



The Leading Edge

QUARTERLY REPORT • September 2018

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Justin Braitling
Portfolio Manager

Message from the CIO

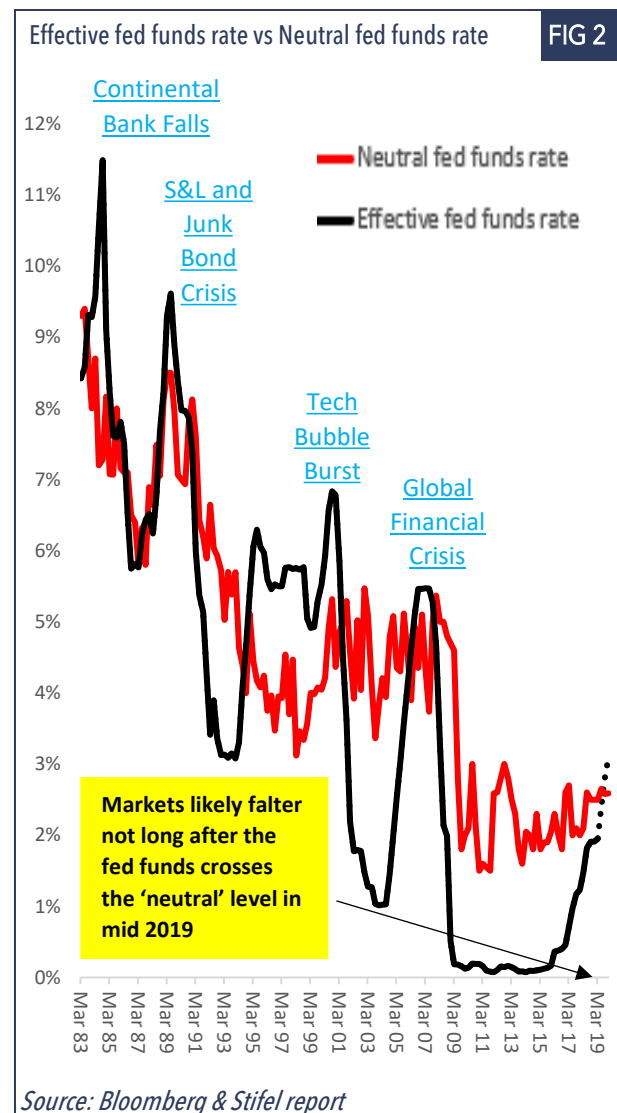
Share markets around the world have fallen precipitously in October in recognition that central banks are pushing ahead in tightening policy and the trade dispute with China is not going away any time soon.

Shares outside of the US have been falling all year with many having already lost 20% of their value (a bear market).



Emerging Markets (EM) and China deserve a special mention as they have led global markets lower. Tighter US dollar liquidity not only impacts lenders in the US but businesses and traders in EM and those that rely on cross border finance. This is important because EM contributes to two thirds of the growth in the global economy.

With activity indicators (PMI) in Europe and EM slowing, the US has been left once again as the key force supporting global growth and risk assets. The runway left in this business cycle is depleting quickly as spare capacity and employment is chewed up by an overheating US economy. You can see in Fig 2; monetary policy is likely to become restrictive later next year coinciding with a runoff in the fiscal impulse from stimulatory tax policies.



The end of each economic cycle has followed soon after this crossover and this cycle will be no different in the absence of a reversal in policy. This has rattled markets, as the US Federal Reserve looks committed to staying the course in raising rates under its new leadership, where previously it would have quickly demurred following any sell off.

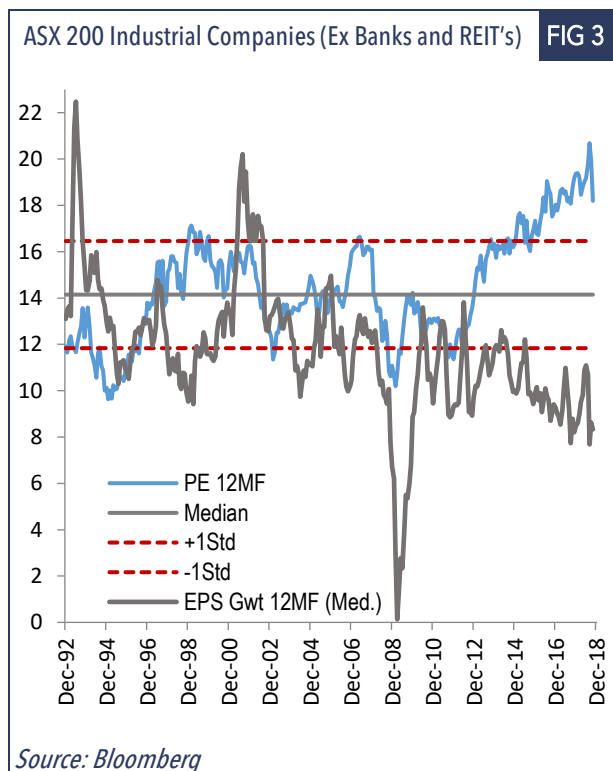
Tactically the Central Bank has few options other than to push ahead as the economy reaches its full potential. If it doesn't and is forced to tighten quickly in response to an

inflation break-out, its actions will be blamed for triggering the next downturn. Investors are starting to work this out.

Supply side factors have been a feature of the recent corporate results also as reflected in the US Federal Reserve Beige Book: "Several districts indicated that firms faced rising materials and shipping costs, uncertainties over the trade environment, and/or difficulties finding qualified workers. Demand for transportation services remained strong. Labour shortages were broadly noted and were linked to wage increases and/or constrained growth"

A strengthening dollar only complicates matters further for companies operating offshore. A late cycle margin squeeze is upon us. All of a sudden, investors are considering peak profits for next year and what it means for the share market.

Even with the pullback in October the Australian share market is still close to 20% overvalued based on historical valuation measures. This is particularly interesting given the soft profit outlook (Fig 3). We are still some way from adding exposure to this market in our directional funds.



Investing in shares is inherently risky. These risks vary considerably depending on where we are in the investment cycle. Today we are late cycle, shares are expensive relative to historical levels, consequently risks are elevated, and investors should think first and foremost of how to mitigate these risks.

Hedging strategies such as those offered by Watermark are one of the few ways to minimise these risks.

International Update

Harvey Migotti

Portfolio Manager

There is a continued high risk that policy shifts will hurt global growth and cracks are appearing through recent datapoints and developments which also raise concerns that the negative feedback loop could gain momentum. Global trade tensions remain high, and while the US and Canada did manage to reach a trade deal at the end of the quarter, the dispute between China and the US continued, with the latter putting a 10% tariff on \$200bn of imports. This rate is set to increase to 25% by the end of the year where Donald Trump has indicated he is ready to implement tariffs on a further \$267bn of Chinese imports if necessary - particularly if China continues to target US farmers and industries. If these additional measures are implemented, \$517bn of US imports from China will be subject to tariffs. The Chinese government has subsequently retaliated with tariffs on \$60bn of US products.

The ongoing trade war has clearly impacted China, with several exposed companies already issuing profit warnings due to project push-outs and deferrals. Sentiment amongst small and medium enterprises is deteriorating and various consumer-exposed shares such as the Macau casinos or European luxury goods companies have seen significant share price falls in recent weeks (down between 30% and 40% since their summer high's).

However, Chinese policymakers have been easing recently and the decline in Fixed Asset Investment (FAI) appears to have finally stabilised. It is possible that we are approaching the point of "whatever it takes" for China and we may observe further initiatives supporting the Chinese economy. Several further measures were rolled out after the quarter end including a plan to cut personal income taxes, President Xi's promise of unwavering support for non-state firms, commitment from the country's stock exchanges to help manage share-pledge risks; and broad comments about support for equities and talking up the broader economy.

European politics were also front and centre with Theresa May's Brexit plan being rejected again by the EU. In Italy, the political situation continued to cause friction, with the new government's intention to increase the budget deficit to 2.4%. This is a complete U-turn from the previous government's plan to bring the deficit down.

