WATERMARK ABSOLUTE RETURN FUND

Monthly update – May 2022

APIR ETL8732AU
APIR ETL5025AU

WATERMARK FUNDS MANAGEMENT

FUND AT A GLANCE

Fund Strategy	Variable Beta
Benchmark	RBA Cash rate
WARF Ord.Unit NAV	$1.108
WARF Ord.Unit Applic/Redeem	$1.112/$1.105
WARF B Class NAV (Ex ALF)	$1.061
WARF B Class Redeem	$1.057

PORTFOLIO CONSTRUCTION

No. Long Positions	91
No. Short Positions	83
Gross Exposure	196%
Net Exposure	-0.4%
Funds in Strategy	115M

GROSS PORTFOLIO STRUCTURE

Investment Type	%
Listed Securities – Long	98
Listed Securities – Short	-98
Cash	100

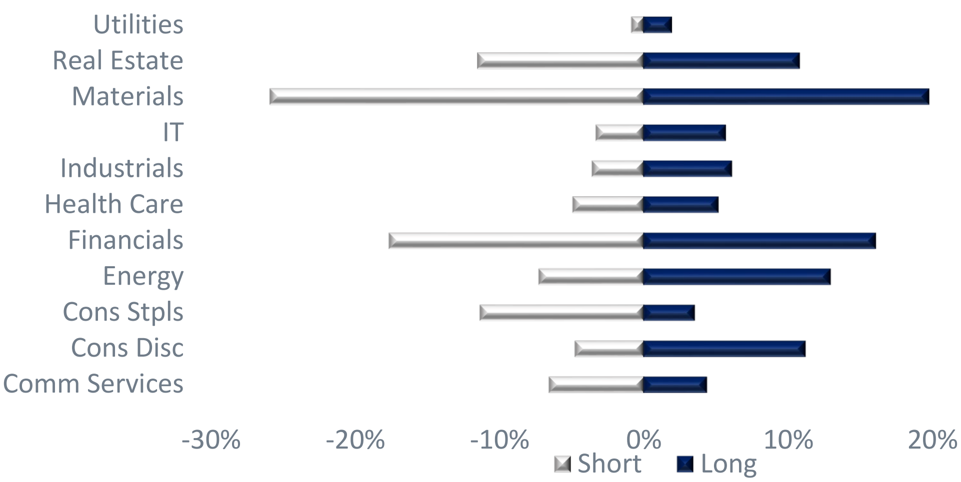
CONTRIBUTION

Top	Bottom
Boral	Goodman Group
Woolworths Group	City Chic Collective
Stanmore Resources	Macquarie Group

TOP 10 LONG HOLDINGS

- Santos
- Stanmore Resources
- Macquarie Group
- REA Group
- Mirvac Group
- Dominos Pizza
- Goodman Group
- QBE Insurance Group
- Evolution Mining
- Vicinity Centres

SECTOR EXPOSURES



KEY RISK INDICATORS

Beta	Volatility	Information Ratio
0.10	4.62%	0.87

MONTHLY NET PERFORMANCE (%)

	1 Month	3 Months	FYTD	**Inception (pa)
WARF Ord Unit (Established May 2019)	0.2	0.5	6.1	9.6
RBA Cash Rate	0.0	0.0	0.1	3.2
Outperformance	**0.2**	**0.5**	**6.0**	**6.4**
	1 Month	**3 Months**	**FYTD**	****Inception (pa)**
WARF B Unit (Established 26 March 2021)	0.3	0.6	7.0	9.7
RBA Cash Rate	0.0	0.0	0.1	3.2
Outperformance	**0.3**	**0.6**	**6.9**	**6.5**

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

UNIT CLASS CONSOLIDATION – Implementation 1 July 2022

Watermark Absolute Return Fund (WARF) has two Unit Classes, Ordinary and B Class units. B Class units were established as a separate class for Ex-Australian Leaders Fund Ltd shareholders (ALF:ASX) and these units had different terms and conditions to Ordinary units. As these separate provisions expired on 26th March 2022 and the Product Disclosure Statements (PDS) are effectively the same, it makes sense to consolidate the two unit-classes.

As there are fewer Ordinary units on issue, we have elected to convert Ordinary units into B Class units. Ordinary unit holders will end up with a few more units in WARF than previously held as the NAV on B Class units is slightly lower. The **value of your investment will be the same.** There are no changes proposed for existing B Class unit holders.

