



The Leading Edge

QUARTERLY REPORT • June 2017

Consumer sector in flux - In this edition of The Leading Edge, we examine the changing paradigm creating challenges and opportunities for global consumer companies.

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Justin Braitling
Portfolio Manager

Message from the CIO

Economic data has been steadily improving for over a year now, principally in response to coordinated stimulus introduced at the end of 2015 when the global industrial economy was teetering on recession. For the first time in nine years since the crisis, economists have been upgrading growth forecasts, in part reflecting how low expectations had fallen last year.

With the new trump administration promising large tax cuts and further spending, investors quickly jumped on the “reflation trade” buying value and cyclical shares in the belief interest rates would rise and the deflationary scourge that has beset major economies would pass.

With a resurgence in both leading indicators and confidence (soft data) the reflation trade quickly moved to over-bought levels as we moved into the new-year. This exuberance has faded however in the first half of the year as “hard data” has fallen short of expectations and as Trump’s reform agenda floundered in congress. Reflecting this, the reflation names have underperformed so far, this year, as bonds have rallied and growth and defensive shares have resumed their leadership. This is certainly consistent with our view- we would expect the pick-up in activity to fade in response to tightening financial conditions as we move through the year, a flattening yield curve is certainly guiding toward this.

A debate is raging amongst investors: is it time to revisit the reflation trade or will growth moderate and deflation return? It is too early to tell if the uplift in activity is sustainable or not. Investors instead are taking their lead from Central Banks, as bond and currency markets break out in response to changes in the policy narrative.

European Central Bank president Draghi was so bold as to suggest in July “the threat of deflation has gone and reflationary forces are now at play”. Following this speech European bonds collapsed in a re-run of the US taper tantrum of 2013. The heads of the Bank of England and the Bank of Canada have followed suit with the BOC raising interest rates vaulting the Canadian dollar and the pound upwards.

The pendulum has shifted, central banks are clearly now looking for opportunities to tighten policy, in the first instance through exiting large-scale asset purchases (ECB) and divesting trillions of dollars of purchased securities in the case of the US Federal Reserve. The liquidity drain is obvious as central banks move from buyer to seller sucking the same quantum of wholesale deposits out of the financial system.

Investors are still coming to terms with this change of tack with many still expecting policy makers to back off on the first sign of weakness in the data. The realisation that monetary policy, the mainstay of this bull market, is no longer supportive of asset markets is yet to fulling sink in. This will be an important source of volatility in the medium term as the new paradigm becomes clearer.

The uncertainty following the crisis saw a steady flow of capital into the US economy pushing the US dollar and the US share market higher at the expense of other markets in the Eurozone and EM which have struggled. As activity is now recovering in many of these regions, these capital flows are reversing pushing these assets markets higher while at the same time putting the US dollar under pressure. A weaker dollar eases financial conditions in emerging markets (EM) accentuating this outflow. The Euro and reflation currencies such as the Australian dollar and Canadian dollar have rallied hard and spreads between European bonds and US treasuries have narrowed.

Markets want to celebrate the return of animal spirits and a return to sustainable growth even as policy normalises, I suspect this resolve will be tested as activity slows later in the year in response to the policy tightening already in train.

With key markets at all-time highs and valuations stretched, we will retain our fully hedged position across each of our funds as this expansion cycle tires. Our first priority is to protect our investors from loss, while at the same time generating alpha through security selection. Shares are expensive, earnings momentum in Australia is sluggish and valuations are very full. The bull market in its ninth year is more than likely approaching its twilight hour.

Investing In The Consumer

The investable consumer universe can be broadly split into two types of companies: brand owners and retailers. While this distinction has blurred over time as brands open stores and retailers expand private label offerings, it remains a helpful way of categorising companies in the sector given the differing dynamics of each category. This note will separately explore the changes taking place in the branded consumer packaged goods (CPG) industry and the current state of retail both domestically and offshore.

Changes in the Consumer Packaged Goods Industry

The widespread branding of consumer goods that we are familiar with today has its origins in the late 19th century. The major economies of the UK, Europe and America were rapidly expanding their national railroad systems while at the same time an emerging middle class was benefiting from rapid wage growth. For the first time in history, consumer goods could be easily moved around a country to consumers who had the means to buy them.

Prior to the arrival of mass-market branded products, consumers could only purchase products made by their local grocers or pharmacists. Given the small-batch nature of local production, quality would vary from vendor-to-vendor and from week-to-week making it impossible for the consumer to know in advance of buying, whether the product would live up to expectations. The key value proposition of the emerging mass-market brands was that of consistency. *Campbell's* condensed soup was certainly not the best soup that money could buy, but a buyer of the product knew with certainty what the quality of the product would be prior to purchase.

Reinvestment of profits back into marketing and distribution resulted in market positions that were relatively stable and safe from new entrants for over a century. Some of the earliest innovators remain dominant consumer companies today. *Unilever* sold their first branded product (Sunlight soap) in 1884 while on the other side of the Atlantic, *Procter & Gamble* were marketing their first branded product (also a soap named Ivory) on a national basis by 1882. The first ever Coca Cola was served from a fountain in 1886, followed in 1893 by the first Pepsi (although it was known at the time as 'Brad's Drink').



After more than a century of relative stability, the consumer-packaged goods industry finds itself undergoing rapid change as the structures that ensured such impressive corporate durability are now breaking down:

1. With the emergence of the internet as a form of 'endless isle', dominant distribution can no longer be assumed simply because all the available shelf space in a supermarket is locked down for national brands.
2. Monopolising television, radio and print media advertising is no longer sufficient to control share of mind as eyeballs and attention move to new media; which is inherently less controllable.
3. Brands become less effective surrogates for product quality in a world where everything is reviewed online. Conversely the ability of a new entrant to be known for quality despite not having brand recognition becomes possible with online reviews.
4. Wholesale customers are increasingly becoming competitors as supermarkets and *Amazon* invest further into private label products.

Online Shopping Changes Behaviours

The change in consumer behaviour as the point of sale transitions from the supermarket to an internet browser or mobile app is transformational. The old model of ensuring your product was appropriately ranged in a supermarket (preferably at eye level) provided a means of stimulating demand as customers browsed the aisles.

Online shopping however is highly reliant on the use of favourites lists which is detrimental to impulse purchases. For additional purchases beyond a favourite list, online shopping relies on search and you can't search for something if you haven't already thought of it.

Recent innovations from *Amazon* however suggest that the pendulum may yet swing back in favour of large brands. Amazon Dash buttons are physical buttons linked to a single branded product (Tide detergent, Kleenex tissue & Mount Franklin water) that you can locate anywhere in the house and push whenever you want to place an automated order (Fig 2). Amazon Echo is a smart speaker that allows for voice-controlled ordering of products. Both innovations lock-in a choice of brand, either chosen by the consumer or *Amazon*, effectively creating a subscription business. Only the largest brand in each category can afford to pay *Amazon* the fees required to become the default choice and as such it is possible that consumer packaged goods companies may yet come to control distribution again, to the detriment of smaller brands.

