drive this growth given declining extraction costs and improving profitability on investment – breakeven costs have moved down significantly from >\$60/bbl in 2015 to just under \$45/bbl today. A record level of drilled but uncompleted wells (DUCs) represents pent-up demand and future revenue for US onshore shale exposed names such as *Weir*. Capacity utilization in the fracking industry remains tight, offering support for pricing as well as potentially stoking a new-build OE equipment up-cycle.

Drilled and uncompleted wells

FIG 7



Siemens AG

Concerns around power generation have weighed significantly on the shares of companies such as *Siemens*, with exposure to these end-markets. *Siemens'* shares have underperformed peers by over 25% in the last 12 months and the company's relative valuation is sitting at a multi-year low (c20% discount to the sector). However, earnings in problematic divisions are now bottoming out. The group is going through an ongoing portfolio reshaping and cost reduction program referred to as the "Vision 2020" plan.

This plan was launched by CEO Joe Kaeser in 2014 following his appointment as head of the German industrial behemoth. The plan stemmed from a series of cost overruns on several projects ranging from rail to wind and power transmission that pointed to poor risk management as well as an overly complicated organizational structure. The company is no stranger to re-organisation, but most observers would admit that this is the most comprehensive shake-up plan for decades.

Siemens is starting to employ a “fleet of ships” strategy for some of its smaller or underperforming businesses and has entered into JV agreements *Siemens-Gamesa* merger in wind and the *Siemens-Alstom* merger in transportation/rail. Synergies from these deals and cost savings from de-conglomeration (i.e. the reduction of inflated HQ overheads relating to the complex structure of the business) should help expand company margins by 150-200bps over coming years.

Secondly, the company has correctly identified that the market is undervaluing its various businesses when compared to other publicly listed peers. As a response, *Siemens* has started to list its various entities to allow separate access to capital markets and in turn a more transparent valuation (amongst other benefits). *Siemens-Gamesa* is already listed, *Siemens-Alstom* will be publicly traded when the merger completes at the end of this year and the company just listed its large healthcare business, *Healthineers*. The listing was a success, with shares in the subsidiary rising more than 20%.

These initiatives are slowly starting to help the market better understand the true underlying value of the *Siemens*’ portfolio. As many industrials approach the end of the cycle for their end-markets, we think names such as *Siemens* that offer cost/productivity self-help and portfolio restructuring opportunities are likely to be relative outperformers going forward.

Basic Industries

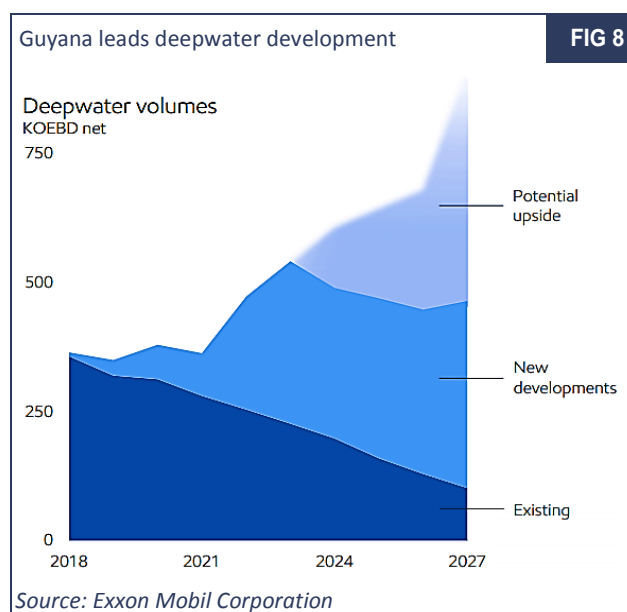
ExxonMobil

The outlook for oil has dramatically improved. OPEC has been disciplined with production cuts; inventories have returned to long term averages; global demand is firing; and US shale producers are also exhibiting capital discipline. Despite Brent surging to \$75 a barrel, oil companies have mostly failed to keep pace, with *Woodside Petroleum* and *OilSearch* trading flat for the year. *ExxonMobil* has also been a laggard, with its shares trading at a similar level to when Brent bottomed at \$28 per barrel.

Exxon has underperformed not only relative to the oil price, but also its peers. This was most noticeable following the company’s investor day in March where the management team laid its plan to double cash flow over the next seven years. This would require capex to increase 50% from current levels to \$30billion between 2020 and 2025. Given how badly the industry squandered windfalls from higher prices during the previous boom, investors are naturally sceptical of investment for growth. *Exxon*’s counter-cyclical investment is at odds with others who have capped investment and are increasing short term shareholder returns

Exxon’s planned step-up in spending is not a response to higher oil prices but the outcome of several years of exploration success and resource capture with success rates of 50-75%. The company believes it has the “best portfolio of opportunities since the *Exxon* and *Mobil* merger” which occurred in 1999. While the company was not immune from challenges in prior cycles. They have better control over their large growth projects.

An example of these is the deep-water development in Guyana. After years of slow progress, the Liza discovery in 2015 has allowed for a series of successes that have delivered a multi-billion-barrel oil field. *Exxon* and the Guyana government have agreed on a PSC (Production Sharing Contract) that allows 75% cost recovery from revenue. This reduces the capital outlay required by *Exxon* as multiple developments are completed, incentivising growth and creating potential upside.



A large acquisition at the beginning of 2017 paved the way for the current development plan, spending \$6bn to double their acreage. While the Permian basin is well understood, the challenges surrounding its growth relate to infrastructure. *Exxon* have a unique position in the region with a suite of US gulf coast refining assets as well as related pipelines. This position will provide a significant advantage as the Permian grows to be the largest producing field in the world.

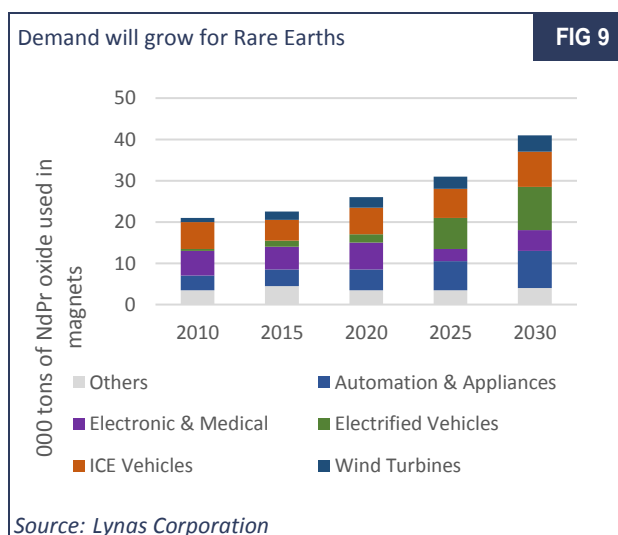
Despite concerns around capital efficiency, *ExxonMobil* increased its second quarter dividend which implies an annualised dividend yield of 4%. We believe at current oil prices the company has capacity to not only deliver on weighty growth plans, but also increase shareholder returns. We expect the company will announce a share buyback in the second half of this year, to complement the current dividend yield as well as the counter-cyclical investment spend.