Following the class consolidation all investors will hold B Class units. In consolidating the Unit classes, we hope to simplify our register and our reporting for investors.

An updated statement of your holdings in WARF will be available online at InvestorServe as of 10 August 2022 and a printed statement will be distributed with your AMMA Statement at the end of August.

Class Consolidation Timeline:

1 July 2022

- Class Consolidation Implementation Date
- Updated PDS for B Class issued which will be open for application and additional Investments
- Cut off for July Application and Redemptions will remain the same, 2pm (AEST) of the last business day of the month

1 August 2022

- Ordinary Units are cancelled
- Ordinary Unit holders will be issued B Class units
- Newly issued B Class units will be uploaded to InvestorServe

10 August 2022

- B Class Unit Price approved and uploaded to website
- InvestorServe updated with the July NAV and total value of holding updated

MONTH IN REVIEW

The Australian share market saw a significant contraction in May with the All-Ordinaries Index down 3.0%, its worst month since January. The sell-off was once again led by Technology stocks with the sector down 8.7%. The Real Estate sector also performed poorly, down 8.9%, led by concerns of more aggressive interest rate tightening and associated impacts on demand. After a soft April, the Materials sector resumed its outperformance in May, aided by expectations of more stimulus in China.

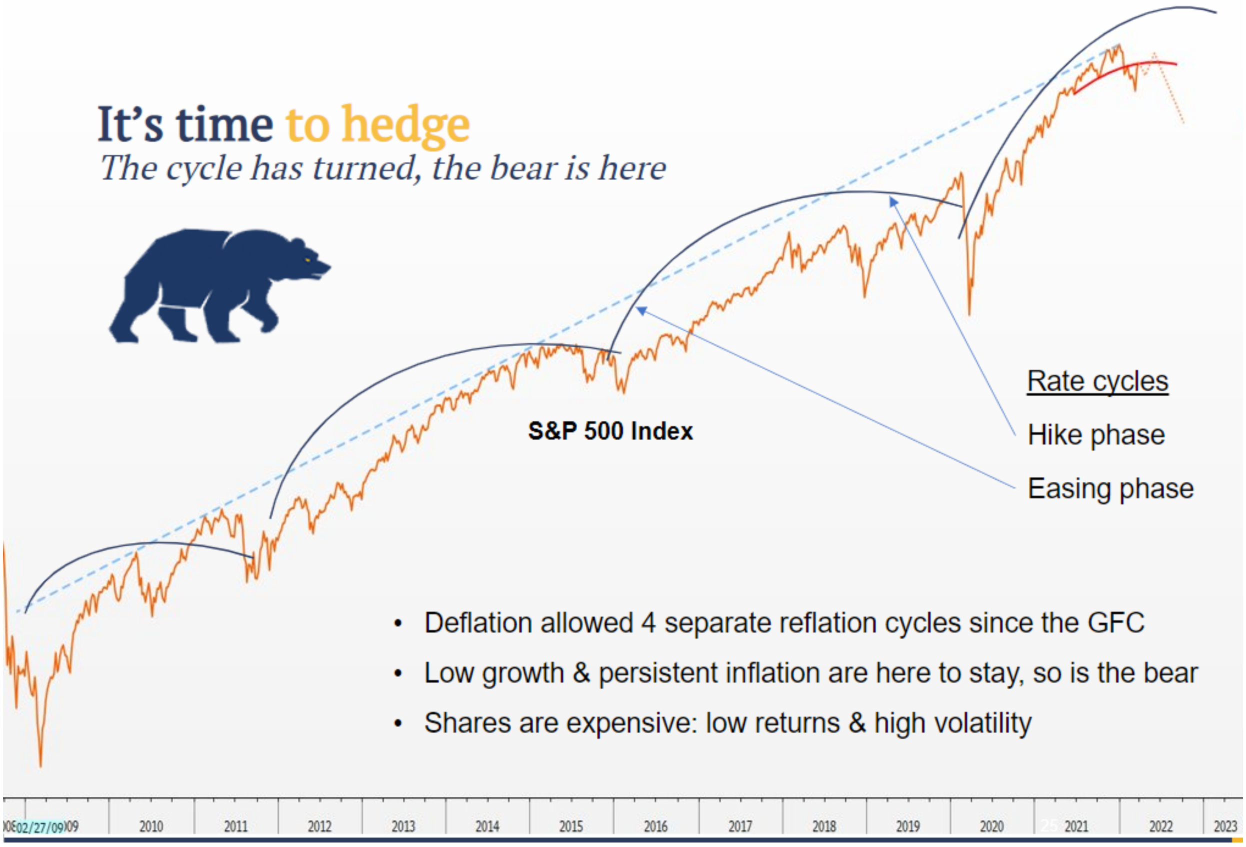
In terms of factor leadership, value resumed its leadership over growth. The value factor has now outperformed growth by 20% over the last 6 months.

