WATERMARK ABSOLUTE RETURN FUND
Monthly update – February 2022

APIR ETL8732AU
APIR ETL5025AU

WATERMARK FUNDS MANAGEMENT

FUND AT A GLANCE

Fund Strategy	Variable Beta
Benchmark	RBA Cash rate
WARF Ord.Unit NAV	$1.103
WARF Ord.Unit Applic/Redeem	$1.106/1.099
WARF B Class NAV (Ex ALF)	$1.054
WARF B Class Redeem	$1.034

PORTFOLIO CONSTRUCTION

No. Long Positions	84
No. Short Positions	73
Gross Exposure	209%
Net Exposure	-1%
Funds in Strategy	123M

GROSS PORTFOLIO STRUCTURE

Investment Type	%
Listed Securities – Long	103
Listed Securities – Short	-102
Cash	101

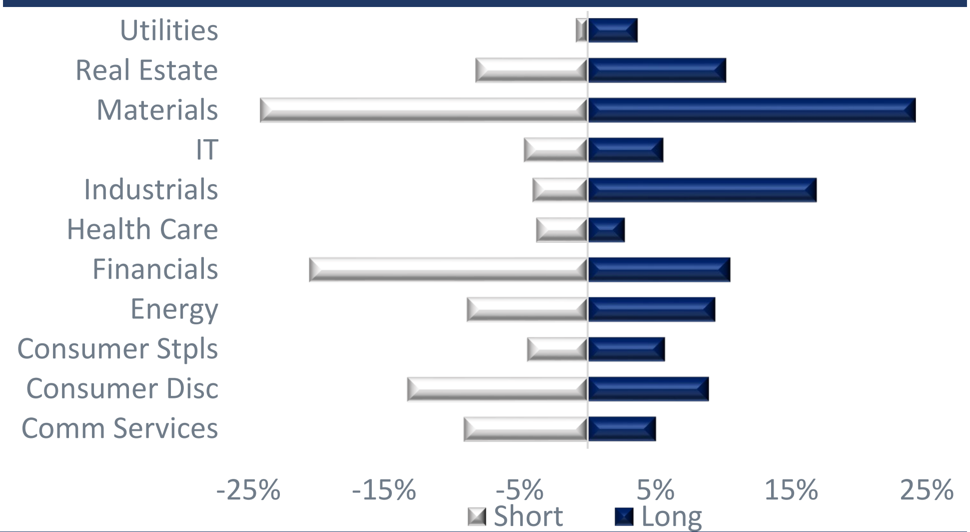
CONTRIBUTION

Top	Bottom
Northern Star Resources	Woodside Petroleum
Computershare	Cimic
Mount Gibson Iron	Alkane Resources

TOP 10 LONG HOLDINGS

- iShares 20+ Year Treasury Bond
- Santos
- Woolworths
- Alumina
- Telstra
- Origin Energy
- Northern Star Resources
- Macquarie Group
- Ampol
- Amcor

SECTOR EXPOSURES



KEY RISK INDICATORS

Beta	Volatility	Information Ratio
-0.07	4.82%	0.87

MONTHLY NET PERFORMANCE (%)

	1 Month	3 Months	FYTD	**Inception (pa)
WARF Ord Unit (Established May 2019)	0.2	0.3	5.5	9.7
RBA Cash Rate	0.0	0.0	0.0	3.3
Outperformance	**0.2**	**0.3**	**5.5**	**6.4**
	1 Month	3 Months	FYTD	**Inception (pa)
WARF B Unit (Established 26 March 2021)	0.2	0.5	6.4	9.8
RBA Cash Rate	0.0	0.0	0.0	3.3
Outperformance	**0.2**	**0.5**	**6.4**	**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 volatile February, with the All-Ordinaries Index recovering 1.1% from the 6.4% contraction in January. Volatility followed the emergence of war in Ukraine and its implications for the energy sector and global growth. The Technology sector was again the largest underperformer, down 6.9% and following an 18.4% loss in January. The Energy sector also continued its January trend, up another 5.8% on the 7.9% increase in January.

In terms of factor leadership, early thinking was that a war in Europe and risk to global growth, would reduce the speed in which central banks moved to raise rates. However, consideration has now shifted to the inflationary impact of Energy supply disruption, and its implication for rates. Reflecting this uncertainty, the 'value' and 'growth' factor leadership remained very volatile in February. For the time being we are positioning the fund to be neutral both value and growth factors until a clear trend emerges.

