



The Leading Edge

QUARTERLY REPORT • March 2019

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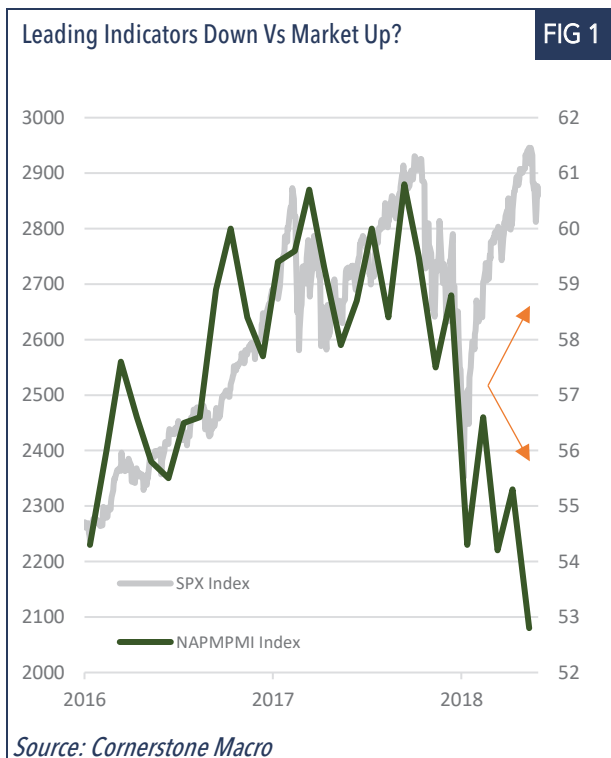


Justin Braitling
Portfolio Manager

Message from the CIO

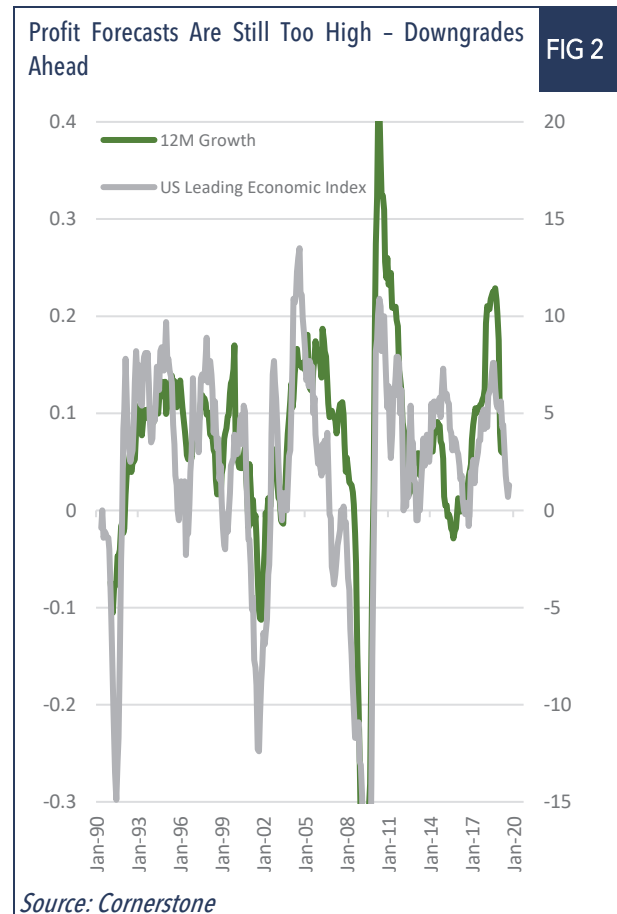
Not a lot has changed with regard to our outlook for shares in the last three months. Growth has slowed both offshore and domestically while shares have rallied higher. As we expected, activity has slowed through the first half of the year but with shares now re-testing prior highs, growth must re-accelerate through the second half of the year to justify the recent rally.

If shares are to rally further, we need to see synchronised growth return; which we doubt will happen this year as leading indicators are still declining. You can see in (Fig 1) global industrial production has decelerated to levels not seen since the industrial recession of 2015, yet the market has shot higher. There has been little conviction with this advance though, with only 36 of the S&P 500 names achieving new highs. Share markets in coming months will most likely squeeze higher, as money is drawn in for fear of missing out (FOMO). We would caution investors against chasing this market, this feels more like a bull trap than a launch pad for the next advance.

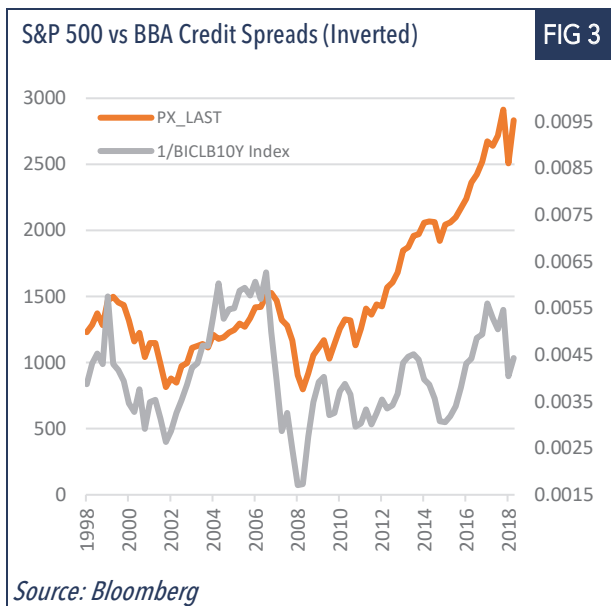


The share market recovered most of last year's losses in the first quarter, as the US Federal Reserve stepped away from further tightening and a trade deal with China looked more likely. The outlook for profits and the economy on the other hand have not improved. Quite the contrary, profits have been revised down and leading economic indicators, such as the ISM and PMI, continue to decline.

In the past 40 years, we have seen a similar relief rally in shares and bonds following the last rate increase of the cycle, which typically lasts anywhere from a few months to a year and a half. In most cases, the economy eventually falls into recession as the impact of the monetary tightening takes hold. Eventually, investor focus shifts back to the fundamentals and while the market still has decent profit growth pencilled in for next year, leading indicators would suggest this will all but disappear by the time we get to the end of the year (Fig 2).



As the business cycle matures and interest rates peak, it is useful to keep an eye on credit markets where stresses will appear first. You can see in (Fig 3), credit spreads on sub-investment grade issuances have not confirmed the rally in shares of recent months - this also occurred in 1999, 2007 and 2014. Shares have rallied while credit markets have been more considered given the prospect of increasing losses as the end of cycle looms.



While the Federal Reserve may have finished raising rates and the markets have rallied hard in relief, it is too early to celebrate. We are yet to see the full impact on the economy of three years of tightening. Activity is likely to slow as the year progresses. Furthermore, while the Fed may have finished, banks are tightening lending standards as they act pro-cyclically to de-risk before the cycle ends - you can see this in money supply growth which has slowed to less than 2%.

The failure to secure a trade deal (at time of writing) would suggest further tariff increases are likely before a deal is struck - Trump has suggested this may take many months. The dispute had a significant impact on supply chains in 2018, undermining business confidence in China in particular. Given the nascent state of the Chinese economic recovery, a protracted dispute will make a resurgence in the H2'2019 less likely.

Shares have already baked in a re-acceleration in growth for the 2H'2019. If growth and profit expectations fail to recover, shares are likely to move sharply lower. If the data improves as the year unfolds the market will likely rally to new highs.