Amazon Dash Buttons

FIG 2



Source: Amazon

recalls, and have introduced an element of agricultural risk to the company given the vertically integrated nature of the *Bolthouse Farms* acquisition.

The Beer Industry Has Seen Rapid Change

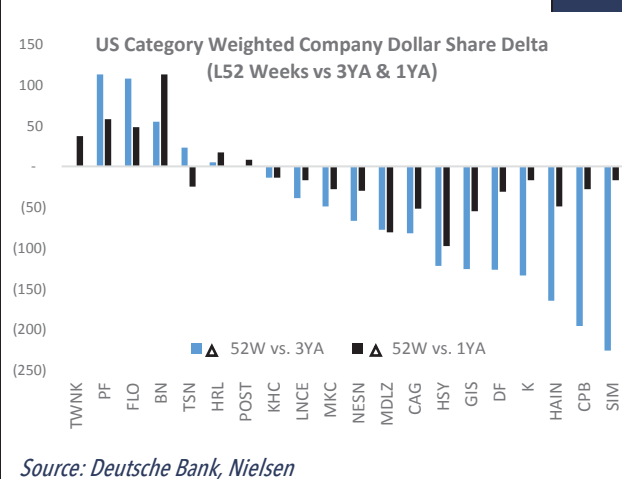
The US beer industry provides another example of how CPG markets are rapidly changing. The US census first started recording the number of brewers in the US in 1873 and each subsequent census reported a decreasing number of brewers with an exception for the few years post-prohibition. A beer drinker in 1990 could have been forgiven for thinking that by 2020 their only options would be a choice between Budweiser and Bud Light. Remarkably today there are more breweries in the US than since records began. Craft beer represents 14% of US beer volumes and 20% of the gross value (Fig 4).

Branded Food is Vulnerable

In the meantime, branded food manufacturers find themselves in a particularly difficult position. Their category is one of the most vulnerable to private label, they are subject to changing consumer preferences for healthier/fresher food, and supermarkets are reconfiguring their floorplans to give more space to edge of the store (fresh goods) at the expense of space previously allocated to the centre of the store (shelf stable packaged goods). Nielsen data summarised in (Fig 3) shows that the majority of US-listed packaged food companies have lost market share over the past one and three years.

As Consumers Opt for Healthier Alternatives, Food Manufacturers Lose Dollar Share

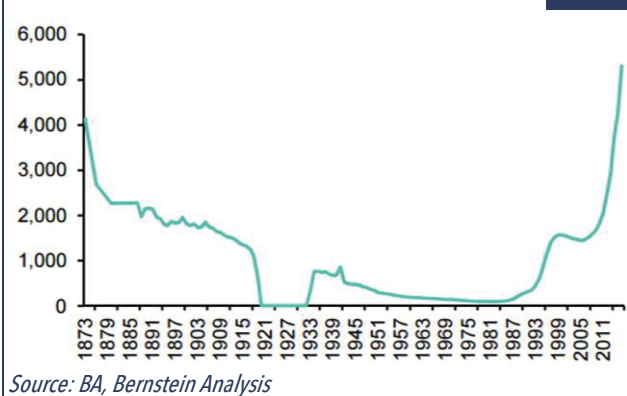
FIG 3



The Watermark funds are short *Campbell Soup* as an expression of this thematic. Shelf-stable soup, broth and beverages comprises 60% of the company's sales and are increasingly threatened by customer preferences for higher priced, fresh, alternatives found on the edge of the store. Competition is proliferating following several years of significant venture capital investment in *Campbell's* categories. Attempts to purchase and integrate smaller competitors have had mixed success, best exemplified by the recent history of product

Number of Operational U.S. Breweries

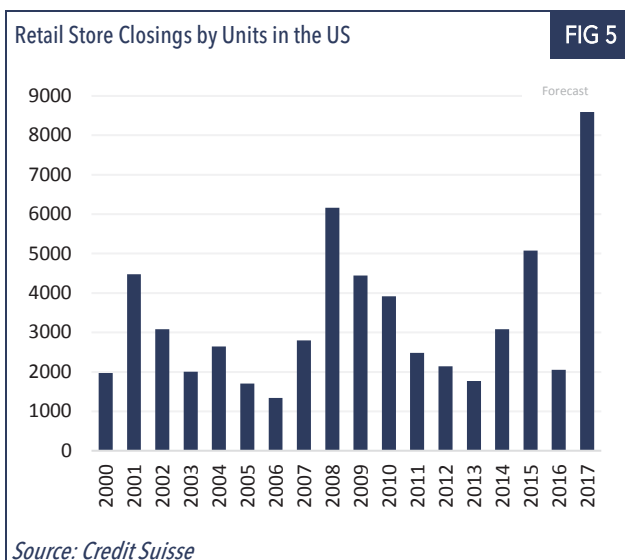
FIG 4



Despite this dynamic we still see opportunities to invest in the global brewers. The Watermark funds are long *Heineken* which has approximately 60% of profits from fast growing emerging markets - the highest amongst peers. The suddenly crowded US market represents just 5% of profits and *Heineken's* US portfolio includes a couple of fast growing Mexican beer brands (*Dos Equis* and *Tecate Light*). The company is cycling a period of elevated expenditure on marketing and selling which bodes well for future demand creation, providing an opportunity to buy the stock at a time when the true profitability of the company wasn't necessarily apparent. The *Heineken* family remain committed shareholders allowing the company to plan and invest for the long run, a relatively rare luxury given most listed companies find themselves compelled to focus on quarterly results.

The State of Retail

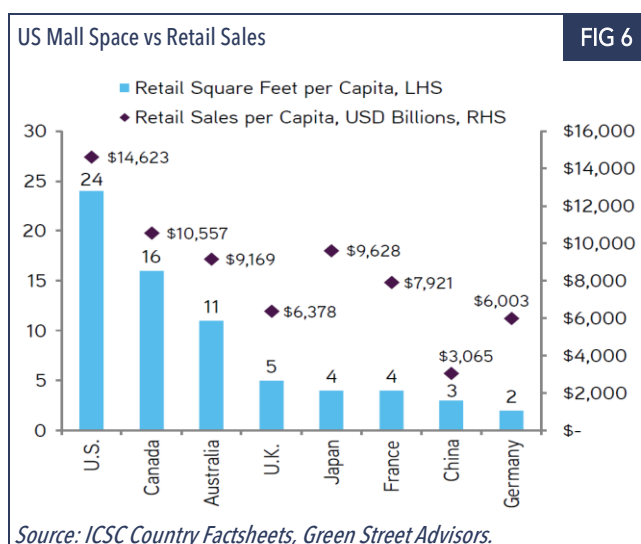
It is no secret that the past year has been a particularly difficult time for companies in the business of physical retail (i.e. not online). If current trends persist, then 2017 will see over 8000 store closures in the United States; which is 30% higher than was seen in the darkest days of the 2008 financial crisis (Fig 5).