The EU continues to stress that they are unwilling to accept such a budget and seems on track to reject it – the first time it would have asked a country to submit a revised budget. Adding to this, Moody's cut Italy's credit rating a further notch, to Baa3, one step away from junk status. To make things more challenging for the region, the European Central Bank will be halving the pace of its monthly asset purchases in October, which are currently set to be completed by December 2018. This could put further pressure on European markets as we move into 2019.

While US economic data generally remains positive, the ongoing trade war, labour shortages and rising transportation costs continue to dampen sentiment. However, there remains a need for increased capital expenditure and higher risk credit spreads are benign – we typically do not see a slowdown without these spreads widening. Moreover, the US labour market remains resilient, wages continue to rise, and consumer confidence bounced once again into quarter end. While real inflation rates remain low relative to historical standards, the Federal Reserve's interest rate hikes have put upward pressure on US yields which broke out towards the end of the quarter, reaching 3.2% – the highest levels seen in 7 years. Investor surveys suggest that higher rates are a bigger risk to the economy than the trade war itself or a slowdown in global growth and it is an area that we continue to monitor closely.

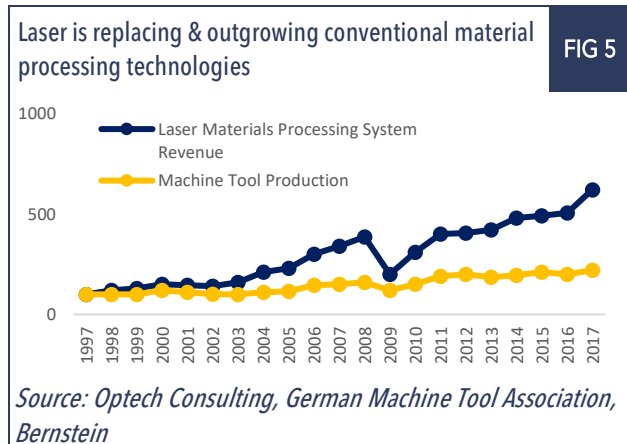
Investors seem to have de-risked for the time being, with higher levels of cash and lower net exposures across many portfolios. The outlook for 2019 still feels somewhat challenging, however we would not be surprised to see a rally into year-end given the aggressive pullback in October (MSCI World was down -8% and the Russell 2000 pulled back by -12%). Valuations in the US are more reasonable with the S&P trading at 15.5x 2019 earnings and the index is currently pricing in a slowdown in growth (Fig 4). However, all eyes remain on the Fed's tightening cycle, the ongoing trade war with China and slowing leading indicators in Europe and emerging markets.



Industrials

IPG Photonics (NYSE:IPGP)

IPG Photonics (IPG) is the global leader in the fibre laser segment, with a 65% market share and a strong focus on high-powered lasers. The company has both a technology and cost advantage through its internal diode and fibre manufacturing, which should enable it to continue increasing its market share in a rapidly growing end-market. Nearly 95% of its products are sold into industrial end markets for uses in material processing, cutting, welding, engraving and additive manufacturing, although its products have other advanced applications (defence, R&D, medical and communications). The company also boasts a broad based and fragmented customer/industry base, giving them pricing power across a number of categories. *IPG Photonics* should be in a position to continue growing its revenues in the teens, driven as much by laser industry trends as through its own innovation and product expansions. Moreover, the shares are now trading at a very attractive valuation post a recent pullback, given the company's underlying growth potential.

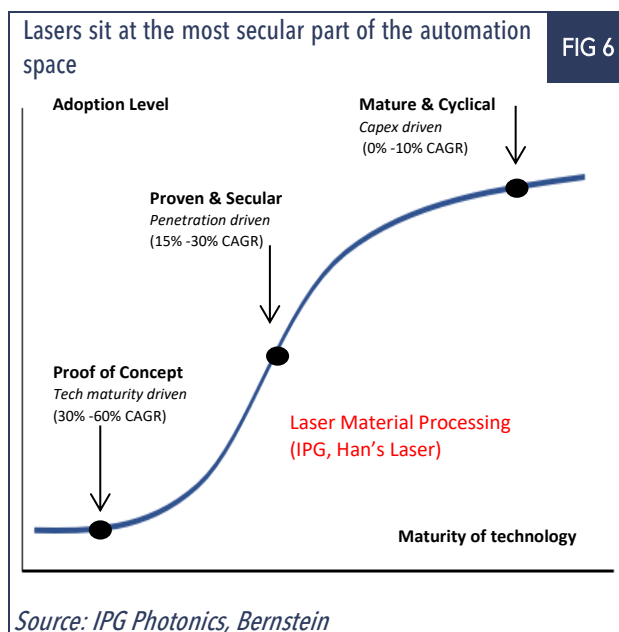


Strong Structural Growth

In factories, lasers have been replacing conventional technologies in cutting, welding and other material processing applications. The benefits (speed, flexibility, precision, quality and cost) are substantial and the upside for customers can be significant. With laser penetration still below 20% across most applications, there remains many years of robust growth ahead for the industry. Within the laser industry, fibre lasers, in which *IPG Photonics* specialises, are in a sweet spot and continue to replace legacy laser types, due to their lower cost; better performance and higher versatility. Industry experts

believe that this segment could grow at a 15% compound annual growth rate over the next half decade.

At present, the industry is approaching an inflection point in the rate of adoption of laser technologies for several reasons: new high-powered speciality lasers significantly expand the addressable market for the industry, making possible the processing of a whole new range of materials. Also, the decreasing cost of manufacturing a laser results in reduced prices for customers, while the integration of lasers with other automation technologies (such as robotics, vision systems and artificial intelligence) enables new novel applications.



Product Centric Growth

IPG's products are a core driver of the company's growth, given its portfolio covers the full range from low to ultra-high-power, continuous wave to ultrafast and even ultraviolet spectrum lasers. It is the only company that can build fibre lasers in the 100+ kW range and end market applications for this product are growing rapidly and offer a much lower operating cost and better/faster performance. Although some of these higher end lasers are still only used in niche applications, the promise of lower prices and better performance should see end markets continue to expand.

Key IPG products & high growth areas FIG 7

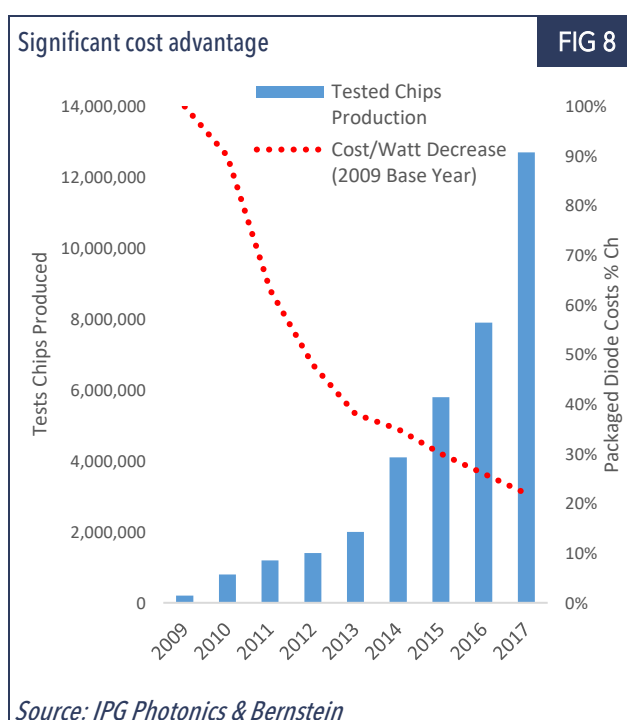
	High Growth Areas
Metal processing	Wider range of material, low end cutting & consumer electronics welding
Additive manufacturing	Aerospace, auto & medical device, dental, surgical & cosmetic applications
Laser systems	Micromachining, large pipe welding & surface treatment
Communications	100G/400G market & IPG tech + Menara market

Source: Bernstein & IPG company reports

Cost Advantage & Defensive Moat

IPG Photonics upstream integration forms a prohibitive barrier to competition – in an industry where innovation drives growth, and economy of scale is significant. Having all key components in-house ensures that *IPG* is always at the cutting edge of new functions, and a cost leader even compared to emerging market players. While lower end fibre lasers are “commoditised”, it becomes exponentially harder when it comes to manufacturing high power, ultrafast or UV lasers. Many have tried to break into this area with no success, including automation bellwether companies such as *Fanuc*. There are hundreds and thousands of pieces of technical know-how in the numerous components that lead to differentiation rather than a handful of big secrets, so there are no shortcuts for competitors or new entrants to easily close this gap.

