



The Leading Edge

QUARTERLY REPORT • June 2018

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Justin Braitling
Portfolio Manager

Message from the CIO

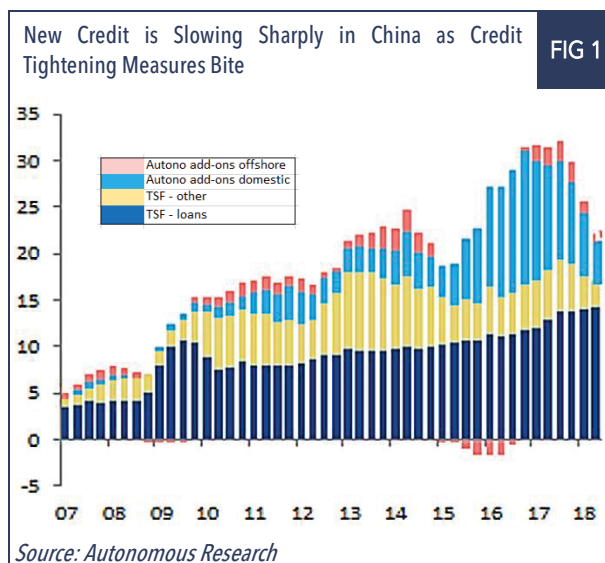
We have passed the sweet spot in this business cycle, where easy monetary conditions and synchronised growth pushed share markets higher. We are transitioning into a more challenging phase, as China and Emerging Markets (EM) decouple and we are left with a US economy at risk of overheating.

Monetary conditions that have been easy for far too long are now tightening, pushing the US dollar higher. This is impacting activity not just in the US, but also in EM that have borrowed in dollars. Finally, globalisation, a key source of growth for decades is now threatened, as trade wars ensue between the world's largest economies.

Credit and trade have for decades grown well in excess of GDP, fuelling global commerce. Indebtedness in many of the world's largest economies has risen to unsustainable levels and can no longer bolster growth the way it has in the past. Just consider Australian household debt, amongst the highest in the world relative to the income required to service it.

Excess liquidity has found its way into Emerging Economies, with cross border US dollar debt doubling to \$7 trillion since the crisis. The stronger dollar and rising US interest rates together act as a tourniquet on world liquidity and for those countries that have borrowed in dollars.

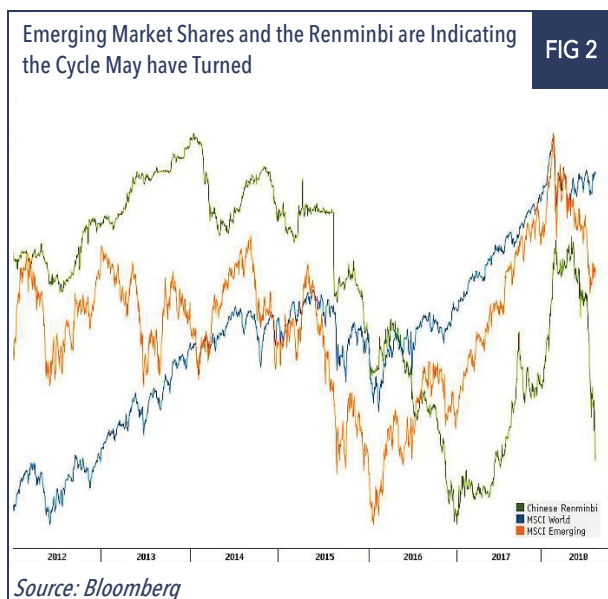
Authorities in China have also restricted credit growth as they try to clean up over-levered companies and contain excesses that have built up in the shadow banking system. In *Fig 1* you can see credit growth has fallen back to 2013-14 levels. Given the extent of tightening, not dissimilar to what preceded the downturn in 2015, we would expect to see activity in China decelerate further in the short to medium term.



Liquidity has tightened acutely in some sectors with credit spreads and default rates rising. The Renminbi has also tumbled, which was a harbinger of trouble when the Chinese economy slowed in 2014.

While investment spending and export volumes have been weak in recent months, the rest of the Chinese economy has proven remarkably resilient. As this crackdown on shadow credit continues, the Chinese economy will likely decelerate further. This is where the trade dispute with the US becomes interesting - the traded goods sector is far larger in China than the US and with the Americans threatening tariffs on a further \$US 200 billion of imported Chinese goods, while facing a slowing economy, the Chinese are in a difficult position. If share markets are the scoreboard for this trade war, the Americans are clearly in front and under no pressure to back down any time soon.

If you cast your mind back to 2014, the primary concern of investors was a slowing Chinese economy. The global industrial supply chain slowed through 2015 as the industrial economy slipped into recession. The Renminbi came under intense pressure and EM shares collapsed (*Fig 2*). Having initiated this downturn, China led the global recovery in industrial production that commenced back in early 2016.



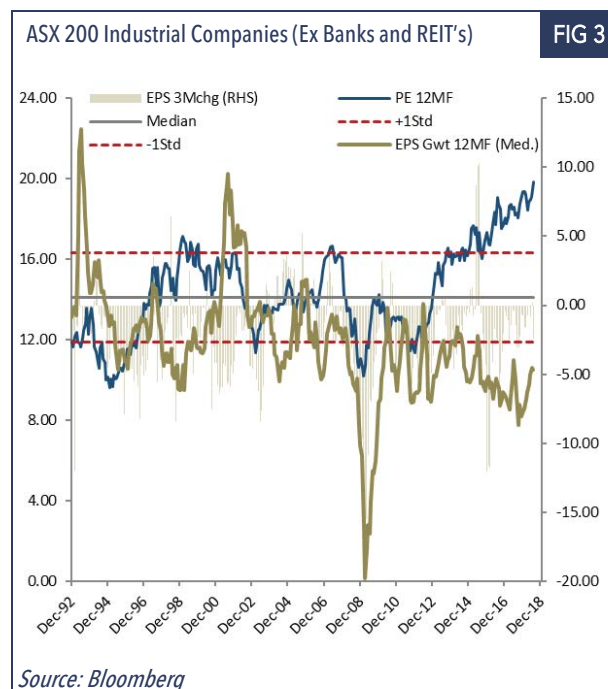
The extent of recent losses in EM shares and debt securities is troubling, the cycle looks to have turned. Meanwhile, share markets in most major economies are testing all-time highs, ignoring this important development. This seems incongruous and is a major risk given EM contribute most of the world's growth.

The trade dispute is not the real problem. After a pause, US interest rates and the US dollar are likely to push higher, ensuring any relief rally in EM from an easing in trade tensions may be short lived.

This has important ramifications for the Australian share market also. The Australian share market is considered a defensive part of the Asian basket and has rallied as EM indexes have collapsed. The Australian banks, not forsaking their challenges with the Royal Commission and the poor profit outlook are considered a safe harbour in an Asian storm.

Mining shares and the mining economy are of course highly levered to commodity prices and Chinese demand. You wouldn't know it though, with *BHP Billiton's* shares reaching a cycle high. Again, investors in mining shares are attributing the weakness in commodities to the trade dispute, when instead they should be focussing on the outlook for EM growth which accounts for all the growth in demand for commodities.

As for the rest of the Australian share market, industrial shares (Ex-Banks and REITs) continue to re-rate higher, becoming more expensive, while profit forecasts are trimmed further (*Fig 3*). At 20 times forecast earnings (blue line) we are paying a very high price for modest profit growth.



Take *CSL Limited* as an example, the largest non-bank industrial company in this group, which we will discuss at length later in this report. While *CSL* is a fine company and is very well managed, investors should not forget it is a 'growth cyclical' benefiting from highly favourable trading conditions. The plasma business goes through deep cycles- the good times won't last forever.

There are also some important challenges ahead for *CSL*, as new technologies using gene therapy and recombinant antibodies target some of *CSL's* key indications. We recently sold our remaining *CSL* shares, as we simply cannot justify the share price, even under the most bullish of scenarios.

Investors are abandoning value and instead are chasing earnings revisions as the market keeps rewarding growth and momentum. This can only go on for so long before it ends badly. The ultimate risk in holding any asset is in the price you pay, and this market is red hot. Hence here at Watermark, we retain our fully hedged settings.

International Update

Harvey Migotti

Portfolio Manager

Notwithstanding a continuation of the volatility seen in Q1, international markets ground higher in the second quarter, with the S&P adding +3% and Eurostoxx finishing up +2.5%. The month of June represented somewhat of a turning point however, with trade fears being the most dominant driver of the market turmoil. The Shanghai Exchange and MSCI Emerging Markets Index were down for the quarter (~10%) with most of those losses materialising in the final weeks of June.

