WATERMARK ABSOLUTE RETURN FUND

Monthly update – June 2022

APIR ETL8732AU
APIR ETL5025AU

WATERMARK FUNDS MANAGEMENT

FUND AT A GLANCE

Fund Strategy	Variable Beta
Benchmark	RBA Cash rate
WARF Ord.Unit NAV	$1.111
WARF Ord.Unit Applic/Redeem	$1.114/$1.108
WARF B Class NAV (Ex ALF)	$1.063
WARF B Class Redeem	$1.060

PORTFOLIO CONSTRUCTION

No. Long Positions	91
No. Short Positions	96
Gross Exposure	212%
Net Exposure	-2.6%
Funds in Strategy	113M

GROSS PORTFOLIO STRUCTURE

Investment Type	%
Listed Securities – Long	105
Listed Securities – Short	-107
Cash	103

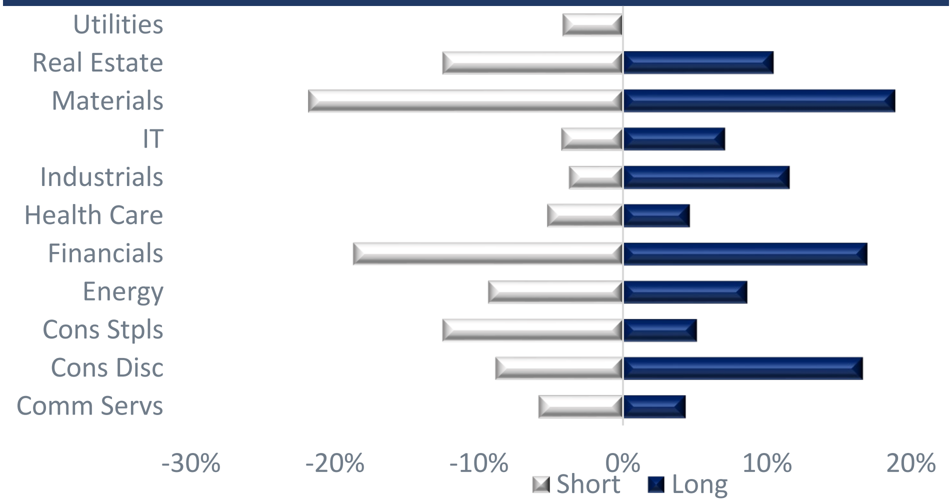
CONTRIBUTION

Top	Bottom
Coronado Global	Stanmore Resources
Ramelius Resources	Green Technology Metals
Silex Systems	Northern Star Resources

TOP 10 LONG HOLDINGS

- Santos
- Aristocrat Leisure
- Commonwealth Bank of Australia
- Domino's Pizza
- QBE Insurance Group
- IDP Education
- Charter Hall Group
- Stanmore Resources
- Goodman Group
- Aurizon Holdings

SECTOR EXPOSURES



KEY RISK INDICATORS

Beta	Volatility	Information Ratio
0.02	4.56%	0.87

MONTHLY NET PERFORMANCE (%)

	1 Month	3 Months	FYTD	**Inception (pa)
WARF Ord Unit (Established May 2019)	0.2	0.3	6.3	9.5
RBA Cash Rate	0.0	0.1	0.1	3.2
Outperformance	**0.2**	**0.2**	**6.2**	**6.3**
	1 Month	**3 Months**	**FYTD**	****Inception (pa)**
WARF B Unit (Established 26 March 2021)	0.2	0.4	7.2	9.6
RBA Cash Rate	0.0	0.1	0.1	3.2
Outperformance	**0.2**	**0.3**	**7.1**	**6.4**

***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.*

DISTRIBUTION AND TAX STATEMENT

The Investment Manager will be announcing the final distribution for the 30 June 2022 Financial Year in the first week of August once the audited accounts have been completed.

Distribution statements and the Attribution Managed Investment Trust Member Annual Statement (AMMA) will be sent to unit holders from 1 August 2022 and will also be made available on the InvestorServe online portal, managed by Boardroom Limited.

MONTH IN REVIEW

The Australian share market finished FY22 with the All-Ordinaries Index down 6.5%, with losses in Industrials (down 9.2%), more than offsetting the small rise in Resources (+3.3%). These top-line numbers disguise what has been a seesawing year for equities markets, with the second half of 2H22 delivering heavy losses. The June month alone saw a material step down, with the All-Ordinaries losing 8.8%.

