WATERMARK ABSOLUTE RETURN FUND

Monthly update – March 2022

APIR ETL8732AU
APIR ETL5025AU

WATERMARK FUNDS MANAGEMENT

FUND AT A GLANCE

Fund Strategy	Variable Beta
Benchmark	RBA Cash rate
WARF Ord.Unit NAV	$1.107
WARF Ord.Unit Applic/Redeem	$1.110/$1.104
WARF B Class NAV (Ex ALF)	$1.059
WARF B Class Redeem/*B Exit Fee	$1.056/$1.039

PORTFOLIO CONSTRUCTION

No. Long Positions	95
No. Short Positions	105
Gross Exposure	225%
Net Exposure	-8%
Funds in Strategy	123M

*B Class Exit price (includes withdrawal fee for all redemptions received up until the 26/03/2022) for more information about the withdrawal fee please refer to the PDS

GROSS PORTFOLIO STRUCTURE

Investment Type	%
Listed Securities – Long	109
Listed Securities – Short	-116
Cash	108

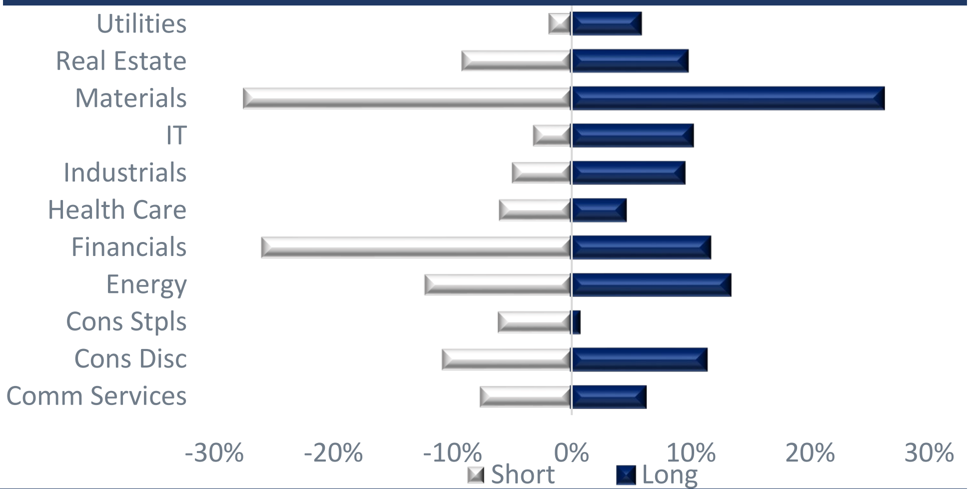
CONTRIBUTION

Top	Bottom
Firefinch	Woodside Petroleum
Allkem	IGO
Computershare	Ioneer

TOP 10 LONG HOLDINGS

- Santos
- Origin Energy
- Telstra
- Computershare
- Northern Star Resources
- Ampol
- Macquarie
- Vicinity Centres
- Goodman Group
- QBE Insurance

SECTOR EXPOSURES



KEY RISK INDICATORS

Beta	Volatility	Information Ratio
-0.01	4.74%	0.89

MONTHLY NET PERFORMANCE (%)

	1 Month	3 Months	FYTD	**Inception (pa)
WARF Ord Unit (Established May 2019)	0.4	0.3	6.0	9.7
RBA Cash Rate	0.0	0.0	0.1	3.3
Outperformance	**0.4**	**0.3**	**5.9**	**6.4**
	1 Month	**3 Months**	**FYTD**	****Inception (pa)**
WARF B Unit (Established 26 March 2021)	0.4	0.7	6.8	9.7
RBA Cash Rate	0.0	0.0	0.1	3.3
Outperformance	**0.4**	**0.7**	**6.7**	**6.4**

***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 saw a strong rally in March, with the All-Ordinaries Index up 6.4%. The recovery was broad based, but led by Technology (+13.2%), energy (+9.6%) and Materials (+8.2%). For the March quarter however, Technology still finished down 14.0% despite the strong March, while Energy and Materials were up 25.1% and 11.9% respectively. The divergence in results has been quite extreme.