Lynas Corporation

A key driver of commodity price strength in recent years has been China's supply side reform and its environmental crackdown. A number of industries that were in chronic oversupply have rapidly adjusted as Chinese authorities have dismantled capacity and restricted supply. Margins for coal producers and steel makers are at record levels. While these stories are well recognised, the pressure from government is also extending into smaller niche sectors. Manganese, molybdenum and caustic soda have all seen prices soar as Chinese supply is restricted. We believe a similar situation exists in rare earth elements and have initiated a position in reformed producer *Lynas Corporation*.

Rare earths are crucial in the production of smart phones, electric vehicles, wind turbines and consumer devices. While quite abundant in the earth's crust, the concentration of deposits and the difficulties in processing them have plagued the industry for some time. Lynas owns the highly endowed Mt Weld deposit in WA, and processes that material in a state of the art facility in Malaysia known as the LAMP (Lynas Advanced Materials Plant). The company developed these assets at an unfortunate stage of the cycle, leveraging the balance sheet just before prices dropped. Through 2015 and 2016, both *Lynas* and the only other non-Chinese producer, *Molycorp*, struggled. In fact, *Molycorp* went into bankruptcy, only to be recently sold to a Chinese consortium, leaving Lynas as the only non-Chinese supplier of rare earths globally making it a highly strategic producer. Prices have been higher for 18 months, enabling *Lynas* to restructure its debt and invest in its business.

Demand growth for rare earths surpasses most industrial commodities. Neodymium and Praseodymium, or NdPr, which generates roughly 90% of the revenue for *Lynas* is the critical raw material in the manufacture of high performance magnets. Growth is accelerating for these products given their use in electric vehicles and wind turbines. Based on demand forecasts the world will require additional NdPr supply equivalent to 'another *Lynas*' every four years until 2030.



The company has launched *Lynas NEXT*, which is aimed at boosting its production to meet future demand. The NEXT project will take production of NdPr from 500 tonnes per month to 600 – a 20% increase. If we look beyond the current expansion, *Lynas* has the ability at both Mt Weld & LAMP to potentially increase production and maintain its market share in this strategic commodity.

However, we see two major factors in the supply of rare earths that could cause a spike in the price. China produces 90% of the world's rare earth needs. Illegal mining is rampant, with highly detrimental environmental effects. Crackdowns have occurred in the past and this harmful mining may be closed. Secondly, China is the major global supplier of rare earth metals. As trade negotiations continue, rare earths could become a critical area for China to exert bargaining power. We saw a glimpse of this in 2010 when China ran export quotas and at one time, cut off supply to Japan entirely. This saw the NdPr price jump to roughly four times today's price. As the only non-Chinese supplier, it is clear to see the strategic nature of *Lynas*' business.

Consumer

Blackmores

Blackmores is the largest vitamin and supplement brand in Australia selling half a billion tablets and capsules a year across more than 250 products. Key products include fish oil, primrose oil, vitamin E cream, glucosamine, and pregnancy vitamins. Production is mostly outsourced to third party contract manufacturers and most products are sold under wholesale arrangements to pharmacies, grocery chains, mass merchandisers, and practitioners.

Chemist Warehouse is the largest discount pharmacy chain in the country and accounts for most of growth in domestic sales of vitamins and supplements. In return for space on its shelves, Chemist Warehouse demands excessive rebates from suppliers, which *Blackmores* have historically been unwilling to meet. As a result, *Blackmores*' products are under-penetrated in this growing channel, which has caused concern for investors and may explain the discount to our assessment of fair value. While it may be missing an opportunity to grow sales locally, if the company can maintain its domestic market share the market would likely view this as a favourable outcome.

Internationally its prospects are much brighter with *Blackmores*, having accumulated over 40 years' experience selling into Asia. The company has strong positions in China and South East Asia, with sales in both regions growing at approximately 20% year to date. China is the larger of the two prospects and currently represents around a third of aggregate sales. Product ultimately ends up in the hands of Chinese consumers via either the formal

cross-border ecommerce channel (Tmall, JD.com, Kaola) or the informal daigou (personal shopper) networks.

These Chinese distribution channels carry an element of regulatory risk and it was changes to oversight of the daigou shopper that caused the inventory digestion issues of 2016 and 2017. Shareholders today own a company that has made significant progress in rebalancing Chinese distribution away from the daigou and towards the more profitable and regulated cross-border ecommerce channel. Politics permitting, *Blackmores* should obtain regulatory approval to sell their products in Chinese offline channels within a year or two, which would provide a fillip to growth in this market.

Benchmarking against competitor *Swiss* (now Chinese owned) reveals opportunities for *Blackmores* to expand its profitability. Rebates paid to wholesale partners are too high because of the excess inventory issues of the recent past, and the company has a trajectory in place to reduce these to more palatable levels. A supply chain optimisation project is also underway which will see most of its production re-tendered at more competitive rates given the expansion in local contract manufacturing capability in recent years. Offsetting this are recent rises in ingredient costs, which will be felt across the entire industry and likely lead to compensatory price rises.

We forecast that sales can grow at a high single digit rate over the medium term and profits roughly twice as fast. The company remains highly strategic as the largest offshore vitamin company yet to fall into Chinese ownership. However, there would be no shortage of mainland companies or private equity firms eager to acquire the company should they become more receptive to external offers.

Melco Resorts

Melco Resorts is the leading Macau casino operator in the attractive premium mass customer category. Across their two main properties: City of Dreams and Studio City, *Melco* captures roughly 15% of all gaming activity in Macau. Both properties are located in the modern Cotai region of Macau and as a result, the company has avoided the challenge faced by competitors of trying to simultaneously manage legacy properties on the Macau Peninsula. *Melco* also has a 70% stake in the City of Dreams casino in the Philippines.

Gamblers in Macau are categorised as either VIP, premium mass, or grind mass. Premium mass is attractive because it comes with less regulatory risk than VIP business, as it does not require the payment of sizeable commissions to junkets and has significantly higher spend per customer than grind mass. As a result, *Melco* has table yields approximately 50% higher than the Macau average. Robust growth in the premium mass customer category can also be anticipated given the continued

strong wealth generation associated with China's ongoing development.

Currently, the most exciting development for *Melco* is the opening of the spectacular Morpheus hotel on the City of Dreams property within the next few months. Morpheus will add 780 premium rooms to the existing base of 1400. Hotel occupancy which is currently at record levels has proven to be a constraint on the property and so the opening of Morpheus will significantly increase the earnings power of the casino at very little risk. The scale of the investment in the new hotel is also likely to earn *Melco* concessions from the Macau government in the form of additional table allocations.