The June sell-off was led by the Materials sector (down 12.4%), with the Gold sector hit hardest. The materials sector has now entered a cyclical bear market, joining the broader index. Technology and Financials were also big contributors to the June loss, down 11.0% and 11.9% respectively. This was also the first major loss for the Big 4 Banks as the potential for recession risk started to be priced in.

In terms of factor leadership, Growth outperformed value by 2.4% in June, which has been a turnaround of the trend since January where the value factor outperformed growth by 20% over the 5 months to May. We are currently long the growth factor and see this leadership continuing near-term.

The Watermark portfolio delivered a return of 0.2% in June, taking the FY22 financial year return to 6.3%. While WARF is benchmarked to the RBA cash rate, the relative outcome for investors versus the All-Ordinaries decline of 6.5% is worth noting.

MARKET OUTLOOK

We pause here at mid-station before heading lower. The first leg down in this bear market was an unwind of inflated valuations as interest rates rose across the term structure. Valuation have normalised as real interest rates have move back to pre-pandemic levels.

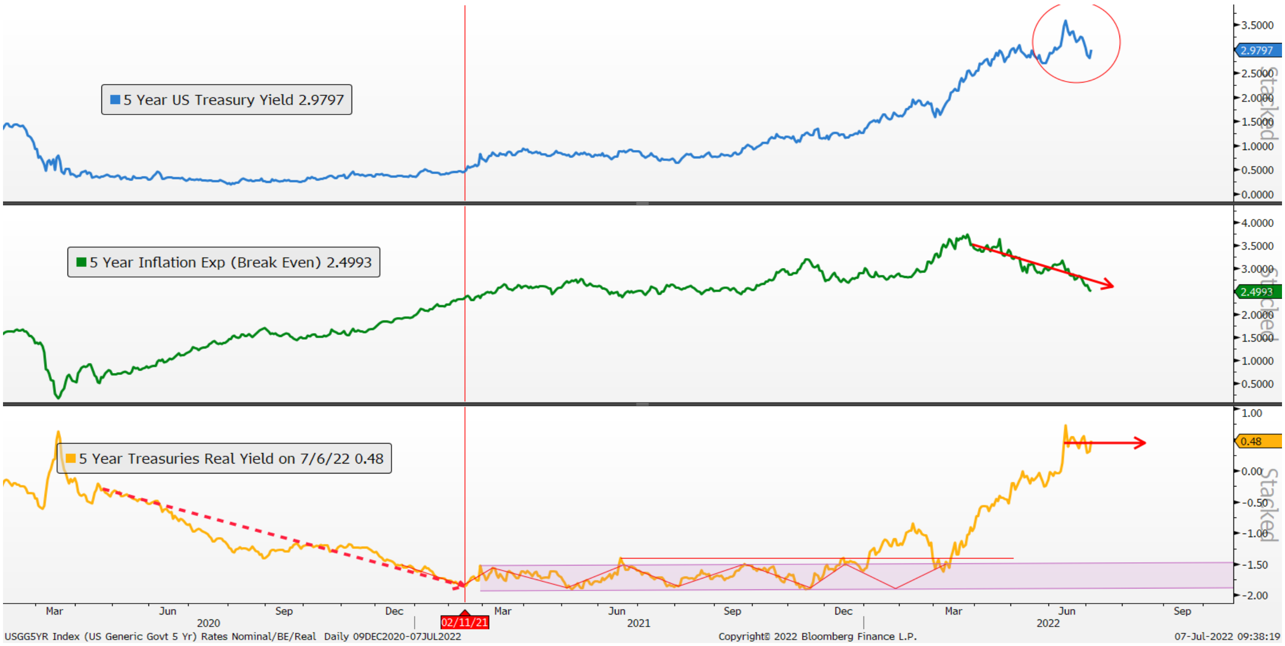
This adjustment was felt most acutely in higher growth sectors of the share market that are more susceptible to P/E contraction. While this de-rate may have further to go, the adjustment in the share market rating is well advanced.

Market expectations for interest rates also look to have plateaued along with inflation which should peak in in the months ahead.

You can see this clearly in the bond market (*Fig 1*), as yields have topped out (top panel below) and inflation break-evens are now falling (middle panel) along with commodity prices.

While real interest rates (bottom panel) are back at pre-pandemic levels, they may need to move higher still if the inflation data does not improve soon.