Australia

On the domestic front, business confidence and trading conditions have slowed through the quarter, as has household spending and employment. The early data coming through in April would suggest these trends have continued into the fourth quarter, with retailers in particular struggling, given the timing of Easter and the late onset of cooler weather. Forward orders in the building sector have fallen away sharply in March and April as the housing slowdown gathers momentum. In

other discretionary sectors like travel, bookings have slowed materially in May.

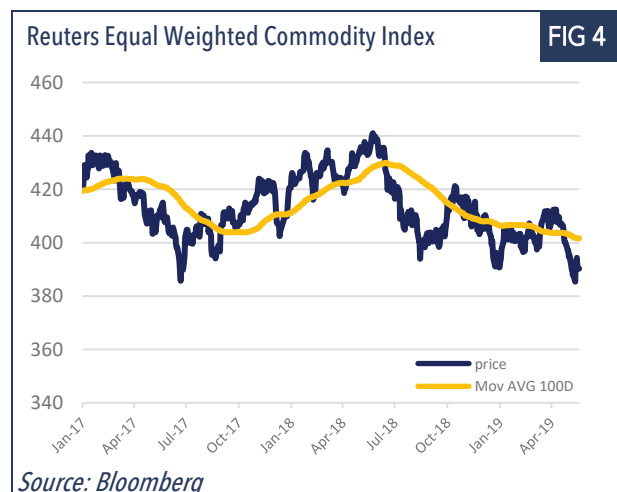
The early signs of this softening in conditions was evident in the first half results reported in February, with a record number of companies expecting a disproportionate share of profits to come through in the second half of the financial year. Inventory accumulation and poor cashflows were also a feature of the soft first half results. We have a set-up in place for disappointment when profits are reported in August.

Weak top-line trends are not the only concern for industrial companies, I suspect margins may also come under pressure. In recent years, labour's share of the national profit pool has fallen, and household income growth has stalled along with productivity. There are some emerging signs of catching up as the economy has moved towards full employment, with retailers in particular flagging wage inflation in the pipeline. This is a similar trend playing out in the US with unemployment at record lows- margins are getting squeezed.

The good news is, the outlook has improved post the election. Business confidence should recover as will consumer confidence as the coalition's tax cuts (\$7bn) are delivered through July-October 2019 boosting retail spending by 1.5%.

Australia Share Market Outlook

Before launching into an industry overview, with all the exuberance around the bounce in equity markets it is worth reflecting on the weakness in bond yields and commodity prices (*Fig 4*), this may be an ominous foreboding of what lies ahead.

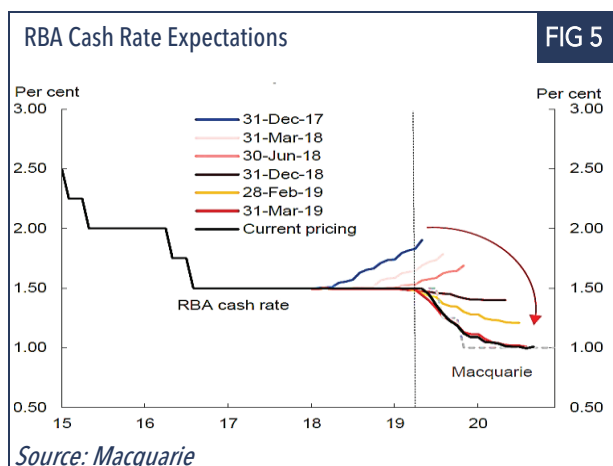


Commodity prices - a key source of income for our economy and the listed miners - are trading poorly

(excluding iron ore) and they are certainly not signalling a resumption of synchronised growth around the corner. The Chinese Yuan has been depreciating in recent weeks, putting pressure on US dollar denominated commodity prices. Maybe this is how the Chinese intend to reflate their economy in the absence of a trade deal. The share market is betting on lots of stimulus instead, however if you are betting on synchronised growth returning - which the share market seems to be - then you would want to see commodity prices also improve as the year progresses.

Australian Commonwealth Government bond yields have fallen from 3% just a few months ago to 1.7% currently, a discount to US treasures - this is the first time in decades this has happened, suggesting there are powerful deflationary forces brewing in the Australian economy. This message has not been lost on the RBA, who are now contemplating multiple interest rate cuts (*Fig 5*). The Australian dollar as usual will do the heavy lifting in providing relief. As rates have fallen across the yield curve, the dollar has broken below 70c and looks to be heading lower.

The RBA is not the only regulator with an eye on the bond market. APRA has also signalled its intention to ease lending serviceability measures for the banks, which along with interest rate cuts, smells of co-ordinated policy support. The question for investors is whether this trifecta of policy support and a business-friendly government will be enough to temper the strong deflationary forces in the economy. With shares breaching new highs, the market is betting on a stronger second half of the year... Time will tell. There is a similar set up for the global economy, with markets looking for an improvement in momentum as the year progresses. The markets have moved and it will now depend on the data to see if this can be sustained, or whether we get a repeat of last year, when shares deflated on weaker data as the year progressed.

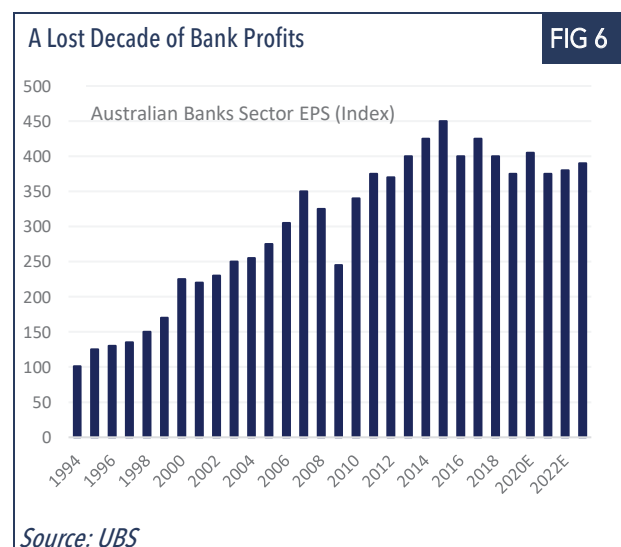


Household deleveraging is clearly weighing on banking shares, which account for 20% of the share market by value. The major Australian banks have a March reporting cycle and have just released what can only be described as disappointing results.

The retail banks are struggling as mortgage credit growth has stalled following a tightening in lending standards in the aftermath of the Banking Royal Commission. We are also seeing an uptick in distressed loans as property prices fall and credit conditions tighten. This is off a very low base of course, bad debt expenses are likely to normalise from here, particularly as write-backs roll off.

Misconduct charges have also been a feature of the recent results. With the Coalition returned to government, it is less likely the 50 recommendations of the royal commission will pass parliament. Good news for the major banks, though I suspect any relief rally will be temporary. Factoring in a modest credit cycle at some stage in the next five years, and ongoing deleveraging in the household sector, we could easily see a lost decade of earnings growth for the Australian Banks. Profits peaked in 2015 and will still be 12% below that level in 2023 under our base-line scenario. With no earnings growth for as far as we can see, Australian bank shares are going no-where in the medium term. Enjoy the dividends, because that is all you are likely to get.

Notwithstanding these challenges, under a Coalition government and with the opposition likely to move towards the centre under new leadership, the outlook for the banks has improved - the tail risks of a credit crunch under a Labor government are off the table. Keep in mind though, while rate cuts will ease pressure on the mortgage belt, it is actually a small headwind for bank profits in the short term.



If we turn to the second largest sector in the market - metals and mining, the outlook is less clear. While the prices of many commodities are heading south, iron ore (the largest profit contributor for Australian miners) has moved sharply higher on the back of disruptions in Brazil that may last many years. While this will ensure supernormal profits for the large miners this year and next, they are unsustainable in the medium term as supply will come back to rebalance the market. Peak profits would suggest we are also looking at peak prices for the large mining companies.

