WATERMARK
FUNDS MANAGEMENT

The Leading Edge

QUARTERLY REPORT • December 2017

As policy makers in China shift their focus from quantity to quality, the outlook for global commodities has changed.

Level 23, Governor Phillip Tower, Sydney NSW 2000

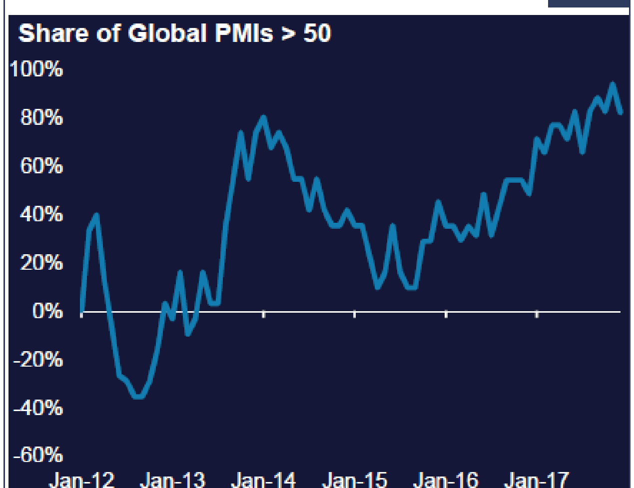
TEL (02) 9252 0225 • FAX (02) 9252 1220 • info@wfunds.com.au • www.wfunds.com.au

Justin Braitling
Portfolio Manager

Message from the CIO

For the first time this cycle, we are seeing synchronised growth across the major economies. As economists upgrade forecasts, the reflation trade is in full swing as risk assets surge higher and risk-free securities, such as bonds falter. The prospect of unnecessary fiscal stimulus in the US has further inflated this bull market as we start the New Year. Against this favourable backdrop, a downturn appears less likely this year, setting up the longest period of uninterrupted expansion since 1850.

Global growth is unusually synchronised FIG 1



Source: Haver Analytics, Morgan Stanley Research

As the recovery has broadened beyond the US and China, the US dollar- a safe haven in recent years - has rolled over as capital has shifted abroad. With fiscal and trade deficits set to deteriorate, the currency has come under further pressure. The uplift in growth has seen commodity markets tighten, this has been further exacerbated by supply side reforms in China. A weaker US dollar has pushed prices even higher in the final quarter of the year.

While there is still ample spare capacity in economies late to join this recovery, labour markets in the US, Germany and Japan are acutely tight. Unemployment in the US is expected to plumb new lows of 3.5% by the end of the year, well below technical levels of full employment. With higher commodity prices inflating the value of finished goods and wages on the rise, inflationary pressures are clearly on the ascendancy. As inflation moves back toward the targeted range, central banks are reversing policies that have bolstered asset values. Policy rates in the US, UK and Canada are all increasing, and government bond yields have gapped higher breaking long-term downtrends.

This shift in the rate structure has driven a meaningful rotation in the share market as industrial and financial shares take over leadership from defensive sectors that have benefited from low interest rates.

This offers some explanation for the relative underperformance of Australian shares, as our market is dominated by mature companies, offering little growth that pay high dividends. These shares have benefited from very low interest rates in recent times. With rates now on the rise, investors are pursuing better growth opportunities elsewhere.

For the two largest sectors of our share market - banks and resources, profits are expected to peak this year. The banks will struggle to grow profits in 2019 as loan losses normalise, while profits in the mining sector should fall along with commodity prices.

Industrial companies that have successfully grown offshore, the strongest performers in recent years, are challenged this year by a rising Australian dollar. Profits for industrial companies (excluding the major banks) are expected to grow by just 5% p.a. over the next three years absent any downturn. This is hardly inspiring given we are paying 20 times this year's earnings for this muted growth.

To give a sense of how over extended this advance is, two popular valuation measures, the Shiller P/E (a cyclically adjusted P/E) and dividend yield, the US market have only once been this expensive in the last century- during the final bubble blow off in 2000 and prior to the great crash of 1929.

We may well experience a final surge higher in shares as this cycle completes in the year ahead. However, we sense the risks associated with inflated asset values and the lateness in the cycle are very high. With this as our starting point, shares today offer the prospect of very low returns in the medium term and hence we maintain fully hedged settings across the funds.

Turning to the prospects for global shares, we are equally circumspect particularly following the sharp rise already this year. Given this looks like the longest cycle in the modern era; available capacity is tight; inflation and interest rates are on the rise; policy support is now being withdrawn and the debt burden is still to be addressed- the odds are high of a downturn in the next year or so and markets will at some stage look to anticipate this.

This would still be a favourable environment for investors if it weren't for excessive valuations. The key risk in holding any asset is in the price, and prices are in many cases exorbitant. Volatility - another measure of risk, is also at record lows, hinting of extreme complacency.

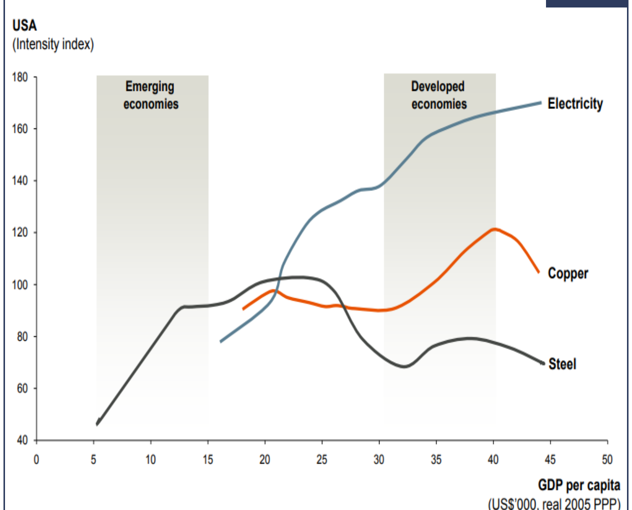
From 'Made in China' to 'Created in China': The Outlook for Commodities

Investors have been moving back into mining shares of late as a hedge against rising inflation, a key tenet of the inflation trade. As most commodities are priced in US dollars, with the dollar now falling, prices have shot higher dragging mining shares along with them.

