# WATERMARK ABSOLUTE RETURN FUND

## Monthly update –January 2022

APIR ETL8732AU
APIR ETL5025AU

WATERMARK FUNDS MANAGEMENT

| FUND AT A GLANCE | |
|---|---|
| Fund Strategy | Variable Beta |
| Benchmark | RBA Cash rate |
| WARF Ord.Unit NAV | $1.101* |
| WARF Ord.Unit Applic/Redeem | $1.105/1.098* |
| WARF B Class NAV (Ex ALF) | $1.053* |
| WARF B Class Redeem | $1.033* |

**After distribution (Please see below)*

| PORTFOLIO CONSTRUCTION | |
|---|---|
| No. Long Positions | 100 |
| No. Short Positions | 89 |
| Gross Exposure | 209% |
| Net Exposure | -1% |
| Funds in Strategy | 124M |

## INTERIM DISTRIBUTION

The Investment Manager has declared the following interim distribution for period ending 31 December 2021

| | |
|---|---|
| WARF Ord.Unit Distribution | 1.02 cents per unit |
| WARF B Class Distribution | 0.97 cents per unit |
| Expected Payment | On or around 22 February 2022 |

## GROSS PORTFOLIO STRUCTURE

| Investment Type | % |
|---|---|
| Listed Securities – Long | 104 |
| Listed Securities – Short | -105 |
| Cash | 101 |

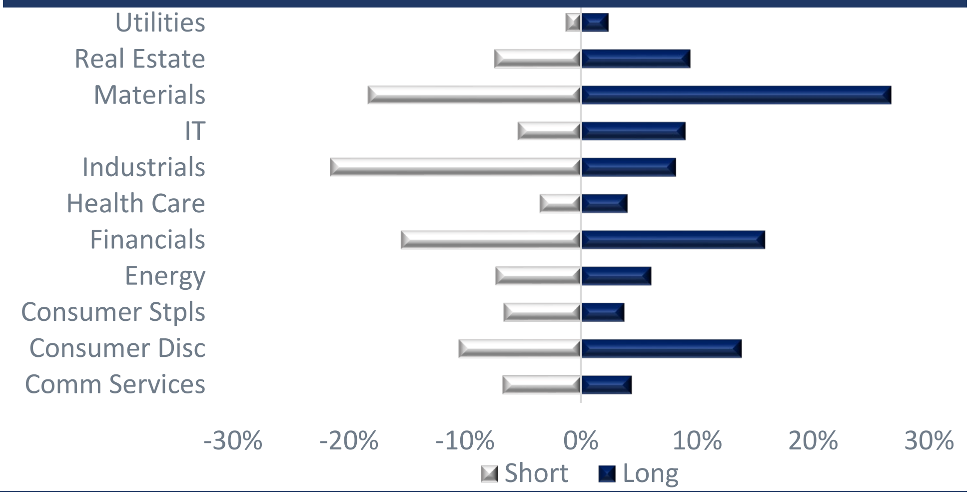
## CONTRIBUTION

| Top | Bottom |
|---|---|
| Wisetech | Woodside |
| Reliance Worldwide | Pinnacle Investment |
| Australian Ethical Investment | James Hardie |

## TOP 10 LONG HOLDINGS

- Santos
- Telstra Corp
- Aristocrat leisure
- QBE Insurance Group
- Macquarie Group
- Computershare
- Bapcor
- Origin Energy
- Allkem
- Atlas Arteria

## SECTOR EXPOSURES




## KEY RISK INDICATORS

| Beta | Volatility | Information Ratio |
|---|---|---|
| 0.11 | 4.89% | 0.88 |

## MONTHLY NET PERFORMANCE (%)

| | 1 Month | 3 Months | FYTD | **Inception (pa) |
|---|---|---|---|---|
| WARF Ord Unit (Established May 2019) | -0.2 | 1.3 | 5.4 | 9.7 |
| RBA Cash Rate | 0.0 | 0.0 | 0.0 | 3.3 |
| **Outperformance** | **-0.2** | **1.3** | **5.4** | **6.4** |
| | **1 Month** | **3 Months** | **FYTD** | ****Inception (pa)** |
| WARF B Unit (Established 26 March 2021) | 0.1 | 1.3 | 6.2 | 9.8 |
| RBA Cash Rate | 0.0 | 0.0 | 0.0 | 3.3 |
| **Outperformance** | **0.1** | **1.3** | **6.0** | **6.5** |

***Historic returns from ALF:ASX- same variable beta strategy established in 2004*
*Difference in monthly returns based on fee structure (B class –no management fee charged in first 12months of issue) and high watermarks for calculation of performance fees. Past performance is not an indicator of future performance.*

## MONTH IN REVIEW

The Australian Share market experienced a steep correction in January, with the All-Ordinaries Index down 6.4%. Hawkish comments from the US Federal Reserve in early January drove markets to price in more aggressive tightening policy. This saw a route in the Technology sector, down 18.4% in the month. The Energy sector out-performed materially, up 7.9%, on risk of supply pressures.