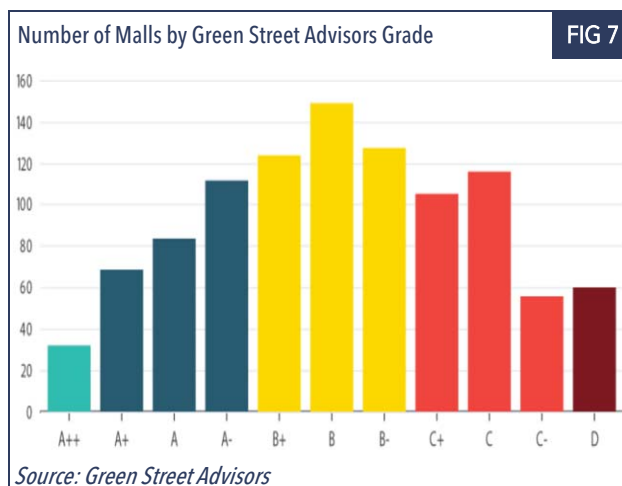
We can identify three drivers that have contributed to the current malaise:

1. Excess Selling Space

Depending on your point of view, certain markets are either over-stored or under-demolished. The US stands out in particular, with 5-6x the selling space per capita of Europe. Maybe as significant, 46% of selling space in US malls is attributable to department stores, which is one of the retail formats under most pressure from declining consumer traffic. By way of comparison 23% of Australian mall space is allocated to department stores.



Space productivity (sales/unit area) is the life blood of retail businesses and we can use this metric to get a sense for what portion of retail space in operation today is existentially threatened (Fig 6). The best data is available for the US (courtesy of Green State Advisors) and is summarised in the chart below (Fig 7).



To be classified as an A- grade mall or better, sales productivity of \$500/ft² is required. These malls are typically located in high-income and heavily trafficked areas. Tenants usually include high-end fashion and technology retailers, complemented with food and entertainment features that are not easily replicated online. Malls that have sales productivities below \$350/ft² are classified as C+ or worse and are characterised by 'value' retailers and significant vacancies.

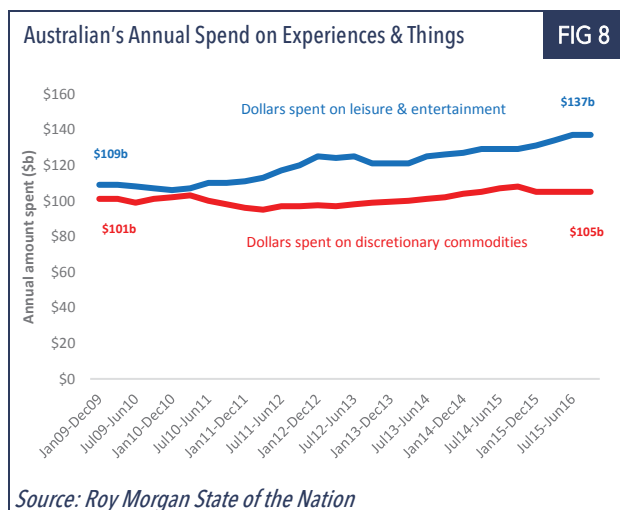
Malls rated C+ or worse account for about 30% of the approximately 1,050 large malls in the US. These malls will not survive and are destined to join the growing list of obituaries available at 'deadmalls.com'. At the other end of the spectrum, the value of high-quality A-rated malls has more than doubled since the financial crisis. Retail is one of the most brutally Darwinian industries available for investment on a stock exchange, and while there remains an excess of selling space, then change should be assumed to continue at a faster pace than usual.

This thematic plays out within our funds where we are short *Gap Inc.* *Gap* comprises of three different apparel retail banners (*Gap*, *Old Navy* and *Banana Republic*) of which only *Old Navy* isn't heavily exposed to struggling malls. Same store sales at both *Gap* and *Banana Republic* have been consistently in decline for three years now and it is hard to envision a reversal of fortune. The more successful *Old Navy* format has a volatile history of performance dependent on merchandising success and looks like it may be over-earning just as lower-price competitor *Primark* (owned by *Associated British Foods*) seeks to expand its presence in the United States.

2. Changing Share of Consumer Wallet

Disposable income available for the purchase of physical goods at retail is a function of gross income, less non-discretionary spending on services like healthcare, rent and utilities (mobile plans can be included in this category). Fifty years ago, consumers split their expenditure in roughly equal amounts on

goods and services. Today the US consumer spends twice as much on services as physical goods. While this dynamic has been driven predominantly by elevated levels of inflation in services such as healthcare and education which have crowded out spending on physical goods, there is now also an unmistakable trend towards 'experiences over things'.



Categories that are gaining share of consumer spending are healthcare, recreation, travel and leisure. Theories as to why this shift is happening includes the rise of the sharing economy and the desire to cultivate the most flattering social media profile possible. Some of the more sophisticated traditional product companies are experimenting with offering their customers experiences: *Louis Vuitton* now own a series of lavish hotels while *Prada* own a pastry shop in Milan to complement their art gallery in the same city. Watermark's investments in antipodean casinos: *Star Entertainment* and *SkyCity Entertainment Group*, fit into this thematic.

3. Ecommerce is Less Profitable

Retailers have had no choice but to follow their customers online, however the returns from selling online are typically inferior to selling in-store. This reality is very different from the common narrative often heard last decade, expounding the low cost to serve of online sales, primarily because there was no requirement to pay expensive high street rents.

A traditional in-store sale typically involves the following steps:

- i) customer drives to the store;
- ii) customer collects the items in the store themselves;
- iii) customer brings them to the cash register;
- iv) customer increasingly scans and bags the items themselves;
- v) customer drives the items home; and if required
- vi) customer delivers any returns in person back to the store.

By comparison an on-line sale involves the following steps:

- i) customer selects and pays for the item on phone/computer;
- ii) company collects the items from storage;
- iii) company packages the items for delivery;
- iv) company pays for delivery; and if required
- iv) company pays for returns.

Consequently, an online sale carries much higher variable costs to the retailer and is dilutive to returns if the sale does not represent incremental business.