Trade war fears have started to impact the market more and more over recent months – it is broad consensus across academia, business leaders and market practitioners that trade wars and protectionism are a lose-lose economic proposition. These trade tensions continue to inflict damage to investor psychology and business confidence. When there are two parties involved in bluffing/threats it can be a useful and successful strategy, but it is more likely to deliver a self-defeating result when operating in a more complex system such as global trade.

Trade fears aside, the underlying backdrop for corporates and consumers is reasonably healthy (*Fig 4 and 5*) – the former shows improving free cash flow generation, particularly for US companies that are benefitting from tax cuts and the beginnings of a manufacturing boom (*Fig 6*). Investment into equipment is running at levels below wear and tear, suggesting the need for increased capital expenditure, while higher-risk credit spreads remain well behaved – typically we tend not to see a slowdown without these widening. Consumer trends also remain positive, with a strong US labour market, rising wages and record high consumer confidence indicators. Key growth drivers do not appear to be fully exhausted, while monetary conditions remain accommodative and equity valuations are more attractive than they were over the past 12-18 months across most sectors.

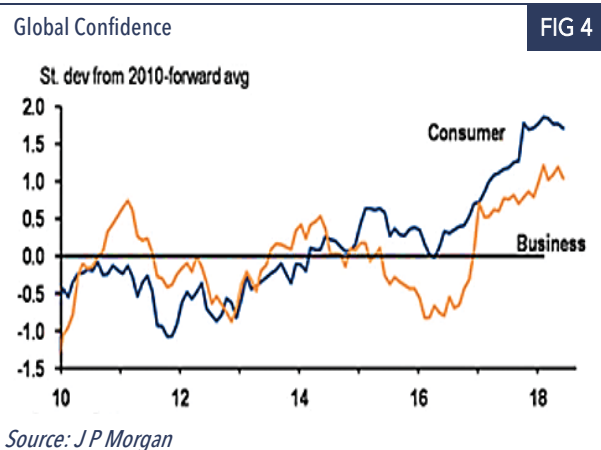


FIG 4



FIG 5

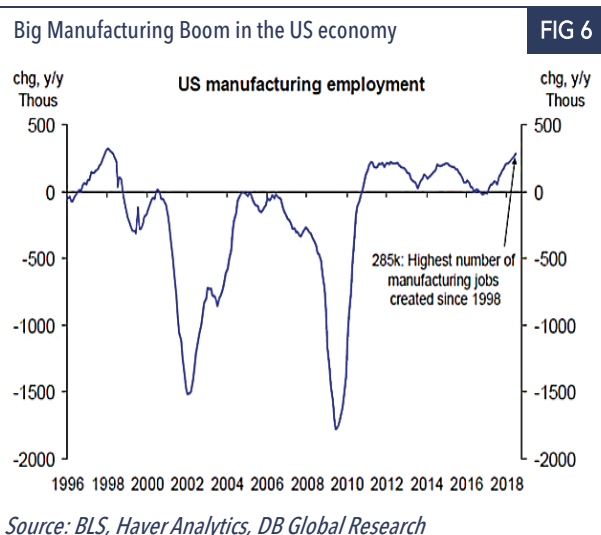


FIG 6

Chinese policy is also easing now, which could set the stage for market support into year end. In 2015, Reserve Requirement Ratio (RRR) cuts led to money supply (M1) re-accelerating, the same could be the case again. More broadly, central bank tightening is still in its early stages, and we note that none of the last eight downturns started with real rates lower than 2% - real rates remain negative in the US at this point.

Finally, investor outlook has also shifted significantly since the start of the year. In January, most seemed to be subscribing to the view that a synchronised global upturn had begun and that the cycle appeared to have legs. People were operating under a "buy-the-dip" mentality and hoping for corrections and pull-backs in order to buy at better levels. Now that the market has shown choppiness over the past few months, the appetite to buy equities has somewhat subsided with the herd shifting towards a "sell-the-rally" stance. Investors have reduced their positioning and certain bull-bear indicators are now flashing a contrarian buy signal.

Whether the market breaks higher or lower from here depends on how long it takes for the trade war concerns to abate - the longer things go on, the more likely that we see underlying business and consumer sentiment impacted and slowing growth. Moreover, it is important to continue to monitor emerging markets closely given that they have been a significant driver of global GDP growth over the past two decades. It is not clear that developed share markets can disconnect and keep ascending for a sustained period when EM are rolling over. We are keeping a close eye on various datapoints and leading indicators, in order to position the Funds accordingly and capitalise on the next market move.

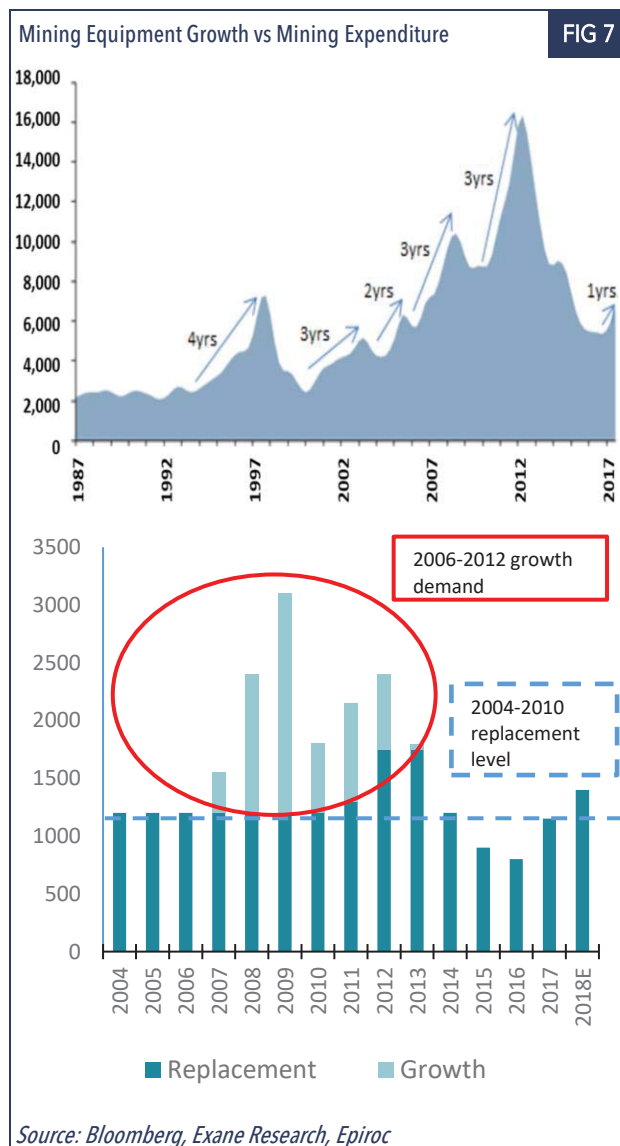
Industrials

Epiroc (EPIA : SS)

Atlas Copco has recently spun out *Epiroc*, a pure-play, best-in-class mining equipment supplier. Much like *Weir*, the company has significant aftermarket/services exposure which results in less volatile earnings compared to many other industrial companies. Having viewed the company's performance through various cycles, it is easy to categorise them as a best in class operator and one of the strongest franchises in the mining space. This is due to the specifics of their market niche and business model: the products have short life-cycles, high aftermarket requirements (two-thirds of *Epiroc* 2017 sales were aftermarket), are mission and safety critical and technologically differentiated. Moreover, they operate in a largely duopolistic market and are exposed to the expensive part of the mining process which incentivizes miners to invest in more productive technologies such as those *Epiroc* offers, including mine automation and self-operated drill machines. Finally, their end commodity exposure is heavily skewed towards copper, gold and other base metals which have a stronger underlying secular demand growth story associated with them.

Cyclical and Structural Growth

The mining recovery is in its early stages, with past investment austerity having curtailed supply, while commodity prices have recovered from their lows – historical cycles typically last 3-4 years and we are only 18 months into the current recovery. Over the past six months most mining companies, which now have healthier balance sheets and solid cash flow generation, have announced investment increases at both existing mines and new locations. Current company sales are running at 2006-2010 replacement levels and there is a large amount of potential sales to be won that relate to the equipment growth we saw in 2006-2012 (Fig 7). This equipment is being heavily utilised and will need to be replaced over the coming years as it is worn down. This cyclical factor leads into a structural one: 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.