In this edition of *The Leading Edge* we look at the recent rally in mining shares and question whether we are on the cusp of another mining boom.

The last commodities super cycle which ended in 2014 was driven by explosive growth in materials demand from China. As twenty million Chinese migrants (just under the Australian population) moved from rural communities to the cities each year, housing and infrastructure was needed to accommodate them. You can see in this early stage of industrialisation; intensity of metals use is very high *(Fig 2)*.

A surge in metals intensity as key infrastructure is built FIG 2

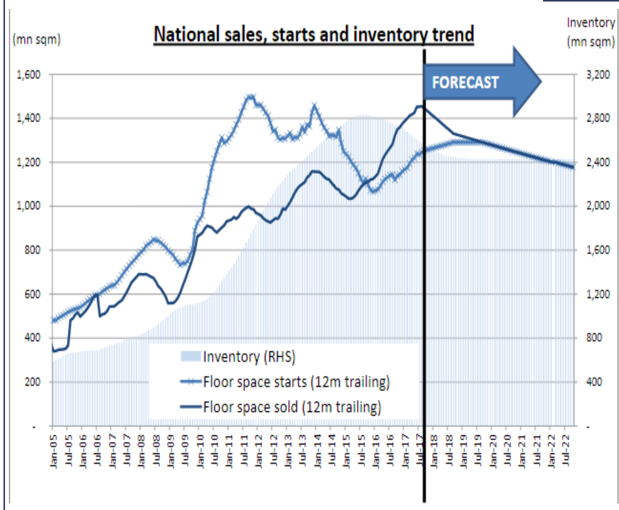


Source: World Bank; Brook Hunt; CRU; IISI; Global Insight; CISA; worldsteel; JBS; IEA; BHP Billiton analysis.

Over this 20-year period residential housing starts have tripled, steel production has grown four-fold and capital formation has compounded at 15% p.a - a phenomenal rate *(Fig 3).* This insatiable demand pushed commodity prices to new highs, incentivising new investment in capacity. China over this period had shifted from a small player, to a dominate buyer consuming half of the world's key commodities.

With infrastructure well established, and housing starts settling at 10 million units per year (Australia builds about 130,000 a year) demand for steel has levelled out. You can see in *(Fig 2),* when an economy passes through the middle-income gap, steel intensity starts to fall as the baton passes to growth in the services economy.

Housing starts tripled and have plateaued FIG 3



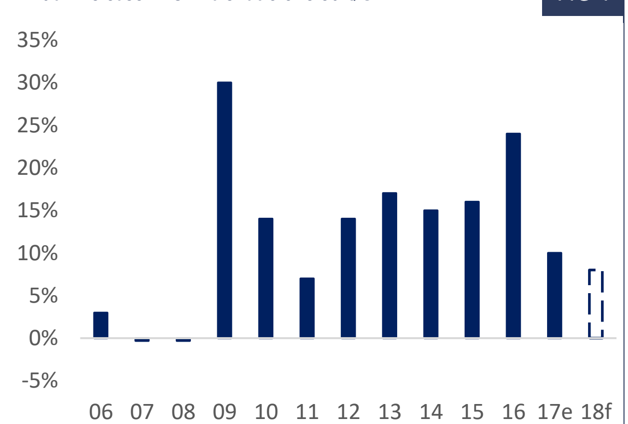
Source: National Bureau of Statistics, Morgan Stanley Research

This frenetic level of growth, funded principally through debt, proved unsustainable as the economy overheated. The central bank tightened policy to contain inflation and investment spending slowed rapidly through 2014, marking the end of the first commodities boom.

Today housing starts are relatively stable and are expected to fall modestly given slowing urbanisation trends, pig iron production is also close to its peak and will be increasingly substituted by scrap as it becomes more available. While the mining boom was set in motion by Chinese demand through urbanisation which has stabilised, the echo of the boom today has been driven instead by supply side factors which have also tightened commodity markets.

Chinese policy has pivoted from one emphasising speed of growth to one emphasising quality of growth. "Made in China" has been replaced with "Created in China". Alongside this shift, the government is trying to address the high levels of debt and unproductive assets accumulated through the investment boom *(Fig 4).*

Annual increase in China's ratio of credit/GDP FIG 4



Source: CEIC, BIS, Autonomous Research

Credit through social financing and unregulated banking channels has for years been growing many times faster than the underlying economy, this cannot persist indefinitely without creating debt sustainability issues.

Recognising this, the China Banking Regulatory Commission (CBRC) Chairman Guo Shuqing recently identified five key reform measures to tighten the financial system:

– Reduce corporate leverage

- Curb rising household leverage

- Rectify cross-market financial products by cutting through shadow banking activities

- Clean up financial holding companies and orderly resolve high-risk financial institutions

- Crack down on illegal financial activities and fund-raising

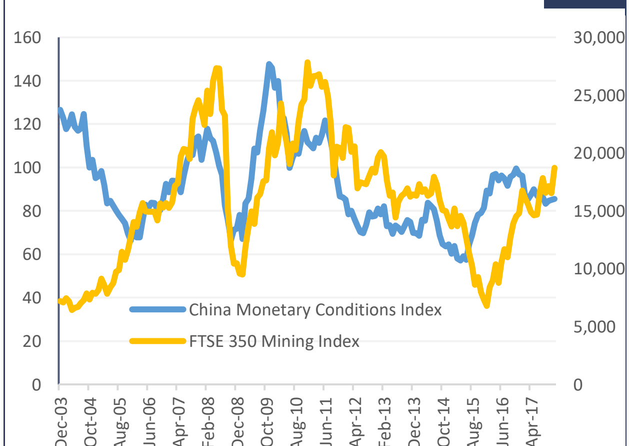
- Curb potential bubbles in the property market and help to control implicit local government debt.