'Value' continued to outperform 'growth' in January. This factor rotation continues to be the dominant driver of returns and has accelerated again in early 2022.

The Watermark portfolio delivered a return in January of -0.2% despite the aggressive market correction. The strategy settings were successful in protecting investor capital, our primary objective. After the first seven months of the FY22 financial year the fund has delivered a return of 5.4%, on track for our 8-10% annual target.

## MARKET OUTLOOK

It looks like the bear has emerged from his cave a little earlier than we expected. Roll forward to mid-year and hindsight will show the 2009 secular bull market peaked 5 months ago in August 2021, when the ASX 200 hit 7630.

The share market failed to reach new highs in December (a warning sign) and while we may see another attempt in the months ahead, I suspect we again fall short, indicating the bear market has begun.

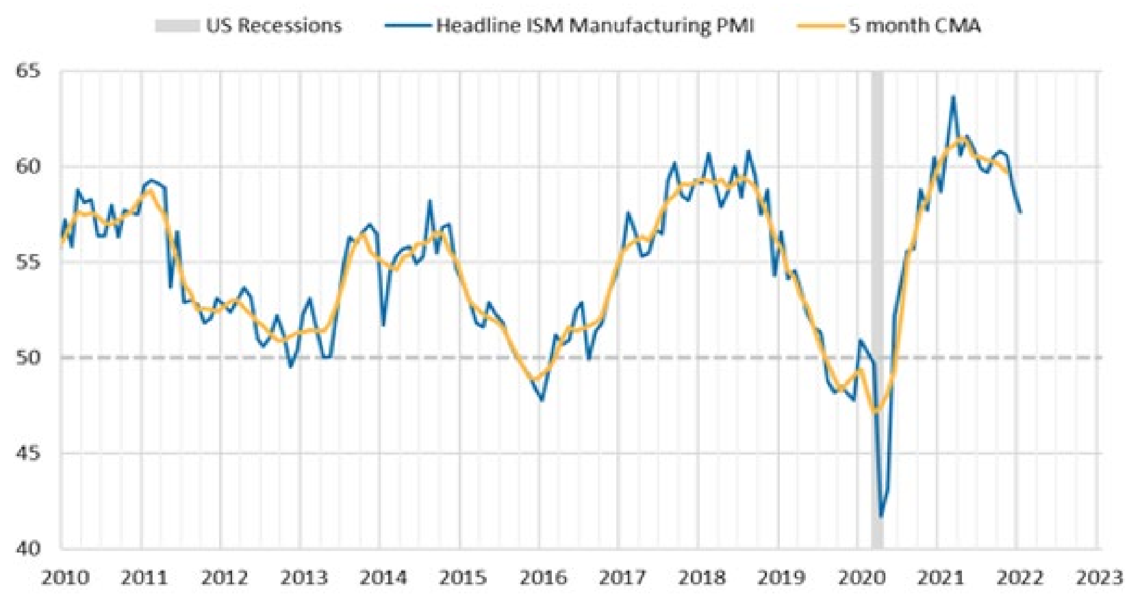
The depth of the draw dawn in January, along with multiple signs of distribution (emerging markets, unprofitable technology, and small caps have all peaked) would suggest the high is in. Instead of 'buying the dips' investors will look to sell the rallies that lie ahead.

As COVID has lingered longer than expected, central banks have continued with emergency settings longer than they should have, over- stimulating western economies.

Ideally, monetary stimulus is withdrawn as growth accelerates. The risk we face now is with central banks tightening abruptly as economies are slowing.

In *Fig 1*, you can see leading economic indicators are already rolling over.

**Figure 1: ISM Manufacturing PMI vs US Recessions**



Following hawkish commentary from the US Federal Reserve in January, rate markets sold off, quickly pricing in further rate hikes this year and a move to 'Quantitative Tightening' from mid-year.

Real interest rates surged higher putting inflated asset values under pressure.

With a few exceptions, inflation has been contained outside of the US to date. In recent weeks however this has changed, with poor CPI reports out of the UK, Japan, Europe and even Australia. The BoE and the ECB have both shifted back to combating inflation. Look at the breakout in the 2-year German bund as a game changer.