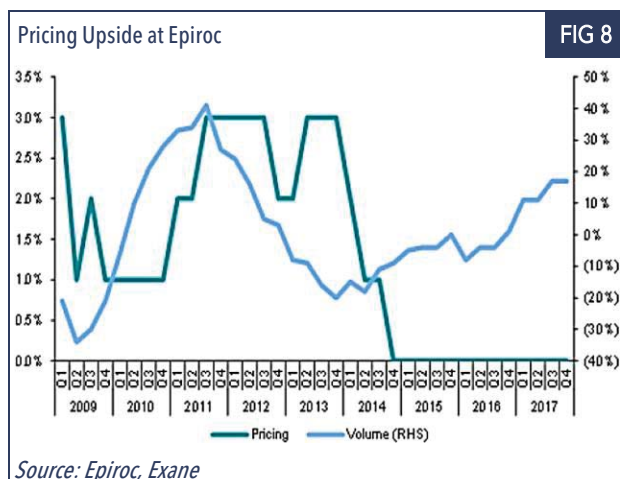
Shift Towards Automation and Digitalisation

Mining company CEO's have all realised the need for automation, with the likes of *Rio Tinto* even starting to bring artificial intelligence to the Pilbara region to optimise their mines. In addition, customers are increasingly prepared to invest in digital mining solutions that help automate processes in the mine to increase safety and productivity while reducing costs. Automation also removes labour from the dangerous parts of the mine where falling debris and poor ventilation can sometimes be an issue. Customers also see an efficiency increase because of predictive maintenance, mine traffic

management and asset location systems. *Epiroc* sits at the heart of this theme, given it is a key innovator in various areas such as battery-powered equipment, asset-tracking, remote monitoring and automated machines that do not require manual labour to operate them.

Pricing Considerations & Conclusions

The company has demonstrated that it has significant pricing power – perhaps no surprise given most of its business is exposed to underground mining and operates in a duopoly. This was evidenced by its ability to hold pricing flat despite its mining customers coming under significant financial pressure during the 2012-2015 downturn, as commodities rolled over. Prices are yet to recover this cycle, however they have typically lagged volume improvements in previous cycles and recent comments about bottlenecks in the supply chain suggest these suppliers are now in a position of strength. As it stands, the street is not expecting any improvement in pricing, which could lead to a positive earnings surprise over the coming 12-24 months. Given where we are in this end-market cycle, we feel with the high-quality nature of *Epiroc's* business and with potential upside from M&A, the company justifies its place as a core holding in our portfolio.

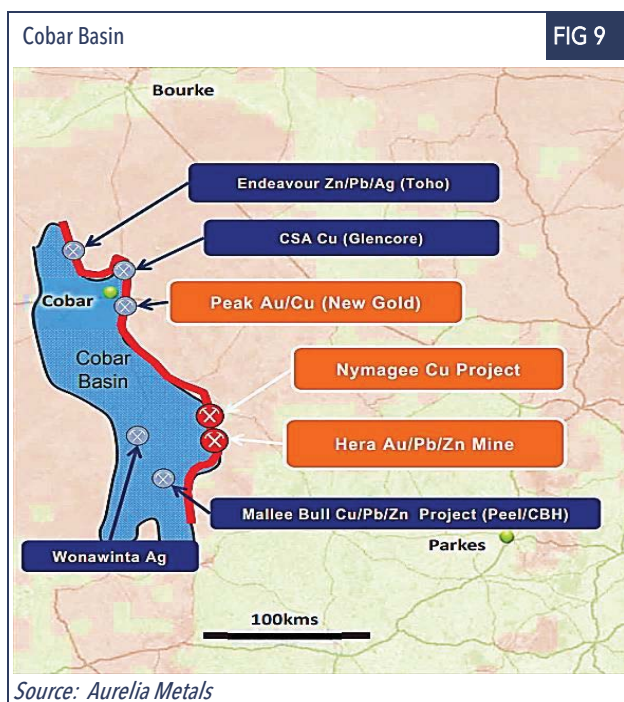


Basic Industries

Aurelia Metals Ltd (ASX: AMI)

Aurelia Metals is an emerging gold and base metal producer located in the prolific Cobar Basin of NSW. The company has recently completed the transformational acquisition of the Peak Gold Mine which provides the company ample growth.

Aurelia developed the Hera gold mine in 2015, and the transition from junior explorer to mid-tier miner was not a smooth one. Construction overruns, ore body issues and excessive debt ultimately led to a major recapitalisation and a share price of 1 cent. The current CEO Jim Simpson joined the business post recapitalisation and adjusted the company's target to reduce costs and improve cash flow. With experience as a general manager of underground mines, Mr Simpson has been able to steer the company towards higher production and profitability.



While the turnaround at the Hera mine was developing, *Aurelia* began assessing the neighbouring Peak gold mine (Peak) as a potential investment opportunity. Run at the time by Canadian company *New Gold*, Peak began its operations in 1992 and was initially thought to have an eight year mine life. This has grown over time and *Peak* is now estimated to have reserves that will last a further 4 years. Late last year, *New Gold* was facing financial problems stemming from over \$USD 1 billion in debt used to fund development of a new mine in Canada - Rainy River. *Aurelia* saw an opportunity and were able to acquire the 25-year-old mine for a modest

US\$58m. The acquisition of *Peak* included a large processing plant and an underground mining fleet with a replacement value of close to \$400m.

This was an excellent deal for *Aurelia*. Peak was *New Gold's* only mine outside of the Americas and received very little attention from head office. Benchmarking between Hera and Peak shows a significant gap in performance. The opportunity now exists for *Aurelia* to significantly improve the operating performance at *Peak* by increasing mining rates and lowering unit costs.

New Gold missed or failed to explore investment opportunities located deeper at Peak due to their financial constraints. One clear example was their recent discovery of the Chronos ore body, a small pod with incredibly high grades of gold. This find alone has enabled *Aurelia* to pay for the acquisition within six months of their purchase. Beyond these near-term opportunities, the acquisition has created a continuous land package along 100km of strike potential. Over the coming years it is highly possible that further discoveries will be made.

The Cobar Basin is a highly prospective area for both gold and base metals. However, due to the ownership of key mines, the area has been underexplored. *Glencore* has under invested in its large copper miner CSA and its exploration potential has been untapped, while the Endeavour mine is owned by Japanese smelter *Toho Zinc* - again, not a company that is likely to have exploration front of mind. The acquisition of *Peak* not only increases *Aurelia's* exploration optionality, it creates a basin play, whereby any discoveries in the region could be processed through the significant infrastructure *Aurelia* now holds.

We are encouraged by the opportunity ahead for *Aurelia*, particularly as this has been a well-established blueprint for success for other local gold miners.. *Northern Star* and *Evolution Mining* have both had great success buying mature gold mines from Canadian companies and reinvigorating the operations. Their share prices' have subsequently risen by 5-10 fold over a number of years - we are hopeful that *Aurelia* can replicate this success.

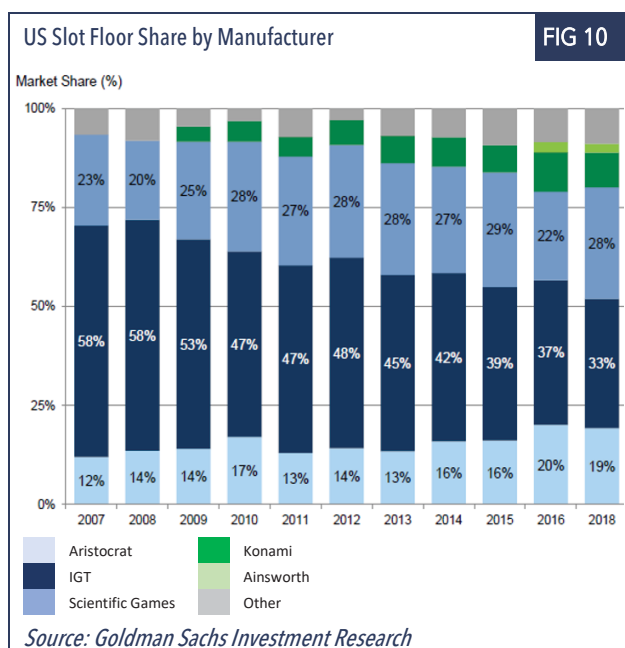
Consumer

Aristocrat Leisure Ltd (ASX: ALL)

Aristocrat Leisure is a developer of gaming products, predominantly of the slot machine variety, both for physical gaming floors (casinos, pubs, clubs) and digital devices (desktop, mobile). The success of the company can be traced back to the release of the Clubmaster poker machine in 1956 which was the first in the market to feature multi-line and scattered payouts.