City of dreams property with Morpheus front centre

FIG 10



Source: City of Dreams Macau Website

Additional earnings growth over time will come from the continued ramp up of the relatively new Studio City property. The property has underperformed relative to its potential to date and recent changes to management are intended to drive operational improvement. While the sub-optimal location of the casino can't be changed, local infrastructure projects will prove beneficial to Studio City over the near term. The new light rail is due to start operating next year and fortuitously a station will be situated adjacent to the property. The property is also positioned adjacent to the new Lotus Bridge immigration complex which will provide another boost to visitation.

Melco's valuation is compelling vs Macau peers with the discount to the more expensive operators currently around 30%, despite comparable growth. One of the reasons for the discount is the more complicated operating and ownership structure of the company. Our discussions with *Melco's* management have made it clear that they are aware of the valuation upside from a simplification of the structure. If/once the company buys out the 40% minority partner in the Studio City property we wouldn't be surprised to see a simplification initiative take place in which the various holding and operating companies are consolidated back into a single listing in Hong Kong which would likely see the discount to peers eliminated.

Healthcare

Ramsay Healthcare

Ramsay Healthcare is Australia's largest owner/operator of private hospitals, accounting for ~25% of the nation's private hospital beds. It also has ~180 hospitals across South-East Asia, France, Italy and the UK; collectively representing a quarter of the company's earnings. *Ramsay's* revenue is largely derived from surgical procedures performed in their operating theatres and procedure suites. Private health insurers pay the hospital a fee to cover the cost of an insured patient's surgery while a separate fee is paid to the Doctor/Surgeon. The Australian business has delivered solid growth for the last decade thanks to a buoyant Australian economy, high levels of private health insurance coverage, strong demand for elective surgical procedures and new operating theatre and bed capacity.

Despite a recent slowing in surgical growth across the private market, the longer-term outlook remains robust and margins are at record levels. The impact of an aging population on growth in surgical and medical trends will become noticeable over the next few years. For *Ramsay* we expect this will underpin consistent earnings growth over the coming decade.

Ramsay's shares now trade at a 23% discount to Australian healthcare peers, the deepest discount in nearly 10 years. We see compelling value in the shares with our modelling implying >20% upside from current levels. We have identified several key issues that are causing concern for investors and which may explain why the shares are trading at current levels.

Issue 1 – Private health insurance coverage in free-fall

The number of Australians with private health insurance (PHI) grew over the last decade, peaking in June 2015 at ~11.3 million people, or 47.3% of the population (up from ~43% in 2005). Coverage has recently declined to 45.6% as affordability/value for money concerns led many younger individuals to reduce coverage or drop health insurance altogether. While this trend will likely continue, we believe the numbers tell a different story showing robust growth ahead.

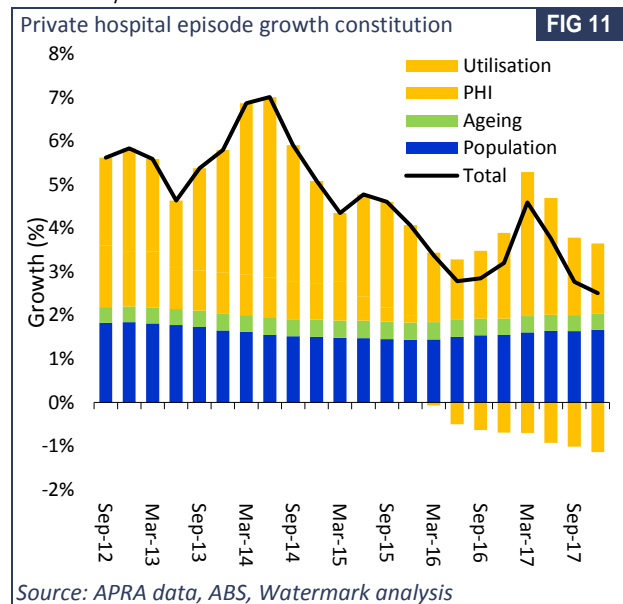
1) The highest utilisers of insurance are the over 50's representing ~72% of all utilisation; growth in this segment will remain resilient as the population ages.

2) Falling PHI coverage has only modestly impacted industry growth (i.e. surgical volume growth); a ~1% headwind. Population growth and utilisation however remain consistent and are important drivers of industry growth which is currently running at ~3% (Fig 11). In fact, the total number of insured lives has not declined over the last 2 years.

3) *Ramsay's* hospital activity is driven by trends/demographics in the local catchment. With hospitals positioned in areas with higher health insurance coverage and favourable

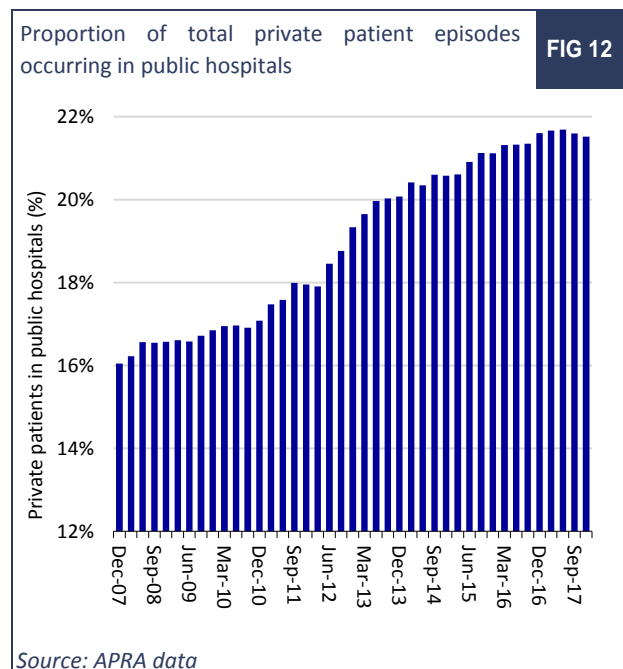
demographics, aggregated national data above may be less informative.

In summary we believe *Ramsay* can continue to grow above market levels and the longer-term setup is compelling. We expect the current period of slower growth will likely revert back to historic levels as many surgical procedures cannot be put off indefinitely.