Figure 1: Longer dated rates have peaked along with inflation

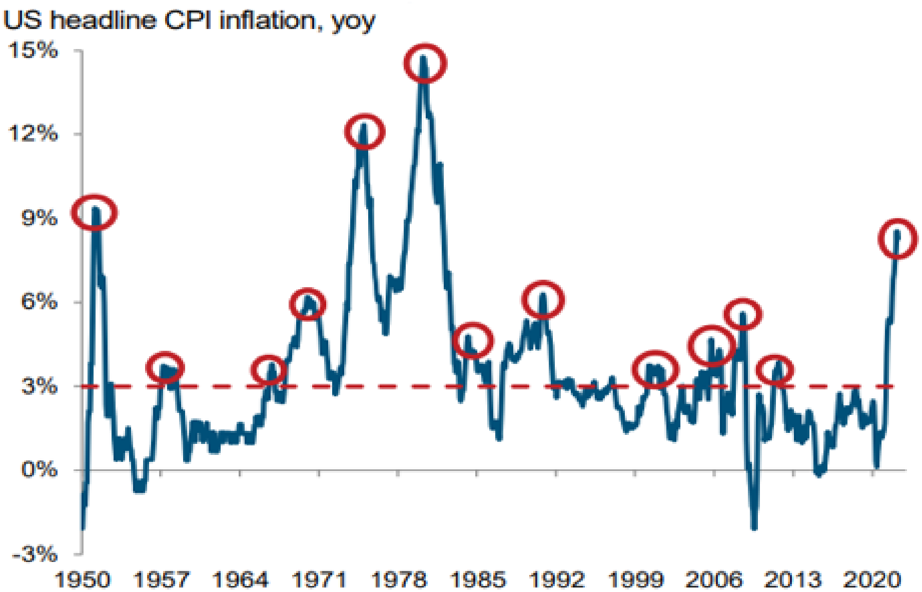


Source: Bloomberg

The signal from the bond market is clear, the focus of investors has pivoting from fear of inflation to fear of recession. Market signals of course are forward looking in contrast to central banks that focus on the emerging data (backward looking).
This is important, Central banks will not walk back from their tightening path until they see at least 3 months of improving inflation data. There is unlikely to be any 'pause' until the end of the year.

In *Fig 2* below you can see inflation as a flow measure will naturally normalise unless expectations become entrenched (1970's).

Figure 2: US headline inflation has peaked >3% 13 times since 1950



Source: Haver Analytics, Goldman Sachs GIR

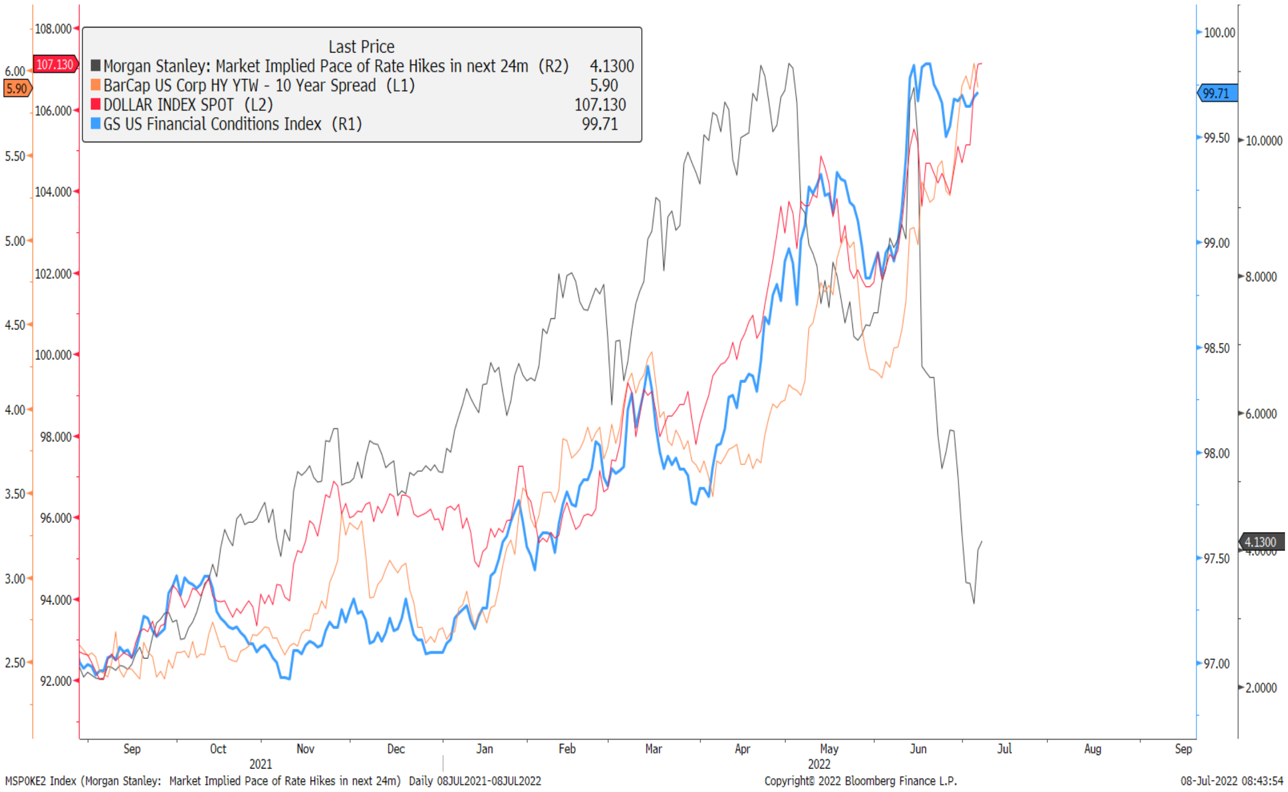
If we end up in recession and commodity prices fall sharply (as they are), inflation may turn negative next year as it did in 2009 following a similar breakout in 2008. This is certainly not on anyone's radar.