The Watermark portfolio delivered a return of 0.2% in May. After the first 11 months of the FY22 financial year the fund has delivered a return of 6.1%.

MARKET OUTLOOK

The secular bull market that ended for Australian shares last August emerged from the financial crisis and was a product of successive waves of liquidity led asset reflation, as central banks pushed real interest rates lower and lower and asset values higher and higher (*Fig1).*

Figure 1: Successive waves of asset inflation



Source: Bloomberg, S&P 500 Chart

Asset inflation of course created excess demand, leaving product and labour markets acutely tight. Unemployment in Australia is now at its lowest in 40 years and with little immigration, the services sector is scrambling to find workers. Fair Work Commission awarded a 5.2% increase in the minimum wage, well above expectations.

This policy led bonanza for asset owners was a consequence of systemic deflation. No one has a complete explanation for the root cause of this deflation which you can see clearly in the value of bonds which have pushed higher for decades (long term interest rates have been falling).

The first phase took place in the 1980's with back-to-back global recessions that killed the inflation of that era. Then in the early 1990's with the collapse of the Soviet Union we had a rapid expansion of western democracies, a deepening of capital markets and the globalisation of trade. This spread of the neo-liberal 'rules based' order (capitalism) was deflationary allowing interest rates to fall and debt balances to accumulate.

The spoils of this period where not spread evenly however, laying the seeds of its demise. Asset owners captured all the gains while labour's share of GDP has fallen sharply. We now have the first generation of citizens in the west who are worse off than their parents in real terms.

The emergence of popularism and de-globalisation where the first phase of its descent. A new cold war between the East and West has manifest in the next phase. With this reversal in these deflationary forces, the good times of ample liquidity and asset reflation have passed.

Even before the health crisis, we were approaching the limits of these policies in driving asset values higher as bond yields in many western countries were already negative. On a hold to maturity basis, investors were guaranteed a loss which of course is nonsensical. Then with the health crisis, policy makers doubled down on these same policies. The excess demand created from emergency stimulus and the associated supply chain disruptions have unleashed inflation which will be with us for years to come.

Investors need to ask two important questions: Are the deflationary forces that persisted for so long still around or has their demise contributed to the inflation we are seeing today?
Secondly, what has caused this inflation, is it established or transitory?

How these inflationary pressures play out will determine the duration of this bear market. If the inflation hangs around for years to come as expected then we are in a secular bear, if it is transitory and the deflationary forces resume/return then potentially shares can make new highs in the years ahead.

We are still early in this bear market. Until inflation moderates and central banks back away from hiking rates further, shares will move lower in the medium term. In the short term at least, share markets globally are oversold and sentiment is extremely bearish. In the weeks and potentially months ahead, we should see a decent bear market rally which investors should sell into as the big drawdown is still ahead in the second half of the year.

Australian shares have proven remarkably resilient through this first phase of the drawdown given our economy's exposure to commodities which are the driving force behind the inflation we are seeing. In simple terms, the Australian economy is a good inflation hedge. The 'quarry and farm' may once again avoid another global recession.

As we get into the 3rd quarter of the year however, around the US mid-term elections, western economies will be slowing quickly and the 'street' will be slashing profit estimates, pushing shares lower.

This becomes a pivotal moment for investors as the policy response will determine the next move for shares. If the inflation data improves as everyone expects, Central Banks may 'pause' on any further policy tightening. Under this scenario economies slow but avoid recession and shares can stage a significant rally early into next year. However, an early pause only ensures inflation lingers for longer, leaving us with 'stagflation'.

Alternately, Central Banks look to overshoot in tightening financial conditions further to kill inflation, only to push western economies into recession. Under this scenario shares obviously fall further into the first half of next year.