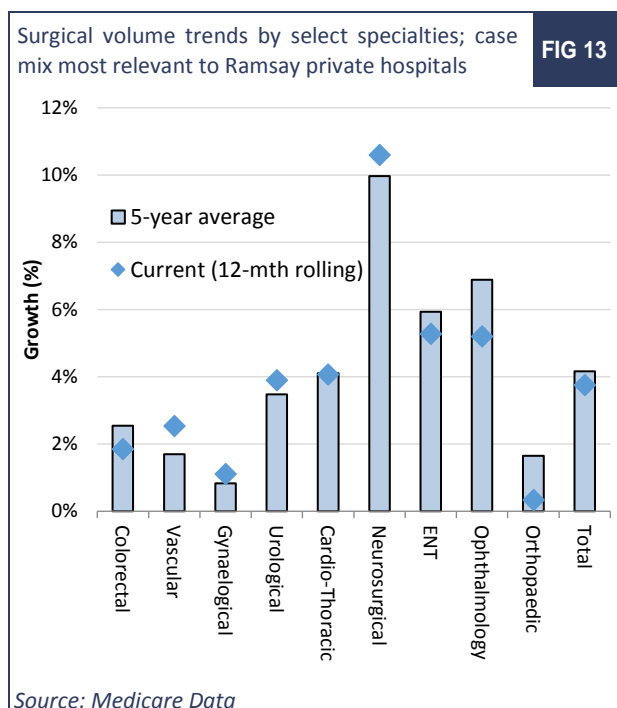
Issue 2 – Public system is a viable alternative to the private

Industry data and feedback from competitors suggests public hospitals have actively pursued private patients to undergo elective surgery in public hospitals. The number of private patients having procedures in public hospitals has grown to nearly 22% (Fig 12). Outcry over public hospitals giving private patients preferential early access to surgery over public patients on waitlists (queue jumping) has caught the attention of the Federal Government. We expect this trend to reverse over the medium term, providing a modest tailwind to private system volumes.



Issue 3 – Surgical growth is slowing

Sceptics believe the private health industry has been over-earning with claims of over-servicing patients via unnecessary or 'low value' surgeries. The media spotlight is likely causing surgeons/physicians to be more cautious about referring a patient for surgery – the 'Choosing Wisely' campaign for example. We believe 'over-servicing' was/is more isolated to doctor-owned day surgery facilities as opposed to occurring at Ramsay's hospitals and suspect referrals for surgery to rebound over time. Importantly, Medicare activity data shows that surgical volume growth for many of Ramsay's core areas remain at or near historic levels (Fig 13).



Despite market concerns, we expect Ramsay's Australian business will remain resilient, with more benefits to come from its global scale and tighter cost control. We take comfort in management's recent review of the project pipeline and its decision to lift spending on capacity expansions over the next few years. While the near term may be volatile for the shares, longer term we are confident in the growth profile.

Novartis AG

Pharmaceutical company *Novartis* has underperformed through the quarter due to investor concerns around:

- 1) The *Alcon* business (ophthalmology) turnaround story taking longer than expected.
- 2) The continued underperformance of Sandoz (division of *Novartis*).
- 3) Growing pressure on earnings from generics (Gleevec), and increased competition in its multiple sclerosis drug Gilenya.

With analysts forecasting only average earnings growth for its peers in the near-future, we suspect investors view *Novartis* as

being fully valued. In our opinion, *Novartis* has the foundation to achieve top quartile earnings growth amongst its peers. Furthermore, *Novartis*' peers are facing greater pressures on their earnings outlook, meaning 'street forecasts' face higher risk of downward revisions. These include:

- 1) *Roche*'s looming competitive threat from biosimilars (a biologic medical product which is almost an identical copy of an original product that is manufactured by a different company). Biosimilars are targeting more than a third of the company revenues- these are high margin products; therefore, the earnings impact will be amplified.
- 2) *Sanofi*'s diabetes business deterioration (~12% of group revenues but higher in earnings) will continue. New and upcoming products like Dupixent and Praluent will disappoint providing little or no offset to the diabetes franchise bleeding. Also, *Sanofi*'s recent acquisitions appear desperate to cover gaps in near-term earnings.
- 3) *AstraZeneca*'s earnings downgrades over the last few years are likely to continue due to their inferior immune-oncology pipeline, a fading diabetes business and a respiratory franchise facing severe competitive headwinds. The company's 'externalisation revenues' (booked as 'core earnings') have been artificially propping up earnings for years. *AstraZeneca* resource/asset base is depleting rapidly- the company has nothing to sell and/or to farm out. The market is forecasting *AstraZeneca* to perform a significant turnaround in SG&A margins in pharma history despite new product launches ramping up.

Novartis issues are trivial in comparison to its competitors and the company is positioned to unlock value and redeploy capital to pivot the business into the next leg of growth – both via M&A and organic investments in the pipeline.

The execution and pace of the *Alcon* business turnaround has surprised us and should allow the company to unlock >\$10 billion value by spinning off (de-merger) the business in early 2019. Furthermore, *Novartis* sold its share of the consumer healthcare joint venture business back to *GlaxoSmithKline* raising \$13bn in capital in late March.

Since taking the reins in February, new CEO Vasant Narasimhan has wasted no time putting his stamp on the business. Narasimhan appears to appreciate a moderate sense of urgency in setting up the business for the future. The company is not afraid to push the innovation envelope with cutting-edge therapies entering the market including its CAR-T therapy for childhood cancers, gene therapy for congenital childhood blindness and an underappreciated immuno-oncology pipeline, to which few give credit.

Despite *Sandoz* (*Novartis*' generic drug and biosimilar business) being under pressure by US generic drug pricing erosion, the business is strategically important in our view and will likely begin to bear fruit over the next few years with multiple launches and a strong European market for biosimilars. The US market is a wildcard and may provide upside for biosimilars if the regulatory pathways change.

PORTFOLIO REVIEW

BASIC INDUSTRIES

Hard commodities were broadly lower in the March quarter after a stellar run in December. Credit conditions in China continued to tighten as the government utilised strength in Western economies to reign in debt in its own backyard. Demand was reasonably weak in China as the winter heating shutdown was in full force. We expect construction projects to ramp up in the second quarter as production restrictions are lifted which will support growth. However, we are cautious about demand growth in the second half of 2018 as the full weight of credit cuts are felt in the Chinese economy. With that profile in mind, and considering the pullback we saw in mining shares, we added to our mining exposure late in the quarter, largely through our key holding in *BHP Billiton*.

Oil continued to rally in the quarter as demand remained healthy and geopolitical concerns added to OPEC supply constraints. Despite the strength in the underlying commodity, equities were sold off with the broader share market allowing us to increase our exposure to the sector. In the medium term, we see a favourable outlook for oil, as discussed above *ExxonMobil* is one of few companies growing production.

Iluka Resources performed well during the quarter announcing a strong result that showed lower debt, increased production and a higher dividend. Zircon and rutile markets continue to remain tight and the price of those commodities will rise further. While the thesis remains intact, we reduced our position as the shares approached our target valuation. We exited our position in *Independence Group*, with the shares having rallied on excitement over nickel and its potential in electric vehicles. We are cautious on the short-term outlook for nickel given nickel pig iron production growth coming through China and shifted our exposure to *Lynas Corporation*.

