



# The Leading Edge

QUARTERLY REPORT • March 2020

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**Justin Braitling**  
Portfolio Manager

## Message from the CIO

The last few months have been a great challenge for everyone. It certainly hasn't been easy managing an investment portfolio, principally because of the unprecedented speed with which this health crisis has played out in financial markets.

While today markets have rallied off their lows, I would like to remind investors we are still early in this crisis. There are no experts that can confidently predict how this plays out, simply because there are no analogues to reference. We have never put the global economy into a deep freeze like this before hoping to emerge unscathed.

While it is folly to make predictions so early in the crisis, we can lay out for you a useful framework to monitor its progress. There are two key dimensions to consider for the share market. The first of course, is the progression of the disease and the second is the political response which in turn will determine the impact on the economy. The depth of the downturn and most importantly the shape of the recovery.

Today we have some sense of how the first phase of the disease plays out, information we didn't have just a few weeks ago. We can start to forecast with some accuracy, the progression of new COVID-19 cases, the burden on the health system and the mortality rate. This of course, helps us answer the second key question when we can lift suppression measures and get everyone back to work.

Epidemic modelling is a dubious pursuit given the difficulties in forecasting transmission rates. Early models of the Corona Virus had overstated the spread of the disease. By the end of March, we got early signs that new COVID-19 cases were abating in the worst affected European cities. US hotspots like New York City were also moving from exponential growth to linear growth, the first

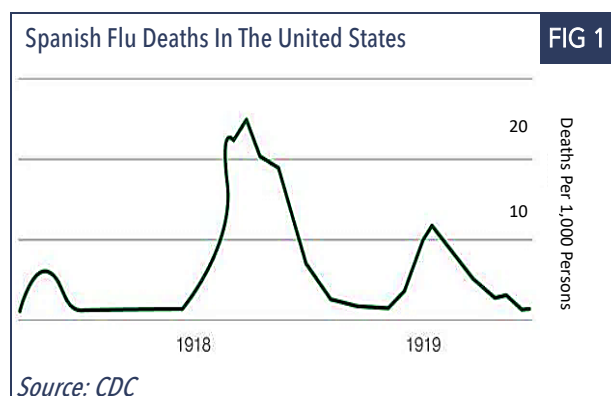
signs of containment. Other US states are yet to experience the worst phase of disease growth.

In late March, governments the world over launched a raft of policy measures to assist businesses and households through the crisis. These measures were designed to remove two key tail risks: firstly, avoiding a deeper downturn, which would prove difficult to recover from and secondly avoid a debt crisis triggered by a wave of defaults and bankruptcies which would cripple the financial system.

Many comparisons have been drawn with the financial crisis a decade ago. One of the most important differences this time around has been the policy response. In 2007, it took almost a year for the authorities to put an effective response in place. This time around the ambulance turned up before we even sailed off the cliff.

This brings me to the second major variable, the political response - the impact on the economy naturally follows from this. There is enormous pressure on leaders to get idle households back to work. This of course is dependent on the progression of the disease. Most Advanced Economies are now moving to re-open their economies. The risk here is around recurrence. As a novel virus there is no immunity in the community, the virus in months to come will be just as lethal as it was months ago. We could never have a V-shaped recovery given the basic physiology of the disease.

Back in 1918 by way of example, in Australia, there were three outbreak waves of the Spanish flu over a period of a year. Health experts like Dr Anthony Fauci of the US National Institute of Health (advisor to the US President) see subsequent outbreak waves as highly probable "reopening too soon will lead to clusters of infections, and he said he would not be surprised if there was a second peak of COVID-19 activity in the fall".



This is exactly what happened with the Spanish Flu in 1918 (Fig 1) if this happens, there will be no V-shaped recovery.

In countries such as the US where suppression measures were less stringent and civil liberties are protected and enforced at a state level, transmission rates could quickly flare up again if social distancing measures are lifted too early.

The key question now of course is the shape of the recovery, will it be V-shaped; U shaped or L shaped in profile. The bulls will point to the size and scale of policy support which will re-float the economy on a wave of liquidity, the bears of course question the efficacy of this support, questioning whether the cash gets into the right hands, leaving activity levels depressed for years. The implications for company profits and for the share market naturally follow.

The weak economic data is now coming through thick and fast - the US is already up to 30 million unemployment claims or 20% of the working population. If we look at forward manufacturing orders which is an accurate indicator of manufacturing activity, in the next 6 months you can see in (Fig 2) we have already fallen past 'great recession' levels of 2009 - this is one book end, of course it can get worse. It looks like a replay of the Great recession- at best!



Investors challenged by low-interest rates have coined an acronym - There Is No Alternative (TINA) other than to hold risky assets. Policymakers are now faced with the same dilemma - there is no alternative but to double

down on the same policies used to reflate the global economy from the last crisis - Unlimited QE to monetise unconstrained fiscal spending from Treasury. At 35% of GDP (Fig 3) the scale of this program is breathtaking, we have moved deep into the realms of modern monetary theory (emphasise theory) - gone are the days of worrying about public sector indebtedness and austerity, the fiat money printing machine just stepped up a couple of gears.

**Global Monetary & Fiscal Stimulus To Fight COVID-19 Impact (Feb To Apr 2020)**

**FIG 3**

	Central Bank Liquidity Injection		Govt Fiscal Stimulus		Central Bank Liquidity & Govt Fiscal Stimulus	
	\$ Trn	% GDP	\$ Trn	% GDP	\$ Trn	% GDP
US	\$ 4.80	22.4%	\$2.71	12.7%	\$ 7.51	35.0%
Eurozone	\$ 1.10	8.3%	\$1.43	10.7%	\$ 2.53	19.0%
Japan	\$ 0.20	3.9%	\$0.99	19.2%	\$ 1.19	23.1%
UK	\$ 0.25	9.0%	\$0.07	2.4%	\$ 0.31	11.4%
China	\$ 1.27	8.9%	\$0.54	3.8%	\$ 1.81	12.8%
Others	\$ 0.65		\$1.85		\$ 2.50	
<b>Total</b>	<b>\$ 8.27</b>	<b>9.5%</b>	<b>\$7.59</b>	<b>8.8%</b>	<b>\$ 15.86</b>	<b>18.3%</b>

Source: CSM Research & Bloomberg

Governments and bureaucrats recognise that they have few choices other than to throw everything at this crisis, time is of the essence - if they allow the economy to sink into a deep hole, they may never be able to get it out again. We had an ex-RBA governor comment recently that "Central Banks are terrified of the next recession given the difficulties in extracting ourselves from the last one".

A decade on, and they haven't been able to withdraw this liquidity support. The US Federal Reserve tried to shrink its Balance Sheet in 2018-2019 and was forced to resume asset purchases as prices fell and liquidity dried up in the repo market (Fig 4). The policy failure is clear - we went into this current crisis with interest rates still at zero in many advanced economies and central banks buying assets like there was no tomorrow.

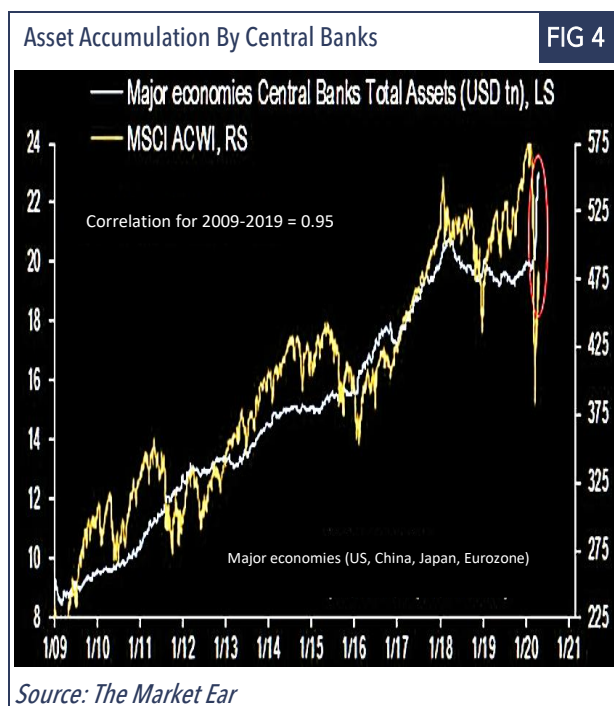
The commitment of central banks this time around to avoid a credit crisis has been unprecedented. In the last 6 weeks, the US Federal Reserve has bought more treasuries than the whole foreign sector bought in 6 years. They have also committed to large scale purchases of lower quality High Yield (Junk) Bonds, leveraged loans and commercial paper as well. They are buying

everything short of equities, which is surely next if this crisis lingers on long enough. The BOJ of course has been buying equity ETF's for some time.