The Oil and Gas names have not fully participated in the recent oil price rally, principally because the large Australian E&P companies are LNG producers and LNG looks oversupplied in the medium term - Spot LNG prices are currently half the contracted price. The good news for oil investors is that absent a downturn in global growth, oil prices are likely to stay higher for longer as US tight oil (which flooded oil markets in 2015/2016) looks to be plateauing in the medium term. Australian East Coast gas markets are also likely to remain tight in the medium term due to a lack of onshore reserve development and depletion in the Gippsland basin, which has less than ten years left.

Turning to the industrial sectors of the share market. We have moved underweight healthcare, a first for many years, and I suspect we will finally see some sector de-rating this year given risks around US healthcare reform. The domestic cyclicals, like building materials, contractors and discretionary retail will slow along with the economy. This leaves us with a bunch of mature defensive sectors like consumer staples, general insurance, telecom and real estate, which we like given the outlook for the markets and the economy. Utilities are a mixed bag, the electricity businesses of AGL and Origin are challenged by ongoing political scrutiny and rising fuel costs. The regulated utilities and infrastructure sectors should continue to perform well.

While these low growth defensive sectors are expensive, they will hold their value in relative terms if share markets deflate later in the year as expected.

That leaves us with little earnings growth from the major companies. I would say 4-5% at best. Investors have gone searching elsewhere for growth pushing up the price of new emerging growth opportunities to unprecedented levels - the current crop of market darlings trade on 50 times earnings, right where they were at the height of the dotcom boom almost 20 years ago. While there are some

exciting new businesses in the group, they are far too expensive even when compared to their offshore peers. For many, it will end badly when the market eventually turns.

Valuation

This share market has all the hallmarks of a major top - on the one hand we have a slowing economy, reflected in bond yields trading below 2%, and on the other hand, we have excessive optimism in parts of the share market.

On most valuation metrics the non-bank industrial companies are at least twenty percent expensive versus history (*Fig 7*).



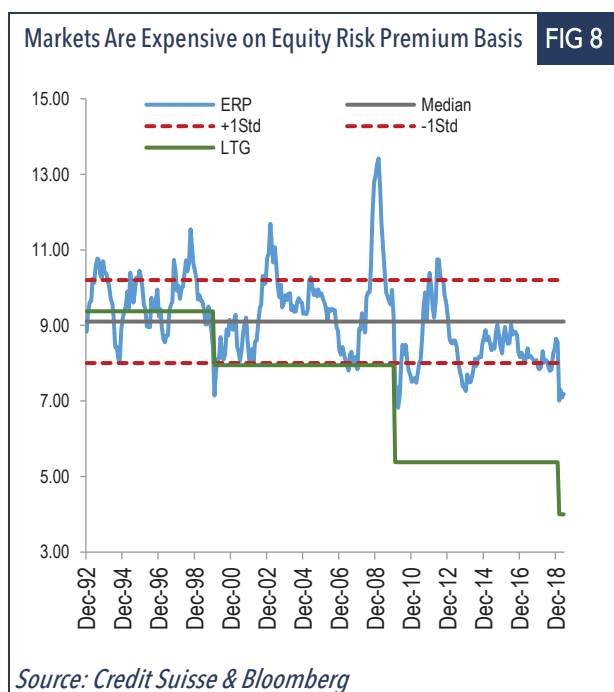
Market bulls will point to low interest rates and bond yields at 1.7% and suggest there is value in shares with an Equity Risk Premium (ERP) currently above 8%. The ERP is the additional return you get over the risk-free government bond at 1.7% for taking on the risk of holding shares.

There are two obvious errors in this logic. Firstly, it assumes bonds are correctly priced. This is folly given bonds in many parts of the developed world are trading on negative yields where you would be mad to invest in them. Because Central banks could not push short term interest rates below zero, they have been manipulating rates along the yield curve, including long term bonds to stimulate liquidity and risk taking. This has led to excessive lending and misallocation of capital that will ultimately create the imbalances that will undermine this business cycle. With bonds grossly overvalued, you

cannot use them as a basis to value equities. You could rightfully say shares are better valued than bonds, but that does not make shares any less expensive.

Secondly, the long-run earnings growth rate expected by the market, which is the basis for calculating the ERP, cannot be directly observed. Typically analysts use the long run historic rate, effectively assuming growth rates stay the same. The long-term earnings growth rate (LTG in Fig 8) has in fact been stepping down in each of the last three cycles. We expect trend growth to continue to slow (this is the real message from low bond yields, they are suggesting growth is going to slow in the decades ahead).

If we input the actual growth rate in recent decades and assume the slowing trend continues, the ERP is actually *well below historic averages* again confirming how expensive this share market is.



What Lies Ahead

With a dual mandate of attractive returns and capital preservation, we stepped out of this expensive market a few years ago when the market P/E moved above one standard deviation from the mean (Fig 7). We were happy to do this in the belief that we could still deliver reasonable returns through our stock selection, while protecting the portfolios from a market draw-down. We have not achieved this, principally due to our failed international strategy.

We have often talked in correspondence to our investors, about the 'cost' of maintaining a fully hedged position. Along with the various lending fees etc, an equity market neutral portfolio is also required to pay away the value of dividends on securities that have been borrowed to sell short, to the beneficial owners of those shares. In simple terms, across the broadly diversified long and short portfolio, the dividends we receive on our longs are paid away on the shorts, and the fund does not receive the 'carry' (dividend yield) that most LIC's receive, even if the market goes sideways. Missing the compounding effect of this dividend yield has accounted for much of the underperformance in recent years.

This has meant that in the absence of alpha creation through stocks selection, the value of the portfolio is largely unchanged. However, because we have continued to pay dividends and a capital return through this period, the NTA has fallen.

The good news is that we have recognised our mistake and have re-set the business, bringing our focus back to what we do best - investing in Australian companies. While it may not as yet be reflected in performance numbers, the dynamic amongst the team feels like it did some years ago, when we were making lots of money for our shareholders chasing down opportunities in the local market. I firmly believe we close to recapturing that form again.

No one is more grateful than I for the patience shareholders have shown us. It is true in any business that a strategic misstep generally takes time to fix. It has been just five months since we re-set the business, bringing in new members of the team. It will take some time for these new members to settle in. In the long run, we will be stronger investors for our experience in International markets, which I can see already in our decision making. The trends in Australia are an outcome of trends that unfold in major markets overseas and the lessons and insights gleaned in recent years will help us get ahead of these trends in the local market.

As for the share market, it is only a matter of time. There is a reason 80% of active managers underperformed last year, I have never seen such a difficult environment for fundamental investors - markets cannot be mispriced indefinitely. Like gravity, fundamental forces will be restored, shares will fall, and value will return to this market. We fully intend to be on the right side of these moves and hopefully make up for the lost ground of recent years.

PORTFOLIO REVIEW

Basic Industries

A series of events led to a rally in mining companies in the first quarter of 2019. Following a tumultuous end to 2018, the US Federal Reserve pivoted away from planned interest rate rises, providing a significant boost to emerging markets and mining companies. Simultaneously, the Chinese Government initiated a range of stimulatory economic policies in response to concerns surrounding the destructive effects of the trade war and weakening economic conditions. Recent manufacturing data suggests these are beginning to support growth as observed in commodity demand. Also, Vale's devastating mine failure in Brazil has resulted in supply disruptions of approximately 50Mt to the seaborne iron ore market. This will take time to rebalance and will lead to outsized profits for some mining companies.