The two greatest hindrances to online profitability are free delivery and high online marketing costs. The requirement for retailers to offer free delivery can largely be blamed on *Amazon* and its decision to offer free delivery to all Prime members which retailers in the US and EU have felt compelled to match (watch for something similar when *Amazon* launches in Australia). *Amazon* lost an estimated \$USD7.2b from shipping last year (difference between shipping revenues and costs) which is effectively a subsidy paid to their customers. Traditional retailers are expected by their shareholders to grow (or at least hold) sales and profits. *Amazon's* shareholders however, allow it to play a different game to everyone else.

Online marketing typically involves bidding for keywords on *Google* or space in *Facebook* feeds and the rapidly growing profits at *Google* and *Facebook* are a testament to the increasing expense of this marketing channel. Emphasising this point, in recent years we have seen many online-only retailers such as *Amazon*, *Bonobos*, and *Warby Parker* open physical retail stores, because it turns out that physical stores can be a cost-effective customer acquisition tool. The end-result is that as ecommerce becomes a larger part of a retailer's sales mix, it is typically dilutive to profit margins and returns on capital.

BASIC INDUSTRIES

Credit growth in China weakened in the quarter as authorities continued their crackdown on the financial sector. More recently however, conditions have eased with the Ministry of Finance announcing it would increase liquidity in the bond market and Government news outlet Xinhua reporting the need for “loose credit conditions”. Resource shares rallied on this potential tempering in approach to financial reform. Energy companies were offered no such respite, even as OPEC production cuts were extended until March 2018. US shale producers increased drilling rig numbers as oil briefly traded above \$50, ultimately pushing the sector lower through the period.

In response to the looser policy settings in China, we neutralised our position in the mining sector. We believe this easing is transitory, as the Government looks to manage the economy into the November Party Congress meeting. The focus will return to Financial reform following the meeting, likely providing an opportunity to re-establish a short position in mining shares. After underperforming through 2017, we are increasing exposure to the energy sector. Recent results from US shale producers have highlighted a “tapping of the brakes”, which will slow production growth and help rebalance the market.

We covered some successful iron ore shorts as the price of that commodity dropped below \$60. Discounts for low grade material particularly impacted certain producers. We increased our new holding in *BHP Billiton* with the company having announced a new Chairman, Ken MacKenzie. We are encouraged by the appointment due to his impeccable track-record at industrial company *Arcor* and see ample opportunities for management to implement further ‘self-help’ measures. The downturn in the price of oil has devastated the US onshore services industry. 2016 was annus horribilis, with no services company producing a profit. We view this as unsustainable, especially in light of the continued productivity improvements and growing production levels. *Haliburton* was added to the international portfolio as it is extremely well positioned to benefit from this recovery.

In aggregate, the Basic Industries portfolio performed well in the quarter, capitalising on weakness across the commodity complex through the Fund’s short positions in mining companies. Our key holding in *Iluka Resources* performed positively, as continued strength in the rutile and zircon markets were compounded by a likely expansion to the company’s royalty position.

INDUSTRIALS

Industrial shares continue to be buoyed by a pickup in leading indicators for the global economy. The US and European industrial economies are showing reasonable strength, and momentum in China is being maintained. With valuations high by historical standards, industrial shares are vulnerable to any disappointment versus elevated expectations. The strength of the Euro in June highlighted this risk, as European industrials with significant offshore businesses were sold-off towards the end of the quarter.

The Funds are hedged in industrials, with long positions in higher quality, undervalued companies, and short exposures in lower quality names where valuations have fully captured the economic pickup. A significant structural theme remains the shift to digital platforms, where leading companies are upgrading their products to be digitally connected and monitorable (e.g. wind farms, jet engines) – with benefits to customers through better productivity and availability. Another key theme is the impact of e-commerce on traditional business models in distribution and logistics.

In Australia, the funds have benefitted from investments in deep value plays such as *Qantas* (trading at a significant discount to foreign competitors). Valuation discrepancies were also exploited in the infrastructure sector, where positions were established opportunistically in *Sydney Airport* and *Macquarie Atlas Roads*. Internationally, the funds initiated a new position in *Honeywell*, an industrial leader in areas such as automation systems and in aerospace components, where the company continues to benefit from continued growth in flying hours and higher demand for aircraft maintenance. *Honeywell* has a successful track record in reducing costs, which should continue. On the short side, the Funds are short companies facing structural pressures, such as growing competition from Chinese competitors, and the encroachment of e-commerce on traditional distribution models.

CONSUMER

The strength of global consumer demand remains inconsistent across both geographies and categories. Overall, we are seeing improving trends in Europe and Asia while the picture in the United States is more uneven. Demand from Australian consumers appears to have strengthened in May and June following weakness in the months prior. Despite accelerating store closures, there remains too many retail stores in the United States given the channel shift to e-commerce. Although the starting points in Australia, continental Europe and Asia look more favourable, retailers in these regions should not assume they will be immune. This quarter was most notable for an

intensification of the turmoil in US retail, which was accentuated by the delayed payment of tax returns to consumers.

Watermark's strategy for the retail segment is primarily to invest in retailers of product categories that have only a minor overlap with *Amazon* (admittedly a very small list) or where we believe fear has driven the market to over-react in factoring the consequences of increased competition into share prices. To date, our best successes on the short side have come from identifying companies with idiosyncratic problems rather than thematic shorts (e.g. department stores, stationary retailers). When investing in brand owners we are looking for sustainably managed brands in growing categories, balanced with short positions in overpriced securities which do not properly reflect the structural challenges that we have identified.

During the quarter, our short positions in domestic consumer brand companies *Asaleo* and *Coca-Cola Amatil* contributed to returns. The grocery channel has become increasingly difficult for brand owners to navigate, given escalating competition and range reviews from the major supermarkets. The fund's long positions in discretionary retailers which were (in hindsight) prematurely purchased after an initial sell-off, detracted from returns as negative sentiment in relating to *Amazon's* Australian entry was compounded by soft consumer data.

Melco Resorts and Entertainment (Macau casino) and *Heineken* (global brewer) made important contributions to performance over the quarter. Macau visitation and gaming revenues surprised the market to the upside and we elected to take profits on the *Melco* investment following its strong performance. Detracting from returns were long positions in *O'Reilly* (automotive parts) and *Kroger* (supermarkets). Both companies were punished by investors after providing soft trading updates, which were presumed to imply structural impairment due to online competition and new market entrants.

FINANCIALS

After trailing global equity markets in April and May, financial shares significantly outperformed in June. This was driven by a rapid upwards repricing of global bond yields after a series of comments out of G7 central banks were widely interpreted as hawkish. Specifically, the minutes from the UK Monetary Policy Committee showed three of the eight members voted to raise interest rates from 25bps to 50bps at its June meeting, an increase from just one of eight voting for a rate rise at the May meeting. Secondly, the minutes from the June meeting of the ECB Governing Council showed that officials discussed whether to end the central bank's commitment to increase the rate of bond purchases if the European economy deteriorated. This

sentiment was also observed with the US FOMC (Federal Open Market Committee), where they raised its Federal Funds Target rate 25bps to a range of 100-125bps in June. The sell-off in bonds was particularly pronounced in Europe where, for example, the German 10-year bund yield rose to a level not seen since the first quarter of 2016.