The Central Banks role in a crisis is to provide liquidity to solvent institutions not to bail out bad credits. Of course, they have little choice other than to backstop credit markets given their policies have contributed to the accumulation of so much debt.

In Figure 4, you can see the asset accumulation from Central banks in recent weeks - \$4 trillion. You can also see the strong relationship with the appreciation in shares since the last crisis. This commitment to backstop asset markets fully explains the strength of the recovery in shares from the March lows - no one wants to be on the wrong side of this.

The end game is also clear, markets are now fully dependent on ongoing policy support and there is no turning back. If this crisis does linger on then we can rely on further Central Bank support, and public sector debt will accumulate further (Australia is heading toward 80% Net Debt/GDP with this crisis). The larger the debt accumulation though, the greater the burden on future growth. It locks us into weaker growth in future years.



With these settings in place, I feel more confident in predicting the medium-term outlook for the economy than I do in forecasting shorter-term trends. The last cycle had poor momentum, and growth was half the levels of

prior business cycles, this was evident in the share market as well, it took over a decade to recover the losses from the financial crisis.

By doubling down on the same reflation policies, further adding to public and private sector indebtedness, we have locked ourselves into another decade of suboptimal growth which I suspect will be weaker again than the last cycle.

Modern monetary policies incentivise investors to take on both risk and leverage with a clear objective of driving asset values higher even as fundamental trends fade. We end up bringing forward growth and returns from future years, locking ourselves into lower returns in the medium term.

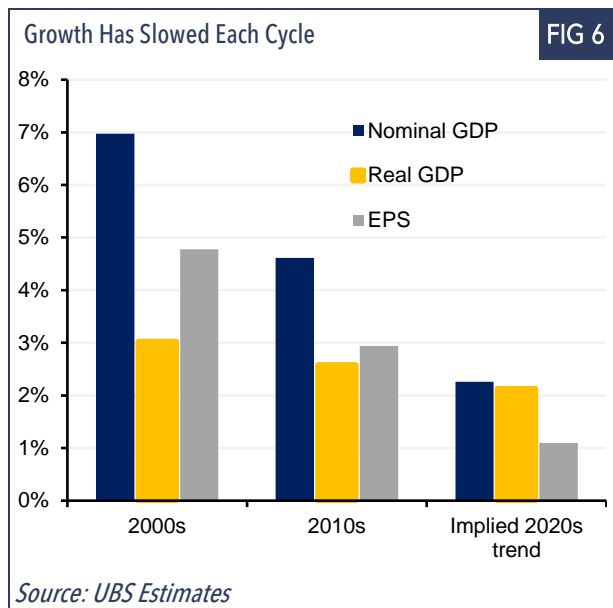
A cursory look at risk free assets such as sovereign bonds (Fig 5) and gold reflect this message. Bond yields are painting a dire outlook for growth and gold (the best performing asset class in recent years), is rallying as investors look to avoid the debasement of fiat currencies.



Many see lower interest rates as good for equities - (TINA) however, if they are lower simply because future growth is weaker then this argument does not hold. It does go a long way toward explaining why growth shares keep outperforming value (lower growth simply means companies that can grow are relatively more valuable).

In Figure 6, you can see how both real growth and inflation have stepped down in recent business cycles. A combination of secular slowing (or secular stagnation) and the reflationary policies designed to correct these trends are contributing to this weaker growth. As these

trends and policies are still in place, growth is likely to step down yet again in the years ahead.



This of course translates into weaker profit growth and lower returns for shareholders. In the last 10 years total returns for investors in shares have been 7% p.a, price appreciation has contributed just 2% of this, in line with profit growth. Investors have realised 85% of their gains through dividends and associated franking. As payout ratios have crept up, dividends have grown faster than profits and are now in many instances at unsustainable levels. Dividends cannot grow faster than profits in the years ahead as they did in the last cycle.

With share markets around the world rallying off lows in the expectation that policy stimulus will counter the impact of the health crisis, markets now appear to be pricing in a timely recovery. The further shares rise, the greater the risk that this scenario does not play out as expected and a tepid recovery or worse, a deeper downturn takes hold.

### What will the restart look like?

In thinking about how quickly the economy starts up again, it is helpful to consider key industries separately. There are many industries that are unaffected by this health crisis, such as consumer staples and technology (the largest sector in the S&P 500). Time will tell how resilient IT will be if we sink into a recession and companies start cutting back on spending, with the NASDAQ close to prior highs, investors are clearly not too concerned at this stage.

Then of course there are the crisis affected industries, such as Travel and Tourism, where activity will take years to recover. This is true also for many service industries affected by recurrent social distancing measures.

Then there are adjacent industries such as Energy and Banking, that will be harder hit. Lower oil prices for example are decimating employment in the oil belt, as drill rigs are parked up and wells are closed. US oil production which pre-crisis was running at 12m b/day supporting 12 million Americans jobs directly and indirectly, will fall to 10m b/day in 12 months time, no V-shape recovery here.

In Banking and Finance, credit losses need to be worked off over many years- there is no such thing as a V-shaped credit recovery - deleveraging takes years to play out, the key reason why growth was so soft in the aftermath of the Financial Crisis.

The obvious area of permanent loss of capital and employment is bankruptcy - when a business fails it doesn't come back - it takes years for these resources to be redeployed and there are significant transition costs which are a burden on the economy in the interim.

This crisis is likely to have a lasting impact on consumer behaviour also. Households will have tapped into savings or drawn on debt facilities to supplement diminished income, and these balances will have to be returned to more prudent levels - this will be a headwind on the recovery.

This is true for businesses as well. We have had countless business managers signal they won't be re-employing everyone that was let go, heeding Winston Churchill's advice not to waste a good crisis in resetting businesses that haven't seen a recession in 30 years.

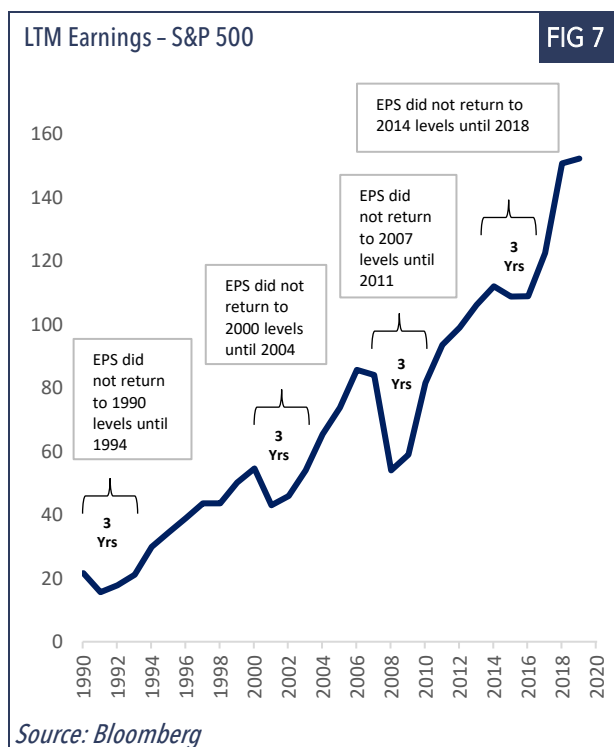
### What does this mean for the share market?