Assuming the inflation data does improve any 'Powell Pause' will depend on how quickly advanced economies are slowing, along with the scale of losses in asset markets.

As the focus shifts from inflation to economic activity (recession), financial conditions (FCI) can still tighten further even if interest rate settings remain the same as allocators of capital de-risk (asset values fall and credit spreads expand).

You can see this below with risk margins moving higher (blue line), a stronger USD (red line), and elevated volatility keeping FCI (black line) higher even as expectation for further rate increases start to fall (black line).

Figure 3: Financial Conditions (FCI) continue to tighten

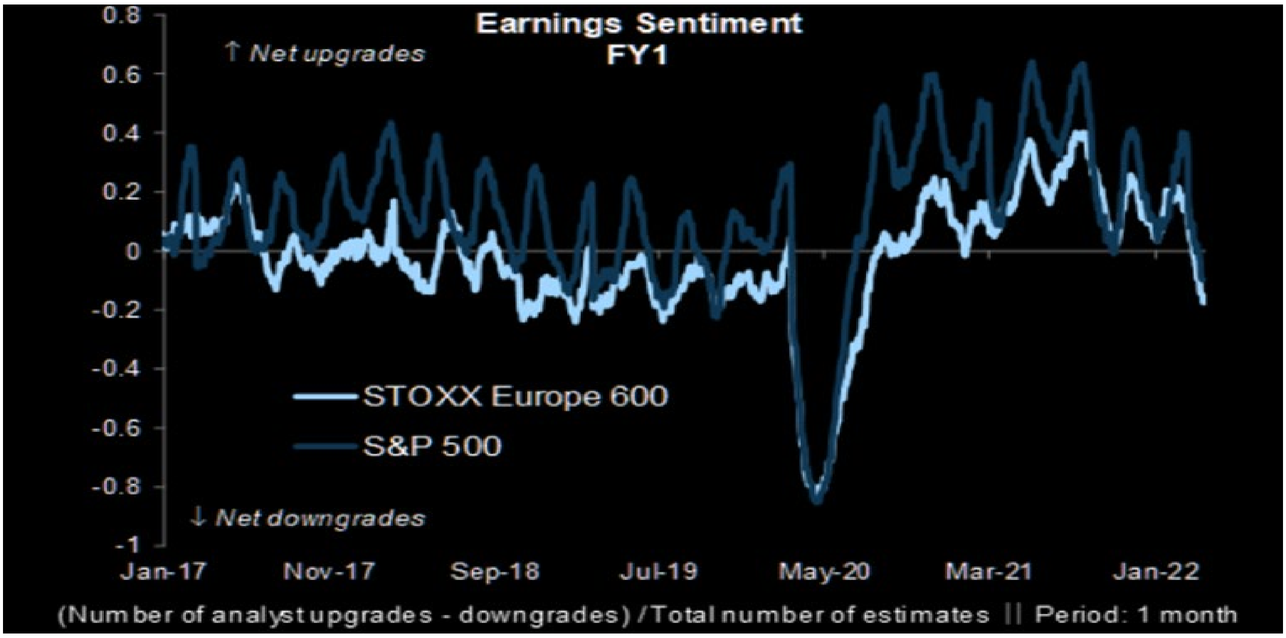


Source: Morgan Stanley, Bloomberg

Which brings us to the next leg down for the share market. As advanced economies slow, investors will start cutting profit forecasts and asset values will resume their move lower.