The funds were strategically positioned to take advantage of this rally, as we had increased their exposure to European and Australian banks throughout the quarter. In Australia, an investment in *Henderson Global Investors* was a stand-out performer, with the company having completed its merger *Janus Capital* during the quarter. A short position in *Stockland Group* also made a strong contribution, with the shares following the broader A-REIT sector lower in June as Australian bond yields rose in sympathy with other G20 bond markets. A long position in *Scentre Group* detracted from performance, which like *Stockland*, traded lower as global real estate stocks and other bond proxies sold-off.

Internationally, a long position in Dutch Life insurer *NV Group* contributed positively. We added to this position in June after the stock sold off following a Dutch arbitration committee ruling, that found the company failed to provide sufficient product information to a unit-linked policyholder at the point of sale. We believed the ruling would be of little economic consequence to the company, and the stock bounced strongly in the final weeks of the quarter. Another highlight from the international portfolio was a short position in *Canadian and Imperial Bank*, which traded lower through the quarter as concerns built around the health of the Canadian mortgage market. This was in light of the difficulties encountered by specialist mortgage lender *Home Capital Group*, which announced that its liquidity position was rapidly deteriorating due to deposit outflows. This forced the company to raise a CAD\$2b credit line (vs. total assets of c. CAD21b) from an unnamed investor at a rate of 10% to shore-up its funding.

HEALTHCARE

The June quarter was marked by considerable divergence in performance between the various subsectors of healthcare. Regional divergences were also notable and volatility has increased overall. European healthcare names ran hard in the first part of the quarter, closing the relative valuation gap to their US peers. This was despite little in the way of new information, and quarterly financial results that were broadly in-line with expectations. These gains were almost completely erased by the end of the period, with sharp falls sparked by pro-inflationary commentary out of the ECB driving a rotation of

capital flows out of defensive shares (like healthcare) into more rate sensitive sectors such as financials.

The US healthcare sector had a slow start following mixed March quarter financial results. Medical device shares (leaders and emerging) materially outperformed the broader healthcare group and remain the preferred 'safe haven' exposure for healthcare investors.

Biotech companies caught a long-awaited bid towards the end of the quarter, driven by a spate of positive clinical data readouts from small and midcap companies. Oncology-focused biotech companies were the standouts, particularly those developing CAR-T cell therapies (*Kite Pharma*, *Bluebird Bio* and *Juno Therapeutics*) where the release of updated clinical data confirmed promising early results in incurable blood cancers and increasingly durable treatment effects (survival). Positive clinical trial announcements sparked a fresh wave of M&A speculation and biotech capital market activity (new and secondary issuances) picked up at the end of the quarter. While this is positive for sentiment towards biotech shares, we remain cautious that M&A activity will remain subdued until greater clarity around US taxation reform and drug pricing emerges.

Large biotech names also drove outperformance following predictions from brokers of solid upcoming 2Q financial results and softening of drug pricing rhetoric out of Washington DC; notables were *AbbVie*, *Regeneron Pharmaceuticals* and *Vertex Pharmaceuticals*. Major pharmaceutical company shares delivered mixed results and broadly underperformed during the period, continuing to reflect what we see as a bear market. Despite perceived softening of drug pricing rhetoric, we are concerned drug pricing pressures are structural and have yet to fully impact major biopharmaceutical companies' revenues.

Australian healthcare shares materially outperformed their global peers, beaten only by the US medical devices sector, which continues to press higher. The share prices of many Australian healthcare companies have reached extreme levels, with sector heavyweights *CSL*, *Cochlear*, *Resmed* and *Sonic Healthcare* all hitting record highs; most valuation metrics finished the quarter more than 1x standard deviation above historic levels. Capital inflows appear to be the driver as investors rotate out of financial shares. There also appears to be some positioning for a weaker Australian dollar. The shares of *Ramsay Healthcare* continue to underperform peers, a result of issues we believe the market is fundamentally misunderstanding. We will look to add to this position on any weakness. With valuations of Australian healthcare companies at nose-bleed levels we continue to see better investment opportunities offshore.

Having held net short exposures in Europe and Australia through the quarter, the healthcare portfolio delivered modest negative returns overall. While this was disappointing, we see clear valuation support for maintaining this net short bias across the healthcare portfolio and used strength in the quarter to add to core short positions. Other notable events impacting performance included the pullback in *Nevro* shares after an aberrant Q1 sales result. We saw these issues as transient and were provided a great opportunity to build a bigger position in this emerging leader in spinal cord stimulation. We took profits in small/midcap biotech shares, *Juno Therapeutics* and *Alnylam Pharmaceuticals* following solid gains.

TECHNOLOGY/MEDIA/TELECOMMUNICATIONS

Despite a brief pullback mid-quarter, technology shares showed continued strength, ending June at new highs. As observed across much of the market, central bank commentary interpreted as positive for inflation sparked a rotation away from tech shares in favour of Financials (with no other clear catalysts for the weakness). This proved to be short-lived, with most tech shares having more than recouped these losses. One key data point which we believe will drive performance of the sector is the sustainability of strong positive earnings momentum for Internet leaders such as the FANG (companies). The recent blowout *Netflix* result indicates that this momentum can indeed be sustained. In the semiconductor sector, we watch for any weakness in the automotive end-market (as new car sales continue to weaken in the US) and whether memory pricing strength can be sustained into the second half of the year, as new capacity is brought online. An interesting feature of earnings releases from benchmark companies such as *Intel*, *IBM*, *Microsoft*, *Oracle* and *SAP* in recent quarters has been the strength in legacy businesses (e.g. PC shipments, on-premise license revenues) which have exceeded expectations, while new businesses (e.g. cloud for the software companies, data centre chips for *Intel*) have disappointed.

The outlook for the advertising market looks like it will progressively deteriorate for the rest of the year, which is ultimately driving media shares lower. This is a result of concerns around measurement and brand safety online, and audience declines offline, which have been amplified by cost-cutting initiatives at FMCG companies (~35% of the advertising sector in Europe) impacting on marketing spend. Telecommunications again ranks among the worst-performing sectors for the quarter, as competitive pressures in the US worsen and regulatory intervention in Europe increases.