Investors are valuing shares on recovered earnings, looking through the valley to profits 1 to 2 years out. The S&P 500 group of companies reported earnings of \$161 in 2019. The bulls will say, we will be back there in 2021, P/E multiples should be high because of low interest rates giving us a target of 3216 (P/E of 20) on the SPX or 8% upside from here. That is certainly not in my playbook given the risks that lie ahead.

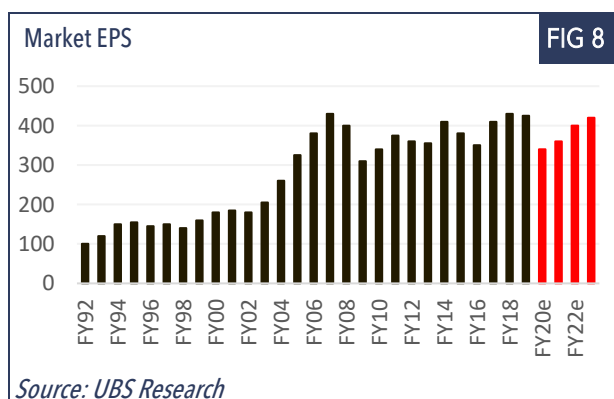
The error in this simple arithmetic lies both in the expected pace of recovery and in the use of 2019 as a starting point. Clearly, we suspect the recovery will take longer than the V-shape markets are starting to imply. Also, 2019 was a year of peak profits, and it will not be easy to get back there.

After 10 years of continuous expansion, many companies were over earning, reflected in margins that were 50% above trend (Fig 10), capital and labour were fully employed. Many public companies were using capital management to inflate earnings, shares and of course salaries, principally through buy backs.

In each of the last 3 recessions, it has taken roughly 3 years each time for earnings to return to pre-recession levels (Fig 7).



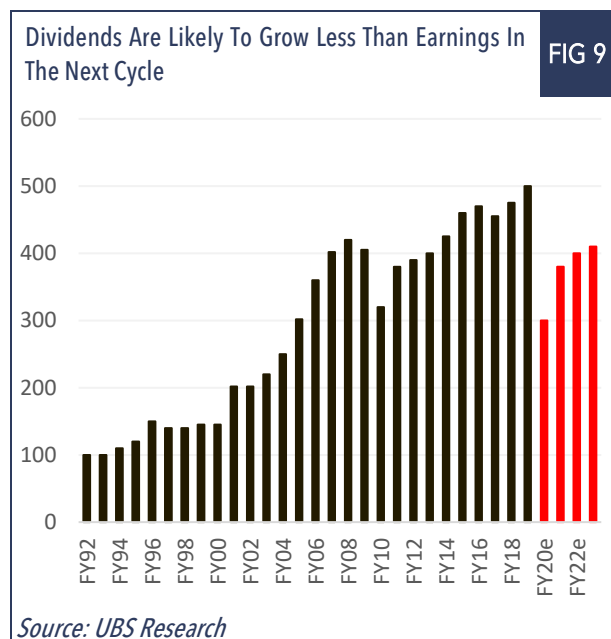
You can see this also in (Fig 8) for Australian companies using UBS forecasts.



The 3 year forward P/E has historically been 25-30% lower than the historic P/E - simple maths would suggest that if it takes 3 years for profits to return to 2019 levels, then the share market should be 25-30% lower assuming it was correctly valued pre-crisis.

Today the SPX is down just 13% from its peak! While the Australian market is down by 23%, I would argue our market was grossly overvalued at the start of the year when industrial companies (ex-Banks) were trading on 24 times earnings.

While Australian companies have not been as aggressive in the use of buybacks, they have returned more capital to shareholders by way of dividends. The credit guarantees are conditional on companies limiting their use of leverage to return capital going forward. This will play out in Australia as well; payout ratios have risen in recent years to unsustainable levels and are likely to fall (Fig 9).



If we think of corporate America as a factory. In 2019, after 10 years of continuous expansion the factory was humming, everyone had a job and capital was levered up and fully deployed. The factory owners had underinvested and were using aggressive capital structures to maximise profits. Returns were as high as they possibly could be. Market bulls would have us believe we get back here in short order.

Today the factory is shut, and we are thinking about starting it up again. The problem is we still have this virus to deal with, and we are faced with additional compliance

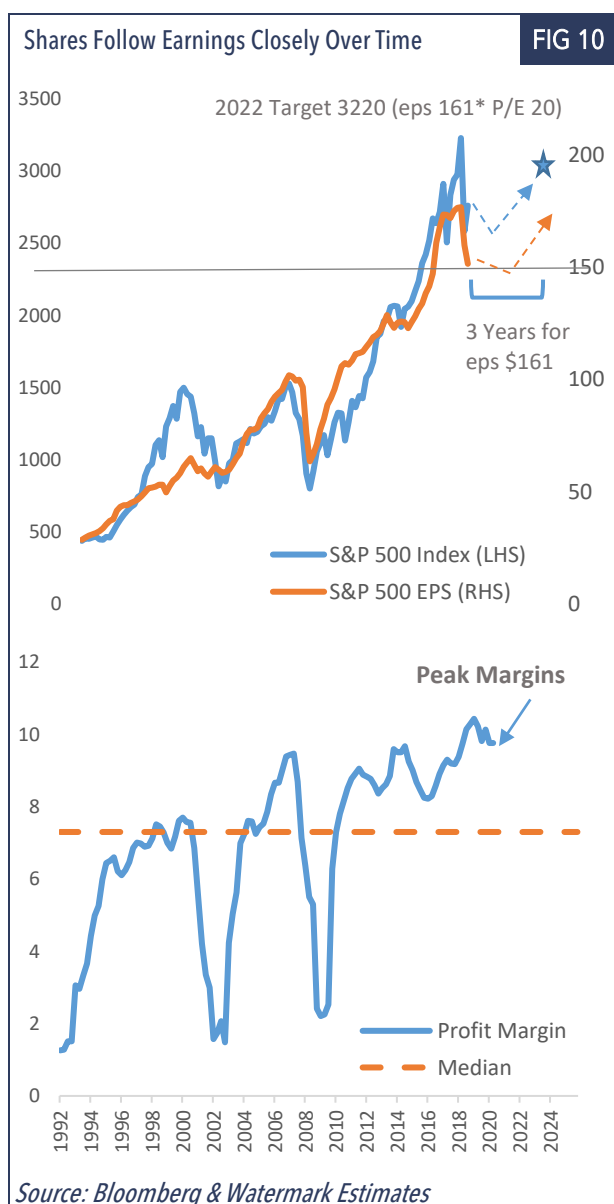


costs and poor productivity as we stop/start the machinery of the economy, this will be a feature of the recovery for some time.

Furthermore, we can no longer inflate performance through debt and buybacks - this is the Faustian bargain with regulators as a condition of the bailout (in the same way the banks had to de-lever after the financial crisis). Buybacks this year are expected to be \$500t less than last year.

### A realistic target for the share market

The share market is not a complete mystery, over time the value of shares closely follow underlying profit trends (Fig 10). Profits for the S&P 500 group of companies peaked last year and are expected to fall by at least 20% this year, as time passes that estimate may prove too optimistic.



Given the inflated starting point for margins (lower panel Fig 10), we suspect it will take at least the full 3 years for profits to return to prior levels.

If we give the bulls the benefit of the doubt and value those earnings on 20 times- (this is 1 standard deviation above the historic average), then the fair value for the SPX in 3 years time is 3220 or 8% above where it is today. In the meantime, we have a very deep valley to get across.