Market share in the slot machine business is a function of relative product performance on the gaming floor, and *Aristocrat's* current streak of success can be distilled down to the market leading performance of their *Lightning Link*, *Dragon Link* and *Buffalo* platforms. While the roll-out of these platforms has likely peaked in Australia, international markets should still deliver good growth in coming years.

The last time a company had a product portfolio this dominant was a decade ago, when *IGT* held a share of the US slot floor just shy of 60%. Today *Aristocrat's* share of the US slot floor sits close to 20%, suggesting that there is no immediate constraint to growth, providing the company can maintain its lead in product performance.



While it is impossible to foresee what *Aristocrat's* new products will look like in two years' time, we can assess the relative resources being spent by the gaming companies in their R&D departments, in order to

handicap who has the best chance of success over the next five years. *Aristocrat* will spend just shy of \$A400m on R&D this year across both physical slots and digital gaming products and the budget will be even larger in 2019. Key peers *Scientific Games* and *IGT* each currently spend less on R&D than *Aristocrat* and their budgets for next year are flat to down, suggesting the conditions are in place for *Aristocrat* to maintain its leadership position.

Outright physical machine sales are the most difficult to replenish from year to year, as most sales are replacement (rather than expansion) and so require the buyer to remove an existing machine from the gaming floor to make room for a new sale. 'Participation' business on the other hand allows, *Aristocrat* to earn a daily fee for placing a machine on the gaming floor (slots as a service). That machine may stay on the floor for as long as a decade, resulting in a more predictable revenue profile. *Aristocrat's* revenue quality is very high with recurring revenues now comprising roughly two thirds of the business, up from 10% at the start of the decade.

Within the next few years the market share gains in *Aristocrat's* favour will start to slow and the company will need to execute a growth relay as the baton is passed from the physical slots business to the digital gaming segment. Anticipating this, the company has built capabilities in digital gaming via three acquisitions with key competence in social casino game development and marketing, over the past few years.

Aristocrat's various social casino products in aggregate equate to the second largest social casino business behind only *Playtika*. The social casino market is still some way from reaching maturity and is currently growing at double digits, with *Aristocrat* growing ahead of the market. Digital gaming today represents over 30% of company profits and should grow over time.

In summary *Aristocrat* represents an opportunity to own a company with above average growth prospects, above average revenue quality, and a recent history of value accretive capital allocation (primarily successful acquisitions) on an earnings multiple which is only modestly above that of the average Australian industrial company.

Financials

Clydesdale Bank PLC (ASX:CYB)

An update following the proposed merger with Virgin Money

In the previous quarterly, we dissected our investment thesis on UK retail bank *CYBG PLC* (formerly *Clydesdale Bank*). Given the news announced over the last quarter we thought it would be beneficial to provide an update on our view.

Our positive view on *CYBG* was predicated on the belief that rising market share; a large cost-out opportunity; excess capital; and rising UK interest rates would drive the shares above GBP4 from GBP3.1 at the time. Adding to this positive story, on the 18th of June *CYBG* announced a recommended all-share offer for *Virgin Money*. We believe this transaction makes strategic and economic sense for both *CYBG* and *Virgin Money* shareholders, and now see a path for *CYBG* shares to improve by more than 30 - 40%.

The new combined management of *CYBG* and *Virgin Money* (*VM*) have several levers at their disposal to improve the company's earnings and returns. Thus far, only a few brokers have updated their numbers for the combined *CYBG/VM* entity. It is likely that the shares will outperform as the street updates and the market appreciates the earnings power of this company. The strategic rationale for combining *Virgin Money* with *CYBG* is robust:

- Both businesses are positioned across the UK (*CYBG* in the North of England and Scotland and *Virgin Money* in Southern England).
- *CYBG* is recognised for its strong business banking franchise but is weaker in the consumer segment. *Virgin Money* fills that gap however, with its clear-cut consumer brand.
- *CYBG* has a strong deposit funding base and current account product. *Virgin Money* does not.
- Both banks were investing in a digital banking platform. When the companies merge only one platform will be required, therefore reducing costs.

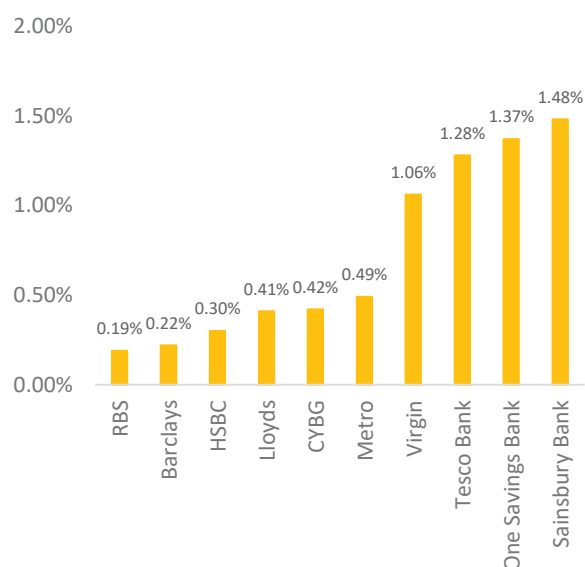
In addition to the strategic benefits of the merger described above, the EPS accretion is also attractive. The pre-tax cost synergies of GBP120m that the company has guided to, equate to about 11% of combined group

costs, which on its own should drive approximately 7-8% EPS accretion for *CYBG* shareholders. However, further cost synergies from the discontinuation of *Virgin's* digital bank and funding cost synergies are not included (*Virgin Money's* cost of deposits (around 105bps) may fall in time towards *CYBG's* deposit costs (around 40 bps)).

If *CYBG* and *Virgin Money* do merge, the potential earnings power of the combined entity could be around 45p per share when the synergies are fully realised, somewhere around 2021. If UK base-rates continue to rise in the next few years, which seems likely, that 45p earnings power estimate could be too low. It is therefore our updated base-case that *CYBG* shares could be worth more than 450p if management can execute in the coming years.

2017 Deposit Rates by Bank

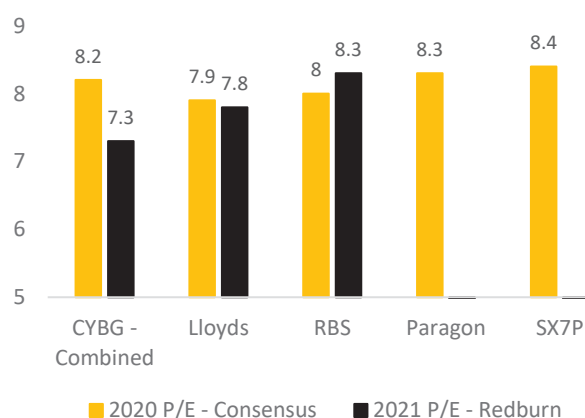
FIG 11



Source: Redburn, CYBG

2020 P/E for combined CYBG relative to peers

FIG 12



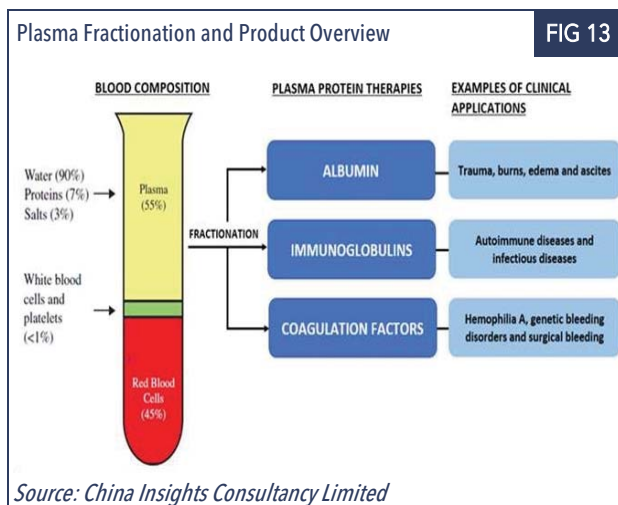
Source: Redburn, Bloomberg

Healthcare

CSL Ltd (ASX: CSL)

CSL is now the largest non-bank company on the Australian stock exchange; the shares have more than tripled in 5 years and trade at a record valuation. It's arguably Australia's most loved and owned growth company. CSL's core business has been in a 'sweet spot' benefitting from competitor mishaps and above average demand. The market is conditioned to CSL beating forecasts, and investor expectations remain elevated. Years of strong performance begs the question, is now the time to sell CSL?