The company boasts a lower cost structure provided by vertical integration of diode and fibre manufacturing, allowing it to grow faster than peers by taking market share from CO2 and YAG competitors (other laser techniques). *IPG* have access to superior earnings leverage on its lower cost structure, due to significant economies of scale as can be seen in the charts below (fig 8). As an example, the company has managed to reduce the manufacturing costs of one of its lasers by 75% between 2009 and 2017 at the same time as sales volumes went up multi-fold.



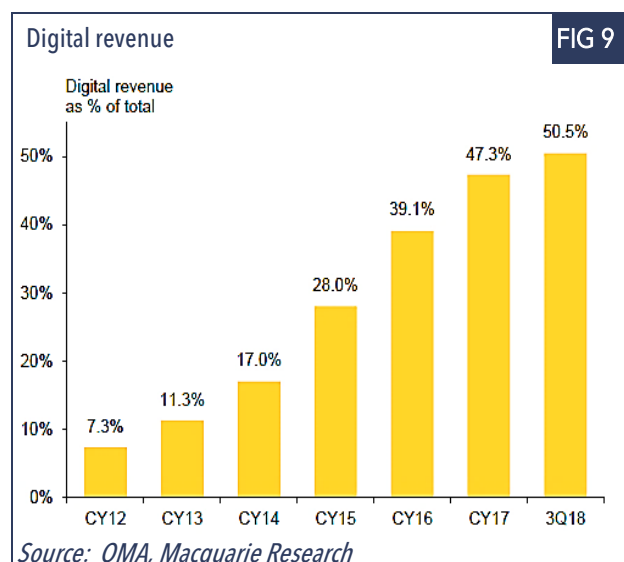
TMT

Ooh!Media Ltd (ASX: OML)

oOh!Media is Australia's leader in the fast growing 'out of home' advertising sector. Digitisation has transformed the industry from sleepy old media to a dynamic, technology led medium for advertisers. The recent acquisition of *Adshel* deepens *oOh's* portfolio and creates an attractive industry structure.

Prior to 2012, the out of home segment maintained a stable share of national advertising spend (approximately 4%). The emergence of digital screens transformed the industry rapidly, increasing this to 6% by 2017. One of the largest benefits of digitisation is the speed of delivery. For static billboards, large print runs require months of planning and remain in place for just as long. With digital assets, advertisers can upload advertisements almost instantaneously. Suddenly *oOh!* had an offer that appealed to tactical advertisers. The share of industry revenue from digital advertising is now over 50%, up from 7% in 2012.

Digital sites enable targeted outcomes for advertisers as screens can exhibit different ads at different times of the day. They can utilise short-form video and increase converge with online and social media. These benefits will result in higher yields for *oOh!* ultimately capturing a larger slice of ad dollars. For clients, the creative opportunities are endless. Live football scores, augmented reality and temperature-controlled screens are very possible today.



The out of home sector has grown at the expense of other traditional media over the last five years. Newspapers still command 13% of national spend, while free-to-air TV holds 26%. We believe readership and audiences will continue to decline. This year the industry has benefitted from the scandals at *Facebook* and *YouTube*. Advertisers are beginning to question their ad spend with tech giants, with out of home sector growing 11% year to date.

Given the significant opportunities that digitisation has created, competition for key assets has been fierce, with instances of irrational bidding pushing rental costs to extremes and posing risks for the segment as a whole. The recent round of consolidation has alleviated these risks somewhat. The acquisition of *APN Outdoor* by *JC Decaux* and *oOh!* acquiring *Adshel* has created an oligopoly in the local market. While some sites will always be acquired as loss-leaders to enhance a portfolio, there will be reduced impetus for this behaviour. The new scale advantage for *JC* and *oOh!* will allow them to broaden their offering to clients while enabling further investment in technology.

Adshel currently derives only 34% of its revenue from digital sites, well below *oOh!* at 64%. This under-representation is a legacy of the previous ownership (*Adshel* was a JV between *APN* (now *HT&E*) and US company *Clear Channel Outdoor (CCO)*). Financial strain had plagued *CCO* for many years, hindering investment.

There remains a significant opportunity for *oOh!* to realise synergies from its recent acquisition. We expect the \$15-18million of synergies announced after the deal will be achieved within 18 months. Revenue synergies are also likely, with an expanded audience reach and ability to cross-sell media on physical, mobile and online platforms.

A key risk to our investment is the loss of concession agreements or renewals on unfavourable terms. *Adshel* has roughly one third of its portfolio expiring in the near future. The City of Brisbane contract is currently held by *Adshel* where an announcement is expected shortly, if *oOh!* were to lose, we would expect a negative market reaction. However, the City of Sydney renewal occurs next year, and *JC Decaux* is the incumbent. This is the largest contract in Australia and *oOh!* is in a good position to challenge. We believe the best outcome is a renewal of both contracts by the incumbents on favourable terms.

In summary, the out of home industry will continue to take share from other advertising mediums, primarily due to increased digitisation. The industry has consolidated creating an attractive structure for *oOh!* We see continued earnings growth with the company trading on an earnings multiple in line with the broader market.

CBS Corporation (NYSE:CBS)

CBS is one of the leading broadcast networks in the US, capturing about 10% of total US audience on average. It has a broad portfolio of sports rights including the NFL (Super Bowls 2019 and 2022) and has dominated the scripted broadcast segment with profitable shows consisting of *NCIS* and the *Big Bang Theory*, among others.

CBS has four key characteristics that make it an appealing investment:

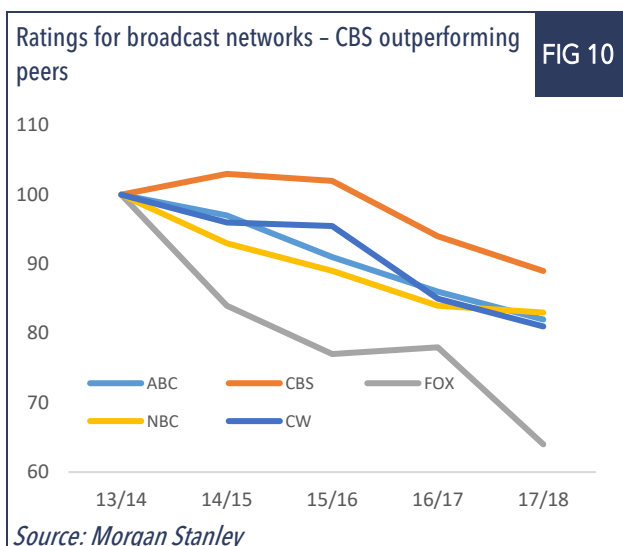
- 1) asset quality
- 2) earnings growth
- 3) the presence of catalysts to catapult the share price higher.
- 4) appealing valuation

Scarcity of quality content in US media and take-out optionality.

The rise of *Netflix* and other streaming-video-on-demand (SVOD) players has disrupted the traditional US pay tv industry with its bloated tv bundle of 400 channels, where only a handful are actually watched. Incumbent media companies have reacted, triggering a round of consolidation. *AT&T* acquired *Time Warner*, *Disney* is now purchasing the majority of *Fox* content assets and *Discovery* acquired *Scripps Networks*. *CBS* stands out among the remaining entities for the quality and strategic nature of its assets: Showtime, ABC network and a successful tv studio.

Runway for earnings growth.