Across the TMT space we are slightly long, selectively identifying investment opportunities in companies with a

structural runway for growth. Within semiconductors we are long analog semis, exposed to content growth particularly in industrial automation and connected devices, while shorting logic semiconductor manufacturers where returns are under pressure as businesses migrate workloads to the cloud. Security investment has consistently outpaced broader IT spend, with recent malware attacks a reminder of how the increasing complexity of enterprise networking environments is becoming more difficult to secure. As a result, we maintain a long exposure in this sector. Growing penetration of high speed internet access is seeing most of us spend a greater portion of our day consuming content in various forms, be it *Netflix* streaming or a *Facebook* newsfeed. While the demand for premium video content is well understood by the market, we see this as an opportunity to invest in undervalued content such as video games and music. Meanwhile, TV networks' role in distributing video remains vulnerable given declining audiences, leading us to short advertising-exposed broadcasters in markets where TV still commands a large portion of overall ad spend (France, Spain) and long broadcasters that have diversified into digital avenues with TV comprising a much smaller share of advertising spend (Germany). Given the struggles across the sector, we are short Telcos that are over-earning or under competitive threat, while selectively investing in 'recovering' and growth markets.

There is a limited universe of Australian TMT companies to consider. Our core holding in *Fairfax* detracted from performance in the quarter as both potential suitors failed to submit bids by the deadline. We saw this as an opportunity to lift our position ahead of the Domain spin-off and as residential listings volumes recover in key markets. Recent weakness also provided opportunities to initiate investments in *TradeMe Group* - which has already paid-off as NZ classifieds grow strongly on the back of a robust economy - and *Here There & Everywhere* (previously *APN media*) which, with recent transactions has transformed into a pure radio and outdoor advertising business. The radio format remains resilient while outdoor is the last remaining non-Internet advertising medium to grow on the back of new digital formats. In technology, we increased our position in *MYOB*, as uncertainty around the timing of a private equity sell-down caused some short-term weakness in the share price.

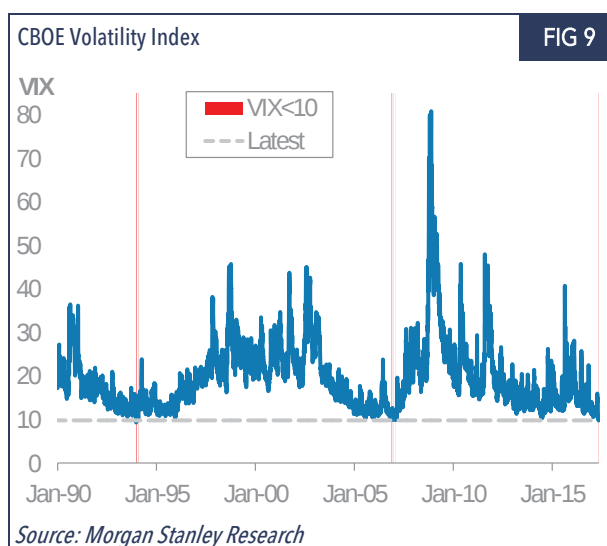
Given the volatility in TMT shares globally during the quarter, we took the opportunity to refresh some positions while maintaining our long exposure. Overall the funds' TMT positions again contributed strongly to performance. We took profits on *Tencent*, which performed well post a new game release, and the telco *Maxis* which traded weakly following a capital raising. Recent malware attacks and European privacy regulations

(which take effect next year) are likely to refocus attention on security spend, validating a timely new investment in next-generation firewall vendor Fortinet. We retain a core investment in *Intuit*, which reported a strong result as its cloud-based accounting software gained traction. We closed our highly profitable US telco position (long *T-Mobile* and short the *Bells*), while in Europe we increased our exposure to *Orange* (our pick of the incumbent telcos) and hedged this with a new short in *Deutsche Telekom*, which has underinvested in its German fixed-line network. Finally, we took profits in German outdoor business *Stroer* and established new positions in European broadcasters as discussed previously - long Germany and short Spain and France. An unexpected factory accident will tighten display panel supply, which led us to close our short in AU *Optronics* at a loss.

Performance Review

Performance across all funds was positive for the quarter, in what was a mixed period for equity markets here and abroad. Macroeconomic themes were again the key determinant in the performance of asset markets, with bonds and equities and currencies all responding aggressively to the growing consensus amongst central bankers for a move towards tighter monetary policy settings. While this impact was short-lived in parts of the market, it is illustrative of the volatility that can be expected as investors read inferences of intent and timing into every utterance from a central banker as to how and when the great experiment in reflationary monetary policy may be brought to an end.

As has been mentioned in previous correspondence, long/short strategies rely on volatility within and between sectors to create divergences and mispricing opportunities that can be exploited by an active investment manager. As seen in **Fig 9**, volatility as measured by the VIX has been very low in recent years, with investors seemingly lulled into a malaise by the soothing message of central banks prepared to “do whatever it takes” to prop up anaemic global growth. We expect that the market will be shaken from this funk as the promise of cheap liquidity and quantitative easing is withdrawn.



The domestic portfolio made the greater contribution to returns in the quarter, with attribution skewed to the short-side given the weakness across the broader Australian share market. Short exposures in the Australian mining and energy sectors were amongst the strongest individual contributors. On the international front, the funds generated a modest positive spread with longs marginally outperforming shorts. Technology was the best performing sector, offset by losses in retail and healthcare.

Performance Attribution for the Quarter

Contributors

Domestic Positions	International Positions
Fortescue Metals Group Ltd	Vivendi SA
Janus Henderson Group	IBM
Iluka Resources Ltd	Alnylam Pharmaceuticals
Woodside Petroleum Ltd	Alphabet Inc
Evolution Mining Ltd	Heineken

Detractors

Domestic Positions	International Positions
Mayne Pharma Group Ltd	Grifols SA
Scentre Group	Royal Bank of Scotland
Westpac Banking	Kroger Co
Super Retail Group Ltd	Tesla Inc
Northern Star Resources Ltd	Vertex Pharmaceuticals Inc.