We maintain a neutral weighting to mining companies despite the recent enthusiasm. Bulk commodity prices remain high relative to history and are beginning to incentivise new supply. We initiated a new position in Mineral Resources through the quarter. The company delivered an outstanding result for shareholders in selling 50% of its Wodgina lithium mine late in 2018. This sale included a valuable services contract which we expect it will deliver \$20-40 million in earnings for the company over the next 30 years (life of the mine). Another insightful transaction was the acquisition of Cliff's iron ore business. The company will most likely ramp production from the Koolyanobbing mine and benefit from the current high prices.

Oil rallied through the quarter as inventory data highlighted continued demand strength, with US sanctions on Venezuela impacting supply. Prices remain highly correlated with equity markets, which helped in the first quarter. We remain balanced in our oil portfolio as last year's sell-off provided a window into market vulnerabilities. US shale production continues to increase, while supply cuts from OPEC and sanction disruptions can reverse quickly.

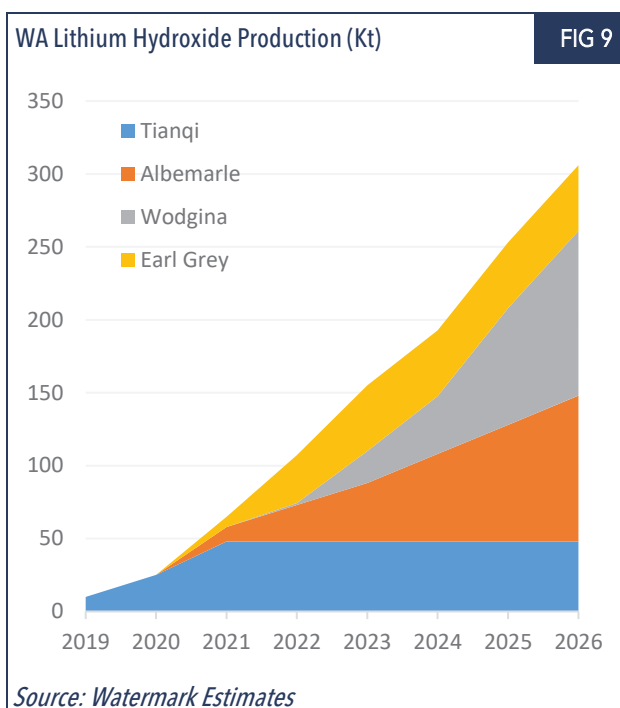
The shares of Australian building companies continued to fall, with a raft of companies downgrading earnings expectations on lower building consents, and as poor weather delays infrastructure projects. However, those companies exposed to the US saw their outlook brighten, with a drop in interest rates sparking a pick-up in demand. This benefited our positions in Reliance Worldwide and James Hardie.

WA – A global renewables hub

Wesfarmers' surprise bid for Lynas highlighted the company's desire to build out its chemical and downstream processing business in Western Australia (WA), particularly focussing on commodities exposed to renewable energy and demand for batteries. However, it is not alone, with a number of companies embarking on a new 'value-add' strategy of converting the state's vast resources into battery-ready chemicals.

Lithium demand has exploded over the last few years and is set to continue rising. WA is blessed with some of the world's best spodumene (hard-rock lithium) deposits. To date, these mines have shipped spodumene across the globe (primarily to China) where it is converted into lithium carbonate or lithium hydroxide – key components in rechargeable batteries. Nevertheless, many companies have announced plans to build hydroxide plants in Australia, benefitting from the proximity of the resource and value-adding before selling to offshore battery manufacturers.

The Greenbushes mine in WA began producing lithium in 1983 and for a long time was the sole producer of the commodity in the region. With the increase in prices in recent years, several new deposits have been discovered and brought into production. The three large new developments are Pilgangoora (Pilbara Minerals), Wodgina (Mineral Resources) and Earl Grey (Kidman Resources). Along with Greenbushes' new owners, Tianqi Lithium and Albemarle, these companies have announced plans to build an integrated business producing lithium hydroxide from spodumene. This will involve large amounts of capital and technical ability. WA will likely become the largest producer of lithium hydroxide in the world – an essential ingredient in transitioning to green energy.



Nickel is a key component in lithium-ion batteries and has quickly become a strategic metal. BHP may have delivered its Nickel West business to the demerged South32 in 2015 if not for the prohibitively large closure liabilities. Roll forward three years and the rise of renewables has BHP investing in this business. At the Diggers and Dealers conference in 2017 BHP announced a US\$40 million investment to produce nickel sulfate hexahydrate, and ambitiously suggested expansion to create the world's largest facility. However, permits have been slower than expected and the company has recently added nickel assets to its wish list. Independence Group, which owns the Nova nickel mine and has a relationship with prolific nickel prospector Mark Creasy, recently announced results of a study to produce nickel sulfate for sales into the battery market. While both ventures are in the early stages, the abundance of nickel deposits in WA creates the potential for the region to be a major supplier of nickel.

We have written about rare earths and Lynas' exposure to electric vehicles and renewable energy in previous editions of the Leading Edge. This quarter saw Wesfarmers recognise that potential, making an unsolicited takeover offer. It has been reported that Wesfarmers' proposal was to build a water leach processing (WLP) circuit at its existing chemical and fertiliser processing hub at Kwinana. WLP is where low radio-active waste is produced in refining rare earths and

circumvents issues in Lynas' Malaysian facility. This plan treats more of the valuable Mt Weld ore body in WA before exporting to customers. While Mt Weld is a unique asset, Australia possesses several potentially exciting deposits that could benefit from investment in downstream processing. Northern Minerals and Hastings Technology own deposits with high amounts of NdPr, the key ingredient for batteries, and have struggled to fund their projects. If this downstream investment was to occur in WA, we believe it would open up these deposits, and potentially more, contributing to the global demand for rechargeable energy.

A slightly less obvious commodity that will benefit from the emergence of electric vehicles is Aluminium. Unlike traditional cars, EVs hold fewer components and moving parts, but the weight of the battery makes it an important element of design. The Tesla Model S has a body and chassis that is almost entirely fabricated from aluminium (low weight metal), a requirement to achieve its phenomenal acceleration. WA holds some of the world's best bauxite deposits, the primary ore of aluminium. Alcoa and South32 own large alumina refineries which we expect will expand in coming years as demand continues to grow.

The construction industry will benefit from this potential wave of investment, but lime use is set to soar. Lime is the most cost-effective option to neutralise acids - an important step in all of the chemical processes listed above. Adelaide Brighton Cement (ABC) has a near monopoly on lime production in WA, achieved through a series of acquisitions 20 years ago. Our research suggests lithium hydroxide plants alone could ultimately add 50% to the current lime demand in WA with even more required should other chemical plants move into production. While ABC has some clear headwinds through the downturn in the housing market, its lime business appears to be profitable.

TMT/Healthcare

Australian technology shares had a stellar first quarter and contributed positively to fund returns. In addition to the bounce in offshore and domestic markets, we saw robust earnings reports (notably Altium and Appen) which further fuelled the rally. This window of opportunity has now been swiftly seized by companies to raise capital for further growth (Wisetech, Appen, Megaport). Very high valuations have now raised the bar for management teams' execution throughout the rest of the year.

Media shares have continued to ebb and flow with expectations for the Australian economy. TV broadcasters like Nine and Seven West have seen their share prices under pressure on expectations of a softer TV advertising market. oOh!media continues to struggle with a weakening of the Out-of-Home (OOH) advertising market, even though OOH is outperforming other segments like print, TV and radio. Internet-focused businesses have fluctuated in line with expectations for a softer housing market and overall weakness in classifieds volume.