Following the 19th Party Congress there is more urgency to address financial system risks and imbalances. The direction of tighter regulation and heightened supervision is clear and will last beyond this year.

Tighter monetary conditions will likely negatively impact China's demand for commodities, a reason to be cautious on mining shares in the near term. You can see in *(Fig 5)* the clear relationship between the Chinese credit cycle and the performance of mining shares.

China monetary conditions vs mining sector

FIG 5



Source: Bloomberg, BofAML

Supply Side Reforms

Oversized fiscal stimulus in the wake of the global financial crisis caused many Chinese industries to build significantly ahead of demand. Fierce competition eroded industry profitability and state owned enterprises (SOE) were further burdened by excessive debts. Wasteful production, pollution in major cities, along with health and safety issues have become a major social concern.

Responding to this discontent, the Chinese government has started shutting facilities. While the threat of closures in the past was rarely enforced this has now changed with the government hardening its stance as part of the 13th Five-Year Plan (2016-20).

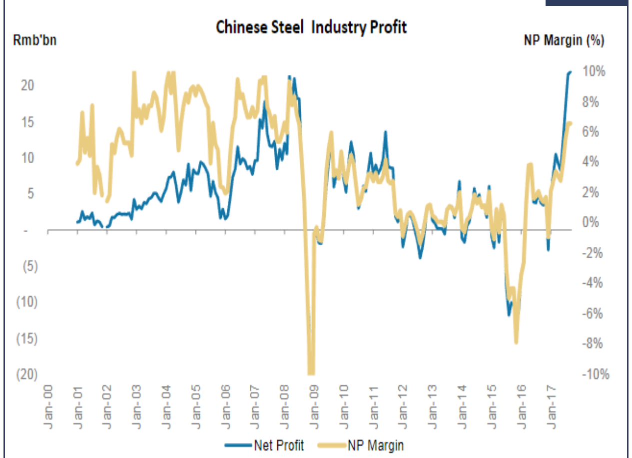
The program was launched in steel and coal as pilot industries, setting capacity elimination targets for 2020, and concentrating capacity amongst the largest players. To help with employee-settlement-related costs, the government established a Rmb100bn fund for subsidies and is focused on the strict execution of that plan.

Stricter environmental controls, monitored via recurring inspections; winter production cuts and environmental taxes have led to mass closures across many industries, including industries not specifically targeted (e.g., paper, iron ore, bauxite, and chemicals).

The objective is to force the closure of less efficient, polluting facilities and to concentrate capacity around larger, compliant plants, reducing pollution. These reforms are ongoing and will sustain tightness in commodity markets.

Chinese steel industry profit

FIG 6



Source: Morgan Stanley Research

Profitability for many of the struggling SOE's has improved markedly as supply has tightened. Profit margins for steel and coal producers have returned to peak levels. Other industries such as chemicals, paper and alumina have also benefitted from these closures.

This policy stance is shaping our investment positioning. In the first mining boom, our preference was to be long the miners and to be short smelting – essentially being long what China lacked, i.e. the natural resources and to be short smelting which China could build. Now that demand has peaked, and smelting margins are improving, steelmakers and smelters the world over are benefiting.

Synchronous Growth

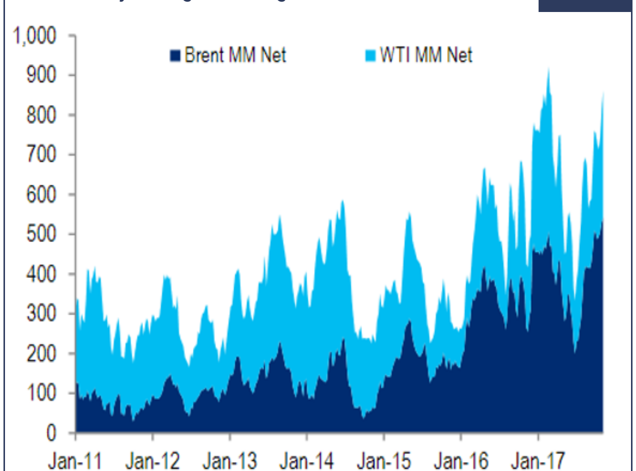
Chinese policymakers have demand-managed the economy to counterbalance momentum in other major economies. We saw this in 2009 when China single-handedly pulled the global economy from the brink of the financial crisis. Today, as the economic recovery broadens across major economies, it is no surprise to see growth in China decelerating. The stronger the growth elsewhere the greater the scope for China to advance their reform agenda which is detrimental to growth in the short term.

With this in mind. Not forsaking the impact of supply side reforms, the winter production cuts will be lifted in the spring and materials demand in China will soften as the credit tightening bites. While commodity prices are still below their record highs, profit margins are back at peak levels given efficiency measures taken during the downturn. This smells to us like peak cycle earnings for mining companies and with demand expected to wane as the year progresses, we remain cautious on mining shares in 2018.

Energy

Oil prices have rallied in the second half of 2017 as investors have chased the reflation theme. The move higher followed the OPEC production cuts announced at the end of 2016. While elevated capital allocations in the sector is creating some short term vulnerability, OPEC and Russia have shown to be sufficiently disciplined in managing supply to support prices through 2018.