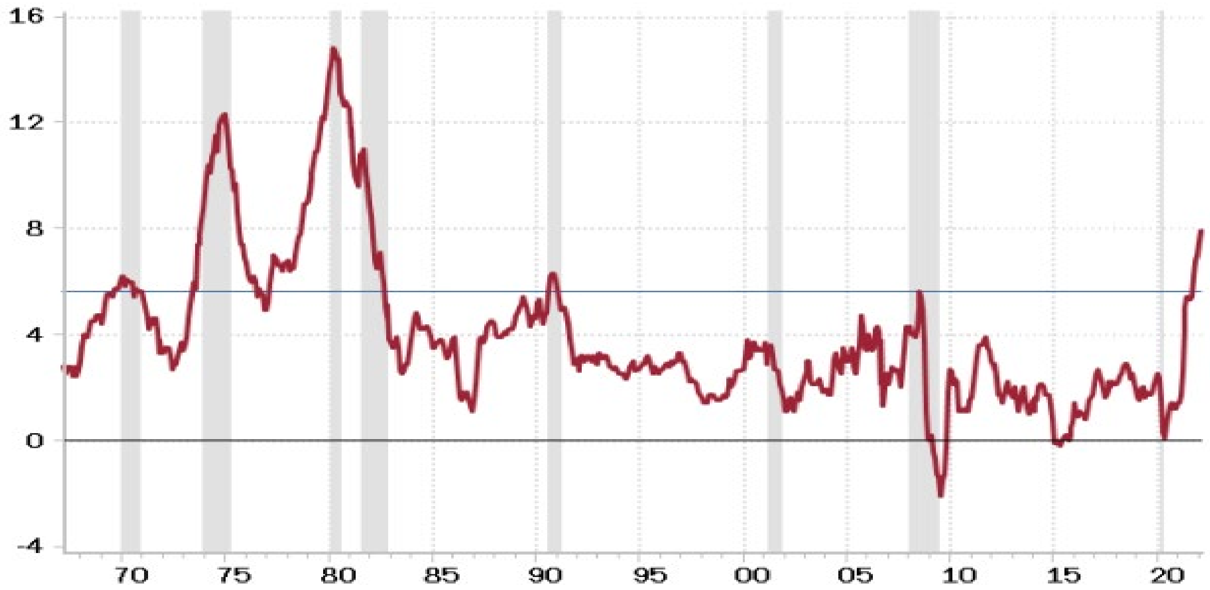
The Watermark portfolio delivered a return in February of 0.1%. After the first eight months of the FY22 financial year the fund has delivered a return of 5.5%, on track for our 8-10% annual target.

MARKET OUTLOOK

We are asking, is this a mid-cycle correction or have we moved into the next bear market? It will depend of course on whether western economies, which are slowing, can avoid a recession.

Policy makers are in a horrible position, with core inflation at its highest level in 40 years they have few options other than to push ahead and tighten policy further. The inflation data will only get worse in the months ahead with the impact of the Russian invasion of Ukraine.

Figure 1: US Core CPI. (YoY Chg)



Source: Bloomberg

Because central banks are tightening financial conditions into a slowing global economy the risk of a recession is elevated. The last time we had this scenario was back in 2008, and that did not end well.

The war in Europe has sharpened the odds of a recession further as economist slash their growth forecasts for the Eurozone and those Asian countries that run trade surpluses with Europe.

In summary, the global economy is facing a succession of shocks ensuring a recession may be hard to avoid.

1. An inflation shock with core inflation crushing real household income and spending.
2. A wealth shock as asset markets fall across the board;
3. A geo-political shock (Russia/Ukraine & China?) weighing on business investment and consumer confidence; and
4. A policy shock as monetary and fiscal support is withdrawn.

It is hard to see the share market rallying while real incomes are eroded from inflation and fiscal drag, while key household expenses in food, fuel and interest are rising, and while household wealth is falling with asset markets.

The demand shock from excessive stimulus during the health crisis was the catalyst for a final blow off phase of the 12-year secular bull market. A legacy of this demand shock and COVID related supply disruptions is inflation that is quickly becoming entrenched.