Telecom shares (being defensive by nature) bounced back, driven by the decline in bond yields and the outlook for stable dividends. Telstra and Chorus are two key examples. Telstra's dividend yield compressed from 6.0% in December to 4.8% by the end of March. Chorus' strong performance was not only driven by yield compression but also by the recognition that it is morphing from an incumbent fixed telco asset to a regulated utility. As a result, Chorus' dividend yield compressed from 5.0% in December to 4.0% by the end of March.

Within Healthcare, we have seen the emergence of idiosyncratic trends. Among the larger healthcare companies, Resmed and Cochlear have suffered from weak earnings reports. Resmed disappointed expectations with higher than expected costs associated with its SaaS strategy and weaker device sales in Europe. From an earnings perspective, we expect this 'air pocket' to last a few more months. Cochlear surprised everyone by reporting no implants growth in its key US market, on account of market-share losses to Advanced Bionics' new MRI-compatible device. CSL, on the other hand, posted a solid Q1 result, with high IG demand growth and very strong vaccines numbers, notwithstanding certain one-

offs in other parts of its portfolio. The debate now is whether CSL will raise guidance before August. Among the smaller companies, defensives like Sonic Healthcare and Ramsay have continued to re-rate higher. We fear Ramsay shares might struggle with a Labour victory given the promise of 2 years of capped private health insurance at 2% and the potential impact on Ramsay's revenue growth.

In summary, the Healthcare and TMT portfolios continue to be defensively positioned in anticipation of a volatile 2019. Our long positions are focused on defensive businesses with a solid earnings outlook and decent valuations. On the other side, our short positions are skewed to shares that are over-priced, leaving little room for disappointment. Even though we appreciate the quality of many of the business models prevalent in Technology these days (Software as a Service being the poster child), we remain concerned about the high degree of complacency exhibited by the investor community, reflected in excessive valuations. We believe this complacency is likely to be tested later in the year and hence wait for a better entry point into what remain attractive long-term secular stories.

NextDC

NextDC is a carrier-neutral data centre, the only publicly listed player in Australia, with \$161m in revenue in FY18 and a \$2 billion market capitalisation. A carrier-neutral data centre (DC) is a connectivity hub for the different participants in the network. It is the place where telecommunication carriers (Telstra, TPG, etc.), enterprises, content providers (e.g. Netflix, Xbox, etc.) and cloud providers (Amazon, Microsoft, Google) all connect and share information directly with each other in a low latency environment. It is defined as 'carrier neutral' to distinguish from wholesale, carrier, or systems-integrator owned DCs. Wholesale data centres tend to be predominantly occupied by a handful of substantial tenants that are focused on computing and storage rather than connectivity. Carrier or system-integrator owned DCs are either owned by one telecommunications player or by someone like IBM or Fujitsu that can provide a wide array of integrated hardware, software and IT

management to its customers. A carrier neutral model is simple as it only provides the space for customers to install their equipment (servers, switches, routers), air cooling, power supply and a high level of security access. In a way, a carrier-neutral DC is a real estate play levered to high growth in data and computing capacity. The developer builds, signs tenants and manages common infrastructure (power, cooling, security). Barriers to entry exist due to the size of capital commitments, the long-lead cycle in developing these facilities, the requirement for strong power connections, very stringent reliability track record (Tier 4 certification requires 99.995% uptime or just 26.3 minutes of downtime annually) and robust financial backing.

NextDC commands around 10% of the Australian carrier neutral DC capacity. Its key competitors include Equinix, Global Switch, Digital Realty, and New Zealand's Canberra Data Centers (CDC). The shares of NextDC have been weak of late, due to concerns about supply outpacing demand and a potential capital raise. We see these short-term concerns as providing an attractive entry point into what we consider a compelling long-term secular growth story, in an environment where many other long-term growth alternatives are priced for perfection.

Like many other capital-intensive industries (cruise ships, hotels, commercial real estate), the DC space often gets caught up in industry cycles where supply is built ahead of demand and then is followed by a period of digestion until supply and demand meet. Unlike cruise ships, hotels or commercial real estate though, the underlying demand for computing power, storage and connectivity is growing rapidly, and will only accelerate as workloads continue to shift from on-premise to the cloud. The arrival of 5G and ultra-fast broadband connections, the move to consumption of enterprise applications as Software-as-a-Service (SaaS), and multiple music and video streaming platforms (Netflix, Stan, Spotify), will require an ever-increasing amount of data to be trafficked across the network. Several industry studies estimate that public cloud workloads are just beginning to move on to the public cloud, resulting in years of +30% growth in workloads that need to be accommodated through the network.

A particular concern for NextDC has been the inability to announce new contracts for its M2 facility in Melbourne. Being the second largest city in Australia with 4.2m inhabitants, it seems most large cloud enterprises are providing incremental demand from Melbourne out of Sydney DCs, for the simple reason that the submarine cables that provide the global connectivity land only in Perth and Sydney. Since this is a high growth industry, and Melbourne is the second most populated city in Australia, we consider it is only a matter of time until new contracts get announced for M2.

The concerns about capital raising are genuine. The balance sheet does look stretched on our estimates with around 5.5x net debt / EBITDA by end of FY19 and a heavy development pipeline. In any event, a capital raise would only happen in tandem with the need to accelerate growth. NextDC management has been prudent so far, and we assume they would only announce a capital raise if they had solid indications of interest from large tenants. Be it for its S3 facility in Sydney or a new DC outside of Australia (Singapore is a destination that comes up often in conversations).

In our view, NextDC is fairly valued for a business where revenue and profits will double over the next 3-4 years. We believe this is a sound investment proposition in the current environment where the downside is somewhat protected by a relative abundance of potentially interested parties, from infrastructure-dedicated funds to global strategic players (competitors).

Valuations in the 'white hot' technology sector are a major impediment to investment. The median share price in this segment of the market trades at 15 times revenue, compared to only 3 times for the broader ASX 200. If we compare profits instead of revenues, the most liquid technology names trade at a multiple of 60 times earnings before interest, tax, depreciation and amortisation (EBITDA), compared to 10 times for the ASX 200. Ignoring valuations in light of market studies which provide decades of historical valuation data is the equivalent of accepting that "this time is different" to everything that occurred before. In comparison to other peers in the sector which do not offer the same valuation support and downside protection, NextDC looks particularly appealing.

Financials

Industry-specific trends have driven the performance of financial shares in the first quarter of 2019. Fund managers have seen support from rising equity markets; banks are selling off as they battle against continued housing and revenue headwinds and as they increase remediation provisions; while Fintech companies push ever higher along with the surging NASDAQ index in the US.

We remain cautious on the Banks as we approach reporting season. Weak revenue trends from a slowing housing market and soft non-interest income, indicate earnings pressure for all banks. We adjusted our positioning in Australian banks through the quarter, establishing short positions in businesses with greater exposure to the residential housing market. We also initiated an investment in NAB, which has the most robust business banking franchise for small and medium-sized businesses.

Fund managers found uniform support as the global rally in equities provided a turnaround in the earnings outlook for the year. We have sought exposure to this through core investments in Macquarie Group and Magellan Funds Management, where both companies are seen to be market leaders.

Afterpay has been a successful investment for the funds.. The company has had continued success in the USA, reaching the 1 million customer milestone in early March. We monitor alternate data sources which show solid trends for Afterpay's US expansion and expect the business to commence transactions in the UK in the coming months.

Link Administration Holdings (LNK) remains a key position in the Financials portfolio. LNK is a market leader with a significant runway in its UK acquisition now called LAS (Link Asset Services). LAS recently sold a non-core business and we expect the capital release to be recycled into strategic bolt-on acquisitions within LAS.