### How are the funds positioned?

Going into this crisis in February all Watermark funds were modestly short the share market, industrials shares in particular were very expensive and susceptible to an external shock like the COVID-19.

Because we were overweight smaller companies and a number of travel names in particular, we suffered a modest drawdown in March. We have since recovered much of this loss, leaving the value of our funds more or less unchanged since the beginning of the calendar year. This is a credible outcome through such a tumultuous period.

We would of course have liked to have made money for our investors through this period, but the speed with which the crisis developed took us by surprise and our stock selection was not ideal for what was an unpredictable turn of events.

We are well into this crisis now though. We have de-grossed our portfolios and tightened up our risk settings considerably. We are in a very strong position to navigate through the difficult period that lies ahead. Do not for a moment think the volatility that we saw in March has passed, there is still a long road ahead before we can safely say this crisis has passed. Our hedging strategies were made for this type of environment. If we can execute successfully, we can make money in both a rising and a falling market. I am very excited by the opportunities that lie ahead.

As you are aware, we have been on the sidelines with fully hedged settings in our directional funds in recent years, missing out on the strong rally ahead of this crisis. With the share market having fallen sharply, we are now looking for value to be restored to this market and the right opportunity to get long again.



That time is not now, with shares having already recovered much of the losses from the first phase of the crisis, we see more risk ahead for the share market, potentially retesting prior lows as the economy plumbs the depths of the downturn. I recall stories from John Galbraith's *The Great Crash 1929* and the smart money that shrewdly avoided the initial crash, only to get suckered into the subsequent rally and wiped out by the subsequent fall.

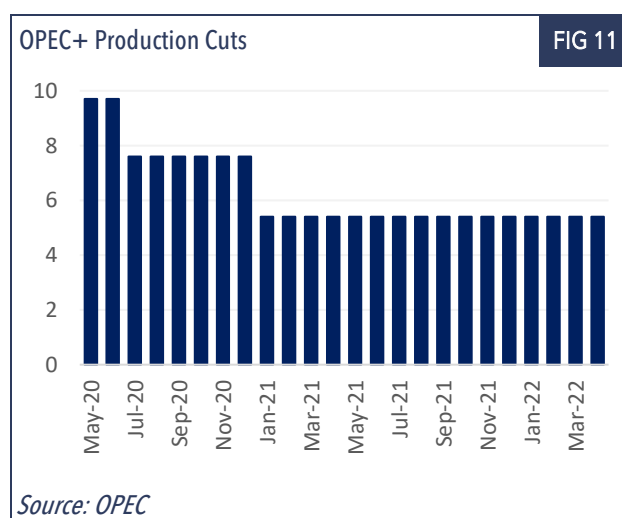
As we get further into this downturn and value is restored to this share market, I would like nothing more than to be presented with an opportunity to get very long once again in our directional funds and repeat the success we had in 2009 and 2010.

## PORTFOLIO REVIEW

### Basic Industries

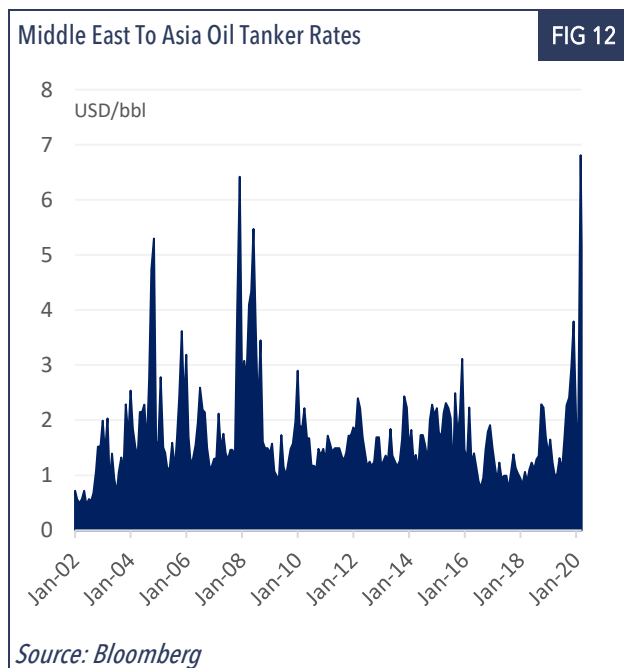
#### Oil: One/Two Punch Knocks Futures Down But Not Out

The oil market suffered two significant shocks in the March quarter. The first being the impact of reduced demand from COVID-19. The second was the failure of Saudi Arabia and Russia in finding an agreement over production cuts, in order to manage prices. Russia's willingness to dance to the OPEC tune had been waning due to a loss of market share (largely to the USA). Both Saudi Arabia and Russia suffer when prices fall below \$30/bbl, however US production is likely to enter a period of significant decline as a result of lower prices, resulting in a rebalance of market share. In early April, OPEC+ was able to form an agreement on cuts over the next two years, nevertheless the levels of cuts were not seen as enough by the market to offset the loss in demand. Oil prices and equities have stabilised for now, but medium-term industry impacts are likely to continue.



Usually, a geopolitical breakdown of OPEC+ would be a significant event in the oil sector, however it occurred at the same time as an unparalleled sudden fall in oil demand. With populations in lockdown, it is estimated that oil demand has fallen by c.25-30%, creating a 25-30mmbbl/day surplus. With OPEC+ cuts only agreed at 10mmbbl/day, the key question will be how the industry deals with this new paradigm. While headline cuts are a positive development, the market remains over supplied, setting up a scenario where storage becomes a limiting

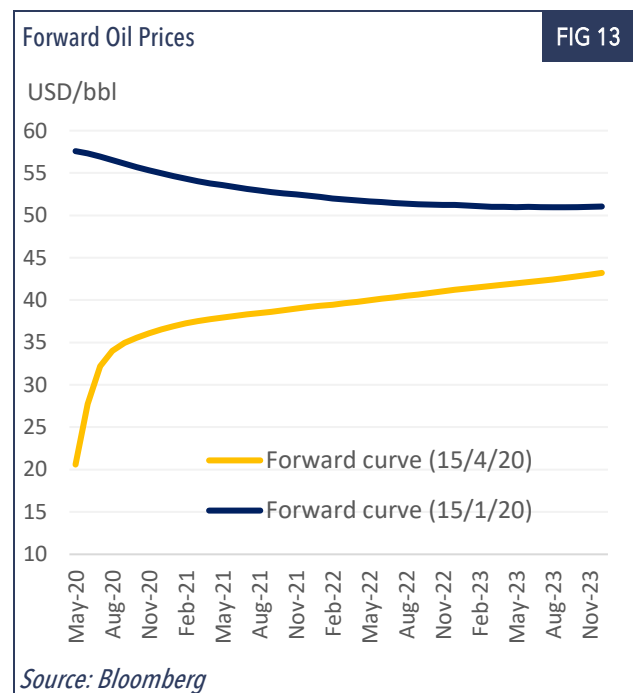
factor. If lockdown restrictions remain in place for an extended period, we are likely to see product inventories build, which will in turn result in reduced refinery runs and a build in crude oil inventory. As storage limits reach 'tank top', spot prices could trade below US\$20/bbl as producers are forced to take discounts due to the high cost of storage. This is already manifesting through increased tanker rates (Fig 12) as ships are repurposed as floating storage. Timing for a tank top event is open, with consensus suggesting between late May and August. However, we expect this to put pressure throughout the supply chain at different times in different locations and result in higher volatility. Producers will also be hesitant to shut-in capacity to avoid well degradation issues associated with turning off the taps on production and the capital required to restart once demand recovers.



Longer term however, the current situation sets the scene for a significant supply disruption. There have already been reductions of over US\$70bn in oil and gas capital expenditure, which will mean as demand recovers over the next few years, investment and production may struggle to keep pace. The US shale oil fields are likely to show larger falls in production given the sharp decline rates and lack of capital investment. With OPEC+ holding back production, CAPEX reductions and an acceleration in natural field decline, pricing will ultimately respond.