In terms of factor leadership, value again led growth as the dominant factor, however this was driven by the relative size of the resources and financials sectors in the ASX (together around 43%). Notably, the rate of value outperformance has eased in recent weeks, and we are mindful that there is risk of some mean-reversion, particularly given recent observations of bond markets. For the time being we are positioning the fund to be neutral both value and growth factors however this may change as opportunities emerge.

The Watermark portfolio delivered a return in March of 0.4%. After the first nine months of the FY22 financial year the fund has delivered a return of 6%, on track for our 8-10% annual target.

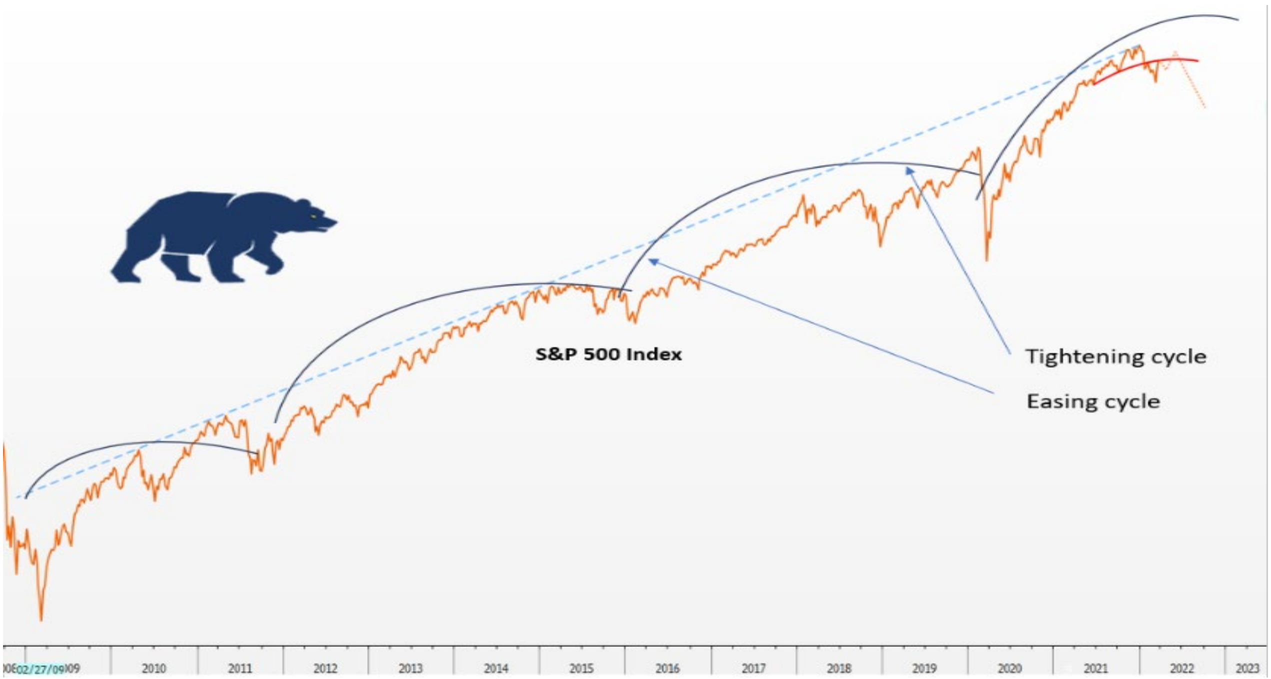
MARKET OUTLOOK

The question everyone is asking, is this a mid-cycle slowdown or have we moved into a new bear market for shares? We are firmly in the later camp.

The balance sheet recession that followed the financial crisis was a powerful deflationary force. Households and businesses de-levered while governments exercised fiscal restraint allowing Central banks to reflate without creating inflation. Low growth with deflation was a 'goldilocks' era for risk assets, not to hot and not to cold.

In *Fig 1* below, you can see four very clear and discrete mini business cycles of four years each starting in March of 2009, as Central Banks's eased and then tightened policy. Together they make up the 14-year secular bull market in shares.