In *Fig 4* you can see the street has started slashing earnings estimates, the upcoming reporting period for European and US companies will not be pretty.

Figure 4: Profit Estimates are falling sharply

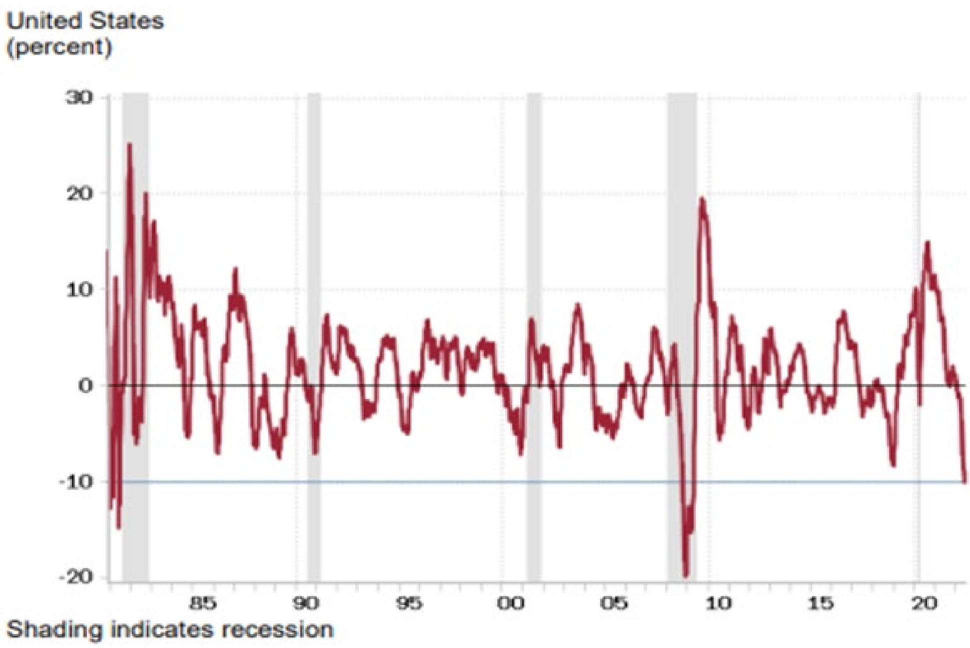


Source: Bloomberg

I don't want to get into the debate around the prospects of recession other than to say we haven't seen a co-ordinate tightening of this scale and pace for many decades as central banks everywhere (Ex-China) are raising interest rates, and they are doing this in a bear market, also a first.

Given this backdrop, the prospects of a recession in advanced economies does appear high. The pace of deceleration in the US economy (*Fig 5*) is the fastest since the early 1980's when we had back-to-back recessions (absent the COVID downturn).

Figure 5: FIBER Weekly Leading Index Growth Rate



Source: Haver Analytics, Rosenberg Research

The question then becomes not if but when and how deep a recession might be, but that's a debate for another day.

In the interests of presenting a balanced view, the bull case will emerge as the inflation data improves. Markets for goods/services and for labour are acutely tight causing inflation. For inflation to ease we need to see the 'output gap' restored. The demand function which has been artificially stimulated (COVID stimulus) needs to shift back to the left, households have been overspending and this will naturally normalise. Business investment has also been elevated but given the uncertain outlook investment will also moderate.

Supply-side disruptions from the pandemic are now resolving quickly, along with labour shortages as employees return to the workforce. If inflation moderates in the months ahead, we could see a policy pause allowing markets to rally.

This I suspect will allow a relief rally of limited duration however as an economic downturn now seems almost inevitable, which means shares move lower into next year.

Short term the share market is oversold and due a decent relief rally which should carry shares higher in the weeks ahead. As bonds are also rallying, the sectors that will lead the market higher are likely to be oversold growth and cyclicals sectors. Defensive shares that have outperformed in recent months will consolidate.

Resource shares are at an interesting juncture. As the focus has pivoted from inflation to growth, late cyclical sectors such as resources have come under increasing pressure as commodity prices across the board have fallen sharply. As with the broader market, commodities are also oversold and will rally in the weeks ahead.