Prices have swung wildly over the past month between market fundamentals and sentiment. It is important not only to look at the headline prices but the future prices, as seen in (Fig 13). While the headline 'spot' price has

fallen from over US\$55/bbl to US\$20/bbl since the start of the year, future prices have only fallen US\$7/bbl. Equities have generally traded in line with spot pricing and this presents an opportunity to start adding quality, long-life oil and gas exposures. While we don't anticipate a V shaped recovery in oil demand, there are enough factors for us to remain optimistic that longer term pricing will see oil names recover some of their losses.



## TMT/Healthcare

### Winners, Losers & The Immune

The onset of the COVID-19 pandemic has had a disparate effect on the TMT and Healthcare sectors. After a period of initial panic selling, the market has started to distinguish between companies that benefit from the outbreak, others that are broadly immune, and those that will definitely suffer. Although the lines between one category and another can often become blurred depending on factors such as discount rates, growth profiles and investment horizons.

#### The Winners

Among the clear winners from COVID-19, we can count those companies that participate in the virus-induced policy and consumer response. For example, businesses that benefit from increased demand for Work From Home (WFH) services, those involved in dealing with respiratory outcomes in and out of the Intensive Care Unit (ICU) and

included in the distribution/retailing of medicines/supplements (Sigma, API and EBOS).

Companies that are benefitting from the WFH trend include telecommunications players (Telstra, TPG, Chorus, Spark) and data-connectivity providers (NextDC and Megaport) currently experiencing a spike in demand for their services. While Telstra has outperformed the ASX200 decline as one would expect from a defensive telco, its broad exposure to the community has also meant its business is not immune to softening activity levels (e.g. incoming tourist roaming revenues, small business bankruptcies, unemployment, etc.). A clear beneficiary of COVID-19 has been Fisher & Paykel, due to the surge in demand for hospital ventilators and its corresponding humidifiers and consumables. Whether this sudden spike is just a pull-forward of future demand or reflects an acceleration of the penetration of its nasal-high-flow solution, remains to be seen. Resmed is an interesting case in that its shares have benefited from both increased demand for its non-invasive ventilator solutions and evidence of accelerated resupply of masks. A question remains however, whether increased rates of new setups for sleep apnea and resupply of masks can be sustained as the health and economic impacts from COVID-19 are brought under control.

### The Immune

Some large and diversified businesses like CSL have suffered little to no disruption to inelastic demand for IG and albumin. At the same time, any supply shocks can, and hopefully will be mitigated further down the track due to the 6-9 months collection and manufacturing process. Other COVID-19 resilient names include many of the ASX-listed growth companies (the "WAAAX team" is a good example) that will undoubtedly suffer some level of short-term pain. In contrast, most of the share price value comes from future growth. These include software names with large addressable market penetration stories, as well as many emerging healthcare names. Ironically, for companies that are early in their development, a greater part of their DCF value is derived from long-term growth opportunities, rather than the first few years of cash flows. Hence, shifting earnings estimates one year forward has little to no effect on analysts' estimate of value. This is before we contemplate the impact of lower costs of funding as policymakers have driven interest rate curves down. This is not to be

confused with early-stage ventures with unproven products or business models and unstable funding structures.

The emerging healthcare sector provides a number of examples of growth companies with little or no revenue to speak of. Companies such as Polynovo and Avita keep growing at high rates just by re-supplying existing customers, although they are probably finding it difficult to land new accounts while hospitals are fully dedicated to fighting COVID-19. More mature businesses, for instance, Promedius are seeing practically no impact to its operations, where most of the revenue is of a recurring nature with guaranteed minimums in place. Companies in clinical trials like Mesoblast, Paradigm and Telix are probably going to have to extend timelines to monetisation events, given that most clinical trials have been placed on hold for safety reasons.

### The Losers

Clear losers from the COVID-19 outbreak include economically sensitive, operationally or financially geared businesses. In TMT, this label applies to virtually the entire media sector. Being highly cyclical, media names have all been decimated by sudden and unexpected collapses in advertising spend, triggering cost cuts (Nine) and capital raises (oOh!media, Southern Cross). Similarly, internet marketplaces (REA Group, Domain, Carsales and Seek) have suffered from a sudden decline in listings. However, debt and operational gearing are less of a concern in this segment - this depends on the length of the economic shutdown.

Similarly, perceived losers in Healthcare would include service providers where profitability, cash flows and dividends depend on the ability to have revenues exceed a substantial fixed cost base. As utilisation for hospitals beds, pathology tests or diagnostic imaging declines, profits decline more than proportionally (in some cases, potentially triggering losses and negative cash flow). Private hospitals represent a compelling hybrid case. As the Government mandated the cancellation of Category 2 and 3 surgeries (those that are not emergencies and can be postponed), private hospitals were left with all their medical and nursing staff on the books, as well as rents and overheads. To avoid having the hospitals shut down capacity amidst a potential surge in need for hospital beds, the Federal and State governments have agreed to



guarantee the viability of private hospitals by covering the fixed costs of nursing and medical staff, medical supplies, rents and some level of overhead. This effectively means that for the duration of the COVID-19 emergency, the hospitals will achieve a balanced result before interests and taxes (EBIT = 0 although the details are still work in progress at the time of writing). Cochlear has been an apparent victim of the pandemic, suffering significant share price falls given its business is at risk of incurring a period of outright negative EBITDA. Most elective surgeries for cochlear implants (especially in adults) will be delayed while hospitals are almost entirely dedicated to tackling the COVID-19 surge.

## Financials

### The Longer It Goes The Worse It Gets For Bank Bad Debts

Unprecedented is quickly becoming the word of 2020. We see ourselves facing the sharpest economic activity decline in history. This may persist for 6-12 months seeing many companies bankrupt, or it may end suddenly with a spike in latent demand fuelled by the largest stimulus ever actioned in Australia.

Prima facie, bank share prices remain cheap and have underperformed in the recent market rally. However, we believe that stimulus measures could prolong the pain and in the long run, will damage the banking system. We see risks that Australia follows Europe into a zombie banking economy where balance sheets remain lazy and sustainable returns fall below the cost of equity. This is coupled with historical low rates and few levers to pull to avoid further crises.

We discuss 3 key drivers for bank balance sheets below:

1. Government/Regulatory support
2. Bank balance sheet lending
  - a) Mortgages
  - b) SMEs
  - c) Consumer Credit

3. What the shape of the recovery means, whether V, U or L shaped.

## Government & Regulatory Support

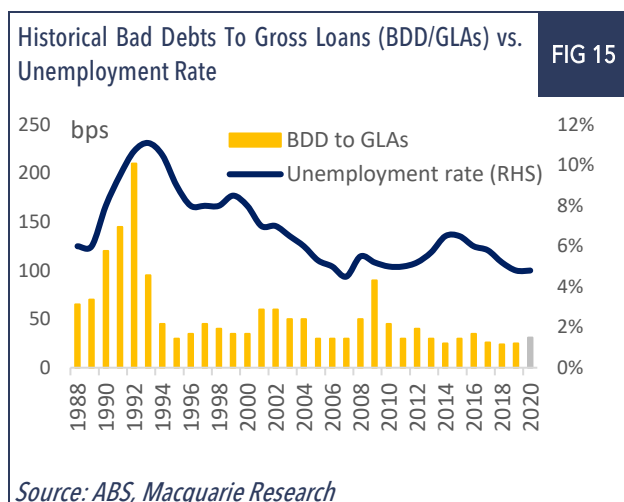
To date, the Australian government and relevant agencies have come out with all guns blazing. The government's Job keeper is, in our view the most significant, equating to ~6.5% of GDP and will keep ~6m people (or more than half the workforce) in jobs. We list notable interventions (Fig 14), each of which we consider significant in isolation. Goldman Sachs estimates total federal & state spending in response to COVID-19 now amounts to around 10% of GDP.