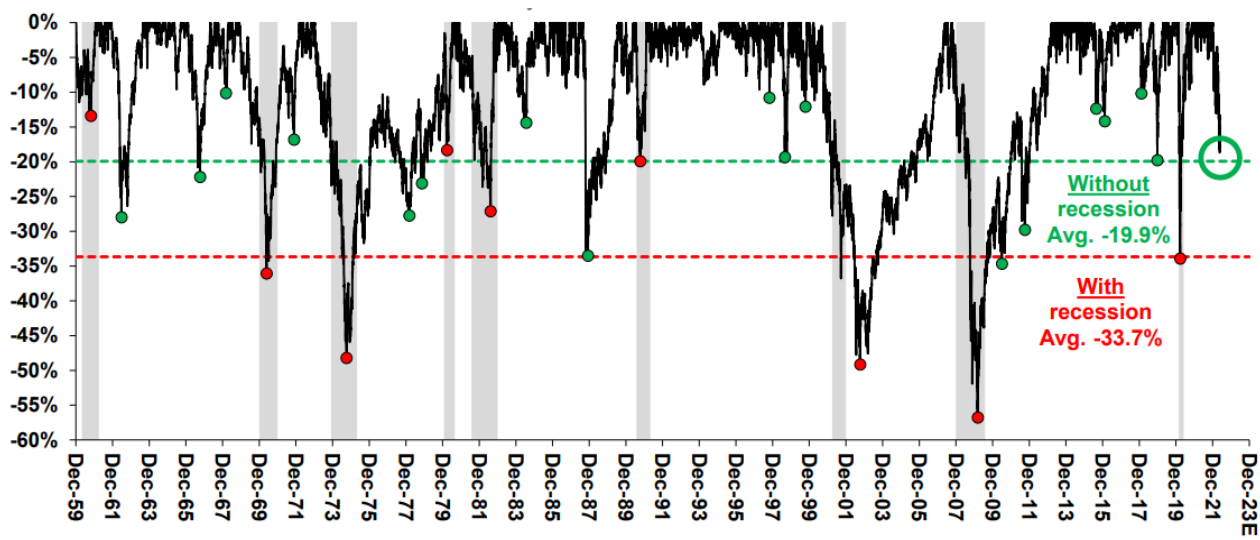
The policy response as the economy slows, asset values fall, and inflation moderates will determine which path the market follows. Either way the medium-term outcome is much the same, shares will be lower.

The emerging data is less than encouraging, with the May CPI report showing further deterioration, Central Banks are once again losing credibility as they were guiding to a moderation in the data. It seems they still have a lot more to do evident in the FOMC decision yesterday to increase the target interest rate by a full 75bpts (3 hikes in 1) which is unprecedented.

With the broader offshore indexes down more than 20% we are now officially in a bear market for shares with investors seemingly still pricing in a soft-landing scenario (green line below in *Fig 2*). They have never tightened once shares have fallen into a bear market before (down >20%), a further demonstration of just how far behind the curve they find themselves.

Given inflation has never been tamed once it gets above 5% without a recession, a recession more than likely beckons and we move lower (the red line in *Fig 2*).

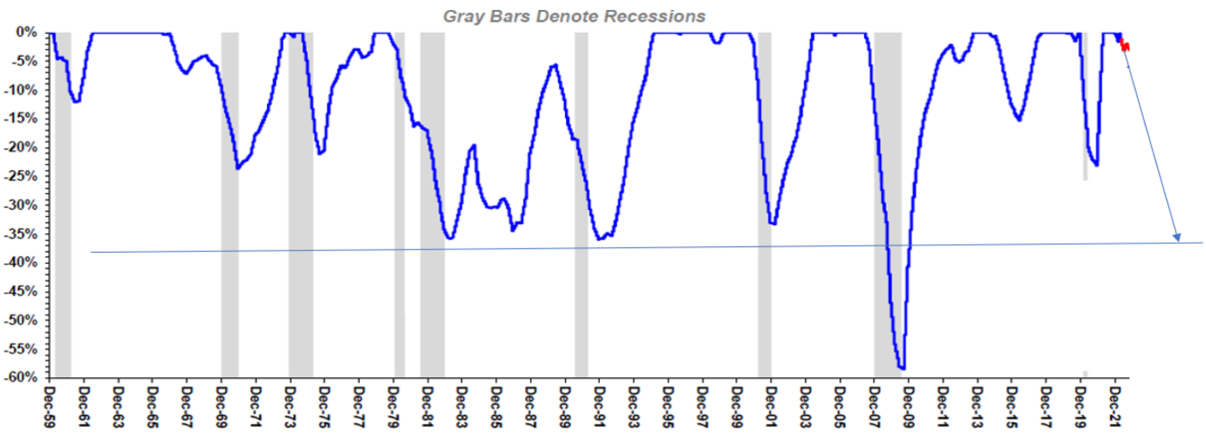
Figure 2: Market drawdowns with and without recessions