Figure 1: The cycle has turned, the bear is here



Source: Bloomberg

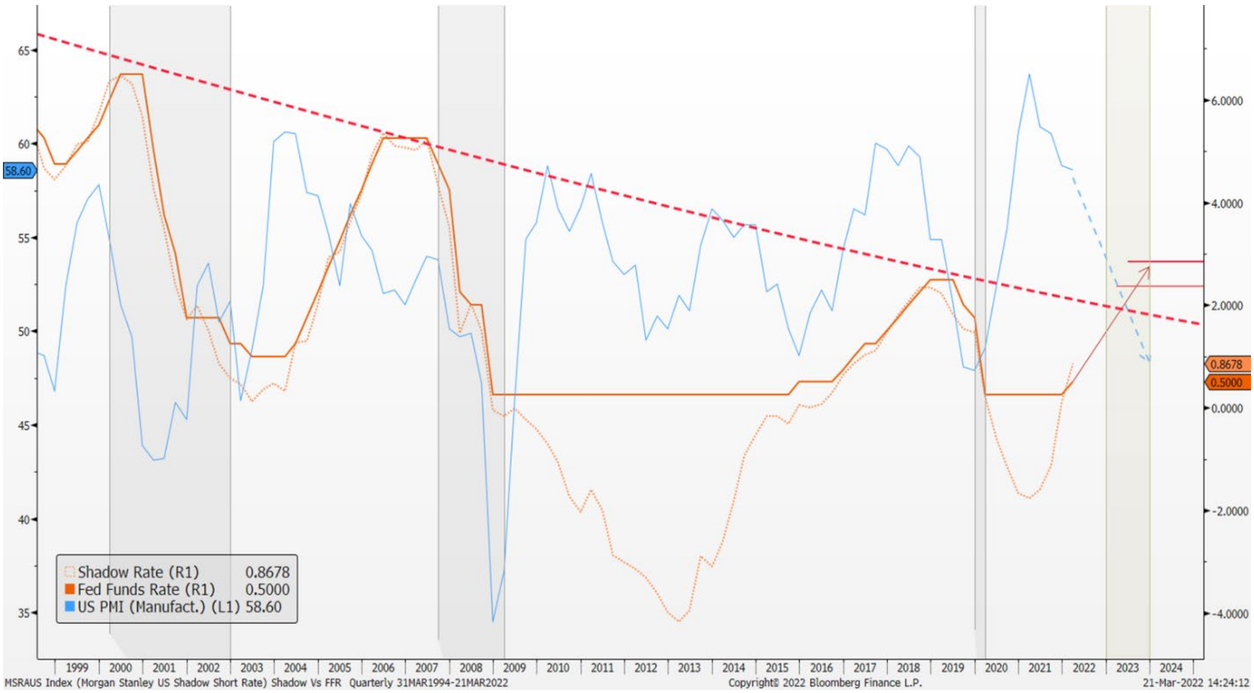
In each reflation episode, real interest rates moved lower and lower and 'financial asset' such as shares and bonds, moved higher and higher. At the same time as real interest rates turned negative, capital was re-allocated away from short duration 'hard' assets such as commodities.

The share market has followed each of these business cycles peaking on each occasion at the blue advance line in *Fig 2* as it has once again in December of last year. As policy support is once again withdrawn, we have moved into the next 'cyclical' bear.

Market bulls will have you believe policy makers can engineer yet another soft landing, pivot, and reflate one more time. It is highly unlikely this time however, as we no longer have these deflationary tailwinds, instead we have inflation at the highest level in 40 years in many western economies.

In the last tightening cycle in 2018 (*Fig 2*), the US Federal Reserve started raising interest rates much earlier while the economy was still expanding rapidly (PMI was rising). They didn't even reach the neutral interest rate however where policy pivots from accommodative to restrictive (the dotted line) before economic activity fell sharply and they were forced to reverse course and ease rates again. Back then, inflation was barely at 2%, and the Fed was still trying to push inflation higher!

Figure 2: US Federal Reserve Target Interest Rate



Source: Bloomberg

This time will be very different, they are late and are tightening as growth slows. Furthermore, to bring inflation back under control, theoretically policy must 'overshoot'. They need to move beyond the neutral rate (dotted line) to slow demand enough to stymie inflation. Goldman Sachs have suggested this overshoot may require interest rates as high as 4% or above to curb inflation.

Interest Rate Markets are clearly well below this level today and with an inverted yield curve, bond investors are already signalling a recession is ahead.