Fund at a Glance – June 2017

ASX Code	ALF
Fund Size	AU\$342.5m
Fund Strategy	Variable Beta
Shares on Issue	272.5m
Dividend (HY17 Interim)	4 cents
Dividend Yield (annualised))	7.0%

Net Tangible Asset (NTA) Backing

	May 17	Jun 17
NTA Before Tax	\$1.27	\$1.26
NTA After Tax & Dividend	\$1.28	\$1.27

Gross Portfolio Structure

	May 17	Jun 17
Long Exposure	119.9%	130.9%
Short Exposure	-121.4%	-131.0%
Gross Exposure	241.3%	261.9%
Cash	101.5%	100.1%

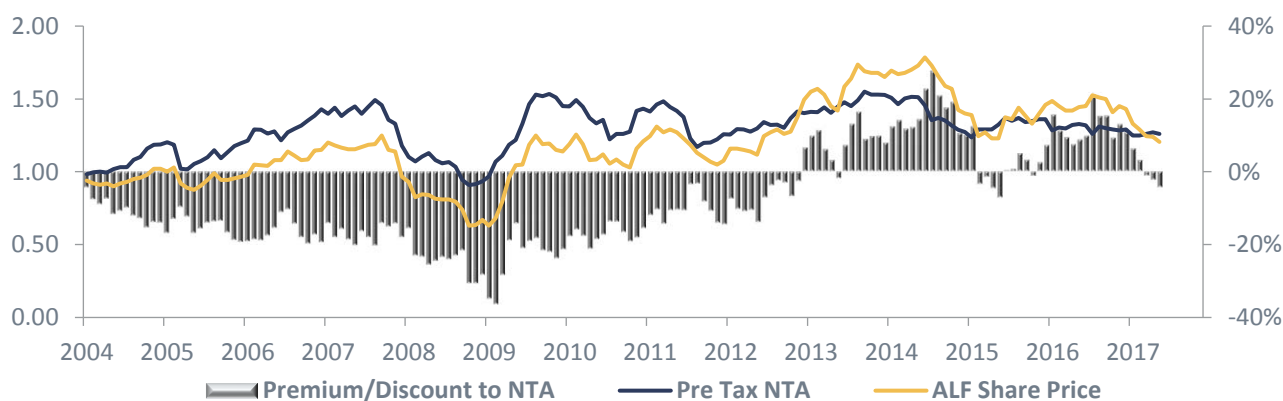
ALF Performance

	1 Mth	6 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	-0.5%	0.7%	2.0%	3.1%	12.3%	11.5%	13.0%
All Ords Accum Index	0.3%	2.9%	13.1%	6.8%	11.6%	8.8%	8.8%
Outperformance (net)	-0.8%	-2.2%	-11.1%	-3.7%	0.7%	2.7%	4.2%

Net Equity Exposure



Historical Premium/Discount to NTA History



Fund at a Glance – June 2017

Fund Size	AU\$202m
Strategy FUM	AU\$247m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

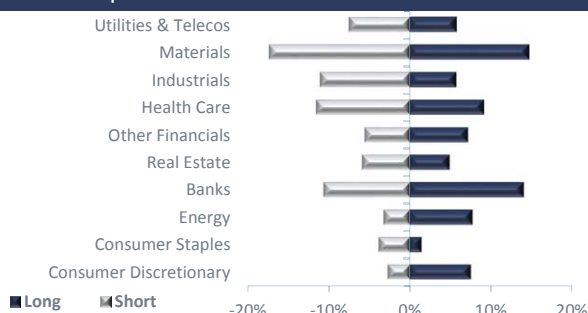
Return Characteristics¹

Positive Months	69.8%
Portfolio Beta	-0.2
Sharpe Ratio	1.4
Sortino Ratio	4.3
Standard Deviation	7.0%
No. Long Positions	61
No. Short Positions	63
Gross Exposure	159%
International Exposure (% of Gross)	19%

Performance²

	1 Mth	6 Mths	Fin. YTD	2 Yrs (pa)	3 Yrs (pa)	S.I (pa)
WMNT (net return)	0.2%	1.9%	2.5%	9.6%	5.6%	12.5%
RBA Cash Rate	0.1%	0.7%	1.5%	1.8%	2.0%	2.3%
Outperformance	0.1%	1.2%	1.0%	7.8%	3.6%	10.2%

Sector Exposures



Long/Short Spread³



Monthly Net Performance (%)

Cal. Yr	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2012	-	-	-	-	-	-	-	1.36	0.97	0.00	6.51	2.88	11.72
2013	-0.71	0.21	4.60	1.55	5.83	5.31	1.11	2.57	1.43	1.86	0.35	-0.06	24.05
2014	1.71	1.45	-1.17	2.80	1.21	0.84	-4.38	-1.77	2.52	-1.57	-1.58	-1.32	-1.26
2015	-1.18	0.70	3.23	0.96	-0.61	3.39	3.82	4.04	2.73	-1.36	1.53	2.93	20.19
2016	-0.14	-1.92	1.13	0.53	1.08	1.76	0.60	-1.46	2.23	-0.34	-0.46	0.07	3.03
2017	-0.81	0.02	0.76	1.13	0.61	0.19							1.90

¹ Return Characteristics are in relation to the market neutral strategy using long/short return series recorded from April 2008.

² Performance data is net of all fees and expenses. The Fund's inception date is August 2012.

³ Long/Short spread shows the gross performance of the long and short portfolios. The Fund makes a profit where the long portfolio outperforms the short portfolio, after the payment of fees. Returns prior to the Fund's inception date are based on return series from the long and short portfolios of the Australian Leaders Fund Ltd in a market neutral structure.

Fund at a Glance – June 2017

ASX Code	WMK
Fund Size	AU\$87.6m
Fund Strategy	Equity Market Neutral
Shares on Issue	87.4m
Dividend (HY17 Interim)	3 cents
Dividend Yield (annualised)	5.7%

Net Tangible Asset (NTA) Backing

	May 17	Jun 17
NTA Before Tax	\$1.00	\$0.99
NTA After Tax & Dividend	\$1.01	\$1.01

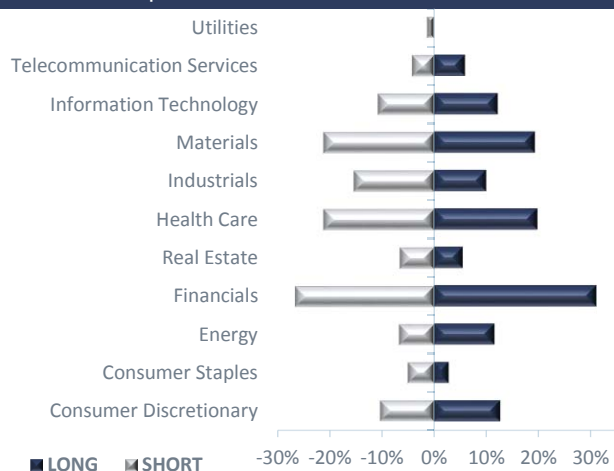
Gross Portfolio Structure

	May 17	Jun 17
Long Exposure	121.6%	131.6%
Short Exposure	-120.3%	-129.7%
Gross Exposure	241.9%	261.3%
Cash	98.7%	98.1%