CBS revenue has been growing at high single digit pace through 2018 and looks like it will continue this trend in 2019. This growth is a result of its increasing distribution of Showtime (25m out 96m pay tv households in America), inflation in affiliate fees (4-5%) and 20% growth in retransmission fees.

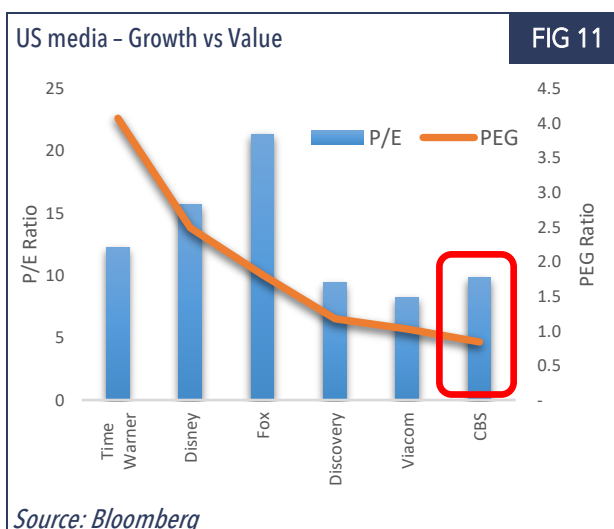


Shareholder conflict resolution as a catalyst for upside.

Shares of *CBS* have been weighed down by the overhang from a potential merger with *Viacom*, pushed by the Redstone family who are large shareholders in both conglomerates. On September 9, *CBS* and Redstone reached a settlement whereby Redstone agreed not to participate in any merger proposals for at least two years and are open to hear other strategic approaches. There are several rumours that the *CBS* board is testing the market for a potential buyer.

Attractive valuation for the quality and growth.

CBS trades at 9x price to earnings per share ratio (P/E) compared to *Disney* at 15x P/E, *Fox* at 20x P/E (in process of selling the majority of its assets to *Disney*). *Time Warner* bought by *AT&T* for 16x P/E. *CBS* is likely to provide consistent earnings growth, and most likely M&A opportunities in the near future, based on its current valuation.



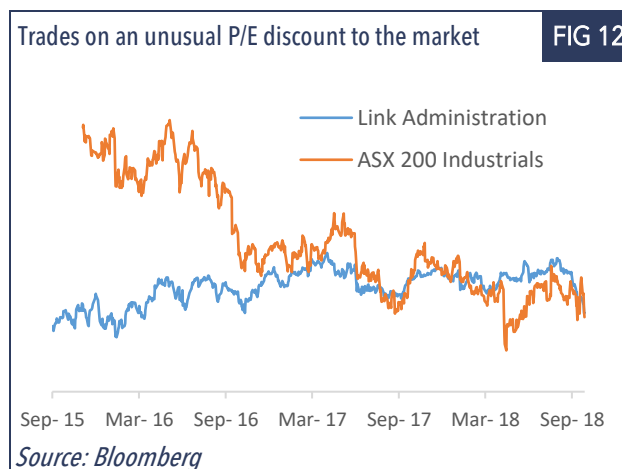
Financials

Link Administration Holdings (ASX:LNK)

Link provides administration services, shareholder management, share registry and other services to corporate clients in Australia, UK and Europe. *Link* enjoys its position as an oligopoly in Australia and has interesting opportunities for organic and acquisitive growth both domestically and overseas. As a result, based on our valuation work, the company is undervalued.

Runway for earnings growth.

Since its listing in December 2015, the company has traded at a premium to the ASX200 for the majority of its life as a listed company (Fig 12). This can be attributed to its strong market position with the Australian fund administration and share registry segment.



However, in recent months investors have become concerned about the defensiveness of *Link's* Australian fund administration business following a decline in customer numbers and uncertainty surrounding possible regulatory changes announced in 2018 budget. The impact of Federal budget changes, the productivity commission report on superannuation and recent small contract losses in our opinion are quantifiable, manageable and explainable. From our perspective, the recent customer losses can be considered as a normal component of any business as their product offering is one of the strongest in the Australian market and any concerns should abate in the near future.

Excess capital and M&A to drive earnings growth.

Earlier this year (April 2018) *Link* was able to raise A\$300m (7% of their market cap) to fund potential acquisitions. If debt was included *Link's* acquisition firepower is likely to be more like \$400m or 10% of the

market cap. With this surplus capital, the company looks to have succeeded in acquiring *PEXA*, an online platform that performs property transactions.

Cost saving opportunity

The company's ability to reduce costs is well recognised by the market and has a reputation for optimising costs of past acquired businesses. The synergy guidance for the company's most recent European acquisition (Capita Asset Services) has produced a cost base of approximately 6%, where average M&A synergies in the sector tend to range between 10% to 30% (Fig 13).

Acquirer	Target	Synergy Target	% cost base	% revenues
Experian	Clear Score	US\$25m	50%	45%
Computershare	Equatex	US\$30m	53%	38%
Computershare	BONY Mellon	US\$78m	30%	27%
Intertrust	Elian	£10m	17%	11%
Equiniti	Wells Fargo SS	US\$10m	12%	10%
SS&C	DST	US\$150m	8%	7%
Link	Capita Asset Services	£15m	6%	5%
Serco PLC	Group ITNET plc	£5m	3%	3%

Source: Morgan Stanley

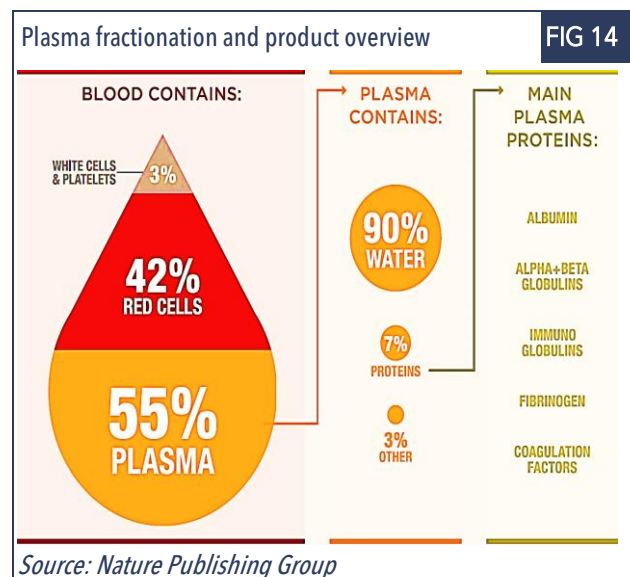
Healthcare

CSL Ltd (ASX: CSL)

In the June edition of "The Leading Edge" we highlighted the competitive threats facing *CSL*'s plasma business (*CSL Behring*) and how profitability is sensitive to slowing growth in immunoglobulins (Ig) and Albumin. Signs are emerging that global Albumin growth is maturing while growth in Ig remains robust. The key concern is what will happen to profits if Albumin sales cannot keep up? In this quarterly, we will focus on Albumin (approximately 12% of group revenue) and explore the implications of potential diminishing growth.

What is Albumin?

Albumin is a protein produced by the liver and is critical in maintaining normal blood pressure by regulating the water content in the circulatory system. It is a powerful antioxidant which binds and transports numerous drugs and has been shown to modulate clotting and inflammatory pathways.