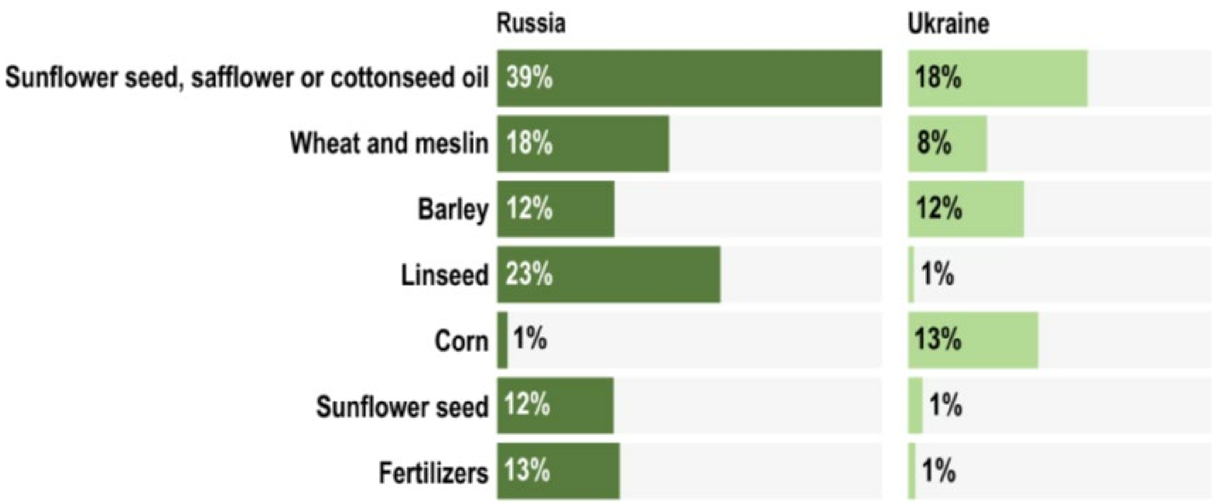
An extended period of ultra-low interest rates has also resulted in underinvestment in 'hard assets' such as food and commodities. The war in European and associated sanctions has exacerbated this situation further given Russia and Ukraine are important suppliers. We are now facing the first energy and food crisis since 1972-73.

The importance of this may not be fully appreciated. Food shortages are a key cause of social unrest. Fertiliser prices (mainly a substrate of gas) have shot up by over 200% and that was before the Russian invasion- again Russia is a key exporter.

Here is just a snapshot of what is happening with food input costs:
Fertilisers- Phosphate, Urea, DAP up 200%+; Beet pulp pellets + 35%; barley feed +70%; oat feed +45%; wheat feed +35%; peas feed +20%; grassland hay +10%; maize feed +45%

Again this was the situation BEFORE Russia invaded Ukraine- together these two countries are the world's largest exporters of grains *(Fig 2)*

Figure 2: % Share of global exports (%)



Food crops are seasonal and input costs where they are, it may not make sense in many areas to plant next year's crop. While some sanctions will be lifted if a peace settlement is reached, western economies have made a major strategic error in their dependence on Russia for food and energy. This will be corrected in the years ahead ensuring prices remain high in the medium term.

As COVID cases are escalating quickly again in China with 23 of 31 mainland provinces now reporting cases and Shenzhen's 17.5m residents going into a full lockdown, China's battle with omicron has begun in earnest. China alone typically generates a third of the world's economic growth, a full COVID outbreak and associated lock downs will defer any recovery here until later in the year. This will also put renewed pressure on supply chains just as we thought they were improving.

Central banks are NOT your friend, the wealth effect which has been the principle means of demand management for a decade through asset reflation works both ways. Central banks need excess demand to cool to contain inflation, it is in their interests to see asset markets fall!

So long as they remain committed to combatting inflation first, and the inflation data remains high as we expect, there will be no central bank pivot, the catalyst for every share market recovery in the last 20 years.

If you were wondering about their resolve, consider this response from Fed Chairman Powell at his Humphrey Hawkins testimony:

Shelby: *"Volcker put the economy in a recession to get inflation under control. "Are you prepared to do what it takes to get inflation under control?"*

Powell: *"I hope history will record that the answer to your question is yes."*

Market price signals are confirming a new bear market is upon us. All the classic signs of a blow off top and distribution are in place. All the technical indicators you would expect from a market top are also present, retail participation, excessive leverage, and speculation.