Crude money manager net length (min bbls) FIG 7

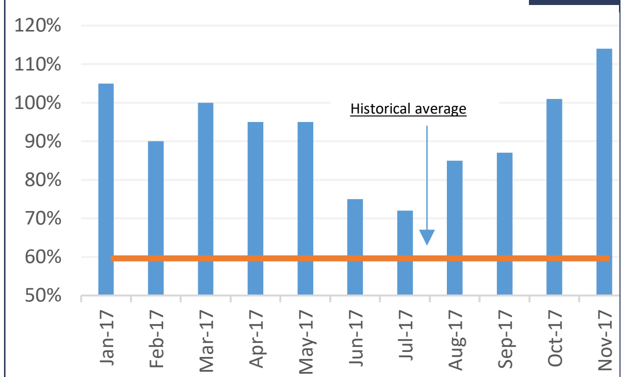


Source: Citi Research

At the 173rd OPEC meeting in November, producers announced a 9-month extension of the existing production agreement on the same terms. The new deal runs for 12 months beginning in January. The move was widely expected and is more than sufficient to achieve the group's goal to bring OECD inventories back down to their 5-year average. Strong compliance with production cuts has removed over 1mb/d of supply for the year, while Russian producers have followed suit and kept production below their 11.3 million barrel per day limit.

Saudi Arabia is looking to float Saudi Aramco in late 2018 – the world's largest oil producer. The kingdom plans to sell 5% as part of a package of major economic reforms. We expect production compliance to be maintained while the sale process is ongoing.

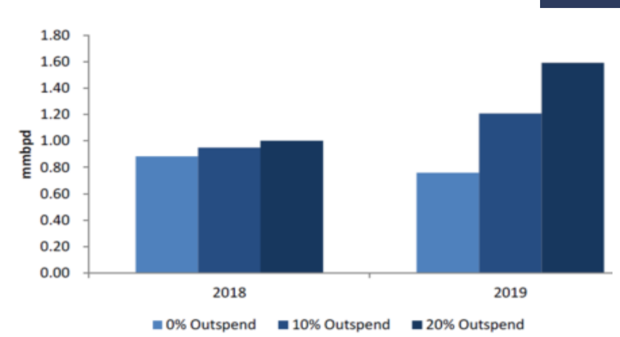
OPEC – 12 compliance (excl Nigeria & Libya) FIG 8



Source: IEA

Traditionally, US shale producers have been quick to respond to any strength in the oil price, adding drill rigs and cranking up production. However, the oil price collapse pushed many to the wall and the narrative has shifted profoundly in favour of capital discipline. The onshore producers (E&Ps) are trying to re-establish their value proposition with investors and capital allocation is the primary tool to further this goal. As we enter 2018 many E&Ps have pledged to bring capital expenditures into closer alignment with cash flows in the coming year. Research from Evercore ISI below shows that if shale producers invest to match cashflow, production will grow by just 800K bpd this year and next, (at the peak US production was growing well ahead of this). Oil demand is expected to grow at 1.3m bpd, the US will deliver about 60% of this growth with the Brazilian pre-salt delivering most of the balance while OPEC and Russia hold production, leaving oil markets balanced and inventories contained supporting prices around current levels.

2019 production could be lower FIG 9



Source: Evercore ISI Research

PORTFOLIO REVIEW

BASIC INDUSTRIES

Commodity prices moved higher in December as global demand surged to its highest level since 2011. Investors were buoyed by a weaker US dollar and rising yields adding exposure to all commodities through the period. The outlook for China however, is not as clear, with tighter monetary conditions likely to impact demand in 2018. Offsetting this is supply side reforms which are supporting numerous commodities. Considering this balanced outlook, and the exceptional performance of the sector in the quarter, we remain neutral mining shares.

OPEC members met in November and as expected, extended production cuts. Compliance among members has been high and with a planned IPO of Saudi Aramco we would expect this to continue. US onshore oil companies shifted rhetoric to value over volume, with a number of companies announcing capital management and lower production targets. This supply management has pushed oil prices to their highest level in four years. Investor positioning is at extreme levels and we are concerned about short term weakness in the price, however we would like to add to our position on any pullback.

Independence Group performed well as their new mine Nova continued to ramp up. We reduced our position following the nickel price rally excitement around electric vehicles will take time to play out. We initiated a position in emerging gas producer *Senex*. The company has two development assets which will add gas to the much-needed domestic market. We also increased our holding in *Iluka Resources* after a positive investor day. The company laid out plans to lift production while also lifting expectations for zircon and feedstock prices.

In the quarter we closed a successful short in *Innogy*. The German based utility business had a profit warning and announced an increase in spending, leading to a 20% drop in the share price. European utilities in general have been feeling margin pressure from increased governmental intervention, and *Innogy's* retail margins have been compressed. We believe the value loss is structural and closed the position with the risk of *Innogy* now becoming a takeover target.

The Funds' short position in *PPL Corporation* also contributed. *PPL* is a US regulated utility, which has approximately half of its transmission business in the US and the other half in the UK. The market had not priced in regulatory risk following Dieter Helm's (British economist) review into the cost of energy in the UK. On the November quarterly investor call, the *PPL* CEO warned on the UK business, which benefited the fund.

INDUSTRIALS

Global industrial shares performed in line with the broader market through Q4, with the group recovering through November as US tax reforms and stronger leading indicators galvanized investors. Survey data continued to strengthen, inventories remain low and demand strength remains robust across most regions. U.S. CFO surveys suggest that tax cuts will be channelled back into capital spending. For every end market that looks to be peaking (such as China heavy duty truck sales), there are a handful of others that have continued to strengthen from relatively low levels such as mining, O&G and marine equipment. Other end markets such as factory automation and commercial aerospace continue to grow above these trends. Valuations for many names are reaching elevated levels and that further earnings upgrades are likely required in order to push the group higher. We will continue to keep a watchful eye on leading indicators, particularly in China where fixed-asset investment growth suffered its first recorded decline (-2.3%) in December and money supply growth continues to slow.