Given central banks are late and tightening into a slowing economy and the need for a policy overshoot to curb inflation, the prospect of a recession in advanced economies next year is high. A soft landing and another round of asset reflation is equally unlikely.

Not just any bear. A new secular bear

This will not just be a 'cyclical' bear market like the four prior episodes but the beginning of a new secular bear where shares move sideways for many years to come. As with secular bulls (the last one lasted 14 years) secular bears typically last 10-15 years

Figure 3: A secular bear market

Source: Bloomberg

Strategists often refer to the 1970's secular bear as a precedent for what lies ahead. You can see in *Fig 3* above this was not a unique period. Inflation eventually kills most secular bull markets and that should be our base case this time also. It is dangerous to expect this time will be different.

Within this secular bear we will still have the four-year business cycle playing out as shares rise and fall, but within a broadly sideways trend.

A new secular bear for bonds also

With the return of inflation, it looks like the 31-year secular bull in bonds is also now complete. It is clear from the momentum signal in the bottom panel below the low for bond yields (the high for bond prices) is in.

Most risk assets are priced off the long bond- the very low yield on these securities has led to a re-rate of other long duration risk assets like shares. The P/E re-rate of shares and for growth shares in particular is an extension of the depths bond yields have fallen too.

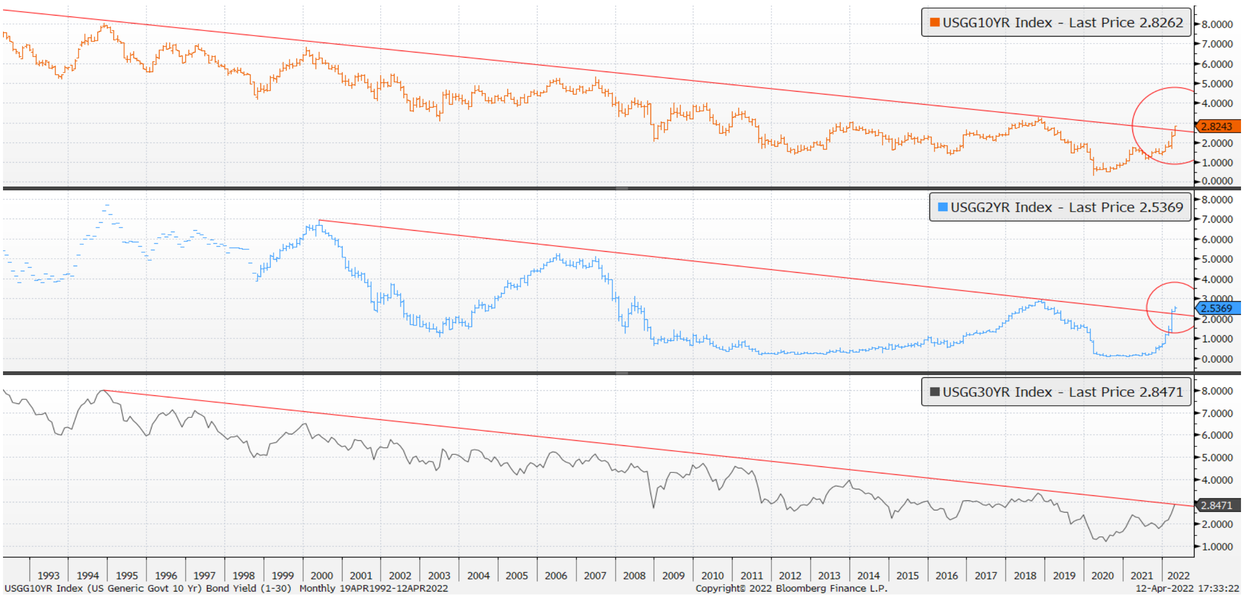
As commodities are an inflation hedge, secular trends in commodities have historically been negatively correlated with financial assets. You can see this indicated in *Fig 4* in red. A new secular bull market in commodities has probably begun.

Figure 4: Secular bear in bonds / Secular bull in commodities

Source: GMCP

A further confirmation of a reversal in bond prices is near to hand. In *Fig 5* below you can see bond yields across multiple durations are pushing up against the 30-year down trend as we speak. If yields break through here, we will be at a seminal moment for risk assets. The 30-year tail wind for share market valuations will have reversed.