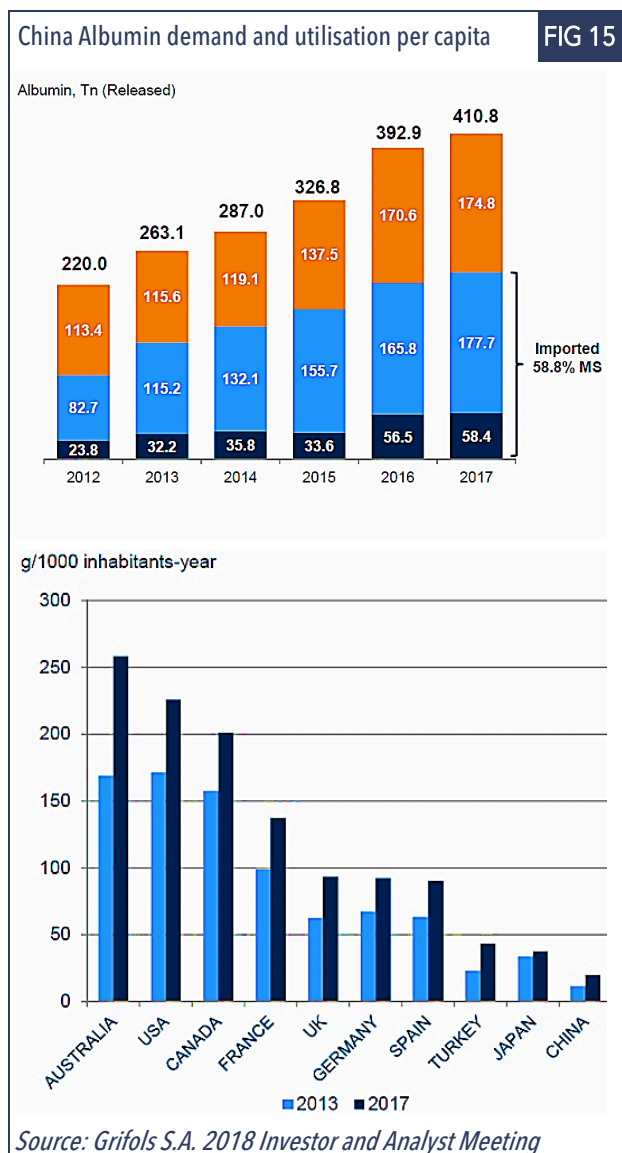
Albumin (5% or 25% solutions) primary function is to replace fluid (low blood volume or hypovolemia) after major trauma or surgery. It is used in critically ill patients suffering from shock, sepsis or hypoalbuminemia (lack of albumin), treatment of burns and certain dialysis patients. However, the use remains controversial as it not supported by clinical data and research. Cheaper alternatives exist for volume replacement and sepsis, namely 0.9% normal saline and other salt solutions.

We believe underlying medical demand is growing at 1-2% (volume) annually and could decline in the absence of

new clinical uses given improvements in surgical techniques (less blood loss) and reduced trauma associated with motor vehicle accidents (improved safety standards).

China - the key driver of Albumin growth

China now represents roughly half of the global demand for Albumin where annual consumption has nearly doubled between 2012 and 2017 (Fig 15) due to an expanding economy and modernising healthcare system. China imports over half of its Albumin where *CSL* is the largest single supplier. While China's utilisation per capita is well below the US, it is comparable with many developed countries (Fig 15). The growing prevalence of non-alcoholic fatty liver disease in China has driven higher medical utilisation of Albumin.



Hospitals are the predominant users of Albumin in China; however the country is facing an epidemic of short supply

and rising prices due to significant volumes being sold into the 'black market'. Inappropriate use of Albumin is rife amongst traditional Chinese medicine practitioners where it is viewed as a nutritional supplement and a 'tonic' for boosting immunity. Recent government reforms have been implemented to disrupt both the hospital and the black market.

In February 2017, China instituted a maximum 'two-invoice' system, cutting out intermediate distributors and improving price transparency. The Chinese government has also capped revenues that hospitals generate from drug sales and mandated all urban hospitals to eliminate drug mark-ups by September 2017 (previously surcharges of up to 15% were allowed). We believe these policies will rationalise Albumin use in hospitals and stifle 'black market' supply. *CSL*'s recent financial results have shown signs of slowing Albumin sales into the country.

Normal saline shortages boost US Albumin growth

Cheaper substitutes for Albumin include normal saline solutions have experienced material supply disruptions due to manufacturer-related issues (weather, regulatory and capacity constraints). The US is a key market for *CSL* (~30% of albumin sales) where prices and utilisation per capita are very high.

History of normal saline shortages in the US **FIG 16**

Product	Date Shortage Began	Date Shortage Resolved	Reason for Shortage
0.9% Sodium chloride, small-volume bags	5/24/2007	7/25/2008	Supply unable to meet demand
0.9% Sodium chloride, large-volume bags	1/28/2013	Not yet resolved	Manufacturing delays
0.9% Sodium chloride for irrigation	8/12/2014	9/25/2015	Manufacturing problems
0.9% Sodium chloride for irrigation	11/9/2016	Not yet resolved	Manufacturing delays
0.9% Sodium chloride, small-volume bags	8/25/2017	Not yet resolved	Manufacturing delays due to Hurricane Maria

Source: The New England Journal of Medicine, April 2018

Shortages of normal saline precede periods of robust Albumin growth in the US (Fig 17). In 2017 shortages were due to hurricanes in the US which was exacerbated by one of the most severe flu seasons on record - providing a likely boost to *CSL's* US Albumin sales in 2018. At the present moment, normal saline manufacturers have reported a resolution in their supply issues where additional capacity has become available online. We expect US Albumin growth to moderate in the near-term with our recent channel checks suggesting abundant Albumin supply and declining prices.



What this means for *CSL*?

CSL has enjoyed a sustained period of strong global demand for its core plasma products, Ig and Albumin. *CSL's* Albumin sales have also intermittently benefitted from competitor mishaps in the last 18 months. That said, with clear signs of a maturing market we believe *CSL's* Albumin growth will moderate in the near-term. As highlighted previously the plasma economic model dictates that *CSL* needs to sell all volume of Ig and Albumin to continue to improve its profitability. With the threats to Ig described in the June quarterly (novel drugs; FcRn) and Albumin growth slowing, there is a risk that *CSL's* core profit engine could fade. Currently, we are waiting for an attractive entry point to invest in *CSL* where risks are appropriately reflected in the valuation.

PORTFOLIO REVIEW

BASIC INDUSTRIES

It was a challenging quarter for mining shares. A weaker Chinese economy, stronger US dollar and escalating trade tensions all contributed to lower commodity prices. A noticeable dispersion appeared between falling base metal prices and higher iron ore and coal prices. The former reflected investor sentiment while the latter revealed robust current demand and the continued impact of supply side reforms in China. We maintained our neutral position through the quarter, adding to names such as *Independence Group*. While we have concerns for the Chinese property sector in 2019, mining companies are far better positioned than three years ago, with strong balance sheets (limited downside).

Continued supply concerns, most recently on potential Iran disruptions, supported the oil price despite weakness in other commodities. These higher prices will ultimately incentivise production, and we are beginning to see a recovery in offshore project development. However, this production will take many years to come on stream and we remain overweight the sector. We are closely watching the emerging market demand trends for any weakness that may disrupt this recovery.

The funds position in *Aurelia Metals* was a key contributor in the quarter. This was particularly pleasing in a difficult environment for gold, where many miners fell over 20%. Further clarity has emerged on *Aurelia's* ability to extend the mine life of its new acquisition (Peak gold mine). Exploration success buoyed the shares this quarter. *Lynas* was a significant detractor after it was announced a review into their facility in Malaysia would be led by MP Fuziah Salleh – a long-time opponent of the company. We maintained our position as prior independent reviews have cleared the plant.

INDUSTRIALS

Industrials were a strong contributor to portfolio returns through the quarter, despite volatility and capital outflows across the sector. Although leading indicators continued to moderate in Europe and parts of Asia including China, the US remains resilient, with the ISM manufacturing indicator holding its own and surpassing expectations in

August and September. Having been sold down in the previous quarter, US industrials finished up 10% while their European counterparts lagged, posting 3%. Positive messaging at conferences highlighted resilient end markets and continued positive trends. This has helped offset investor worries over concerns surrounding the trade war with China and inflationary pressure.