Australian industrial companies saw muted performance in the quarter other than companies exposed to infrastructure investment. The Funds have taken a position in *Brambles*, following a significant pull-back last year, on fears of competitive pressures in its US business. The company retains a strong position globally in pallet pooling. We added to our position in *Qantas* after the company was sold down following a surge in the oil price. In December we participated in the IPO of *Wagners Holdings* – a highly successful family run business based in Queensland. The company has a cement mill and a number of construction businesses benefitting from the large infrastructure spend in the region.

Internationally we increased our industrial net long exposure throughout the quarter and continue to use pull-back opportunities that open up in high quality names that are trading at reasonable valuations to add to existing positions. A recent example of this being French aerospace leader *Safran*, which will continue to benefit from very strong airline passenger activity given their exposure to the engine aftermarket. We also initiated a position in *Ashtead*, where we identified double digit earnings upgrades on the back of stronger US equipment rental activity, and *Hexcel*, an aerospace composite material manufacturer that is benefitting from strong secular growth tailwinds as *Boeing* and *Airbus* transition to new platforms. Other new investments include machinery names such as *Cummins* and *Weir* due to their relative underperformance, despite imminent earnings.

We continue to hold our position in *Volkswagen Group* which has performed well. Vehicle sales continue to be largely unaffected by the recent emissions scandal, the portfolio of brands is robust, and we continue to see upside as the company rebuilds credibility with investors. Short positions include companies facing structural pressures, such as manufacturers of more commoditised products facing low cost Chinese competition, players exposed to peaking end-markets and distributors facing competition as e-commerce challenges traditional distribution models.

CONSUMER

Overall, we are seeing improving consumer trends across the major markets of the United States, Europe and China. The most prominent exception is the UK, where the self-inflicted impacts of the Brexit vote continue to weigh on consumer confidence. Soft Australian consumer demand from the September quarter continued in October, before strengthening in the lead up to Christmas. This quarter was most notable for a rapid reversal of fortune for the US retailers. Strong Thanksgiving weekend sales coincided with significantly improving mall traffic trends, supported by personal tax cuts and one-off payments from corporate employers. Retailers which had endured five years of declining store sales suddenly returned to growth.

Consumer facing companies can be broadly divided into retailers and brand owners. Given the crowded short positions in many traditional retailers, our strategy has been tilted more towards brand owners where we look for sustainably managed brands in growing categories, balanced with positions in overpriced securities which do not properly reflect the structural challenges that we have identified.

During the quarter a new position was established in the Australian domiciled gaming machine business *Aristocrat*. Despite producing very strong financial results driven by the success of Lightning and Dragon Link products, two acquisitions in quick succession in the less well understood social and casual gaming markets signalled an evolution in corporate strategy that wasn't initially received well by the market. We used this sell-off created by the churn in the investor base to establish a position in one of the highest quality businesses in Australia.

A new international position was established in the global fast fashion retailer *Inditex*. Despite an enviable record of sales and earnings growth, *Inditex's* share price remains unchanged over the past three years due to market concerns about the sustainability of the broader apparel retail industry and the unhelpful comparison to *H&M*. We view *Inditex* as one of the highest quality retailers globally with profitability temporarily supressed due to a strong Euro, trading on its lowest earnings multiple in four years.

FINANCIALS

Financial shares performed in line with market indices in the fourth quarter of 2017. In Australia it was a quarter of two halves. In the first half, Australian banks underperformed the ASX200 while REITs outperformed. However, in the second half, banks stabilised relative to the market and REITs suffered a set-back. These trends were driven principally by moves in global bond yields.

During the quarter we closed positions in A-REITs as the sector rallied in October and November. By December the portfolio was net short and we benefitted as A- REITs deteriorated into year-end. We also sold our position in *Westfield Group* following the announcement of its acquisition by the European shopping centre operator *Unibail Rodamco*.

Our participation in *Netwealth Group* IPO contributed strongly, as the share price gained more than 50% over its IPO price.

The financials portfolio at the start of the new year is balanced across most subsectors, however we do have a favourable view on Australian banks. Global bond yields are rising as a result of emerging inflation indicators, hawkish central banks and a shift away from fiscal austerity. Australian bond yields are positively correlated with yields offshore and Australian banks are positively correlated with Australian bond yields. Australian banks have failed however, to participate in the recent rally in bank shares offshore, due to political uncertainty and evidence that the house-price boom is over. Notwithstanding those risks, given rising bond yields and the underperformance of Australian banks, we believe Australian banks are trading at attractive values.

Internationally we broke even in financials in the period. We lost money on *Swedbank*, which fell 12% in the quarter vs the European banks down only 3%. The principle concern of investors on *Swedbank* is Swedish house prices, which fell during the quarter after three and a half years of double digit gains. Modest house price falls will be very manageable for *Swedbank*; the last time Swedish house prices fell sharply (2011: -6% YoY), mortgage losses peaked at just 1bp. Additionally, *Swedbank* is the best capitalised bank in Europe, it grows 4-6% p.a; earns a 16% return on tangible equity; pays a 6.5% dividend yield and trades on the same P/E multiple as the broader European banks sector.

Losses in *Swedbank* were offset by gains in US-listed *Synchrony Financial*, which is a consumer credit provider. *Synchrony* rallied during the period for two main reasons:

- It purchased a book of credit card receivables from *eBay* which is expected to be 7-9% EPS accretive; and
- The US corporate tax cuts are expected to be about 15% EPS accretive for the company.

During the quarter we increased exposure to European shares and reduced exposure in the US, mostly in response to changes in our view of relative value following the outperformance of the US banks versus their European peers.

HEALTHCARE

Global healthcare shares were flat in the period. European healthcare shares languished as a result of the strengthening Euro and negative sentiment following a lacklustre September earnings period. European sector heavyweights *GlaxoSmithKline* (GSK), *AstraZeneca*, *Sanofi-Aventis* and *Roche* were weak on softer earnings outlooks with competitive and pricing pressures set to accelerate in the year ahead. This aligns with our view of the region and we are net short European pharma.