Response To COVID-19		FIG 14
RBA	Cash rate: -25bps to 0.50%	
Govt.	One-off \$750 to welfare recipients	
RBA	Cash rate: -25bps to 0.25%	
RBA	RBA starts QE targeting 3-year bond of 25bps	
APRA	Loosens capital requirements for banks	
Banks	Defer affected SME & household repayments for 6 months	
Govt.	Govt loosens responsible lending restrictions	
Govt.	Early release of superannuation up to \$20k;	
Govt.	SME Guarantee Scheme of 50% (up to \$20b) to support \$40b in new SME loans	
Govt.	Increasing bankruptcy and insolvency thresholds	
Govt.	JobKeeper wage subsidy of \$1,500 per fortnight per eligible employee for up to six	
APRA	Writes to regulated institutions suggesting dividends be reassessed.	

Source: RBA

## Bad Debts

It is easy to call on the GFC as a reference point, but given the relatively small move in unemployment during that period, we prefer to use the 90's recession experience. During this period, credit charge offs rose to more than 10 times the level observed last year in FY19. To put this in perspective, 200bps of losses would wipe out more than a year's earnings for each of the major banks.

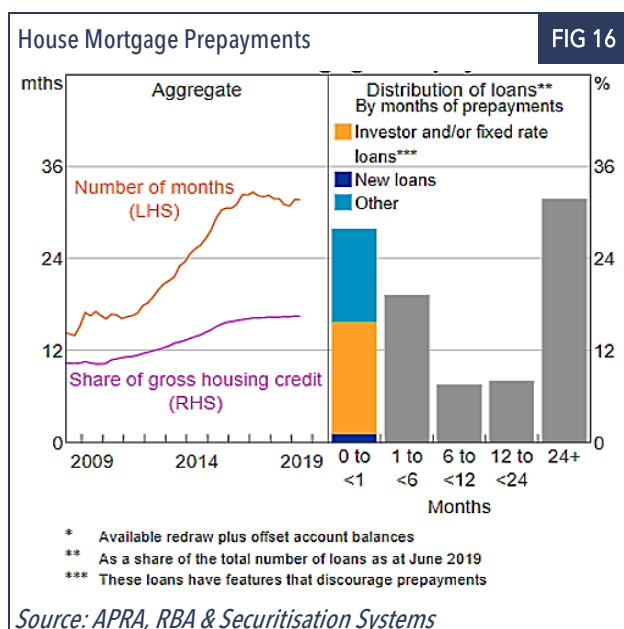


## Mortgages

Residential mortgages remain the largest exposure across the major banks. While we expect unemployment comparable with the early 90's, we see numerous factors offsetting widespread losses across mortgage books, including:

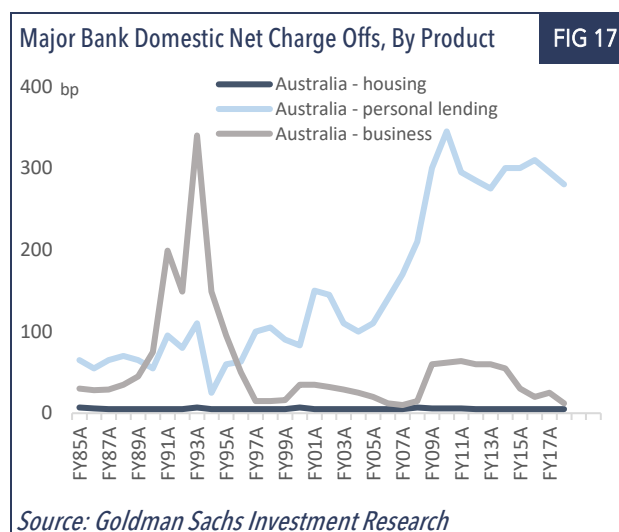
1. Significant stimulus ~10% of GDP
2. Borrower repayment breaks, additionally a large proportion of borrowers are ahead of payments - this has accelerated during rate cuts (Fig 16).
3. Dynamic (after house price appreciation) Loan to Value ratios of ~50% across mortgage books of the big 4 banks.

Even during the 90's recession, Australian mortgage losses remain modest, however household leverage has increased significantly since that period. Household debt to income has now increased by a factor of three, to 180% of income.



## SME

Outcomes for business loans remain a key unknown. During a typical recession we would expect a material drop in revenue, however the nature of COVID-19 sees entire streams of revenue halted for some industries. In the 1990's, business lending losses drove most bad debt charges, peaking at >300bps. This is nearly 10x FY19 charges - we would also expect sharper losses than early 90's in a concentration of highly exposed industries. As indicated by CBA credit card data below, some businesses are facing a near complete loss of revenue and therefore no ability to service debt.



## Personal Lending

Again looking at the 1990's recession, the most significant losses in household lending were in personal lending and credit card books. Banks have reduced lending to this space, but losses take time to emerge, particularly in credit cards.

## The Shape Of The Recovery Is Key

Australia appears to have avoided the L scenario, a structural and persistent decline in economic activity. This leaves us with a U shape recovery as a base case, where certain businesses which can survive a ~6 month demand collapse benefit from a sharp increase in consumer demand and stimulus on the other side. For banks, this means that issues won't emerge in the short term, but we are likely to see a deluge of issues when stimulus and regulatory support subsides.

While efforts from governments and other agencies to provide financial support will provide short-term relief,

measures implemented to contain the spread of COVID-19 are likely to last for longer than 6 months. This will surely have a severe impact on many industries which face an extended period with near total loss of revenue – think international travel, entertainment, events and hospitality involving groups of more than 50 people gathering (think entertainment events, large scale hospitality, weddings, sports). The data below shows declines in credit card spending across a range of categories. While these are averages, it is fair to assume given the quantum of the declines that many businesses have had revenues completely wiped out.

Change In Card Spending In the Week Ended 3 <sup>rd</sup> April 2020 From A Year Ago		FIG 18
Category	% change on year	
Food services (includes cafes & restaurants)	-0.38	
Alcohol services (pubs, hotels, etc)	-0.71	
Clothing & footwear	-0.6	
Personal care (beauty and barber shops, massage parlours, etc)	-0.56	
Medical care & health	-0.3	
Transport (including public transport)	-0.3	
Recreation (accommodation, air travel & travel services)	-0.33	

Source: Commonwealth Bank of Australia

There are of course many peripheral areas of the economy and borrower incomes that rely on this activity. This has the potential to leave an already challenged banking landscape even more vulnerable for years to come.

## Consumer/Industrial

### Super Retail Group

Share price movements in the Consumer sector were more volatile than most in the March quarter given COVID-19 social distancing policies directly discourage consumption. In the case of ASX listed companies such as the casinos; leisure and retail operators, revenues have dropped to zero in recent weeks. This has seen some companies rapidly approach insolvency, driving exponential moves in equity valuations.

In general, management teams and investors have been working with limited information that is also continually changing. To reflect this, most impacted companies have removed earnings guidance from the market, leaving consensus earnings forecasts largely worthless as no one really knows what the earnings bases of these companies will be in 1-2 years. Reflecting the lack of company-specific information and the volatility of markets, most of the share price moves to date appear to have been macro-driven. These businesses have been placed in baskets such as; 'staple', 'discretionary', 'debt-laden', 'insolvent', and traded as such. The principle focus for investors in recent weeks has been to de-risk at pace.

Looking forward however, the rapid de-risking has created opportunities for specific shares that have been placed in the wrong basket and are therefore mispriced. For example, it is clear to us that action taken by the Australian government to curb COVID-19 infection spread together with geographic isolation, will almost certainly see Australian domestic consumption recover earlier than in other economies globally. For this reason, we have built long exposure to domestic cyclical and hold a short tilt to businesses with US consumer exposure. We expect US unemployment to increase materially and take longer to recover.