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 are 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 investments in *Airbus* and *Safran* and a short in *Tesla*, which was hit by an SEC investigation into share price manipulation post Elon Musk's barrage of tweets through the quarter. Exposure to the US machinery segment in names such as *Caterpillar*, *Deere* and *United Rentals* generated profits, while *Zebra Technologies* was by far the biggest positive contributor following a strong earnings upgrade, along with continued interest in the warehouse automation, RFID scanner and advance data capture device space. We initiated a position in *IPG Photonics* following a share price decline that we felt it was an overreaction to the slight guidance reset that the company issued, due to project push-outs in China. We think this is one of the most exciting growth stories in the sector.

CONSUMER

Global consumer shares had a strong third quarter. Consumer Staples shares were lifted higher by a combination of bond yields retreating and M&A speculation.

The luxury sector in particular has been hit hard by the deteriorating outlook for marginal consumer luxury

goods and the affluent Chinese middle upper class. This benefitted short positions in *Salvatore Ferragamo* and *Burberry*. A short position in *Kingfisher* also worked well as the company continues to struggle to reignite growth and boost profits through cost savings. Looking forward, higher interest rates, higher gas prices and deteriorating global trade rhetoric may cause headwinds for Consumer Discretionary names.

Within our domestic portfolio, recent investments in stationery retailer *Premier Investments* and kitchen appliance maker *Breville* were the strongest performers. *Premier* rallied in response to strong sales results from a number of domestic apparel peers which represents a marked change from the pressure the sector has been under in recent years. *Breville's* share price responded positively to strong full-year results and news that the pilot project converting the German and Austrian markets to a direct distribution model has been a success. *Breville* will progressively convert other European markets to a direct model over the next few years to mirror the successful structure used in Australia.

Bapcor was another name that added positively to the Consumer portfolio. The company delivered a positive earnings result and provided an update to its five-year strategic plan. It upgraded the targeted store numbers for its core Burson Trade business by 15% to 230 stores, and also indicated plans to increase its Service business to 500 centers, up from the 128 centers it currently supplies. The company also indicated scope for a 'mid-sized' acquisition.

FINANCIALS

Financial shares modestly underperformed broader share market indices globally. Government bond yield curves continued to flatten, as investors ponder over the timing of the next global economic slowdown.

Our investment in *Clydesdale Bank (CYBG PLC)* performed well. As mentioned in previous quarterlies, *CYBG* had announced that it had made an offer for competitor *Virgin Money* in June. This has triggered brokers to update their previous valuations and we believe it is hard to argue with the logic of the deal. Between July and August the percentage of buy-recommendations rose from 17% to 39%. Consensus EPS expectations are still too low, in contrast to this we

forecast EPS > 40x when the synergies are fully-realised around 2021.

A long position in Australian retirement village operator *Aveo Group* detracted from returns during the quarter. The shares continued to trade poorly despite positive fundamental developments during the period. The announcement of a strategic review suggest management is considering a partial or full sale of the business. This should reduce the gap between the fundamental value of the company (around \$4) and the share price (\$1.88).

Our position in *Janus Henderson* detracted on news that Andrew Formica will step-down as Co-CEO and leave Dick Weil as sole-CEO. Having met with Mr Weil in Sydney following their results, we are satisfied that there will be continuity in the strategy and believe the shares offer excellent value at below 10x earnings.

HEALTHCARE

After languishing for most of the period, European health care names staged a late rally to finish in line with major industrial indices. The relentless rally of Australian healthcare shares finally came to an end with prices in the sector plunging though the quarter. The rally in US healthcare was broad-based, with leaders in the Medical Device and Life Science sectors extending year-to-date gains, while the laggards (Pharmaceuticals and Services) were also up sharply, on solid June quarter financial results and investor rotation into more 'defensive' segments of healthcare. While we agree Pharmaceutical results were solid across the board, we are concerned investors have become complacent on the drug pricing debate in the US, which we expect will re-ignite in the lead-up to the US midterm elections and in response to outlook statements for 2019 through the US reporting season.

The domestic Healthcare portfolio was a key contributor to fund performance, with solid results from investments in *CSL*, *Sonic* and *ResMed*, and strong results from the short portfolio. We exited our investments in *Cochlear* and *Sonic* during the period. With valuations in the sector stretched and vulnerable to a correction in the near term we retain a modest net short bias.

Our offshore investments delivered modest positive returns in the quarter driven by strong performances from *Boston Scientific* and *Thermo Fisher*. These were partially offset by shorts, which rallied in sympathy with the broader US healthcare sector. We are reviewing our investments in smaller biotechnology and medical device companies as valuations are becoming stretched and investor appetite appears to be shifting towards 'value' biased healthcare names.

TECHNOLOGY/MEDIA/TELECOMMUNICATIONS

The domestic TMT portfolio detracted from returns in the quarter, largely due to a position in *TPG Telecom*, which announced a merger with *Vodafone*. In an NBN world, *TPG* would have lost 30% of its broadband profits in connection payments. While a merger had been a faint prospect for some time, the deal caught us by surprise.

We initiated a new position in *News Corp*, after the shares fell 20% following increase in ownership of *Foxtel* and subsequent consolidation of debt. The debt is non-recourse and while the business is structurally challenged, this consolidation should ultimately not affect the value of the business. *News Corp* has evolved over the last five years from traditional old media into a suite of fast growing digital and subscription businesses. The portfolio is grossly undervalued, but we are hoping the sale of 21st Century Fox to *Disney* (asset restructure) may highlight value.

Our *Fairfax* position made a positive contribution to the portfolio after receiving a takeover offer from *Nine Entertainment*. We believe the combination of these two companies makes sense as it provides a larger audience and can integrate content across multiple platforms driving advertiser demand. The subscription business will potentially be bundled, enhancing the consumer offering. Although the consolidation will ensure a stronger business, we exited our position as the valuation upside from the tv assets and *Domain* investment is limited.

Performance Review

All Watermark funds got off to a positive start in the September quarter, with July delivering the strongest monthly performance in almost two years. The market neutral funds delivered net returns of 1% while ALF fared slightly better at 1.2%, having picked up modest gains from directional tilts made in response to market falls towards the end of August. The Watermark Global Leaders Fund didn't get off to the same strong start as the domestic focused strategies but finished the quarter strongly to post a net return for the period of 0.8%. This was against a market backdrop that has wrong-footed many long / short managers, both locally and abroad.

Healthcare was the best performing sector in the quarter and benefitted from strong returns from a range of investments in domestic healthcare names and one domestic short. There were solid contributions from Financials, Basic Industries and Industrials, while stock-specific issues in the TMT portfolio detracted from returns.

Global markets have proven particularly difficult to navigate in recent months. Macroeconomic issues such as President Trump's trade war, tighter policy and interest rate settings in most developed economies, and a flight of capital away from emerging markets have buffeted global share markets, leading to increased volatility and rotation of capital between sectors, as skittish investors look to reposition their portfolios. The global equities team have navigated these conditions with success, positioning the portfolio to profit in burgeoning sectors such as global industrials and TMT, while ensuring risk controls remain tight and exposures fully hedged.

The investment mandates for each Watermark fund apply tight risk limits which ensure that the portfolios remain true to label, as low beta or fully hedged strategies. As a result, our funds deliver returns that are uncorrelated with the broader share market, with very little by way of factor or concentration risk. While our effort and resources are focused on lifting fund returns back to stated targets, we have been satisfied to see our risk management framework, which ensures careful monitoring factor risks, has protected the funds from a significant draw down during this volatile period.