In the US, performance was mixed across subsectors with tax reform again a major driver of performance for healthcare services and medical device companies. Benefitting relatively less from domestic tax cuts, pharmaceutical and biotechnology companies underperformed.

Australian healthcare was the strongest of the regional sectors, rallying in spite of an appreciating Australian dollar. This was largely driven by a recovery for the prior quarter's laggards rather than any meaningful news flow. Valuations for local companies remain stretched, with fundamentals taking a back seat to momentum. A strong contribution from our position in *Ramsay Health Care*, was offset by the outperformance of short positions in lower quality companies.

The healthcare portfolio accounted for much of the drawdown in the quarter. Losses were concentrated around three international investments, namely: *Celgene Corporation, Allergan and Merck & Co*, which all suffered set-backs in the quarter. The sell-off in these companies' shares was exacerbated by increasingly negative investor sentiment towards pharmaceutical and biotechnology sectors. While this was disappointing, we remain confident in the thesis supporting all three investments.

Allergan shares suffered as a result of a negative court ruling relating to intellectual property (patents) protecting its key dry-eye drug Restasis. This will likely result in sooner-than-expected competition from generics. We remain attracted to its leading medical aesthetics business, with limited exposure to US drug pricing risks, robust growth and exposure to a strengthening US consumer.

Celgene's setback was sparked by the announcement that company was to discontinue its high-risk-high-reward clinical programme (GED-0301) and was compounded by an earnings downgrade which followed. Further (unresolved) questions were raised over the potential for generic competition for CELG's key drug – Revlimid and investors sold the shares off aggressively as a result.

Finally, *Merck's* decision to delay the readout of a key clinical trial programme using Keytruda in lung cancer (Keynote 189) was the major catalyst behind the fall in its share price. This event potentially hands back *Merck's* lead in the lung cancer immuno-oncology race to its competitors and raises questions over its declining base business outside of Keytruda. We acknowledge the latter issue but see a different story for *Merck* emerging longer term where, if our thesis proves correct, Keytruda will emerge as a superior drug versus its competitor's and worries about the base business will fade.

TECHNOLOGY/MEDIA/TELECOMMUNICATIONS

TMT performance was volatile during the December quarter. The key driver was US tax reform, which provided a boost to earnings expectations of up to 25% for more domestic-focussed companies. The technology sector – which has a larger proportion of earnings from outside the US, with lower effective tax rates – pulled back after the reforms were announced. Investors piled into more domestically focussed sectors such as media and telecom (short interest was high in these sectors, which compounded the moves). Some key corporate activity also emerged, including the cancellation of a long-anticipated merger between US telcos *T-Mobile* and *Sprint*, and a lawsuit filed by the US Department of Justice against *AT&T's* acquisition of *Time Warner* which has thrown the deal into jeopardy.

Domestically there was little in the way of news flow. November marked a largely uneventful AGM season, with most companies reiterating guidance. *Domain Holdings* demerged from *Fairfax Media* with a strong debut upon listing, albeit the shares have faded since. *Oracle* bid for local construction software firm *Aconex* at a 50% premium which buoyed the domestic software sector, while *Bain Capital* sold down another tranche of their shareholding in *MYOB*.

Across the TMT space we are slightly long but remain conscious of the sector's strong performance. We have been selective in identifying companies with a structural runway for growth to invest in. Within semiconductors we are long analog, exposed to content growth particularly in industrial automation and connected devices, and short logic, where returns are under pressure as workloads migrate to the cloud. 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 an opportunity to invest in undervalued content such as video games and music. Meanwhile, the role of free–to-air TV networks in distributing video remains vulnerable given declining audiences. The funds are short broadcasters in markets where TV still commands a large portion of ad spend, and the media agencies which create and sell traditional marketing campaigns. In telecom, we are short companies that are over-earning or under competitive challenge, while selectively investing in 'recovering' and growth markets.

During the quarter, our domestic TMT performance was mixed. Our investment in *Fairfax Media* benefitted from the spin-off of *Domain Holdings*, while volatility around contract losses in the outdoor-media companies provided an opportunity to invest in the only media still taking share of advertising spend outside of digital. Our domestic short positions were the primary detractors from performance given the strong rally in the Australian market. We participated in a sell down from *Bain Capital* to increase our shareholding in *MYOB*. For the growth the company is delivering, its shares look particularly undervalued relative to both the broader market and its peers.

The funds' global TMT portfolio was flat over the December quarter, in line with the global sector's performance. The biggest detractors from performance were shorts in the semiconductor sector. *Intel's* dominance in server/data centre processors is under threat from GPUs and FPGAs particularly for machine learning applications; its 90% share in desktop CPUs is also under threat from a resurgent AMD which has lacked a competitive product for many years; and successive developments in chip architecture are becoming much more capital-intensive delaying *Intel's* technological progression. *STMicro* meanwhile is a supplier of mostly commoditised sensors, with the shares bid up on excitement around their participation in 3D sensing components in the new iPhones – this is despite iPhone sockets tending to be competed away rapidly. Unfortunately, both positions rallied with the rest of the semiconductor sector.

A significant contribution to performance also came from positions within the European telco sector – with our core longs in *Vodafone* and *Orange* reporting exceptional results as revenue growth improves and with increased discipline around costs. Both companies are also benefitting from deteriorating competitive dynamics across telco markets. Following a trip to Europe to meet management of leading companies in the TMT space, we initiated an investment in Polish telco – *Play Communications*. This exciting company has been highly successful in disrupting the mobile market and has enjoyed rapid commercial success – growing from zero subscribers at launch in 2007 to 28% market share today. The company's shares offer great value and a 7.5% dividend yield.