New additions to the Energy portfolio over the quarter consisted of *Woodside Petroleum* and *ExxonMobil*. *Woodside* shares fell sharply after their acquisition of the Scarborough gas field and their surprise equity raising. This changes the narrative for *Woodside* from high dividend payer to potentially a series of large capital developments. With LNG markets returning to balance earlier than previously thought, we believe this acquisition strengthens their position in the basin and will ultimately be rewarded. Similarly, we added *ExxonMobil* to the portfolio following the announcement of increased medium-term investment spending.

INDUSTRIALS

The industrials sector was a strong contributor to market returns in H2 2017 and through January 2018. However, the sell-

off in February and associated market volatility caused many names to de-rate rapidly despite continued strength in underlying data and end-markets. We used this opportunity to add to positions where we believe end-markets are still at mid-cycle (or a trough) while security pricing reflects end-of-cycle dynamics, and to self-help stories.

Internationally, the Industrials portfolio was a positive contributor during the quarter. On the long side, *Airbus* continued to deliver strong results and an upward surprise on FCF generation and *Zebra Technologies* saw earnings revisions of c20% on the back of tax reform and a stronger corporate capex spending environment. Given the market volatility, our shorts were solid P&L generators: some successful shorts during the quarter included *Kone* which has been trending downwards since hitting a high of EUR47 in October; and *IMI*, where the management team had to reset expectations given weaker power end markets and high sell-side expectations that had run ahead of themselves.

Detractors from performance included: *Kennametal*, which despite solid end market momentum underperformed its European peer *Sandvik* despite sitting on an all-time high P/E discount of over 25%; and *Ashtead*, where the outgoing CEO sold a portion of his holdings in the company triggering profit taking post a strong run.

New positions initiated over the quarter include *Siemens* and *Alfa Laval*, which is set to continue benefitting from the O&G recovery while its other major end market (marine) has troughed. The new management team is also focused on self-help and productivity initiatives which will drive an upside surprise to margins.

CONSUMER

Consumer staples shares were down over the March quarter with global names underperforming domestic peers. The main driver was the upwards move in the US 10-year bond yield, with earnings multiple applied to consumer staples stocks being typically inversely related to bond yields given there is a degree of substitutability between the two asset classes. Global consumer discretionary shares were broadly flat while Australian names were down following predominantly underwhelming results from the Australian retailers.

The largest contributor to performance in the consumer sector came from our Australian retail shorts. Reported results in February disappointed the market, with promotional activity elevated through Christmas trading because of subdued consumer spending and in part because retailers were defensively positioned for the (ultimately underwhelming)

entry of *Amazon* into the domestic market. Domestic gaming shares (*Tabcorp* & *Star Entertainment*) were detractors from performance over the quarter. We sold *Tabcorp* in January when the market met our valuation but ultimately were too quick to re-establish the position following a disappointing wagering result. Offshore contributors to profits included our Macau casino and our European beverage positions.

We took profits on *Woolworths* when it became clear that the reinvestment needs of the business would be larger than we originally anticipated. We remain positively disposed to the business and management and eagerly await the market providing an opportunity to re-establish the position at more attractive levels. New positions were established through the quarter in *Blackmores* (see earlier summary), *LVMH* (luxury conglomerate owner of Louis Vuitton and numerous other storied brands), and *Treasury Wines Estate* (Penfolds).

FINANCIALS

Global financial shares performed in line with broad equity market indices in the first quarter of 2018. The Financials portfolio was a detractor to performance, as alpha generation in the Real Estate sector was offset by losses in Diversified Financials.

In Australia positions in both *Janus Henderson* and *BT Investment Management* detracted from returns. Both companies suffered from the same issue in 1Q18: net fund outflows and falling equity markets. For *BT*, it's UK business (*JO Hambro*) reported its second consecutive quarter of outflows, a dynamic not seen in almost 7 years under ownership by *BT*. We believe these shares offer compelling value at these levels and are encouraged by the fact that net out-flows in the quarter ending March 2018 moderated to \$200m from \$1.9b in the quarter ending December 2017.

In the case of *Janus Henderson*, recent outflows have been caused by a combination of a negative flow environment for active investment managers and uncertainty amongst its clients around the integration of the Janus and Henderson businesses. It is our view that the merger of Janus Capital and Henderson Group creates a combination that will facilitate deeper client relationships, an improved global product offering and the potential for further cost-out opportunities. While we expect some disruption in net flows as clients wait to see how the integration proceeds, we believe *Janus Henderson* is now one of the most attractively valued fund management companies globally on around 10.5-11x 2019 P/E. As clients become comfortable with the integration of the combined group and their investment professionals' ability to perform, flows should improve, and the company's depressed valuation should normalise.

HEALTHCARE

Global healthcare shares modestly underperformed major global bourses in the March quarter; the Australian healthcare index however was a material outperformer while European healthcare shares struggled versus global peers. Large pharmaceutical and biotechnology companies remain dogged by patent expiries protecting large drug franchises, drug pricing pressures and an intensely competitive environment. A key announcement by the Trump administration on US drug pricing is imminent and likely keeping a lid on an unloved sector. While most market commentators view the Trump's drug pricing announcement as 'tinkering around the edges' we are less sanguine noting the strong messaging from the Trump Administration's FDA commissioner Gottlieb and HHS secretary Azar.

The medical devices and life science tools sector continues to lead with robust fundamentals (volume growth and innovation) driving results that continue to beat expectations. While there are worrying signs of over-crowding and 'safe-haven' status in these companies, we believe this is warranted and see little reason for investors to shift funds into higher risk/more volatile companies like pharmaceuticals, drug distributors and deal heavy managed care.

The Healthcare portfolio delivered positive returns in the March quarter. Domestically, half year company results dominated share price as strong results from positions in *CSL* and *Cochlear* delivered positive returns for the quarter. Our investment in *CSL* ahead of the result stemmed from a change in our perspective around the company's ability to turnaround the flu business (partly due to a strong US flu season) and its strength in plasma collections versus peers. More importantly, it renewed our analysis on the margin growth opportunity for the Behring business driven by new products (haemophilia, angioedema) and shifting product mix to its subcutaneous immunoglobulin therapy Hizentra. We closed our position in *Ramsay* ahead of the interim result which proved to be correct as the shares underperformed on the results despite the company meeting guidance and delivering record Australian margins. As a result, we re-established our position in *Ramsay*.

Positive contributors in the international portfolio were investments in *Merck*, *Nevro*, *Boston Scientific* and *Anthem*. *Merck* continued to deliver to our thesis (discussed previously in March 2017) that it would emerge as the leader in the immune-oncology drug development race with the company unexpectedly announcing early positive results from its major lung cancer trial Keynote-189. *Nevro* delivered a stellar Q4 2017 result that alleviated concerns it was losing share in the spinal cord stimulation (SCS) market to rivals *Medtronic*, *Abbott* and *Boston Scientific*. *Anthem's* new CEO announcement was well

received, and the company continued to deliver above peer results for a below-peer valuation.