CSL faces an unprecedented list of threats to its core profit engine (CSL Behring in the next few years). CSL Behring manufactures and sells therapeutic products derived from blood called plasma proteins. These products treat mostly incurable chronic conditions and rare diseases requiring long-term therapy. The process of extracting and purifying plasma proteins from blood or 'fractionation' - is outlined (Fig 13).

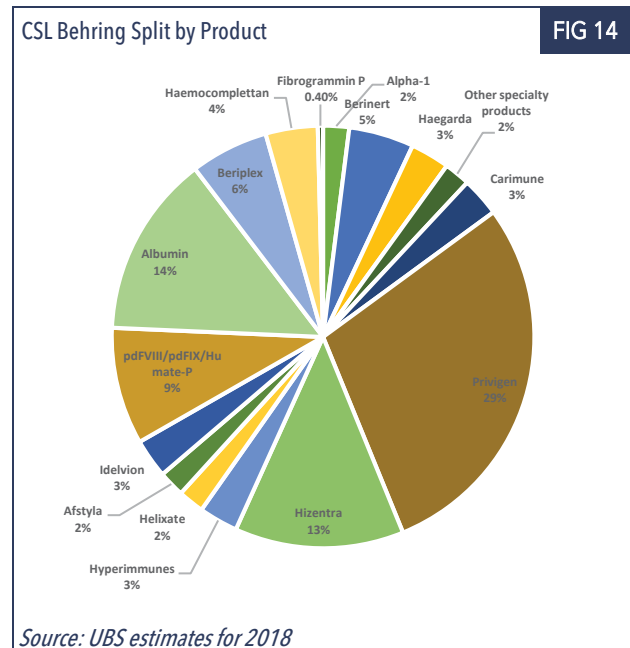


CSL operates in an oligopoly of three rational players CSL, Shire and Grifols. There are very high barriers to entry and competing technologies have not materialised.

Profits are driven by sales of immunoglobulins (Privigen & Hizentra), albumin, speciality products (Kcentra, Haegarda) and clotting factors. CSL requires large volumes of raw material called plasma to make its products. Plasma is sourced from paid donors attending CSL's plasma collection centres in the US; the turnaround from donor to shelf takes ~9 months. Collecting and fractionating plasma is far more expensive than

pharmaceutical manufacturing, creating not only a barrier to entry but also a stringent economic model.

Plasma economics dictate that the more products CSL sells from each litre of plasma, the more profit it makes. In practice, demand for immunoglobulins and albumin far surpasses any other plasma product, therefore, CSL calculates its future plasma needs based only on the volume of immunoglobulins and albumin it is certain can be sold. If all immunoglobulin and albumin is sold, profits can be boosted by speciality products sales on top. Profitability suffers when all immunoglobulin or albumin is not sold as no other product has sufficient demand to make up the shortfall. CSL achieves higher profitability versus its peers by selling significantly more products per litre of plasma.



CSL in a sweet spot... the key drivers

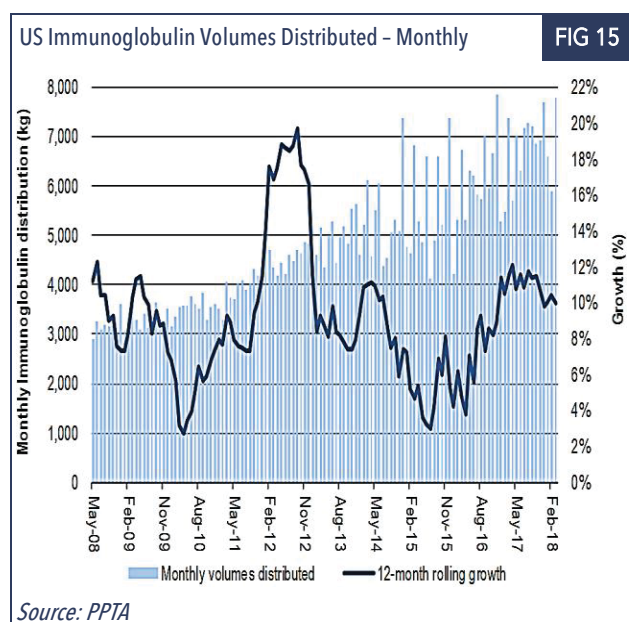
Investors have had little reason to worry about plasma economics described above. Global demand for immunoglobulins and albumin has been strong, supply is tight, competitors have mis-executed, and CSL is winning.

CSL's decision to aggressively expand US plasma collection centres (doubled in 5 years) was prescient, as plasma supply tightened considerably in the last 2 years. CSL's greater access to plasma meant it could meet above-normal US immunoglobulin demand. Being constrained by supply, Shire and Grifols were unable to participate to the same degree.

Above-normal demand for immunoglobulins in the US stemmed from growing use in new diseases (neurology) requiring significantly higher doses, as well as competitor supply issues. A strong US economy (full employment drives greater therapy compliance) and perverse drug reimbursement incentives in some segments have also fuelled utilisation in our view.

Albumin demand has kept pace largely thanks to years of stellar growth in China, now the world's largest albumin market. China's albumin is mostly imported; other plasma protein imports are banned.

Finally, *Shire*, *Grifols* and *Octapharma* all had mishaps including product recalls and supply disruptions, handing market share to *CSL* on a platter.



Multiple Threats Emerging

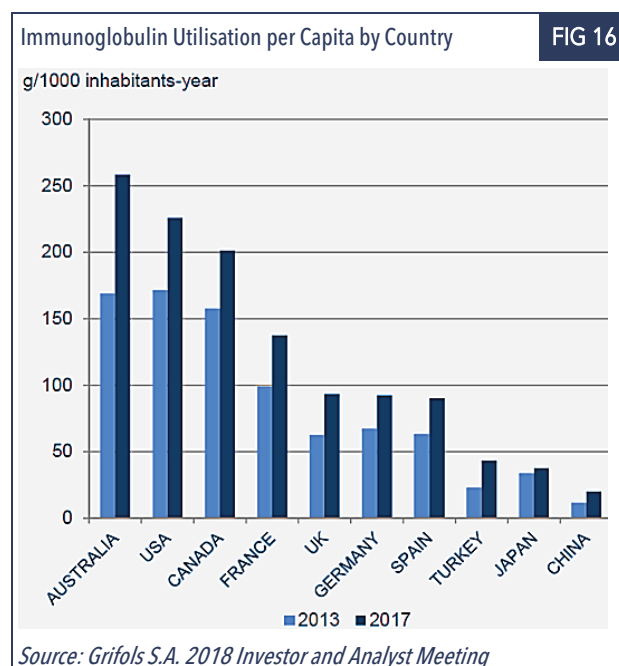
Immunoglobulins are now facing threats from new antibody therapies targeting the 'FcRn' pathway. Data presented thus far is encouraging with at least 30% of current immunoglobulin use at risk in our view. Multiple late stage clinical trials are commencing, and approval could arrive in 2 years. While *CSL* has invested in 'FcRn' technology (licensing agreement with Momena), its profitability would be severely impaired owing to plasma economics, if 30% of immunoglobulin use is ultimately replaced. We believe *CSL*'s US immunoglobulin growth will also normalise as competitor supply comes online and perverse incentives are removed (340B drug program).

Global albumin sales appear to be maturing as China has clamped-down on local drug distributors (2 invoice

policy) and hospitals making super profits from drugs. Pricing is also under pressure. We believe China will ultimately seek to become less dependent on foreign supplied albumin. Notwithstanding China's decisions, growth in global demand for albumin must keep up with immunoglobulins for the economic model to deliver. Price hikes are not the answer given the current US environment and shifting product to emerging markets hurts margins.

CSL's highly profitable portfolio of haemophilia and speciality products (~25% of sales) is also facing unprecedented competition. The market likely underestimates the risk from emerging gene therapies in haemophilia B where 2 pivotal studies are underway (*Pfizer*, *BioMarin*); *Shire*'s looming Lanadelumab launch; and, *Roche*'s growing Hemlibra sales.

While we are not calling the end for *CSL*, we note the company has never before faced such challenges. The shares are priced for perfection, while risk appears asymmetrically stacked to the downside in our view.