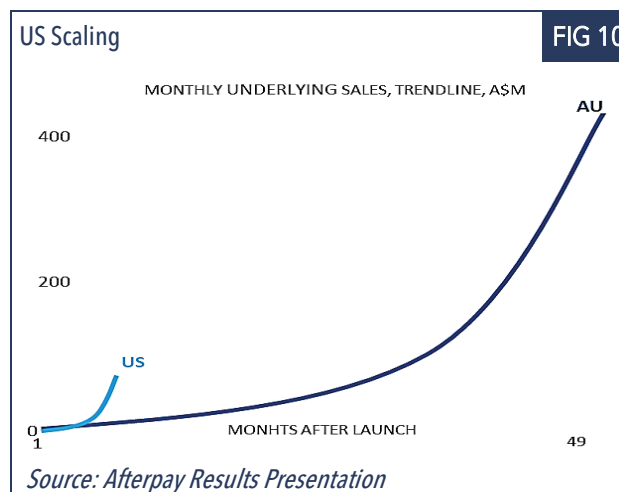
REITS performed strongly through the quarter as bond yields continued to contract. Shopping Centres Australia (SCP) has performed well, due to its holdings in convenience shopping centres, which focus on groceries, food, beverage and services. These segments are proving to be resilient in a challenging retail environment.

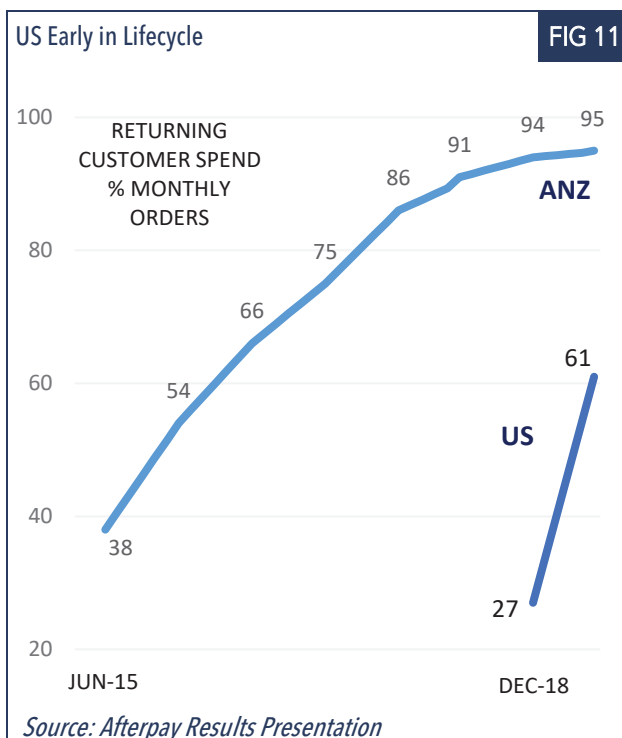
Afterpay Touch Group

Afterpay Touch Group (APT) is an Australian payments fintech company that also has operations in the USA and the UK. It is similar to a traditional layby product in that it allows customers to split payments for goods and services into four fortnightly payments. In contrast to conventional layby practice, Afterpay funds the purchase upfront, allowing the purchaser to obtain the product straight away at no extra cost, providing that payments are received on a timely basis. Afterpay business model profits by charging the merchant a fee (averaging around 4%). In essence, the customer receives the goods and or service, the merchant gets paid by Afterpay (less a fee), and the business collects the funds from the customer.

Afterpay has seen a dramatic increase in valuation since listing on the ASX in 2016. The company floated at a valuation of A\$125m and now trades at around A\$6 billion. The growth has been exponential, in Australia and New Zealand (ANZ) alone where APT has 2.6m customers, purchasing at a rate of more than \$4bn a year through 23,400 merchants. While we believe the rate of customer growth in ANZ may slow, the usage is set to increase, as 95% of the customer base are repeat users. As ANZ customer spends per month has nearly doubled to A\$400 since January 16.

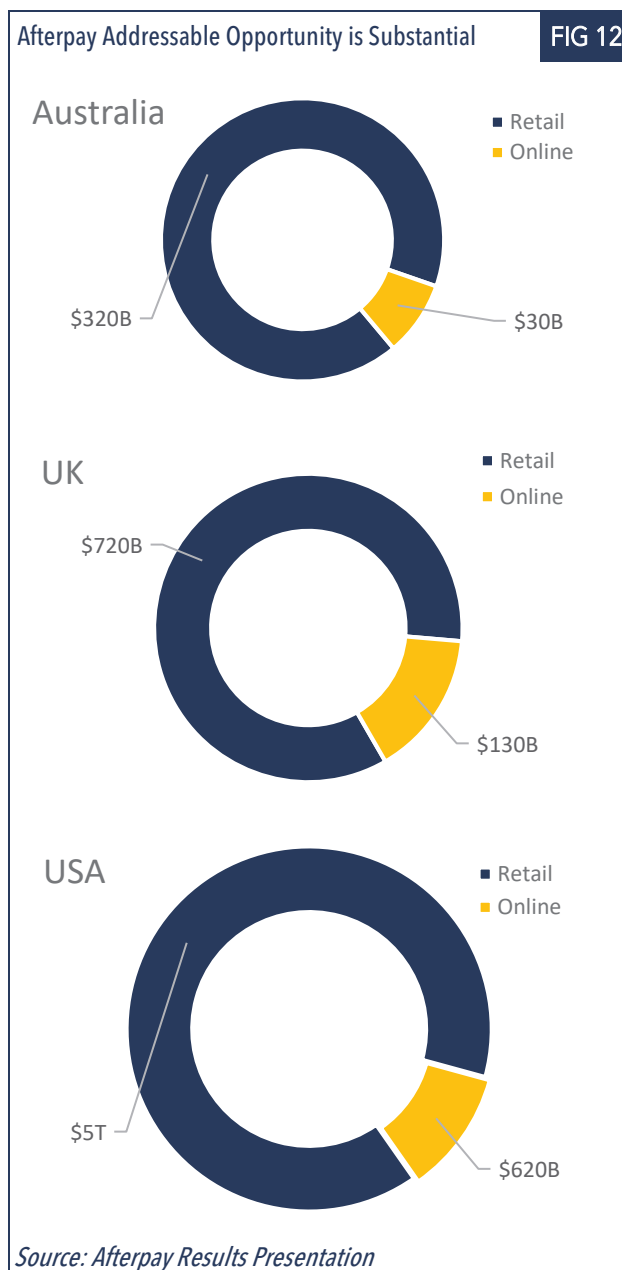
While these ANZ statistics are impressive, the US platform reached 1 million customers within ten months of launching. We expect to see international operations exceed ANZ numbers in the medium term. Extrapolating the recent growth rate, Afterpay should have more customers in the US than ANZ by the end of the year.





Australia and New Zealand can be viewed as a roadmap for how entrenched the product can become in the lives of millennials. The UK launch is scheduled to occur in the next two months. To put these markets in perspective, Australia has \$30b of online sales; the UK has \$130b, the USA has \$620bn (~\$310b ex-amazon). These statistics are based on the online platform model. Afterpay is now expected to roll out in-store opportunities internationally in the coming years. If the Afterpay platform is in any way as penetrative (APT now transacts 10% of Australian e-commerce) in the UK and the US as it is in Australia, we would expect this to be the beginning of a new global payments platform.

The platform is highly scalable, where merchants can be added and operational within a day, and customers have the ability to sign up to the platform within minutes. The capital requirements to run the business are low due to the short duration of the loans where Afterpay is able to fund ~\$13 of sales per annum with \$1 of funding. Beyond the funding of sales, APT's international expansion has come at a cost of ~\$50m. We consider this to be quite modest in the context of customer growth numbers and the potential for future earnings for the business.