This strong performance was offset by *Celgene*, which continued to languish following another unexpected announcement by the company regarding its key growth product Ozanimod which received a refusal to file letter from the US regulator (FDA). This was a disappointing announcement but has not changed our investment thesis.

TECHNOLOGY/MEDIA/TELECOMMUNICATIONS

The Technology sector has become a very large component and driver of the US share market. This leadership has faltered recently due to a range of factors, including the *Facebook* privacy scandal and weakness in iPhone demand. Further complicating the matter are the regulatory overhang that has emerged around data privacy online, M&A deals falling through (e.g. *AT&T / Time Warner* in court with the DoJ, and *Broadcom's* bid for *Qualcomm* blocked by the foreign investment board) and of course the escalating trade war rhetoric with China, to which the US is a massive exporter of technology. With this in mind, TMT performance was volatile through the March quarter and many shares have fallen from all-time highs.

The Funds' TMT portfolio navigated well through the earnings period both domestically and offshore. We took a contrarian position in traditional media companies earlier this year (with investments in *Nine Entertainment* and *Seven West Media*, in addition to our core holding in *Fairfax*), which paid handsomely when these companies reported strong results. The structural negative view around traditional advertising spend moving online and the declining audience trends for free-to-air TV are well understood; but we identified flow away from online ad-spend amidst the *Facebook/Google* data privacy scandals. Our shorts in the telecom sector continued to deliver, with the migration to NBN resulting in pressures on profitability and competition. Valuations of ASX technology shares remain lofty by global standards, and consequently companies that missed heightened expectations were punished. One of these domestic tech position worked in our favour and one worked against us as its valuation premium stretched even further. Regretfully our core position in *MYOB* also detracted from performance despite beating forecasts on subscriber additions as analysts brought down their earnings expectations with lower margin guidance for the company.

Internationally, the TMT portfolio was flat during the quarter. Many of the movements were company-specific. Large contributors to performance included *Activision Blizzard* which continued to deliver excellent results, and semi equipment company *Lam Research* which highlighted a growing addressable market and initiated a large capital return program

at its analyst day. Some successful shorts during the quarter included our core short on the advertising agencies (*WPP* and *Omnicom*) which has kept delivering since the quarter end; and our holdings in the network equipment and telecom sectors. Detractors from performance included: *China Telecom*, which despite reporting strong results, fell as a result of overreaction to concerns around regulatory influence; *Bitauto*, whose auto financing subsidiary reported a slippage in the quality of its loan book; and *CBS*, which also reported strong growth in earnings but unfortunately has been embroiled in a strong-armed takeover of low-quality cable network *Viacom*.

While we believe *Facebook* shares will be shrouded in uncertainty until their next earnings results, we saw the 20% decrease as overdone as their valuation is very compelling for growth. We also opportunistically initiated positions in *Google* (which has traded down in sympathy with *Facebook* for no apparent reason) and *Microsoft*.

Performance Review

A modest improvement in performance for the March quarter belies more significant developments for Watermark Funds. In a volatile period for most global share markets, all Funds delivered positive returns between 1-1.5%. Volatility provides an opportunity to stress-test hedged portfolios, which are designed to be insulated from the influence of macroeconomic and other exogenous forces that can impact markets. If the Manager has done its job, returns during volatile periods should be driven through security selection, rather than exposure to other factors. Our portfolios performed well on both counts during the period.

Performance from the domestic book was solid in February and March, reflecting a successful Australian reporting season and renewed focus on alpha generation in the local market. With the appointment of a dedicated portfolio manager for international equities, Justin Braitling is now working exclusively on managing the Australian portfolio, as well as retaining oversight of Watermark's risk management program. Over 12 months to the end of March 2018, the domestic portfolio for the Watermark Market Neutral Trust delivered a return of 5.09%.

Recent performance of international investments has also been encouraging after a difficult December quarter. Under the stewardship of the newly appointed Head of International Equities - Harvey Migotti, significant work has been done to de-risk the portfolios. This project has been underway since early in 2018, leaving the portfolios well-positioned to weather the correction in global share markets in February and subsequent volatility though the latter part of the quarter. The international portfolios are populated with some of the investment team's most exciting ideas; some of which have been covered in this edition of The Leading Edge. This, along with enhanced risk-management, has seen the performance of the international portfolios continue to strengthen month by month, with another solid result posted in April.

Also encouraging have been the spread of contributions across a broad range of sectors, with all but Financials delivering positive returns in the period. Notable results came from the Consumer and TMT sectors, while in Basic Industries, positive contributions on both the long and short side of the ledger bucked the prevailing negative trend across the market and substantiate the strength of stock picking in this part of the portfolio.

Quarterly Performance by Sector

Sector	Domestic Portfolio *	International Portfolio **
TMT	0.37	0.07
Healthcare	-0.05	0.11
Consumer	0.18	0.03
Industrials	-0.04	-0.40
Basic Industries	1.69	0.01
Financials	-0.20	-0.32

*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.

Fund at a Glance – March 2018

ASX Code	ALF
Fund Size	AU\$315.6m
Fund Strategy	Variable Beta
Share Price	\$1.04
Shares on Issue	270.2m

Net Tangible Asset (NTA) Backing

	Feb 18	Mar 18
NTA Before Tax	\$1.20	\$1.21
NTA After Tax	\$1.21	\$1.22

Gross Portfolio Structure

	Feb 18	Mar 18
Long Exposure	89.9%	101.8%
Short Exposure	-83.8%	-91.2%
Gross Exposure	173.7%	193.0%
Cash	93.9%	89.4%