For example, Super Retail Group (SUL) is a domestic consumer cyclical company that was added to the portfolio in recent weeks. It owns and operates a portfolio of retail brands across Australia which include automotive retailer Supercheap Auto, outdoor and leisure retailers Macpac and BCF and sporting retailer Rebel Sport. SUL was placed in the 'capital raise' basket and was sold down as low as \$3.02 on the 23<sup>rd</sup> of March from a high of \$10.20 in February, a 70% value reduction. There are several factors that attract us to this business which include:

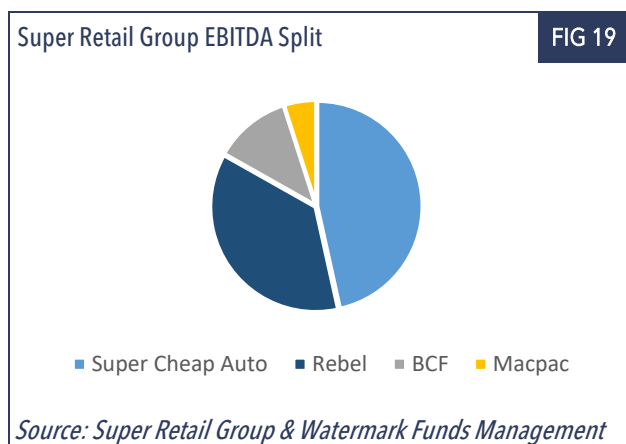
- 1) First and foremost, ~90% of SUL's store network remains open for business, and its two core chains are trading well. This is a key differentiator. We note that retailers such as Lovisa, Accent Group, Premier Investments and Kathmandu have closed most of their stores. Importantly, any retailer that is closed and in cash-burn mode will come out of the lockdown period with either much higher debt or more shares on issue, either of which would constitute a structural change to their balance sheets and be detrimental to their valuation. In



addition, it is also likely that the reopening of stores will be complex and bringing key stakeholders (employees, insurers, landlords) along for the ride will be challenging. Some retailers will also find that a number of customers have left for other channels, which may make some of their stores uneconomic. SUL investors can be less worried about these issues.

2) While SUL is not an exciting company for its growth opportunities, it does have two market leading retail brands in Super Cheap and Rebel. This is important from a balance sheet perspective, as banks have shown a tendency to open lines of credit to their existing and highest quality customers first. In recent weeks SUL has secured additional lines of liquidity, reflecting the quality of its brands. This, together with its functioning store network, means it has not required new equity.

3) We were attracted to the relative valuation at \$3.02 as SUL has seen similar magnitude share price declines as other retailers. However, the risks facing the business are far less severe. We see this as a good risk/reward investment for the current climate.



## Fund Review

The Funds avoided any major damage as markets crashed in the final week of February. Up until that point, performance through the Australian corporate reporting season had been solid, managing to keep pace with a strong underlying market and on the right side of most results.

As has been mentioned earlier in this newsletter, the speed and severity with which the COVID-19 pandemic impacted asset markets in late February took us by surprise and the Funds were exposed, albeit to a limited

extent, due to modest skews in favour of smaller companies, and companies with cyclical exposure to the recovering economy – namely travel, leisure and casino companies.

The Consumer sector was the biggest detractor from returns in the quarter, having borne the brunt of the worst impacts of measures taken to restrict the transmission of the virus. In Healthcare, losses were more limited, having carried relatively conservative positioning into to crisis. The Basic Industries portfolio was largely flat, apart from some losses on investments in smaller gas producers, which sold off with the broader energy sector. Financials was the best performing sector, with nimble positioning allowing us to take advantage of increased risks for the 2nd tier banks and emerging platform businesses, which are impacted by lower interest rates. Shorts in the real estate sector, particularly those REITS with exposure to the retail sector were also successful.

We use Share Price Index Futures to manage the Funds' net exposure levels, where we need to make adjustments in response to changing market conditions or where there is a mismatch between the net exposure arising from long and short exposures and our view on the market. With volatility rising to levels during the quarter not seen since the European sovereign debt crisis, our ability to respond quickly and make changes to the portfolio settings has been valuable. Exposures to SPI Futures (mostly to move the fund shorter) were also a valuable contributor to returns in the period.

## Quarterly Performance by Sector

Sector	Portfolio
TMT	-1.52
Healthcare	-0.14
Consumer	-4.98
Industrials	-0.31
Basic Industries	-0.54
Financials	3.86
Other	1.19

Portfolio data is for positions in Watermark Market Neutral Trust.

## Fund at a Glance – March 2020

ASX Code	ALF
Fund Size	AU\$208.8
Fund Strategy	Variable Beta
Share Price	\$0.87
Shares on Issue	199.0m
Net Exposure	-6.6%

\*The After-Tax NTA includes a \$0.075 per share deferred tax asset, which is net of tax liabilities accrued in the current financial year.

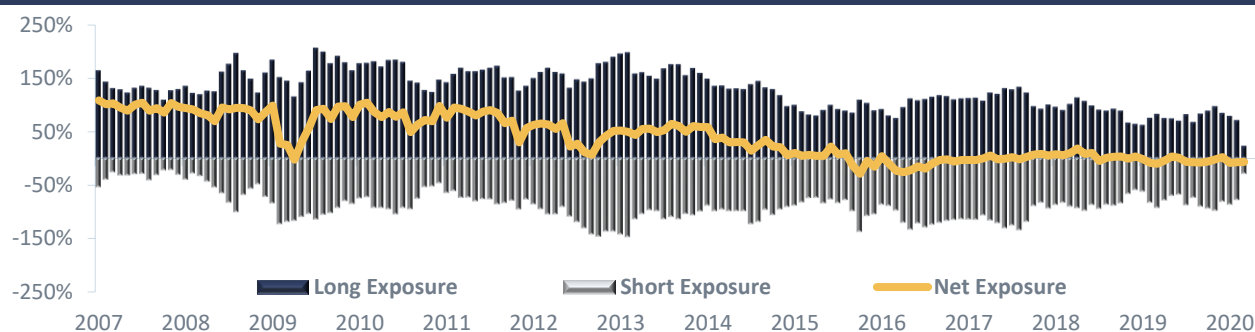
## Net Tangible Asset (NTA) Backing

	Feb 20	Mar 20
NTA Before Tax	\$1.15	\$1.13
NTA After Tax	\$1.13	\$1.13*

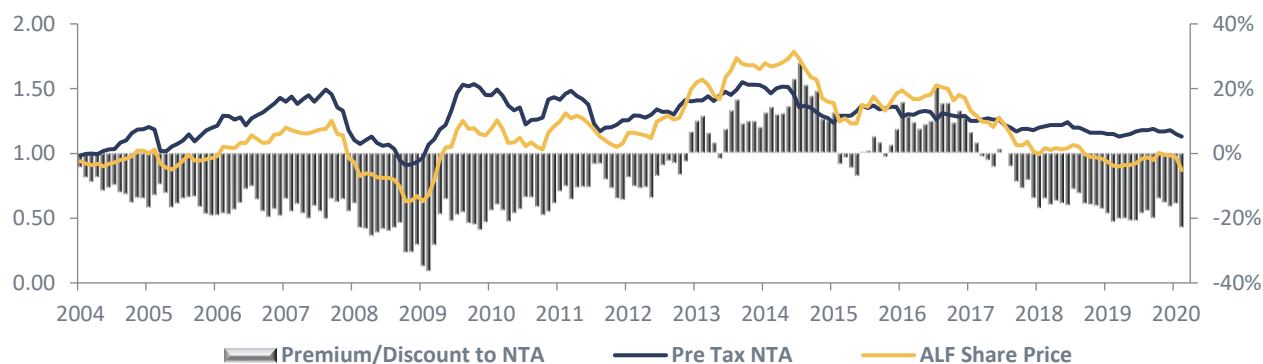
## Gross Portfolio Structure

Long Exposure	71.8%	23.6%
Short Exposure	-78.8%	-30.3%
Gross Exposure	150.6%	53.9%
Cash	107.0%	106.6%