**Figure 2: 2-year German Bund**


*Source: Bloomberg*

This is a significant shift from last year, where markets where comfortable policy would normalise slowly without impacting demand or asset markets.

Going back over 50 years, as policy has been tightened, economies fall into recession most of the time. There are very few exceptions where recessions have been avoided when policy has been tightened as an economy slows.

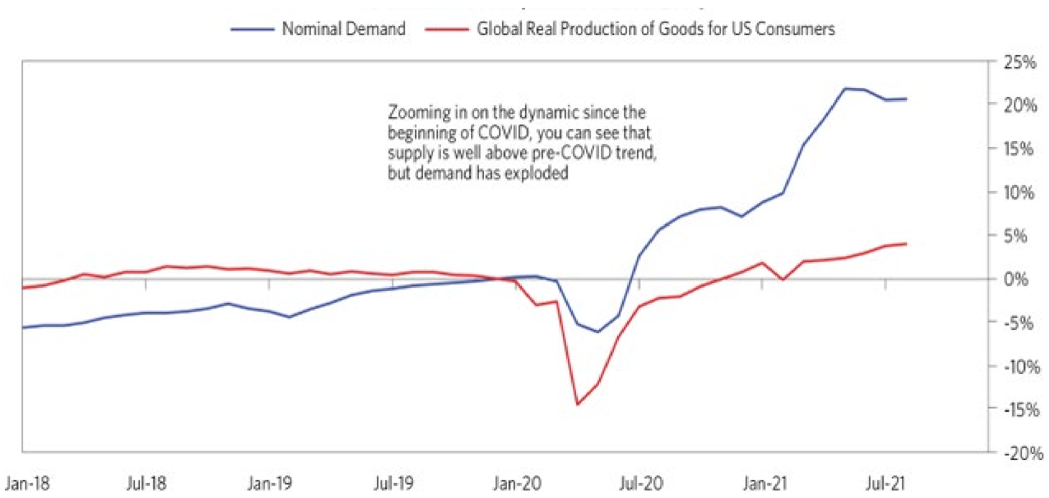
This is complicated further this time around given both monetary and fiscal policy tools were fully deployed to combat COVID. The US Congressional Budget Office expects a 4% drag on GDP from the unwind of fiscal measures alone, with the fiscal deficit falling from 12% of GDP to 8% of GDP. Couple with tighter monetary policy, which is an unprecedented 5-6% combined drag on growth.

You would be aware of the great debate raging over the persistence of inflation. Policy makers have pointed to supply chain disruptions from the health crisis, as the root cause of pricing pressures, expecting them to abate as COVID passes and the supply side of the economy recovers.

An alternative, equally compelling case (put forward by Bridgewater Assoc.) suggests the tightness in product markets has been caused by a demand shock, a consequence of excessive stimulus.

In *Fig 3*, you can see real production of goods globally is well ahead of pre-COVID levels (red line), the demand/supply gap is principally a result of excess demand- over $US2 trillion of stimulus was injected into the US economy alone last year, an economy of $23 trillion.

**Figure 3: US Consumer Goods (Indexed to End of 2019)**




*Source: Bridgewater Assoc.*

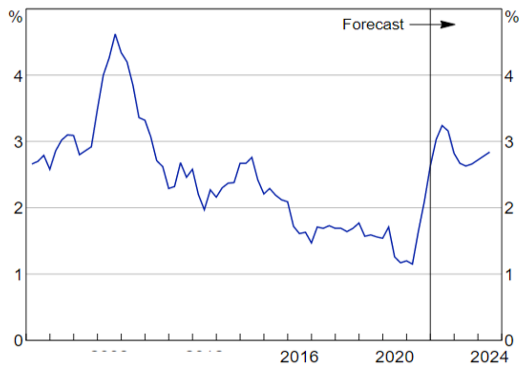
This is an important distinction and certainly not one central bank want to hear, as it lays the blame squarely at policy maker's feet.

It's not quite as simple as taking the punchbowl away either. The excess demand will continue for longer given accumulated savings; excess credit; and inflated asset values (US household net worth is up 30% in recent years). The demand bubble may need to be punctured rather than deflated.

Excess demand has tightened product markets for materials, energy, and labour. As the services side of the economy recovers this will put further pressure on the labour supply. Central banks across the OECD including Australia have revised down their expectations for unemployment. We are quickly approaching full employment with zero interest rates and ongoing liquidity injection (QE).

The RBA truly has its head in the sand. While they cancelled any further asset purchases, they are sticking to forward interest rate guidance (no hikes before 2023) all the while shifting upwards expectations for inflation and employment. This is a major risk for asset markets in Australia, the RBA has the longest path to walk in re-establishing its inflation fighting credentials (*Fig 4*).