PORTFOLIO REVIEW

BASIC INDUSTRIES

We saw robust Chinese activity early in the quarter, as construction ramped up following the winter period shutdown. This provided a shot in the arm for mining companies through March but was not sustained. Physical data out of China softened at the margin, but more importantly, several broad indicators began flashing red. Copper fell precipitously, the renminbi dropped against the US dollar and emerging market equities rolled over. This left us quite concerned about the outlook for resource companies. Despite these fears, the Australian mining companies held together, materially outperforming their international peers. We exited our core holding in *BHP Billiton* and remain neutral the sector, hoping to find some clarity into the second half.

Oil fared much better, with less reliance on Chinese demand and further supply disruptions. President Trump's actions towards both Iran and Venezuela risk reducing the output from those countries. OPEC agreed to increase production by 1 million barrels per day however, this will only provide slight relief to an ever-tightening market for oil. We remain overweight the energy sector but are cognisant of several vested parties attempting to keep the price of oil below \$80.

BHP Billiton turned out to be an excellent investment. The simplification of the portfolio and high returning smaller projects lifted the shares ahead of its peers. While the ultimate sale of the US oil business and subsequent capital management is yet to be announced, we believe this is now reflected in the share price. We added to our position in emerging gold producer *Aurelia Metals*.

INDUSTRIALS

Industrials had a volatile second quarter, moving higher through April and May and then paring back some of their gains in a volatile fashion throughout June. Leading indicators continued to moderate in Europe and parts of Asia including China while the US showed resilience with the ISM manufacturing indicator beating expectations in June. Despite all of this, European industrials finished the quarter up +4% while US industrials were down -3%, given the latter investor base sees the trade war as a bigger risk to their companies' future prospects. Rising

steel prices in the US are also eroding sentiment for the machinery group in particular as investors are concerned that profit margins could be compressed by higher input costs.

Domestically, we exited our holding in *Qantas*. The company has performed well and the discount to global peers has now closed. We have some reservations around the rapid ticket price increases in the domestic business and whether these will impact demand. The rising oil price also creates a headwind to earnings for 2019. We initiated a position in pallet pooler *Brambles*. The company has suffered a significant de-rating as earnings in its US business is under pressure from rapidly rising costs. We feel this is a transitory problem, with a market structure affording price rises over the medium term. The European business has also been performing exceptionally well and could offset some of the US challenges.

Internationally, the Industrials portfolio saw a positive contribution from positions in *Airbus* and *Safran*, which continue to benefit from strong air travel demand, healthy airline profitability and improving free cash flow generation as they continue to ramp-up their new engines and aircraft programs. *Ashtead* was also a clear winner, with the stock appreciating by 17% on the back of continued strong US equipment rental dynamics and a weakening GBP supporting their earnings growth. In June, the portfolio had a set-back due to a profit warning from *Osram* where the company lowered its profit guidance for the year due to project push-outs in its automotive division and with *Samsung* deciding to step away from the iris scanner in future Galaxy phone models. We used the pullback to add to our position given the strong growth prospects that the business has on a 2-3 year view.

CONSUMER

Global consumer staples stocks were down over the June quarter while domestic consumer staples names showed no correlation and were up strongly. Global consumer discretionary stocks were modestly up over the quarter while Australian names performed well, particularly those with offshore earnings.

The largest contributors to performance were shareholdings in gaming company *Aristocrat Leisure* and

auto parts retailer *Bapcor*. *Aristocrat* gained upon the release of very strong interim results with growth driven by North American installations of their successful link products and a mixture of organic and acquired growth in their digital business. *Bapcor* rallied as the company continued to execute on its program of disposals that it had committed to at the time of the Hellaby acquisition. Sentiment towards *Bapcor* has also likely been enhanced by the news that *Wesfarmers* is open to disposing of its Kmart Tyre & Auto business for which *Bapcor* is a natural suitor.

During the quarter the fund established new positions *Breville* and *Premier Investments*. *Breville* is a well-known kitchen appliance company and we consider it to be one of the best managed consumer companies in Australia with a strong appetite for reinvestment in product development and marketing helping to ensure a long duration growth profile. *Premier Investments* is the owner of the fast growing and high return Smiggle and Peter Alexander businesses. Our analysis indicates that *Premier Investments* is trading at a substantial discount to the sum of the value of each of its individual retail concepts.

FINANCIALS

Financial shares underperformed broad share market indices every month in the second quarter, as a perceived increase in global macroeconomic risks drove amplified investor risk aversion. Global government bond yield curves continue to flatten, forcing investors to grapple with the narrative that a US recession could be coming in the next 12-24 months.

The Financials portfolio detracted from returns in the quarter. In Australia, a long position in *AMP* was the major detractor. Our channel checks indicate that there is no mass-exodus of *AMP* planners or clients, but that both sets of constituents desire more clarity on the company's long-term business model. In this regard, we are disappointed that company management has not been more outspoken in defending its business model to the public. These defences should be straightforward for management to communicate after the preliminary findings from the Royal Commission which will be published around September this year. We hope that the

appointment of a strong new CEO will help *AMP* investors, customers and employees to better understand what the long-term priorities for the business will be.

We benefitted from our long position in *Genworth Mortgage Insurance Australia*. The shares rallied following an aggressive sell-off in the March quarter, presenting compelling value for investors. The catalyst for the rally was the re-commencement of the company's on-market share buy-back, following the announcement of the company's results and AGM in early-May.

Internationally, positive attribution came from our short position in Spanish lender *Bankia*. *Bankia* is the fourth largest bank in Spain by domestic assets. The Spanish banking market is characterised by intense competition for a shrinking pool of loans, which has seen banking revenues fall consistently in recent times. Until interest rates in Europe rise, *Bankia* will struggle to grow revenues. We find it difficult to understand, therefore why the market consensus predicts 5% YoY net interest income growth in 2019 and 2020, despite the fact that the rates forward market has the first ECB deposit rate hike sometime in 2020. Having said that, in recent days we covered the short as it appears European rate markets are now pricing interest rate outcomes which can only be consistent with an extremely negative European economic scenario, which is not our base case.

HEALTHCARE

Global healthcare shares were up modestly in the June quarter with domestic healthcare again materially outperforming global peers. Pharmaceuticals struggled as drug pricing rhetoric in the US stepped up, while medical devices' leadership continued. Despite increasingly attractive valuations, we suspect investors still have little desire to put money to work in pharmaceutical shares, given drug pricing will likely be a notable issue during the coming midterm elections in the US. European healthcare shares and globally exposed Australian healthcare names caught a bid as the US dollar strengthened. Domestic healthcare's sharp rally was also driven by increased M&A activity (*Healthscope*, *Sirtex*) and stronger capital inflows as emerging market investors shifted into the more 'safe-haven' Australian healthcare names following US\$ strength and trade war concerns.

The domestically focussed Healthcare portfolio detracted from performance in the quarter, driven by a rally in domestic short positions and a sharp decline in our investment in *Ramsay*, after the company disappointingly announced a modest downgrade to its 2018 financial targets. This led us to materially cut our investment in the company and reassess the investment case. These losses were partially offset by strong performances in *CSL* shares after the company raised its 2018 targets, and our investment in *Merck & Co.* which rallied after the company reported strong data for its immune-oncology drug Keytruda at a major cancer conference in June.

After the strong outperformance of domestic healthcare shares, both in absolute terms and relative to global peers, we believe the sector is very vulnerable to a correction or a period of underperformance in the near term. We have trimmed our investments in *CSL* and *Ramsay* leaving the domestic funds with a modest net short position. Following strong performances in the quarter we also took profits in *Merck & Co.* and *Boston Scientific*.

TECHNOLOGY/MEDIA/TELECOMMUNICATIONS

The Technology sector has been a primary driver of returns for the US share market, with a narrow group of leading names continuing to dominate in the quarter. The Funds benefitted from core holdings in *Microsoft Corporation* and *Alphabet Inc.* Given the escalating tensions over trade, software and internet companies outperformed more cyclically exposed shares in the semiconductor space. An investment in video game producer *Activision Blizzard* was a notable contributor to returns in the quarter.

Traditional media has been out of favour for investors for some time, as advertisers have moved spending to online media formats. However, with *Disney* and *Comcast* engaged in an escalating battle for Fox, there were better returns on offer in the period. Advertising companies to have been squeezed as online platforms disintermediate traditional advertising models. A selection of shorts in European advertising agencies were beneficiaries of this trend.