An investment in China's second-largest video game publisher, *NetEase*, also performed well, with the successful launch of the viral global game PUBG. We took profits on this position, redeploying proceeds into *BitAuto*, China's number two auto classified website. *BitAuto's* shares have been under pressure due to regulatory intervention in Chinese consumer lending, raising concerns over the value of its stake in a car financing business called *Yixin*. These measures will have little impact on *Yixin*, which does not offer any predatory/payday loans, presenting an opportunity to buy shares on a P/E of 7x despite double digit earnings growth for the foreseeable future.

Performance Review

December 31 marked the end of a difficult year for the Watermark funds, exacerbated by a poor final quarter of 2017. With much of the underperformance concentrated in the international portfolio, those of our funds with a greater exposure to international shares were hardest hit, with losses across the listed vehicles of 2-3% for the quarter. The Watermark Market Neutral Trust posted a modest net gain in the period of 0.5%.

Performance issues throughout 2017 followed two clear themes:

- Long portfolios added value while shorts detracted; and
- Domestic investments performed better than international

In reflecting on last year and the challenges of 2017, it is worth re-stating the tasks that we have set ourselves and the outcomes that investors should expect if we are successful in meeting these objectives. Watermark manages hedged portfolios, both directional (where the amount of hedging will vary through time), and market neutral funds which are always fully hedged. For the funds to make a profit, our portfolio of long investments must out-perform the portfolio of shorts. We aim to deliver positive absolute returns, largely independent of the prevailing direction of markets, however our objectives in building these discrete long/short sub-portfolios are not dissimilar from most active fund managers running relative return strategies. We aim to build a long portfolio that outperforms the broader share market, adding 'alpha' (returns in excess of the market index) of 3-5%. In addition, we aim to build a short portfolio that underperforms the market by the same amount (also a form of alpha return). In creating a 6-10% spread between the longs and shorts, we are able deliver an attractive return to our investors which is uncorrelated with the share market.

Herein lies the difficulty for a Long/Short investor in a bull market such as we saw in 2017. Our task requires us to find 50-60 short positions from a universe of investible companies that will go up less than the market. We do this by looking for companies to short that are of low quality, with management who are struggling to execute or have flawed strategies, and whose shares are expensive relative to our assessment of 'fair value'. Unfortunately, in 2017 many of those expensive and/or low-quality companies fared very well, as investors - flush with an abundance of cheap liquidity and an insatiable appetite for risk assets - pushed prices of all securities higher. As a good illustration of where the problems were felt most acutely, WMK's domestic long portfolio rose in value through 2017 by 14.1%, delivering 'alpha' (returns in excess of the All Ords Accum Index) of 1.6%. Over the same period, the short portfolio rose by 16.3%, leaving the fund with a negative spread. For the international portfolio, this problem was more pronounced, with no alpha created on the longs or the shorts.

While the market backdrop arguably made our job difficult in 2017, poor stock selection was the critical factor behind performance issues. We remain confident that we have the right team and investment process to deliver on our objectives and are looking forward to delivering better results in 2018.

Performance in the quarter was marked at a sector level, by strong returns from financials and basic industries, and weaker performance in the Healthcare and TMT portfolios. Attribution was also heavily skewed to the domestic portfolio, which strongly outperformed the international portfolio. This was a departure from the major themes in FY17, where the international healthcare and TMT sectors were the strongest contributors to returns.

Quarterly Performance by Sector

Sector	Domestic Portfolio *	International Portfolio **
TMT	-0.16	-0.57
Healthcare	-0.45	-1.76
Consumer	0.24	-0.40
Industrials	0.30	0.04
Basic Industries	0.42	-0.12
Financials	1.50	-0.02

*Domestic portfolio data is for Australian positions in Watermark Market Neutral Trust. ** International portfolio data is for international positions in Watermark Market Neutral Fund Ltd.

Performance Attribution for the Quarter

<u>Contributors</u>

Domestic Positions	International Positions
Independence Group NL	Synchrony Financial
Ramsay Health Care Limited	Volkswagen AG
BHP Billiton Limited	Vodafone Group
Tabcorp Holdings Limited	Teck Resources Limited
CBA	Honeywell International Inc.

<u>Detractors</u>

Domestic Positions	International Positions
Resmed Inc	Celgene Corporation
OZ Minerals Limited	Intel Corporation
Seek Limited	Allergan
Medibank Private Ltd.	STMicroelectronics NV
Northern Star Resources	Merck & Co

Fund at a Glance – December 2017

ASX Code	ALF
Fund Size	AU$311.3m
Fund Strategy	Variable Beta
Share Price	$1.09
Shares on Issue	272.5m
Return of Capital (2HFY17)	4 cents

Net Tangible Asset (NTA) Backing

	Nov 17	Dec 17
NTA Before Tax	$1.19	$1.19
NTA After Tax	$1.20	$1.20

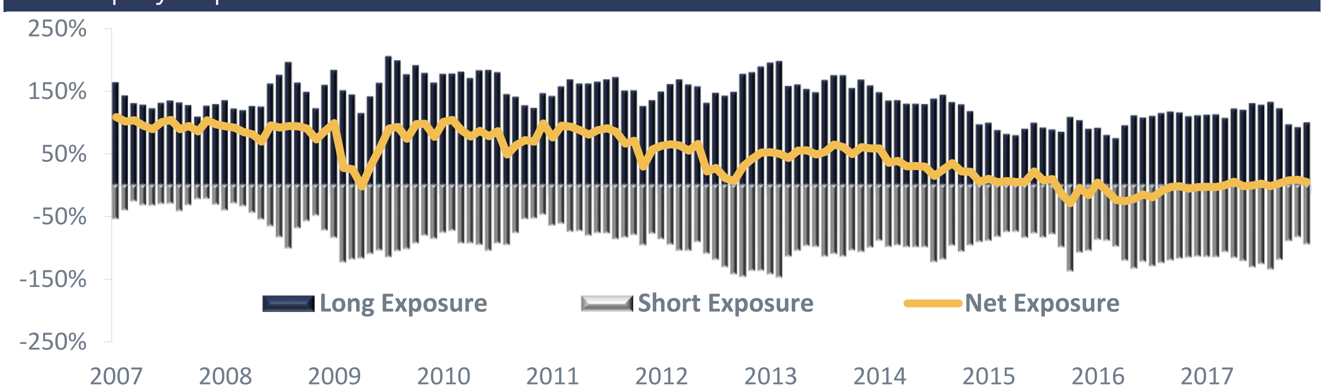
Gross Portfolio Structure

	Nov 17	Dec 17
Long Exposure	92.6%	100.2%
Short Exposure	-83.7%	-94.8%
Gross Exposure	176.3%	195.0%
Cash	91.1%	94.6%