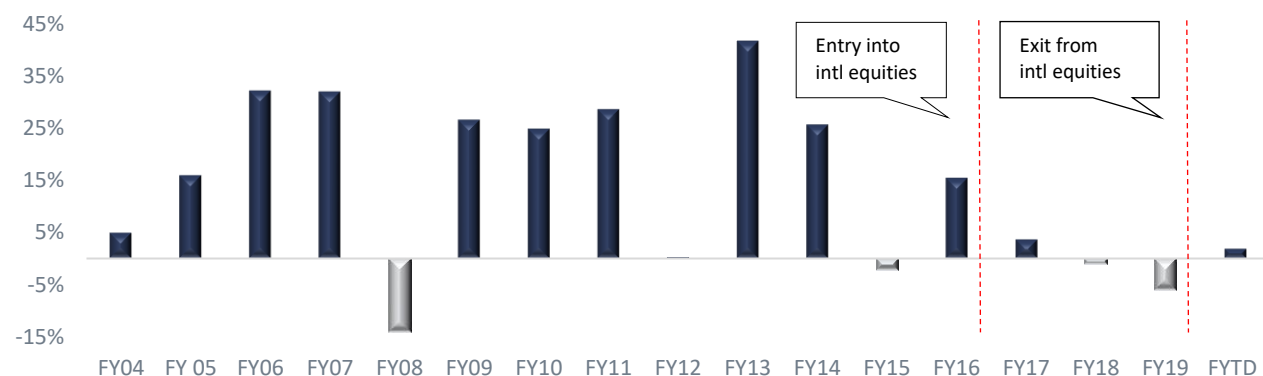
## Net Equity Exposure



## Historical Premium/Discount to NTA History



## Gross Portfolio Return





### Fund at a Glance – March 2020

Fund Size	AU\$44m
Strategy FUM	AU\$120m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

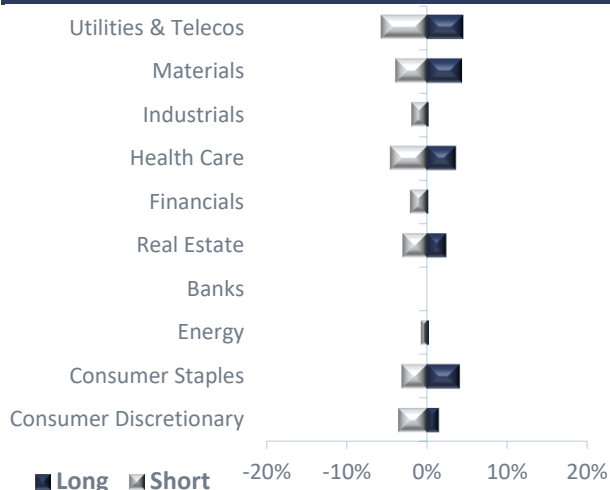
### Return Characteristics

Positive Months	65%
Portfolio Beta	-0.1%
Sharpe Ratio	0.7
Sortino Ratio	2.2
Standard Deviation	6.6%
No. Long Positions	28
No. Short Positions	42
Gross Exposure	50.1%

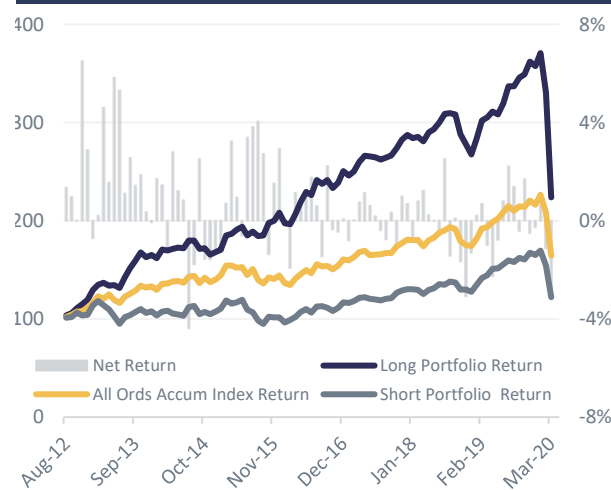
### Performance

	1 Mth	FYTD	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	SI (pa)
WMNT (net return)	-2.7%	1.3%	-1.0%	-1.2%	3.3%	5.4%	7.0%
RBA Cash Rate	0.0%	0.6%	1.0%	1.3%	1.5%	1.8%	1.9%
<b>Outperformance</b>	<b>-2.7%</b>	<b>0.7%</b>	<b>-2.0%</b>	<b>-2.5%</b>	<b>1.8%</b>	<b>3.6%</b>	<b>5.1%</b>

### 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	-0.78	0.80	2.21	1.38	-0.41	1.69	-0.51	-0.27	1.68
2020	1.08	-1.12	-2.72										-2.76





### Fund at a Glance - March 2020

Fund Size	AU\$33m
Strategy FUM	AU\$242m
Fund Inception Date	May 2019
Fund Strategy	Variable Beta
Application/Redemption	Monthly
Benchmark	RBA Cash Rate

### Return Characteristics

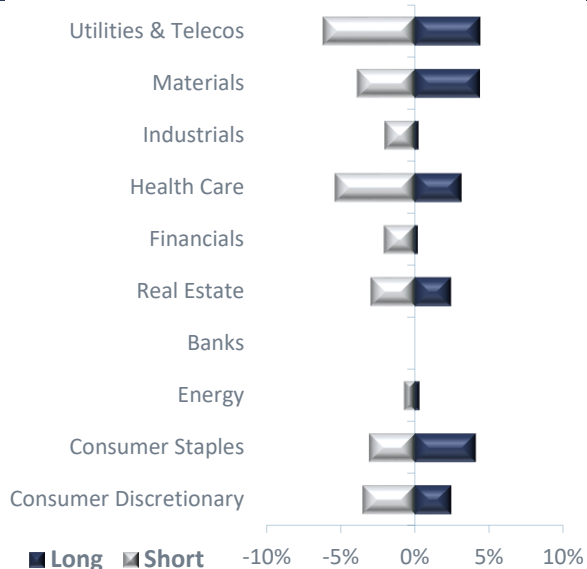
No. Long Positions	31
No. Short Positions	44
Gross Exposure	53.8%
Net Exposure	-6.5%

**Unit Price** **\$1.0158**

### Performance

	1 Mth	3 Mths	FYTD	SI
WARF (net return)	-2.4%	-2.8%	1.3%	1.6%
RBA Cash Rate	0.0%	0.2%	0.6%	0.8%
<b>Outperformance</b>	-2.4%	-3.0%	0.7%	0.8%

### Sector Exposures



### Gross Portfolio Structure

Investment Type	\$m	%
Listed Securities - Long	7.8	23.7
Listed Securities - Short	-10.0	-30.2
<b>Net Exposure</b>	<b>-2.1</b>	<b>-6.5</b>
Cash	35.1	106.5
<b>Capital</b>	<b>33</b>	<b>100</b>

### Managing your Investment

The Fund is priced monthly, on or around the 6th business day of each month. Boardroom Limited, who manage the unit registry for the Fund, will accept applications and redemption requests up until 2pm on the 10th business day of each month, giving investors the opportunity to review the latest unit price before deciding to apply for, or redeem units. Redemption proceeds will ordinarily be paid within 5 days of the cut off. Investors should refer to the Product Disclosure Statement for the Watermark Absolute Return Fund for details on applying for and redeeming units in the Fund.

For any queries regarding your unit holding, please contact the unit registry managed by Boardroom Limited at [watermark@boardroomlited.com.au](mailto:watermark@boardroomlited.com.au); or 1300 737 760.

## Notes

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