Many investors have struggled to come to terms with the market's valuation of Afterpay. On traditional valuation metrics, it is one of the most expensive shares on the ASX, at ~200x 2020 Price to Earnings and 76x enterprise value to EBITDA. But one needs to question the relevance of these metrics on a company growing so quickly with such a scalable platform. Amazon regularly traded with a 3-digit price earnings multiple between 2012 and 2015, where the stock also added ~300%/\$500bn in value over this time. We take a longer-term view on the earnings profile and consider the current valuation as still attractive given the business is still growing in the US and the UK.

Consumer

The major cyclical headwinds facing Australian consumers are weaker housing activity and prices, spilling over into consumer spending. While discretionary spending has already slowed, we expect this to decline at a faster rate over the next 12-months. Of importance will be the housing construction cycle and industry reaching 'peak completions' for new developments. We expect this to have flow-on effects for the economy through lower employment and consumption activity.

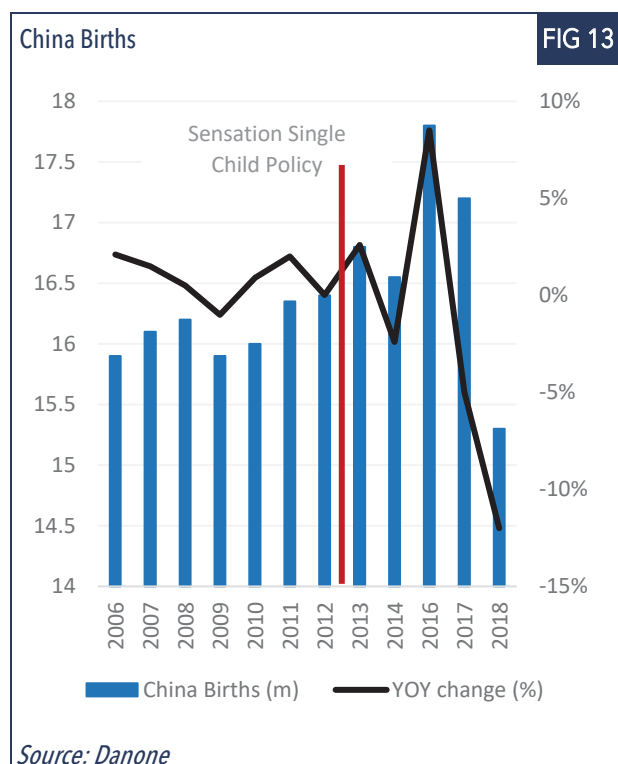
The Consumer portfolio is tilted towards businesses with defensive cash flows, or with internal initiatives that can see them grow through the cycle. Woolworths is a core holding in the portfolio that displays strong defensive characteristics and is seeing positive operational momentum. Within our short portfolio, the recent rally in equity markets has provided 'another bite of the cherry' for consumer shares exposed to the housing cycle. While earnings risk has increased for cyclical shares in recent months, many have become more expensive. As such, we have selectively added shorts to shares with direct exposure to declining housing starts.

Infant Formula

Infant formula companies tend to attract a disproportionately high level of attention from investors. This can be explained by the seemingly insatiable levels of demand from Chinese mothers for the product, coupled with low investor transparency and high volatility. While this recipe can make for a nervy place to invest, it also creates a significant opportunity for those investors that follow the businesses closely. Watermark has been active in this space with both long and short positions which have contributed to returns.

Much has been said in recent months in regard to the Chinese infant formula market and concerns that a declining birth rate would result in a peak for the market. Most of this concern has come from one data point, that being a 12% decline in the birth rate in 2018. While this data point is important, there are also other things to consider. Firstly, looking at data over a longer timeframe (*Fig 13*), four years after the relaxation of the one-child policy in 2013 the birth rate has run well above trend (at around 16 million births pa). So, while the number of births declined by 12% from 2018, it is only 6% below the long-term trend. Notwithstanding these short-term

statistics, the significance of the removal of China's one-child policy cannot be overlooked. This draconian policy has been the cause of angst for many families, and its removal may result in structural support for fertility rates in coming years. So why did birth numbers fall in 2018? While there are several reasons why the birth rate might move around, the answer may be in the stars. The 'zodiac impact' is a phenomenon where traditional Chinese parents time the birth of their Child to coincide with lucky periods, such as the highly desirable 2019, year of the pig.



Bellamy's Australia

It is difficult to make a call on the outlook for the Chinese birth rate at this stage, as this is only important in determining the outlook for the total infant formula category. Within the broader group, there are specialist segments that are outperforming and growing strongly. Organic infant formula has been growing in excess of 35% pa over the last 4 years, despite the trend in the birth rate. Organic formula penetration remains very low in China (around 2%) compared to other markets globally (+20%), so we see plenty of runway for this category.

Bellamy's has been selling organic infant formula in China for 12 years and has one of the most recognised brands in the category. It is well placed to ride the trend. The company has been mismanaged in the past and is part way through a restructure under a new and high-quality

team. As part of the restructure, Bellamy's has recently relaunched it's brand and product formulation to appeal to Chinese mothers. We see this as a turning point for the business and a significant opportunity.

The key risk to our view is Bellamy's ability to gain approval to sell in physical Chinese retail stores. While many companies have successfully built brands in the digital channel only, Bellamy's will want this approval to exploit the opportunity to its full potential. This approval creates a ceiling on the valuation we can attribute to the business, and as such we have been prudent in managing our position.

Performance Review

On 23 April 2019, Schemes of Arrangement for WMK and WGF were implemented, having been approved by shareholders at a 1 April Scheme Meeting. All shareholders were issued units in the Watermark Absolute Return Fund, which will operate under a new investment mandate, focusing on Australian shares. This brings to completion, a reset of our business, bringing our focus back to the local share market, where we have many decades of combined experience amongst our investment team.

Performance of Watermark funds in the first quarter of 2019 was flat. Despite being defensively positioned and carrying a modest net short bias for much of the quarter, the Funds held their ground in a rising Australian share market, which rallied over 11% in the period. Strong returns in the financial and media portfolios were offset by losses in consumer and energy shares.

While these sectors have weighed on performance in the short-term, we see significant upside from being on the right side of deteriorating trends in these sectors, that will play out through the rest of the year. As such, we have retained our defensive settings.

Quarterly Performance by Sector

| Sector | Domestic Portfolio * |
|------------------|----------------------|
| TMT | 0.40 |
| Healthcare | -0.40 |
| Consumer | -0.35 |
| Industrials | 0.14 |
| Basic Industries | -0.09 |
| Financials | 0.84 |

*Domestic portfolio data is for Australian positions in Watermark Market Neutral Trust.

Fund at a Glance - April 2019

| | |
|-----------------|---------------|
| ASX Code | ALF |
| Fund Size | AU\$260.3 |
| Fund Strategy | Variable Beta |
| Share Price | \$0.90 |
| Shares on Issue | 244.2m |
| Net Exposure | -4.0% |

Net Tangible Asset (NTA) Backing

| | Mar 19 | Apr 19 |
|----------------|--------|--------|
| NTA Before Tax | \$1.15 | \$1.13 |
| NTA After Tax | \$1.15 | \$1.14 |