Source: Stifel

While we have seen some contraction in valuations (P/E's) already as financial conditions have tightened, we are yet to see any move lower in profit expectations. With the demand shock from the COVID stimulus, many public companies are over earning, profits have moved well above trend. In a garden variety recession earnings typically fall by a least one third *Fig 3* below.

Figure 3: S&P 500 Profit (EPS) drawdowns from prior peaks



Source: Stifel

If we are in a stagflation environment of lower growth and persistent inflation, then valuations may well move to the lower end of the historic range (P/E's are low during periods of inflation) which along with lower earnings leaves us with a share market that still has a long way to fall.

This is playing out as this report goes to print with shares falling sharply so far in June. The portfolio is well positioned for this setting with the hedging protecting investors capital so far this month.

SECTORS IN REVIEW

The ***Consumer*** sector delivered a flat result for the month, with gains in supermarket shorts, offsetting losses in some consumer growth stocks.

Our long position in the ***Fuel Marketers*** has been gaining momentum as fuel security becomes an increasing issue for Western Governments. *Ampol (ALD)* and *Viva Energy (VEA)* refining assets, historically loathed by the market, are now generating super returns and driving upgrades for both companies. This sector is under-owned and offers defensive exposure at a cheap multiple.

As mentioned in the April monthly, the ***Agriculture*** sector is building as fertile ground for short ideas. Share prices have risen aggressively given the confluence of a strong domestic grain harvest, and sky-high soft commodity prices driven by supply-chain dislocation. We know however, as with all highly cyclical industries, that conditions are ever changing, and we should be careful extrapolating at either the top or the bottom of the cycle. Using a 'normal season' as the basis for valuation, earnings multiples look extreme. We see several catalysts, including the successful negotiation of a humanitarian export corridor in the Black Sea to correct over-inflated soft commodity prices.

Financials had a flat month in terms of attribution. Our shorts in the ***Banks*** delivered returns, as we saw the beginning of a major sell off across the sector. Banks had held up well for most of the broader market volatility of 2022. This changed when investors came to appreciate the consequences of faster than expected rate rises. We have been highlighting for some time the nexus between bank returns and the property market. Offsetting these profits was weakness in our long position *Macquarie Group (MQG)*, we continue to see good earnings prospects for Macquarie in the short term amidst the energy market volatility. Commodities trading remains a key driver of results.

Technology delivered some modest positive returns. Largely from our short portfolio. The sector continues to be the most sensitive to higher than expected inflation outcomes. Which are then leading to higher interest rates expectation. Selling across the sector has been indiscriminate.

The ***Building*** Material companies continue to come under considerable pressure as it has become clearer that interest rates will be moving a lot higher. This is the case not just for the local Builders but the US based ones as well *James Hardie (JHX)* and *Reliance Worldwide Corporation (RWC)*. As manufacturing businesses these companies are also very exposed to escalating fuel and energy costs.

In ***Media***, cyclical business like *Nine Entertainment (NEC)* and *Seven West Media (SWM)* have come under considerable pressure on fears of a fall in advertising spending. NEC shares are starting to look attractive with a full recession now factored in.

Contractors: We expect the resources sector to hold together relatively well even as growth slows elsewhere. *Monadelphous (MND)* an important contractor in energy and iron ore operating in WA should perform well in the years ahead, especially as energy investments picks up. The iron ore hubs are so large and established now having doubled in size over the last 15 years, spending in this sector will remain elevated for years to come.

As a defensive sector, ***Healthcare*** has held up relatively well in a difficult market, it's probably time to take profits here.

Resources: The lithium sector has fallen hard following some negative research pieces suggesting the market is over supplied in the medium term as Chinese production ramps up. We have a balanced portfolio of attractively prices emerging producers/explores and a short portfolio of expensive explorers in pre-production.
Producers of bulk commodities have held up very well in recent weeks, it's time to take profits in some of the iron ore miners in particular. The iron ore prices is still above $150/t and looks vulnerable here.

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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	-0.1	0.2		6.1

**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.

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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