In *Fig 3* below you can see the dominos have been falling for some time, emerging markets and the EURO STOXX 50 have drawn more than 20% (a bear market) and peaks appear to be in place for broader indexes like the Russell 2000 and even the ASX 200.

Figure 3: Asset classes don't peak all at once…signs of distribution

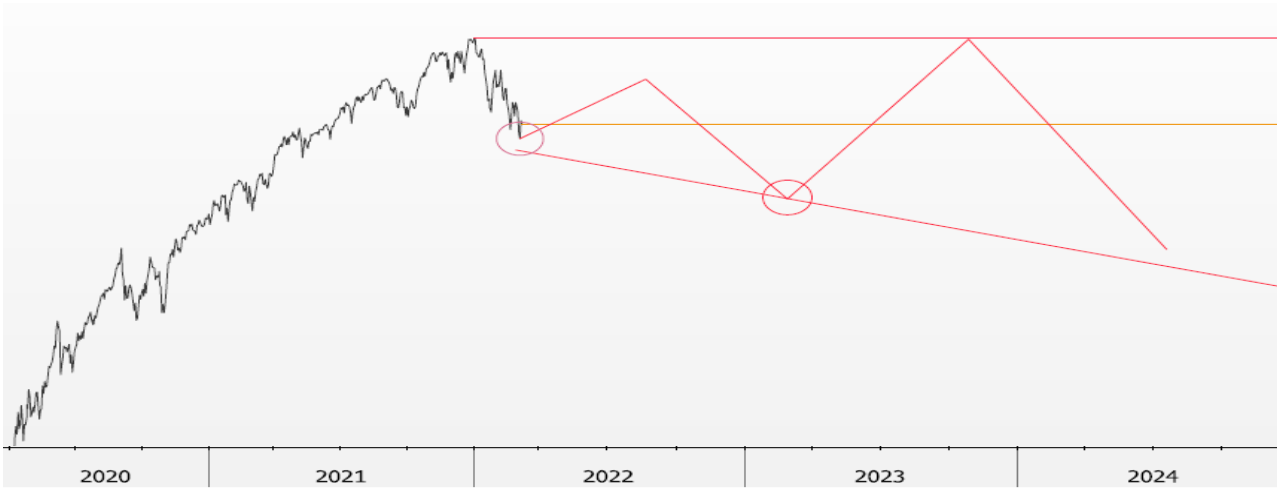
Source Bloomberg

Hindsight will show we are well and truly into this bear market already. As markets always keep you guessing, chances are by the time this becomes obvious to all, the market will rally. On this basis, I would suggest we are close to completing the first major leg down in this cycle.

If we get a peace settlement in the Ukraine in the weeks ahead, we should see a decent rally into the Northern hemisphere summer before the real fireworks begins in Q3/Q4 when global economies are slowing quickly, and investors realise there is no bailout this time

The secular bull market that started in 2009 is over and a new bear market has begun. As valuations are so high to begin with, they can only move one way from here in the absence of policy support. I suspect we see markets move sideways within a typically cyclical pattern for many years to come.