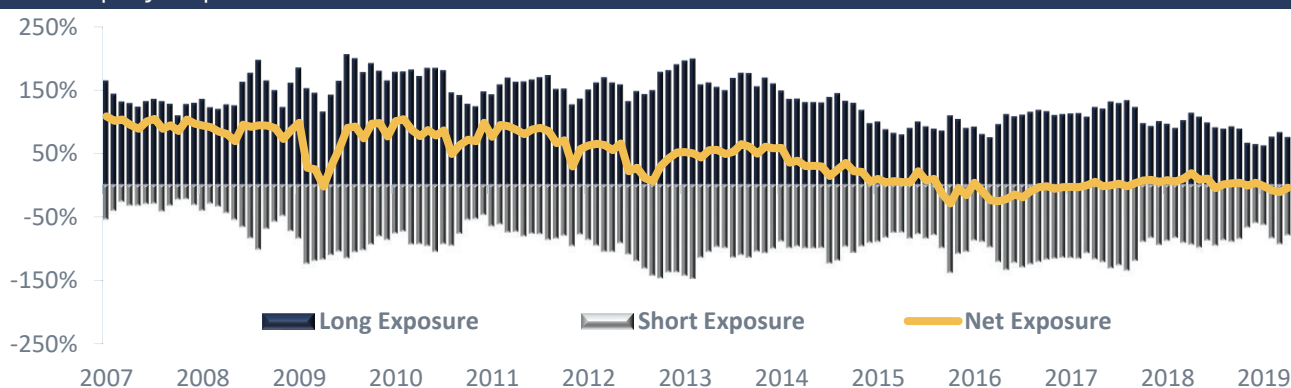
Gross Portfolio Structure

| | | |
|----------------|--------|--------|
| Long Exposure | 83.0% | 75.4% |
| Short Exposure | -93.3% | -79.3% |
| Gross Exposure | 176.3% | 154.7% |
| Cash | 110.3% | 104.0% |

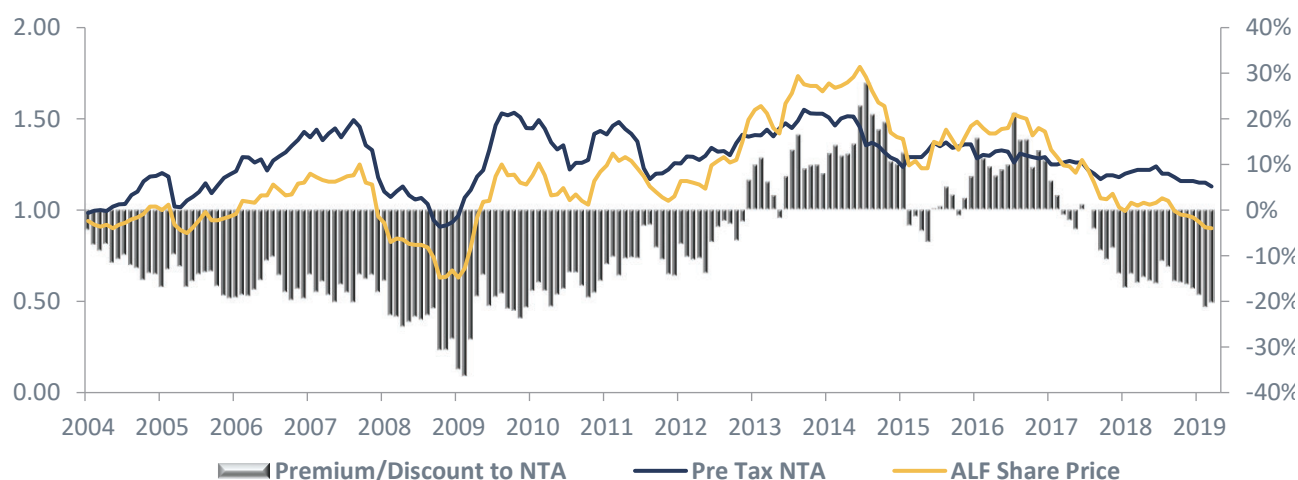
ALF Performance

| | 1 Mth | 3 Mths | 1 Yr | 3 Yrs (pa) | 5 Yrs (pa) | 7 Yrs (pa) | S.I. (pa) |
|------------------------|-------|--------|--------|------------|------------|------------|-----------|
| Portfolio Return (net) | -2.3% | -2.5% | -7.5% | -1.6% | 0.2% | 6.9% | 10.6% |
| All Ords Accum Index | 2.5% | 9.5% | 10.2% | 11.0% | 7.8% | 9.9% | 9.0% |
| Outperformance (net) | -4.8% | -12.0% | -17.7% | -12.6% | -7.6% | -3.0% | 1.6% |

Net Equity Exposure



Historical Premium/Discount to NTA History





Fund at a Glance - April 2019

| | |
|------------------------|-----------------------|
| Fund Size | AU\$121m |
| Strategy FUM | AU\$191m |
| Fund Inception Date | August 2012 |
| Fund Strategy | Equity Market Neutral |
| Application/Redemption | Daily |
| Management Fee | 1.5% |
| Performance Fee | 20% |
| Benchmark | RBA Cash Rate |

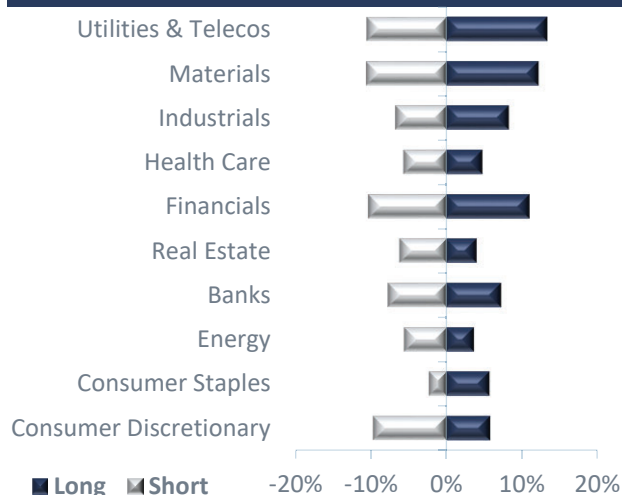
Return Characteristics

| | |
|---------------------|-------|
| Positive Months | 66% |
| Portfolio Beta | -0.1% |
| Sharpe Ratio | 0.8 |
| Sortino Ratio | 2.5 |
| Standard Deviation | 6.7% |
| No. Long Positions | 60 |
| No. Short Positions | 61 |
| Gross Exposure | 157% |

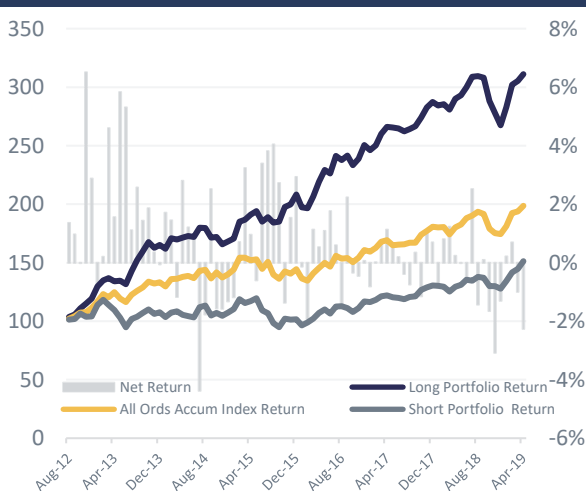
Performance

| | 1 Mth | 1 Yr | 2 Yrs (pa) | 3 Yrs (pa) | 4 Yrs (pa) | 5 Yrs (pa) | SI (pa) |
|-----------------------|--------------|--------------|--------------|--------------|-------------|-------------|-------------|
| WMNT (net return) | -2.3% | -7.7% | -3.0% | -0.5% | 3.6% | 2.3% | 7.8% |
| RBA Cash Rate | 0.1% | 1.5% | 1.5% | 1.5% | 1.7% | 1.8% | 2.1% |
| Outperformance | -2.4% | -9.2% | -4.5% | -2.0% | 1.9% | 0.5% | 5.7% |

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 | -1.65 | -3.08 | -1.30 | -4.11 |
| 2019 | 0.22 | 0.69 | -1.00 | -2.27 | | | | | | | | | -2.36 |

Notes

Notes

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