Quarterly Performance by Sector

Sector	Domestic Portfolio *	International Portfolio **
TMT	-1.52	0.32
Healthcare	0.87	0.17
Consumer	0.64	0.51
Industrials	-0.01	0.33
Basic Industries	-0.21	-0.29
Financials	0.72	-0.18

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



Fund at a Glance - September 2018

ASX Code	ALF
Fund Size	AU\$310.0
Fund Strategy	Variable Beta
Share Price	\$1.05
Shares on Issue	266.3m
International Exposure (% of gross)	19.2%
Net Exposure	2.9%
Dividend (FY18 Final)	2 cents

Net Tangible Asset (NTA) Backing

	Aug 18	Sep 18
NTA Before Tax	\$1.22	\$1.20
NTA After Tax	\$1.22	\$1.20
Dividend Declared	(\$0.02)	-
NTA After Tax & Dividend	\$1.20	\$1.20

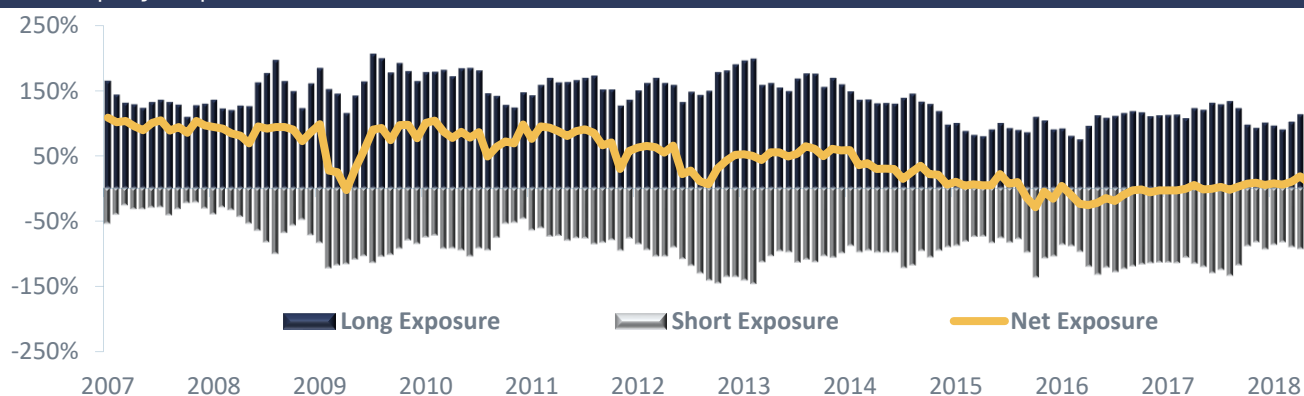
Gross Portfolio Structure

	Aug 18	Sep 18
Long Exposure	88.8%	92.3%
Short Exposure	-87.1%	-89.4%
Gross Exposure	175.9%	181.7%
Cash	98.3%	97.1%

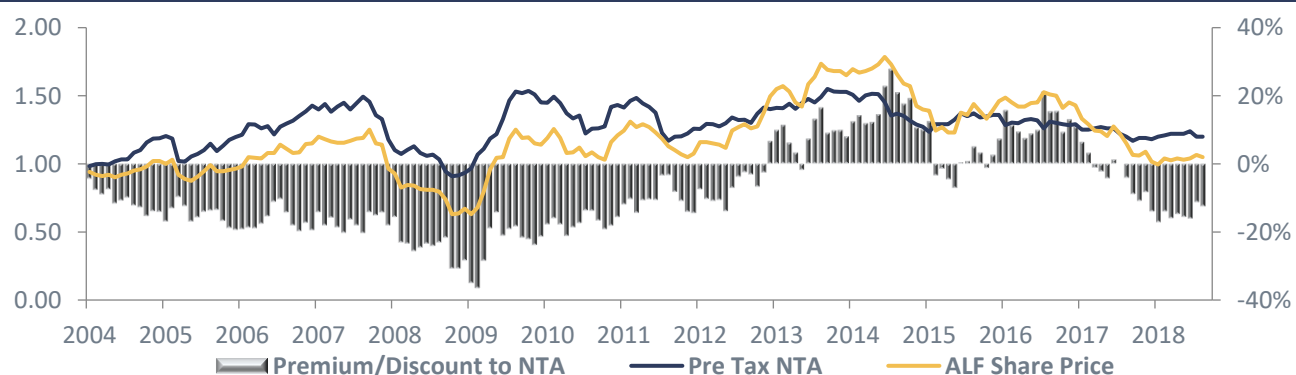
ALF Performance

	1 Mth	3 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	0.2%	1.2%	0.8%	1.1%	3.6%	11.2%	11.7%
All Ords Accum Index	-1.1%	1.9%	14.7%	12.4%	8.5%	11.2%	9.1%
Outperformance (net)	1.3%	-0.7%	-13.9%	-11.3%	-4.9%	0.0%	2.6%

Net Equity Exposure



Historical Premium/Discount to NTA History



Fund at a Glance – September 2018

Fund Size	AU\$247m
Strategy FUM	AU\$321m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

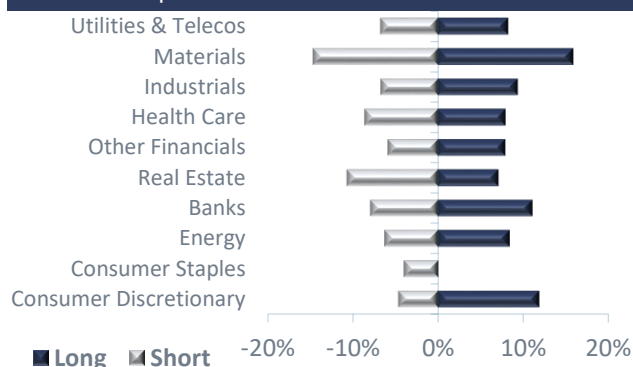
Return Characteristics¹

Positive Months	68%
Portfolio Beta	-0.2%
Sharpe Ratio	1.2
Sortino Ratio	3.7
Standard Deviation	6.6%
No. Long Positions	74
No. Short Positions	63
Gross Exposure	170%
International Exposure (% of Gross)	16.4%

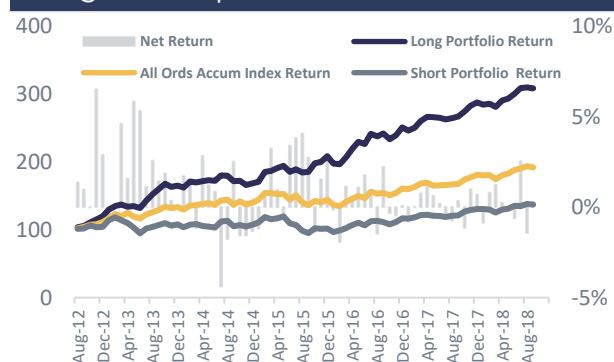
Performance

	1 Mth	1 Yr	2 Yrs (pa)	3 Yrs (pa)	4 Yrs (pa)	5 Yrs (pa)	SI (pa)
WMNT (net return)	0.1%	2.5%	1.4%	3.2%	5.6%	5.5%	10.1%
RBA Cash Rate	0.1%	1.5%	1.5%	1.6%	1.8%	1.9%	2.1%
Outperformance	0.0%	1.0%	-0.1%	1.6%	3.8%	3.6%	8.0%

Sector Exposures



Long/Short Spread



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	2.52	-1.44	0.10				1.93

Fund at a Glance – September 2018

ASX Code	WMK
Fund Size	AU\$76.9m
Fund Strategy	Equity Market Neutral
Shares Price	\$0.83
Shares on Issue	83.3m
Dividend (FY18 Annual)	1.5 cents