**Figure 4: Trimmed Mean Inflation (Year-ended)**




*Source: ABS: RBA*

To be clear, I am not concerned about inflation surging higher from here, as long as product and labour markets remain tight, upward pressure on pricing will continue. As we move through the year, investors will worry less about inflation as demand moderates and supply recovers, focusing instead on the prospect of a recession next year.

Shares short term are over sold and will rally in the months ahead, providing us an opportunity to get short ahead of an even bigger draw down in Q2.

The portfolio held its value in January while risk assets were falling everywhere. We will be selling into any rally, getting short, so we can profit from the next move lower. It's going to be a great year to be short the share market.

## SECTORS IN REVIEW

***Financials*** had a marginally positive month. Shorts in banks and fintech shares helped offset losses in real estate and insurance sectors. Our key long in the month was *Macquarie Group (MQG), which is moving* from strength to strength. The business continues to benefit from volatile energy markets through its *Commodities and Global Markets (CGM)* division. At the same time, *MQG* is leveraging its exposure to the energy transition through its *Green Investment Group (GIG). MQG* may see some volatility in the turbulent markets, but it remains a structural beneficiary of the two big thematics we see driving the next decade.

***Technology*** had a strong month in January. This was defined by our overall short stance on the sector. The biggest contributors were large cap tech shares *Wisetech (WTC)* and *Xero (XRO).* These market darlings held strongly over the first half of the month. They then joined the sell off with vengeance, finishing the month down 26% for *WTC* and 20% for *XRO*. We have since brought down our overall short exposure in technology but remain cautious on the sector with interest rates continuing to press higher.

The ***Consumer*** sector made a positive contribution to the month aided by short positions in consumer 'growth' stocks and discretionary retailers. Looking forward, we expect the sector to be impacted by the hangover from excessive government stimulus and a redirection of spending away from durable goods back toward services (travel, restaurants, etc). In addition, the prospect of higher interest rates will likely impact household disposable income and sentiment in the year ahead.
In the near-term, stock performance will be dictated by the upcoming interim results and trading outlooks. We expect outlook statements to be more subdued given a less certain consumer setting. Given both the near-term and medium-term outlooks for discretionary spending are now negative, we have lifted our net-short positioning on the sector.

In ***Consumer Staples***, we have pivoted from a net-short position to net-long having added long positions in Fuel Retail. Supermarkets outperformed in January and may continue to do so if equity markets remain volatile.

***Building Materials:*** While residential building activity is strong, investors are thinking about weaker trends later this year and into next year and selling 'builders.' Mortgage rates have backed up 100bpts; the migration hole from COVID means less household formation next year.

***Chemicals:*** We have taken profits in *Incitec Pivot* (*IPL*), while fertiliser prices may move higher still, there is a new emerging threat from Chinese producers. We have added *Orica* (*ORI*) to the portfolio, the business has been downgrading for years, profits have rebased and as COVID passed the disruptions to the business should abate and the company can start growing again.

***Healthcare:*** *Ansell* (*ANN*), a key short in the portfolio downgraded guidance with weaker pricing in exam gloves as Asian manufacturing add new capacity and demand softens from peak COVID levels. While *ResMed* (*RMD*) is well positioned to capture share following the Phillips recall, in the short term they are struggling to meet demand given component shortages, weighing on results.

In ***Mining*** –Suppliers of battery materials performed well in January as Lithium prices soared. Key names in the portfolio – *Allkem* (*AKE*); *Fire Finch* (*FFX*), *Galan Lithium* (*GLN*) performing well. We initiated a position in *Green Technology Metals* (*GT1*) one of a handful of players opening a new lithium province in Ontario, Canada.

In ***Gold***, emerging producers *Tietto Minerals* (*TIE*) and *Predictive Discovery* (*PDI*) have both release exciting new drilling results adding meaningfully to resource estimates.

***Energy:*** We have added to *Vintage Energy* (*VEN*) one of a handful of emerging gas producers with exciting prospects in the Cooper and Perth basins. They have signed off stake agreements with *AGL* (*AGL*) and will be in production by Q2'2022.