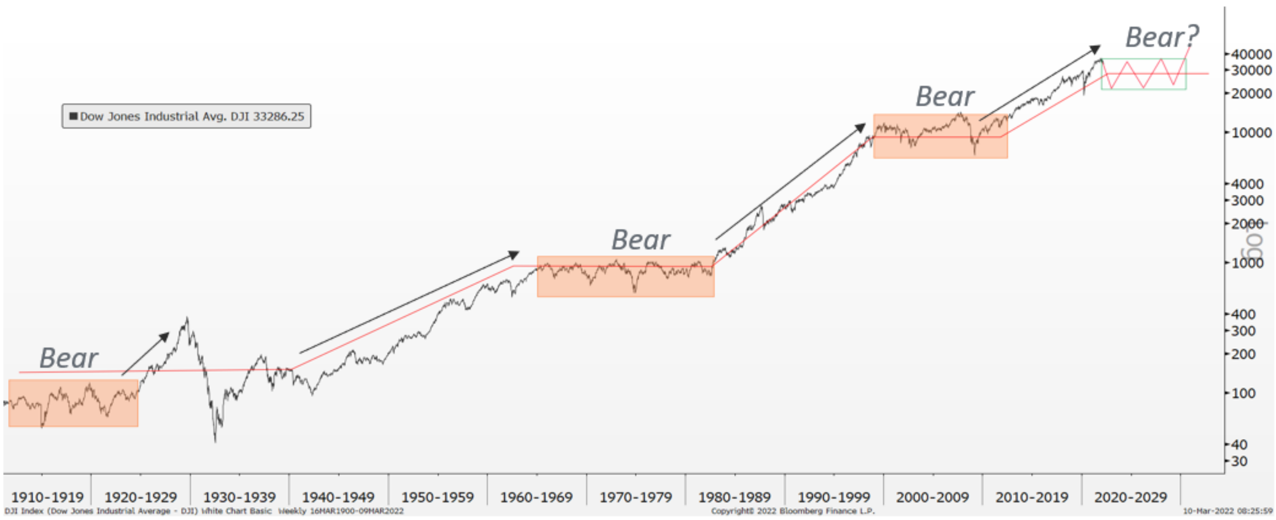
Figure 4: S&P 500 Index



Source: Bloomberg

This is not dissimilar to other periods of inflation in the past where we saw very low returns for shares *Fig 5*.

Figure 5: Dow Jones Industrial Avg



Source Bloomberg

The tail end of the last bull market was hard for us, we did not participate as asset markets inflated beyond reasonable levels. In contrast we are very excited with the current outlook, it is perfect for a 'variable beta' strategy that is alpha led and less dependent on a rising market. Hopefully we can make money in rising and falling markets while adding lots of value through stock selection.

SECTORS IN REVIEW

The ***Consumer*** sector made a flat contribution for the month, with long positions in travel stocks offset by losses on supermarket shorts. 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, there has been a huge variation in performance of stocks, particularly between small-cap retailers and their large-cap peers. This has created a number of relative valuation discrepancies when compared to recent trading history. The question is, will these valuation gaps close again, of is this discount the new normal for small-caps in a bear market? At this stage we have avoided building long exposure in small-cap retail stocks and prefer to play any rallies via quality large-cap options.

Whilst covid-19 appears well in the rear-view mirror now, in our view there are still relative gains to be made on the 'open-up' trade. Consensus numbers for many companies have been skewed by this short-term phenomenon and still need to normalise. For example, forecasts for Wesfarmers' Bunnings business seem inflated relative to its pre-covid earnings capability. It will be hard for a stock to outperform in the medium-term with this overhang.

In ***Consumer Staples,*** we have pivoted from a net-short position to net-long having added long positions in Fuel Retail and Supermarkets. Supermarkets were sold off in anticipation of higher costs, however with this now better understood, and the outlook for food inflation improving, supermarkets should rally.

Financials delivered a neutral performance outcome in February. We saw strong attribution from our core investment in *Computershare (CPU)*. Inflation numbers continue to come in ahead of economists' expectations. This in turn sees bets places on a more accelerated cash rate hike profile. *CPU* remains a significant beneficiary of cash rates, having nearly doubled is exposed balances in its Corporate Trust Services acquisition last year.

Another driver of performance was our investments in ***Retail REITs***, *Scentre Group (SCG*) and *Vicinity Centres (VCX)*. Both companies' share prices continue to trade significantly below pre-covid levels. Consumer spending remains solid and hence demand for leases continues from retailers. With the share prices remaining relatively suppressed we find this part of the market relatively cheap and consider earnings to be defensive.

Technology had a solid month in February. Short positions drove performance. A key theme that came out of the February reporting season was expensive growth stocks that delivered at results, were subsequently sold off. This was evident in Internet classified names, *Carsales (CAR), Realestate.com (REA), Seek (SEK)* and *Domain (DHG)*. All delivered decent results, mostly resulting in chunky upgrades to earnings forecasts. Even so we saw dramatic declines in share prices over the month.

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	0.1					5.5

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.

CONTACT

Watermark Funds Management
+61 2 9252 0225
info@wfunds.com.au
wfunds.com.au

Boardroom Limited – Unit Registry
watermark@boardroomlimited.com.au
boardroomlimited.com.au
1300 005 027 (in Australia) +61 2 8023 5474 (international)

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