Figure 5: Yields testing 30-year downtrend



Source: Bloomberg

How it plays out for shares this year

Following the strong bear market rally in March, shares are likely to track sideways in the months ahead but will fall short of prior highs. It is still too early for a major draw, shares still offer decent profit growth this year and analysts are still upgrading profit estimates. Furthermore, with money is pouring out of the bond market, investors have few alternatives other than to invest in shares.

The next major drawdown in the share market is likely to occur later in the year as economies slow and the street starts cutting profit estimates. As shares start to move lower and investors come to realise there will be no Central Bank bailout this time around, share markets will fall hard led by mega cap technology- the last and largest bubble still to burst.

Figure 6: Crunch time in the second half

Source: Bloomberg

Closer to home, we may well see a replay of the Teck Wreck and the GFC where the lucky country once again misses the recession bullet given our exposure to a resurgent resources sector. Given our markets heavy weighting to resources, the ASX may still make a new high in the months ahead.

From here, I would advise thinking of the Australian share market as two discrete markets – the All industrials share market which today is still 7% below the August 2021 high and a resources market which is making new highs as I write this piece. Don't chase it though, the initial advance in commodities is nearly complete. As late cyclicals, resource shares will also fall in the second half of the year as global growth slows.

SECTORS IN REVIEW

The ***Consumer*** sector made a largely flat contribution for the month, with gains in Fuel marketing longs offset by losses on Consumer Discretionary shorts, specifically *JB Hi-Fi (JBH)* and *Harvey Norman (HVN)*.

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 relative valuation discrepancies for some stocks when compared to recent trading history. For example, *JBH* is trading near its 12-month high while *Nick Scali (NCK)* is 30% below its 12-month peak despite both retailers servicing in similar home durables category. The question is, will these valuation gaps close again, of is this discount the new normal for small caps in a bear market? We think there are some interesting pair-trades to be had here.

Whilst COVID-19 appears well in the rear-view mirror now, 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 the 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 to our long positions in Fuel Marketing. This trade is gathering momentum as fuel security becomes an increasing issue for Western governments.

Financials had a solid March. Core longs in *Macquarie (MQG)* and *Computershare (CPU)* led the performance. Both remain key positions for the portfolio. *MQG* has both short and long term, structural growth drivers. In the near term, it benefits from energy price volatility driven by the war in Ukraine. Longer-term its Green Investment Bank sees it continue to lever its exposure to the global energy transition from fossil fuels to renewables. *CPU* has long been flagged as our key inflation hedge. As inflation numbers continue to outpace estimates, so do expectations around short term interest rates. *CPU*'s funds held for clients are set to benefit immensely from the global lift-off in interest rates.

In ***Technology***, we had a weaker month. Overall we have been moderately short the sector, March saw moderate appreciation of most technology stocks. We continue to see pressure on the sector given high valuations and selectively take positions in high quality, sold off names, such as *Xero (XRO)* and *Life360 (360)*.

Building Materials: We have re-established an investment in *James Hardie (JHX)* following recent underperformance. As US mortgage rates have increased, US homebuilders have underperformed. We believe longer term interest rates have peaked for the time being and we should see money flow back into these names.

Chemicals: Fertiliser prices continue to move higher following Russia's invasion of Ukraine. *Incitec Pivot (IPL)* should have at least a couple of spectacular years in nitrogen based fertilisers as gas prices will take some time to correct.

Healthcare: The pathology companies are oversold given the fall in PCR testing post COVID and now factor in little underlying growth in the years ahead, we have added *Healius Ltd (HLS)*.

Resources: Suppliers of EV materials have rallied in recent weeks. As the price of both rare earths and lithium chemicals appear to have peaked short term, we are trimming our positions and shorting some of the more highly valued explorers.

We have added to our position in *Stanmore Coal (SMR)* following the acquisition of QMC from BHP Limited. The company has tripled in size following the transaction and should be able to retire the debt taken on as part of the deal within a few years.

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WATERMARK FUNDS MANAGEMENT

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**	**0.4**				**6.0**

**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@boardroomlimited.com.au.

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