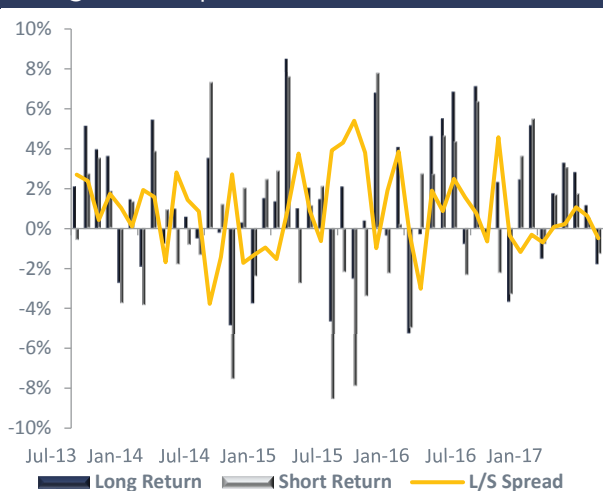
WMK Performance

	1 Mth	3 Mths	6 Mths	FYTD	1 Yr	3 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	-0.4%	1.0%	0.3%	1.2%	1.2%	4.9%	6.7%
RBA Cash Rate	0.1%	0.4%	0.7%	1.5%	1.5%	2.0%	2.1%
Outperformance (net)	-0.5%	0.6%	-0.4%	-0.3%	-0.3%	2.9%	4.6%

Sector Exposures

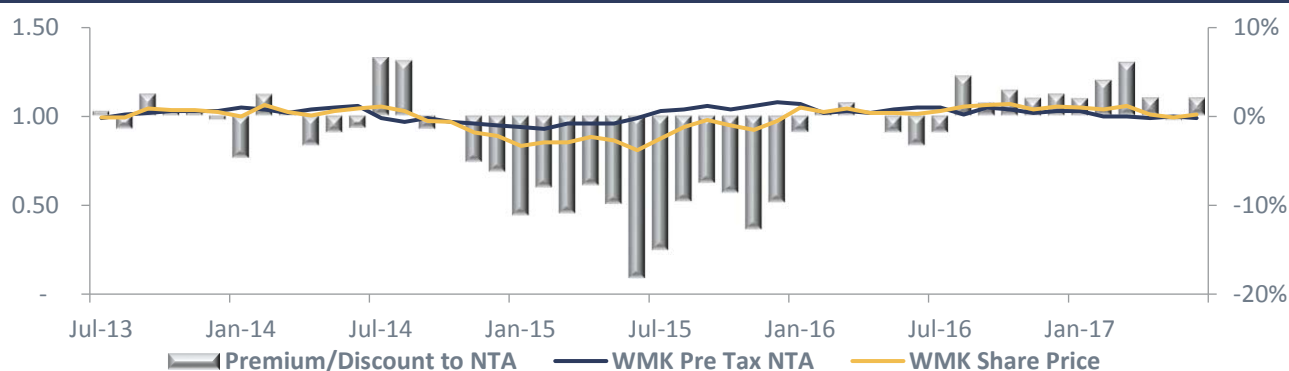


Long Short Spread*



* Long Short spread shows the gross monthly performance of the Company's long and short portfolios. The difference between the two represents the gross performance of the portfolio as a whole. The company will make a profit where the long portfolio outperforms the short portfolio, after the payment of fees and expenses.

Historical Premium/Discount to NTA



Fund at a Glance – June 2017

ASX Code	WGF
ASX Code Options	WGFO
Fund Size	AU\$89.4m
Fund Strategy	Global Market Neutral
Share Price	\$1.02
Shares on Issue	82.8m
Option Price	1.5 cents

Net Tangible Asset (NTA) Backing

	Mar 17	Apr 17
NTA Before Tax	\$1.08	\$1.08
NTA After Tax	\$1.07	\$1.08

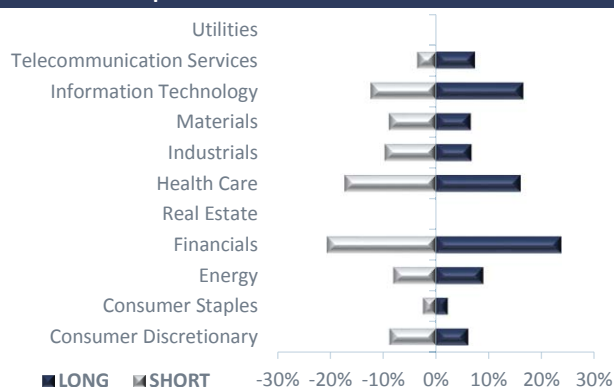
Gross Portfolio Structure

	Mar 17	Apr 17
Long Exposure	85.6%	89.8%
Short Exposure	-79.5%	-80.7%
Gross Exposure	165.1%	170.5%
Cash	93.9%	90.9%

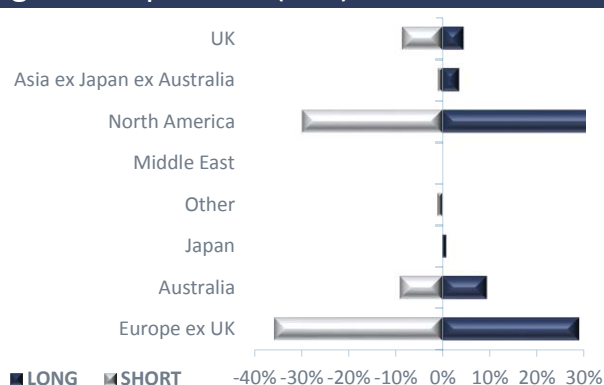
WGF Performance

	1 Mth	3 Mths	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I.
Portfolio (net return)	-0.2%	0.6%	0.8%	-	-	-	0.8%
RBA Cash Rate	0.1%	0.4%	0.7%	-	-	-	0.7%
Outperformance	-0.3%	0.2%	0.1%	-	-	-	0.1%

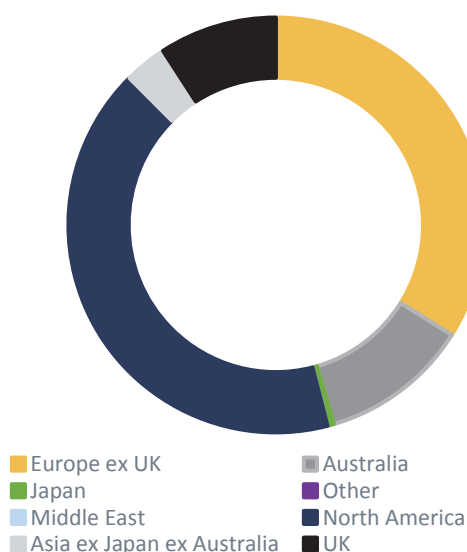
Sector Exposures



Regional Exposures (Net)



Regional Exposures (Gross)



Contributors/Detractors

Top 3 Contributors	
Allergan plc	0.2%
Australia and New Zealand Banking Group Limited	0.1%
Juno Therapeutics, Inc.	0.1%
Top 3 Detractors	
Kroger Co.	-0.4%
Au Optronics Corp	-0.4%
Roche Holding Ltd	-0.3%

Notes

Notes



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