## MONTHLY NET PERFORMANCE (%) *

| YEAR | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | FYTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| FY04 | | | | | | | | 0.3 | 1.1 | 0.2 | 0.0 | 1.8 | 3.4 |
| FY05 | 1.0 | -0.3 | 3.7 | 2.3 | 3.6 | 2.0 | 0.3 | 1.0 | -0.7 | -4.9 | -0.4 | 3.9 | 11.7 |
| FY06 | 2.0 | 2.2 | 3.9 | -2.3 | 3.1 | 3.1 | 1.3 | 1.6 | 5.3 | 2.7 | -1.0 | 0.9 | 25.0 |
| FY07 | -3.1 | 4.4 | 1.8 | 6.3 | 2.5 | 2.0 | 2.8 | -1.7 | 2.8 | 1.1 | 2.2 | 1.8 | 25.0 |
| FY08 | -1.0 | 4.1 | 2.5 | 0.8 | -0.1 | -1.4 | -11.7 | -8.3 | 1.4 | 4.4 | 1.5 | -7.1 | -15.1 |
| FY09 | -1.1 | 5.3 | -5.2 | -16.0 | -6.3 | 3.2 | 2.5 | 3.1 | 16.2 | 7.3 | 10.1 | 7.1 | 24.5 |
| FY10 | 9.3 | 11.2 | 6.0 | 0.1 | 0.5 | -0.5 | -2.3 | 1.9 | 3.5 | -1.7 | -5.7 | -1.9 | 20.8 |
| FY11 | 2.9 | -3.8 | 2.4 | 0.1 | 2.7 | 10.8 | 2.2 | 1.7 | 3.6 | 2.0 | -1.2 | -1.3 | 23.6 |
| FY12 | -4.0 | -6.7 | -8.3 | 6.5 | -1.3 | 1.0 | 5.0 | 4.8 | 3.8 | 0.9 | -2.3 | 0.8 | -1.0 |
| FY13 | 3.8 | 4.2 | 0.0 | -1.2 | 6.7 | 3.0 | 2.7 | 1.2 | 3.0 | 2.2 | 1.6 | 2.9 | 34.2 |
| FY14 | 3.9 | 3.6 | 2.9 | 3.7 | -0.2 | -0.1 | 0.4 | 3.1 | -1.3 | 2.4 | 1.1 | 0.6 | 21.8 |
| FY15 | -3.6 | -2.4 | 1.4 | -1.2 | -2.5 | -1.1 | -1.2 | 1.0 | 3.0 | 0.8 | -0.5 | 3.1 | -3.5 |
| FY16 | 3.8 | 4.6 | 1.9 | -2.1 | 0.6 | 2.6 | 0.4 | -2.6 | 1.8 | -1.0 | 1.7 | 1.8 | 13.9 |
| FY17 | -0.3 | -0.6 | 3.9 | -0.5 | -0.9 | -0.2 | -0.7 | -0.1 | 0.2 | 1.2 | 0.8 | -0.5 | 2.3 |
| FY18 | 0.2 | -1.9 | -0.4 | -3.1 | 1.3 | 0.1 | -0.6 | 0.7 | 0.9 | 0.9 | 0.0 | -0.6 | -2.4 |
| FY19 | 3.0 | -2.0 | 0.2 | -2.0 | -2.9 | -1.4 | 0.5 | 0.7 | -0.9 | -2.3 | -0.6% | 1.1 | -6.6 |
| FY20 | 2.1 | 1.5 | -0.5 | 1.6 | -0.4 | -0.1 | 0.7 | -1.1 | -2.4 | 0.9 | -0.7 | -1.2 | 0.3 |
| FY21 | 1.2 | 1.1 | 0.1 | 1.4 | 2.8 | -1.1 | 0.8 | 3.9 | -1.1 | 1.0 | -0.5 | -2.4 | 7.0 |
| FY22 | 0.7 | 0.5 | 0.0 | 2.9 | 1.1 | 0.4 | -0.2 | | | | | | 5.4 |

**Historic returns from ALF:ASX- same variable beta strategy established in 2004. Past performance is not an indicator of future performance.*

## MANAGING YOUR INVESTMENT

To view details of your investment such as your transaction history and distribution payments, please register via the secure portal (investorserve.com.au) operated by Boardroom Pty Limited.

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 redemptions up until 2pm on the last day of the month.

In the first 12 months of B Class units issued, there will be no base management fee however a withdrawal fee will apply to those who redeem up until 26/03/2022, please refer to PDS for more information.

WARF Application and Redemption forms can be found on our website wfunds.com.au, once completed please return to watermark@boardroomlimited.com.au.
Product Disclosure Statement Watermark Absolute Return Fund ETL8732AU PDS & ETL5025AU PDS

For further information about the InvestorServe portal or queries regarding your holding, please contact Boardroom Limited 1300 005 027 (in Australia) +61 2 8023 5474 (international) or email watermark@boardroomlimted.com.au.

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FUNDS MANAGEMENT

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