Telecommunication companies have been amongst the worst performers in recent years, where fundamentals have deteriorated, and the regulatory landscape has been increasingly difficult to navigate. Shorts in *Telefonica SA*, *Swisscom AG*, and *Deutsche Telekom AG* were all solid performers in the quarter, although some of these gains were reversed, with the value on offer deep enough to entice investors back to the sector

Our investment in Fairfax performed well with this backdrop, further buoyed by a deal with *Google* for online advertising sales. *APN Outdoor* increased earnings guidance and we exited our position following this news. Unfortunately, soon thereafter *JC Decaux* announced a takeover offer for the company. *OOH Media* also acquired *Adshel* further consolidating the outdoor media sector. ACCC will need to approve both transactions however, we are optimistic and hold a position in *Ooh Media*. Our investment in *MYOB* impacted performance in the quarter as the company decided to not pursue their *Reckon* acquisition. We believe their preference to further develop the current product is strategically sound, and *MYOB* has begun reaping rewards with high subscriber growth in recent years.

Performance Review

After a promising start to the quarter, performance deteriorated in June. There was a notable dispersion in returns between the directional and market neutral strategies. With a greater exposure to the rising market early in the period, ALF delivered a net return of 0.4% while the domestically focused market neutral portfolios fell by between 0.4 and 0.7%. WGF's international portfolio also performed well in April and May before losing ground in June, finishing in positive territory at 0.6% for the quarter after all fees.

At a sector level, returns were also varied. For the Australian portfolio, there were strong contributions from the Basic Industries and Consumer portfolios, while investments in local media shares also lifted the TMT portfolio into positive territory despite challenges in the domestic technology sector. Financials was the weakest sector, with shorts in Real Estate names weighing most heavily on returns.

In the international portfolio, Healthcare was the strongest performing sector, with notable contributions also coming from Basic Industries and TMT. As the sector most directly exposed to the mercurial influences of disputes over trade, Industrials was the weakest performer in the period, while Financials also detracted.

Quarterly Performance by Sector

Sector	Domestic Portfolio *	International Portfolio **
TMT	0.20	0.70
Healthcare	-0.45	1.68
Consumer	0.61	-0.10
Industrials	-0.04	-1.23
Basic Industries	0.78	0.79
Financials	-1.24	-0.44

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



WATERMARK
FUNDS MANAGEMENT



**AUSTRALIAN
LEADERS
FUND**

Fund at a Glance - June 2018

ASX Code	ALF
Fund Size	AU\$314.4
Fund Strategy	Variable Beta
Share Price	\$1.03
Shares on Issue	267.8m
International Exposure (% of gross)	22.6%
Net Exposure	10.5%

Net Tangible Asset (NTA) Backing

	May 18	Jun 18
NTA Before Tax	\$1.22	\$1.22
NTA After Tax	\$1.23	\$1.22

Gross Portfolio Structure

	May 18	Jun 18
Long Exposure	107.1%	98.3%
Short Exposure	-98.7%	-87.8%
Gross Exposure	205.8%	186.1%
Cash	91.6%	89.5%

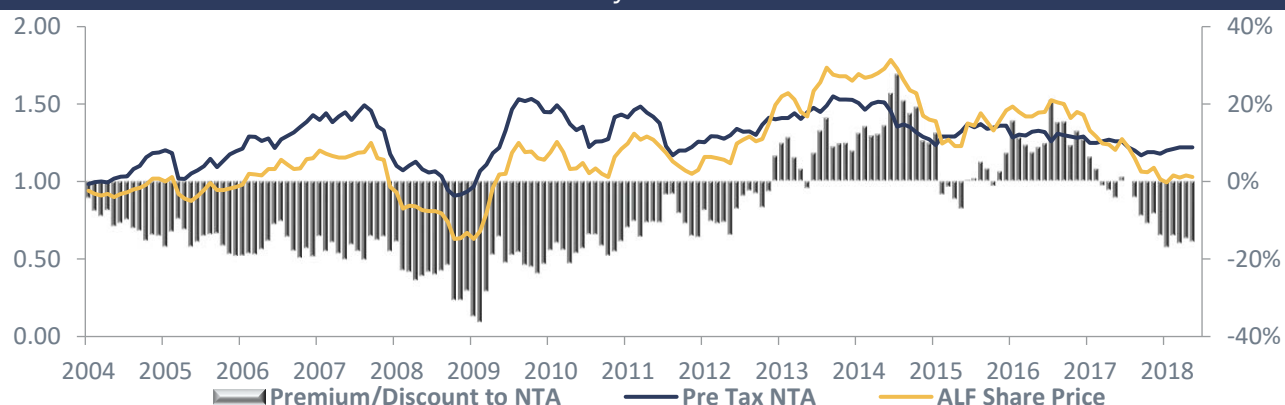
ALF Performance

	1 Mth	3 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	-0.6%	0.4%	-2.3%	3.5%	5.4%	7.9%	11.8%
All Ords Accum Index	2.9%	8.0%	13.7%	9.5%	10.3%	9.0%	9.1%
Outperformance (net)	-3.5%	-7.6%	-16.0%	-6.0%	-4.9%	-1.1%	2.7%

Net Equity Exposure



Historical Premium/Discount to NTA History



Fund at a Glance - June 2018

Fund Size	AU\$253m
Strategy FUM	AU\$322m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

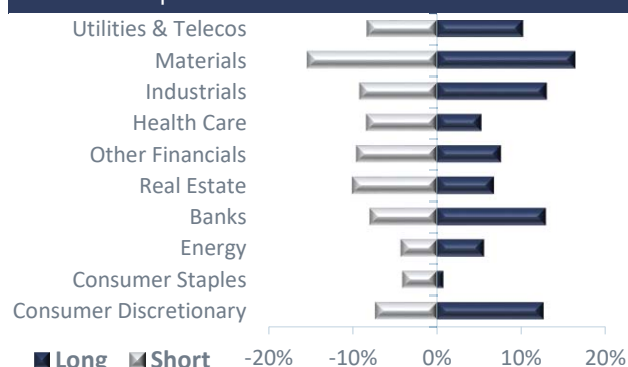
Return Characteristics¹

Positive Months	68%
Portfolio Beta	-0.2%
Sharpe Ratio	1.2
Sortino Ratio	3.8
Standard Deviation	6.6%
No. Long Positions	79
No. Short Positions	76
Gross Exposure	177%
International Exposure (% of Gross)	19.5%

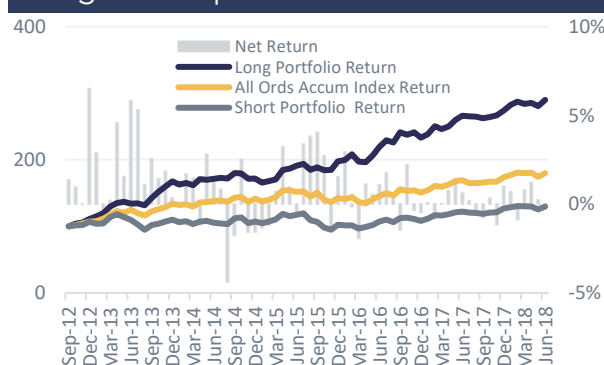
Performance²

	1 Mth	1 Yr	2 Yrs (pa)	3 Yrs (pa)	4 Yrs (pa)	5 Yrs (pa)	SI (pa)
WMNT (net return)	-0.6%	0.5%	1.5%	6.5%	4.3%	6.4%	10.3%
RBA Cash Rate	0.1%	1.5%	1.5%	1.7%	1.9%	2.0%	2.2%
Outperformance	-0.7%	-1.0%	0.0%	4.8%	2.4%	4.4%	8.1%

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	12.14
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	26.57
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	-1.51
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	21.92
2016	-0.14	-1.93	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	1.62
2018	-0.86	0.80	1.23	0.23	-0.01	-0.61							0.77

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 – June 2018

ASX Code	WMK
Fund Size	AU\$78.5m
Fund Strategy	Equity Market Neutral
Shares Price	\$0.80
Shares on Issue	84.5m
Dividend (HY18 Interim)	1 cent