Net Tangible Asset (NTA) Backing

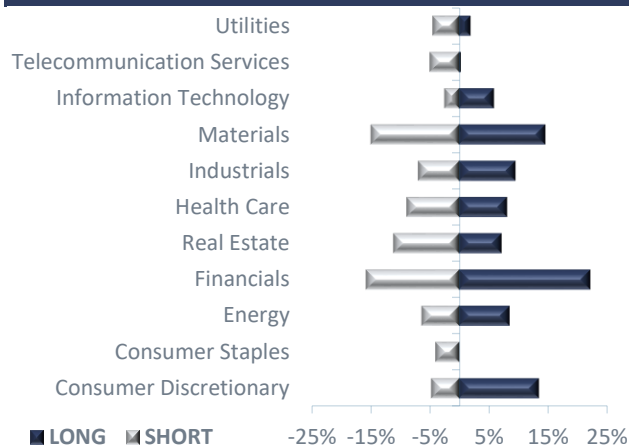
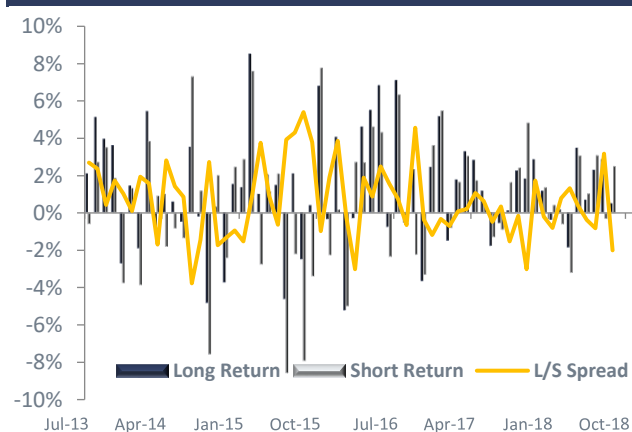
	Aug 18	Sep 18
NTA Before Tax	\$0.96	\$0.95
NTA After Tax	\$0.97	\$0.95
Dividend Declared	(\$0.015)	-
NTA After Tax \$ Dividend	\$0.95	\$0.95

Gross Portfolio Structure

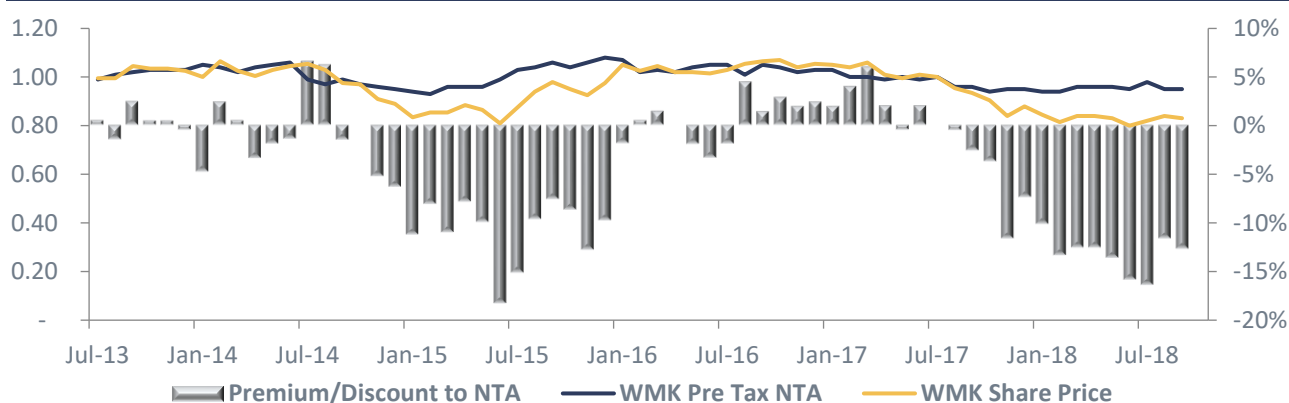
Long Exposure	89.1%	92.3%
Short Exposure	-87.1%	-89.5%
Gross Exposure	176.2%	181.8%
Cash	98.0%	97.3%

WMK Performance

	1 Mth	3 Mths	1 Yr	2 Yrs (pa)	3 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	0.1%	0.9%	-1.1%	-2.0%	1.0%	4.5%
RBA Cash Rate	0.1%	0.4%	1.5%	1.5%	1.6%	2.0%
Outperformance (net)	0.0%	0.5%	-2.6%	-3.5%	-0.6%	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 - September 2018

ASX Code	WGF
ASX Code Options	WGFO
Fund Size	AU\$78.1m
Fund Strategy	Global Market Neutral
Share Price	\$0.86
Shares on Issue	74.5m
Option Price	0.1 cents

Net Tangible Asset (NTA) Backing

	Aug 18	Sep 18
NTA Before Tax	\$1.08	\$1.08
NTA After Tax	\$1.07	\$1.07
Dividend Declared	(\$0.0075)	-
NTA After Tax & Dividend	\$1.06	\$1.07

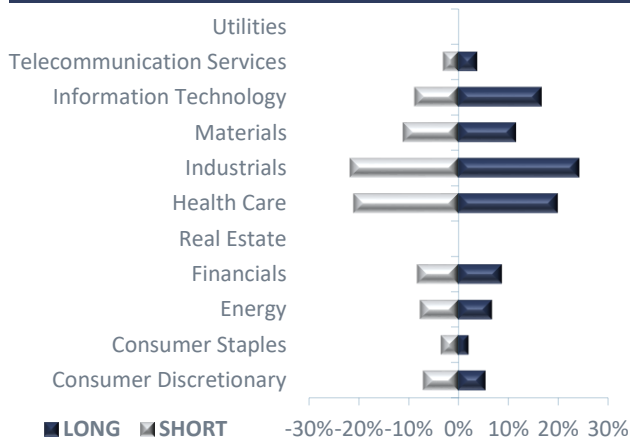
Gross Portfolio Structure

Long Exposure	102.7%	100.2%
Short Exposure	-97.8%	-95.5%
Gross Exposure	200.5%	195.7%
Cash	95.1%	95.3%

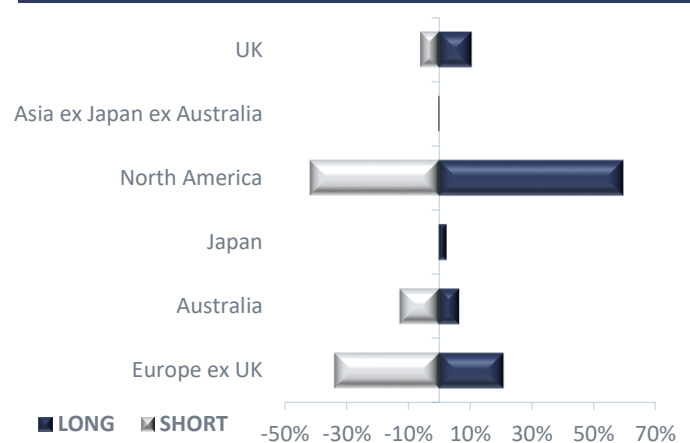
Performance

	1 Mth	3 Mths	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I. (pa)
Portfolio (net return)	0.8%	0.0%	0.5%	0.0%	-2.8%	-	-1.6%
RBA Cash Rate	0.1%	0.4%	0.8%	0.4%	1.5%	-	1.6%
Outperformance	0.7%	-0.4%	-0.3%	-0.4%	-4.3%	-	-3.2%

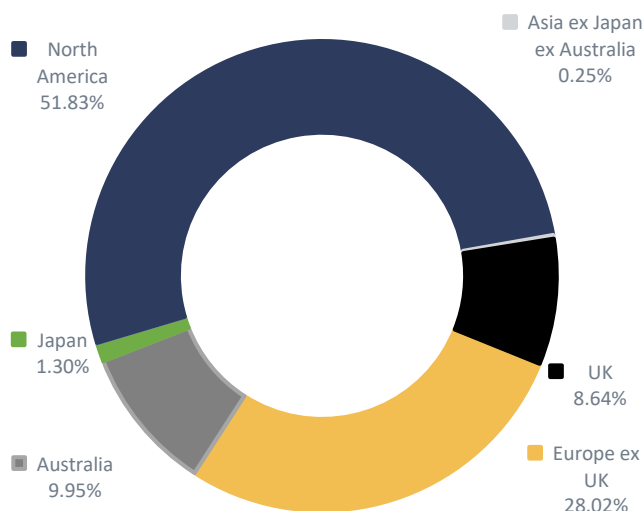
Sector Exposures



Regional Exposures (Net)



Regional Exposures (Gross)



Contributors/Detractors

Top 3 Contributors	
Aurelia Metals Limited	0.4%
Snap Inc	0.2%
Fisher & Paykel Healthcare	0.2%
Top 3 Detractors	
Lynas Corporation	-0.4%
BHP Billiton Limited	-0.4%
IPG Photonics Corporation	-0.2%

Notes



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