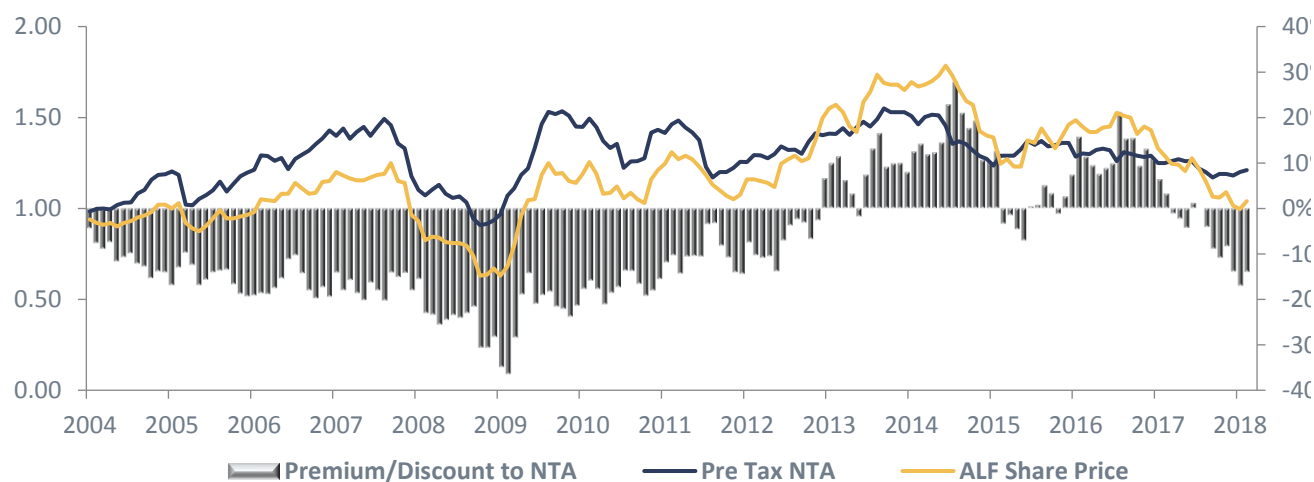
ALF Performance

	1 Mth	3 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	0.9%	1.1%	-1.3%	4.5%	6.5%	7.6%	12.0%
All Ords Accum Index	-3.5%	-3.7%	3.6%	4.4%	7.9%	7.1%	8.7%
Outperformance (net)	4.4%	4.8%	-4.9%	0.1%	-1.4%	0.5%	3.3%

Net Equity Exposure



Historical Premium/Discount to NTA History



Fund at a Glance – March 2018

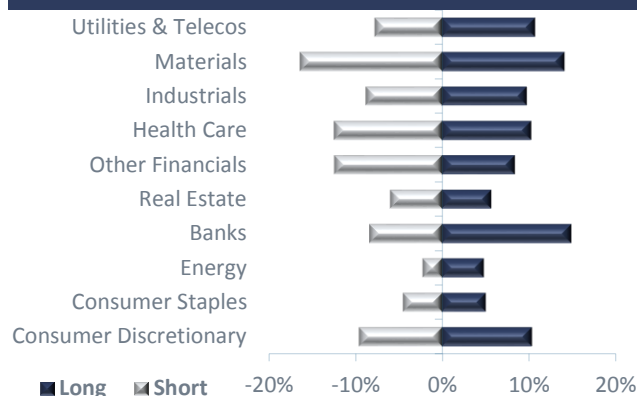
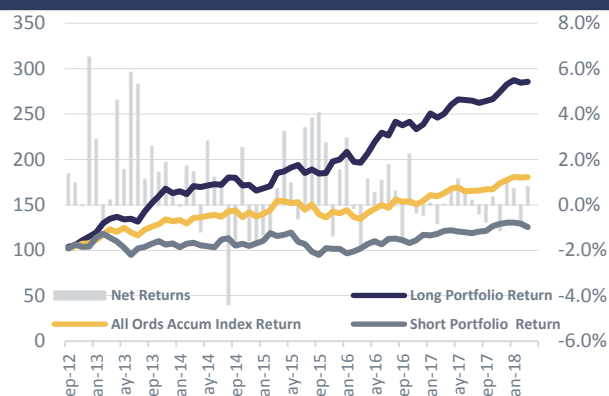
Fund Size	AU\$258m
Strategy FUM	AU\$298m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

Return Characteristics¹

Positive Months	67%
Portfolio Beta	-0.2%
Sharpe Ratio	1.3
Sortino Ratio	3.9
Standard Deviation	6.7%
No. Long Positions	76
No. Short Positions	77
Gross Exposure	183%
International Exposure (% of Gross)	19.6%

Performance²

	1 Mth	1 Yr	2 Yrs (pa)	3 Yrs (pa)	4 Yrs (pa)	5 Yrs (pa)	SI (pa)
WMNT (net return)	1.2%	2.8%	3.4%	7.9%	5.7%	9.1%	10.9%
RBA Cash Rate	0.1%	1.5%	1.6%	1.7%	1.9%	2.1%	2.2%
Outperformance	1.1%	1.3%	1.8%	6.2%	3.8%	7.0%	8.7%

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	1.00	0.69	1.65
2018	-0.86	0.80	1.23										1.17

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 – March 2018

ASX Code	WMK
Fund Size	AU\$81.4m
Fund Strategy	Equity Market Neutral
Share Price	\$0.84
Shares on Issue	85.9m
Dividend (HY18 Interim)	1 cents

Net Tangible Asset (NTA) Backing

	Feb 18	Mar 18
NTA Before Tax	\$0.95	\$0.97
NTA After Tax	\$0.96	\$0.97
Dividend Declared (1.0¢)	(\$0.01)	(\$0.01)
NTA After Tax \$ Dividend (1.0¢)	\$0.95	\$0.96

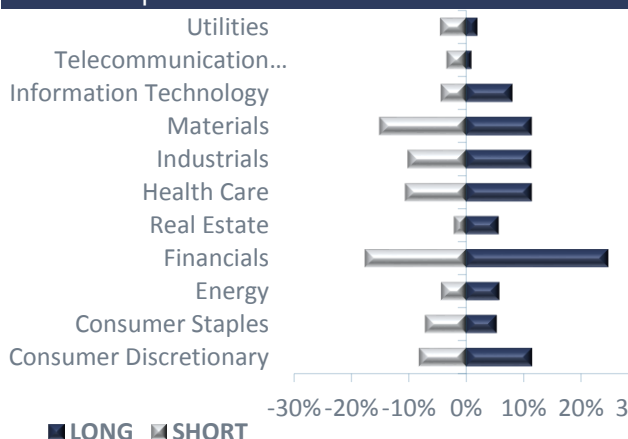
Gross Portfolio Structure

	Feb 18	Mar 18
Long Exposure	87.3%	99.2%
Short Exposure	-83.4%	-92.3%
Gross Exposure	170.7%	191.5%
Cash	96.1%	93.1%

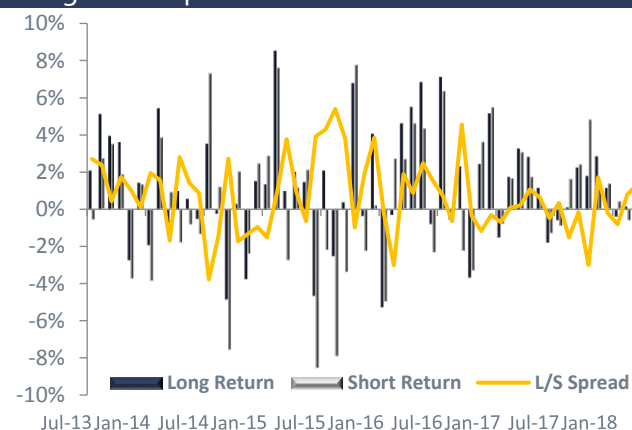
WMK Performance

	1 Mth	3 Mths	1 Yr	2 Yrs (pa)	3 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	1.0%	0.8%	-1.9%	0.8%	5.7%	4.9%
RBA Cash Rate	0.1%	0.4%	1.5%	1.6%	1.7%	2.0%
Outperformance (net)	0.9%	0.4%	-3.4%	-0.8%	4.0%	2.9%