Investors should look to sell into this rally however, if a recession in advanced economies becomes a reality, commodity prices will move a lot lower.

A subtle but important distinction needs to be made here between a secular bull market for commodities and a cyclical bear. The longer-term outlook for commodities is favourable given the underinvestment in the sector in recent years. Short term though, as deep cyclicals, resource shares are most exposed to a slowing global economy.

When the 'cyclical bear' market completes some time next year, resources will be the first sector to own and unlike most other sectors, they are likely to make new cyclical highs next time around.

SECTORS IN REVIEW

We have changed the portfolio review to align with the 3 principal factors rather than the GICs sector. This is more helpful in following market trends:

CYCLICAL SECTORS:
Shares in those sectors that are more leveraged to economic activity have fallen sharply in recent months as investors worry about the prospect of a recession in advanced economies. In many of these sectors, you could argue a recession is already priced in.

If we do see a decent rally in the weeks ahead cyclical shares are oversold and should fully participate. Having said that, we are still early in any slowdown in the economy, any rally in cyclicals will be corrective in nature, they will move lower with the market in the months ahead.

Building Materials: Industries exposed to housing have struggled as detached housing approvals have been falling. With interest rates increasing, there is a broad consensus that house prices have peaked. Given supply side constraints in accessing labour and materials, the backlog of housing completions has increased significantly, so we are not expecting a sharp correction in activity. The housing names are looking more interesting down here. Shares exposed to US housing *James Hardie (JHX), Reliance Worldwide Corp (RWC), Reece (REH)* have performed better as US Mortgage rates look to have peaked.

Chemicals*:* The fund owns all 3 major chemical companies- *Incitec Pivot (IPL), Nufarm (NUF)* and now *Orica (ORI). Orora (ORA)* will benefit from rising ammonium nitrate prices used in fertilisers, AN is also the substrate used for explosive grade AN.

Media: *Nine Entertainment (NEC)* holdings is a good example of a company that is already priced for a downturn, it is an outstanding business that is very well priced.

Discretionary Retail: with the sharp adjustment in price in this space in recent months we have neutralised our settings here.

Contractors: Many of these companies are exposed to the mining sector. Mining shares and commodities are all falling now along with growth expectations. Those contractors more exposed to essential services such as Downer and Ventia Services are better placed for what lies ahead.

DEFENSIVE SECTORS:
These industries have outperformed in recent months as investor worry about a downturn in the economy.

As mentioned in the May 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. Our short position is now starting to deliver results as global Wheat prices begin to contract.

We closed out our long position in the ***Fuel Marketers*** in June. While fuel security becomes an increasing issue for Western Governments, a softening demand profile also needs to be considered. Both *Ampol (ALD)* and *Viva Energy's (VEA)* are likely to beat earnings expectations in August, and both remain on our watchlist.

GROWTH SECTORS:
In late June 'Growth sectors' led once again as the market sensed the adjustment in interest rates may be complete (bond yields have peaked), we built overweight position in consumer growth companies, focussing specifically on those with relatively defensive demand characteristics. We established positions in *Aristocrat Leisure (ALL), Dominos Enterprises (DMP) and IDP Education (IDP)* in particular. Within TMT we focussed on companies in the internet space *Carsales.Com* (*CAR), REA Group (REA)*, which partly offset our shorts in technology.

Resources: As late cyclical shares, mining and energy companies are falling along with commodity prices which have broken down. We are keeping a balanced book of exposures to this sector. Industrial metals were the first to be hit with, steel, aluminium and copper prices falling sharply. Commodities exposed to the 'future materials' sector have performed better. Lithium Chemical prices in particular are not far from all-time highs. We suspect EV sales will soften in the months ahead and prices will fall. We are neutral this sector. Oil and Gas shares have followed mining shares lower though the oil prices have held above $100/barrel.

Mining costs, particularly in the West are becoming a major problem. Though boarders are now open, labour is not flowing to the westward. This will not be resolving any time soon. With fuel costs also skyrocketing, miners are now caught between rising costs and falling commodity prices.

Financials: Banks finally capitulated in June after bucking the downward trend of most global indices in the first half of the year. Concerns of credit quality issues emerging followed the RBA "double" rate rise, with expectations of a 3%+ cash rate by year end. We have been avoiding the banks, highlighting the disconnect between their share prices and the direction of the housing market. Whilst banks sold of the insurers held up relatively well over the month, seeing modest gains for our position in *IAG*.

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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**	**0.2**	**6.3**

**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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