Net Tangible Asset (NTA) Backing

	May 18	Jun 18
NTA Before Tax	\$0.96	\$0.95
NTA After Tax	\$0.96	\$0.96

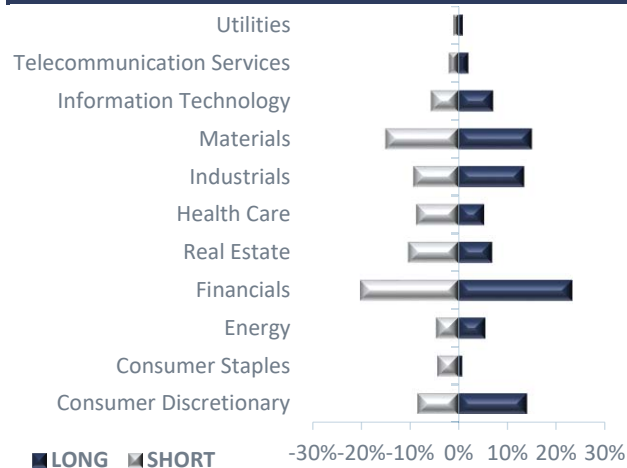
Gross Portfolio Structure

	May 18	Jun 18
Long Exposure	100.5%	95.2%
Short Exposure	-94.3%	-92.5%
Gross Exposure	194.8%	187.7%
Cash	93.8%	97.4%

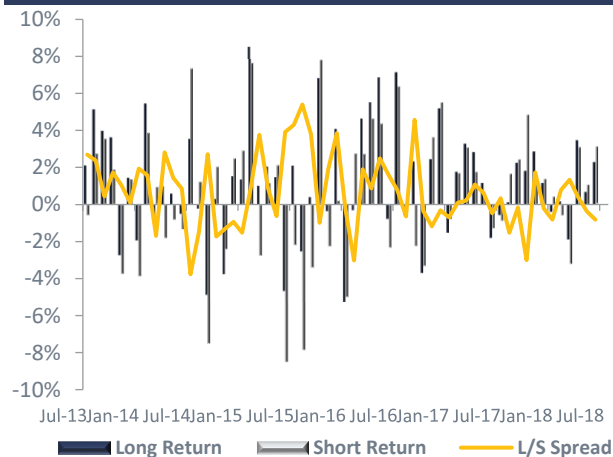
WMK Performance

	1 Mth	3 Mths	1 Yr	2 Yrs (pa)	3 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	-0.8%	-0.7%	-3.5%	-1.2%	4.3%	4.5%
RBA Cash Rate	0.1%	0.4%	1.5%	1.5%	1.7%	2.0%
Outperformance (net)	-0.9%	-1.1%	-5.0%	-2.7%	2.6%	2.5%

Sector Exposures

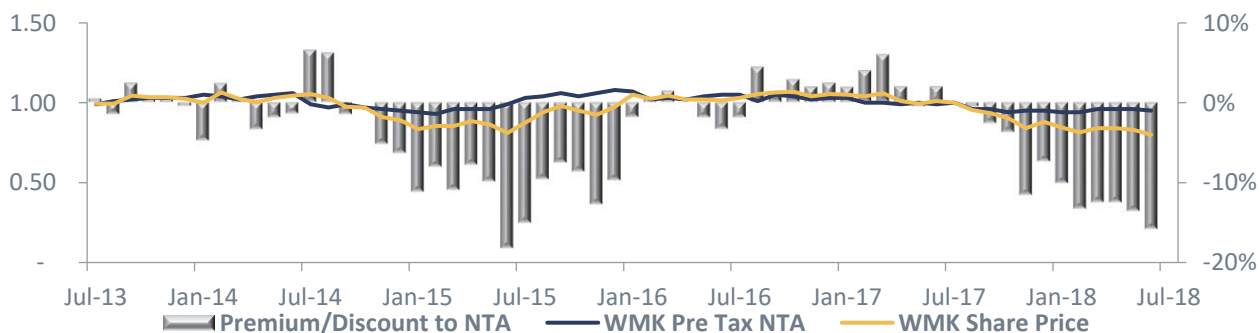


Long Short Spread*



* 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 - June 2018

ASX Code	WGF
ASX Code Options	WGFO
Fund Size	AU\$79.7m
Fund Strategy	Global Market Neutral
Share Price	\$0.92
Shares on Issue	75.7m
Option Price	0.1 cents

Net Tangible Asset (NTA) Backing

	May 18	Jun 18
NTA Before Tax	\$1.10	\$1.08
NTA After Tax	\$1.08	\$1.07

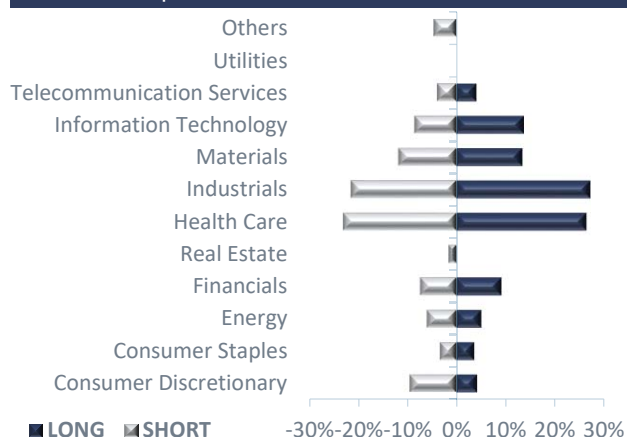
Gross Portfolio Structure

Long Exposure	113.2%	108.2%
Short Exposure	-110.9%	-101.9%
Gross Exposure	224.1%	210.1%
Cash	97.7%	93.8%

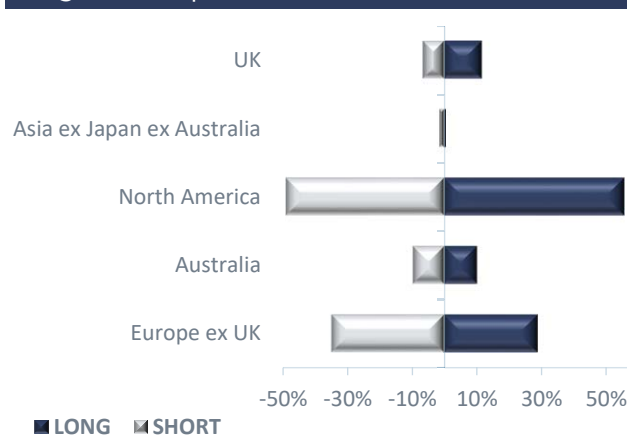
Performance

	1 Mth	3 Mths	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I. (pa)
Portfolio (net return)	-1.2%	0.6%	0.0%	-3.5%	-3.5%	-	-2.7%
RBA Cash Rate	0.1%	0.4%	0.7%	1.5%	1.5%	-	2.4%
Outperformance	-1.3%	0.2%	-0.7%	-5.0%	-5.0%	-	-5.1%

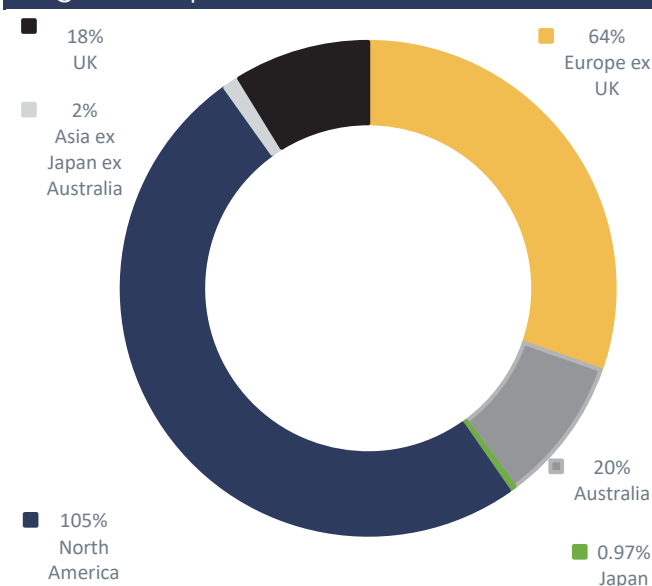
Sector Exposures



Regional Exposures (Net)



Regional Exposures (Gross)



Contributors/Detractors

Top 3 Contributors	
Foundation Medicine, Inc.	0.2%
Heron Therapeutics Inc	0.2%
Boston Scientific Corporation	0.2%
Top 3 Detractors	
OSRAM Licht AG	-0.5%
United States Oil Fund LP	-0.3%
Tesla Inc	-0.3%

Notes



WATERMARK
FUNDS MANAGEMENT

Level 6, 139 Macquarie Street, Sydney NSW 2000

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