Sector Exposures

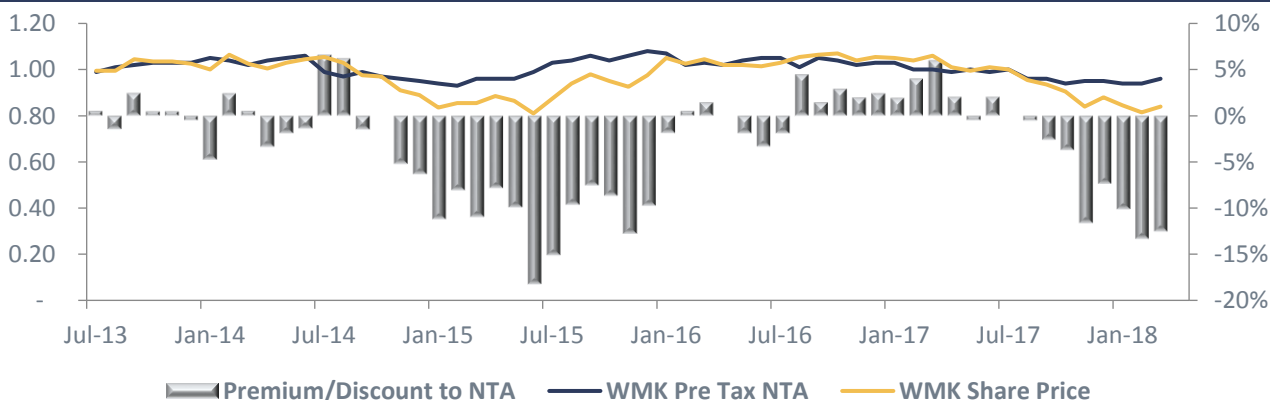


Long Short Spread*



* 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 – March 2018

ASX Code	WGF
ASX Code Options	WGFO
Fund Size	AU\$81.5m
Fund Strategy	Global Market Neutral
Share Price	\$0.89
Shares on Issue	78.3m
Option Price	0.2 cents

Net Tangible Asset (NTA) Backing

	Feb 18	Mar 18
NTA Before Tax	\$1.05	\$1.07
NTA After Tax	\$1.05	\$1.06

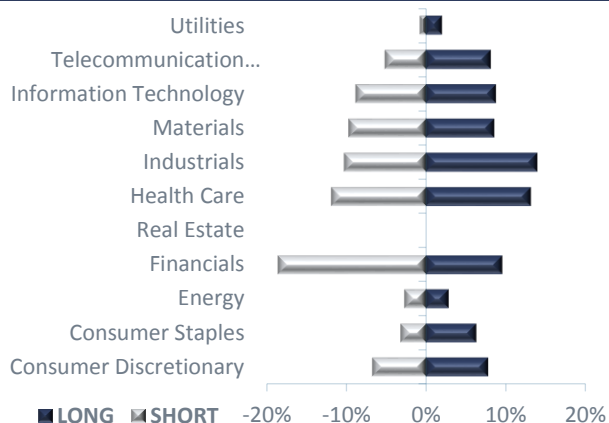
Gross Portfolio Structure

Long Exposure	85.9%	106.5%
Short Exposure	-88.0%	-103.0%
Gross Exposure	173.9%	209.5%
Cash	102.2%	96.5%

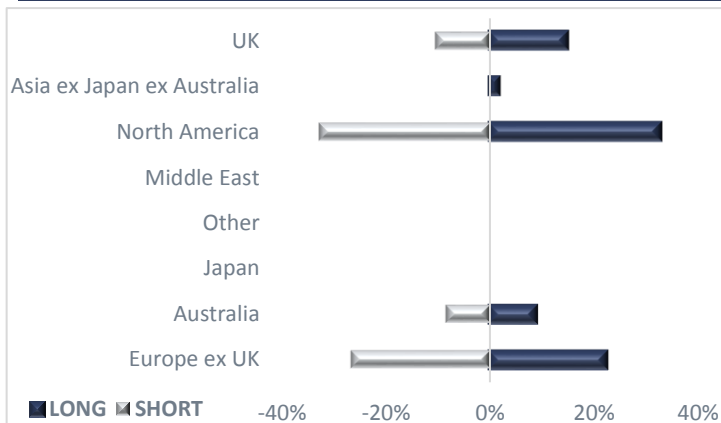
Performance

	1 Mth	3 Mths	6 Mths	1 Yr	2 Yrs (pa)	3 Yrs (pa)	S.I. (pa)
Portfolio (net return)	0.8%	-0.6%	-3.3%	-3.5%	-	-	-3.2%
RBA Cash Rate	0.1%	0.4%	0.8%	1.5%	-	-	2.0%
Outperformance	0.7%	-1.0%	-4.1%	-5.0%	-	-	-5.2%

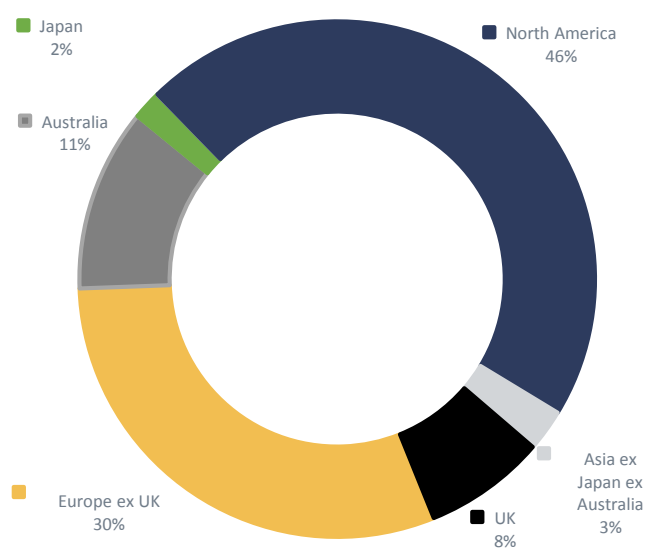
Sector Exposures



Regional Exposures (Net)



Regional Exposures (Gross)



Contributors/Detractors

Top 3 Contributors	
Siemens Healthineers AG	0.4%
Rio Tinto Limited	0.3%
WPP Plc	0.2%
Top 3 Detractors	
Continental Resources, Inc.	-0.3%
W.W. Grainger, Inc.	-0.2%
Fortescue Metals Group Ltd	-0.1%

Notes

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