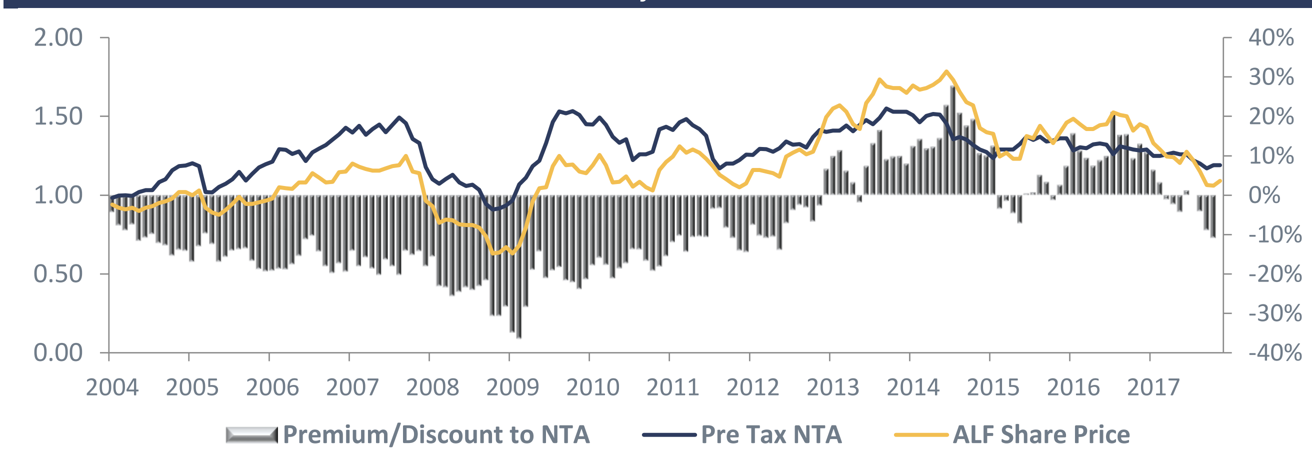
ALF Performance

	1 Mth	1 Yr	2 Yrs (pa)	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	S.I (pa)
Portfolio Return (net)	0.1%	-3.0%	0.1%	5.1%	7.9%	8.5%	12.2%
All Ords Accum Index	2.0%	12.5%	12.1%	9.2%	10.4%	8.1%	9.2%
Outperformance (net)	**-1.9%**	**-15.5%**	**-12.0%**	**-4.1%**	**-2.5%**	**0.4%**	**3.0%**

Net Equity Exposure



Historical Premium/Discount to NTA History



Market Neutral Trust

APIR: WMF0001AU

Fund at a Glance – December 2017

Fund Size	AU$250m
Strategy FUM	AU$295m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

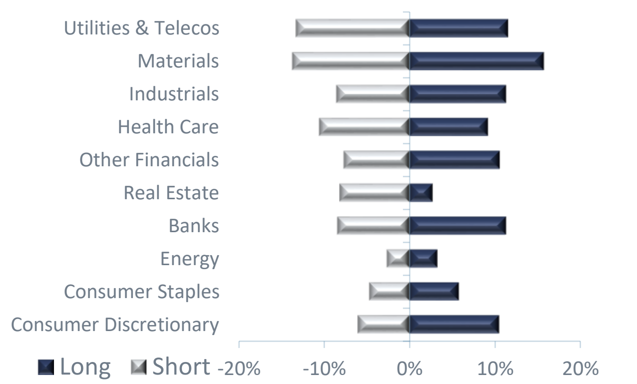
Return Characteristics[1]

Positive Months	68%
Portfolio Beta	-0.2%
Sharpe Ratio	1.3
Sortino Ratio	4.0
Standard Deviation	6.8%
No. Long Positions	75
No. Short Positions	66
Gross Exposure	176%
International Exposure (% of Gross)	18%

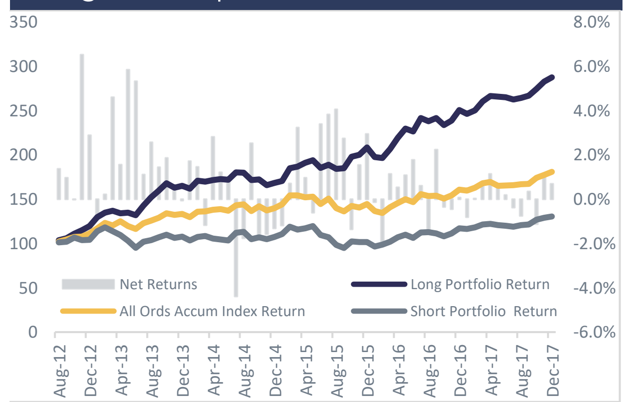
Performance[2]

	1 Mth	1 Yr	2 Yrs (pa)	3 Yrs (pa)	4 Yrs (pa)	S.I (pa)
WMNT (net return)	0.7%	1.6%	2.3%	8.5%	5.9%	11.2%
RBA Cash Rate	0.1%	1.5%	1.6%	1.8%	2.0%	2.2%
Outperformance	0.6%	0.1%	0.7%	6.7%	3.9%	9.0%

Sector Exposures



Long/Short Spread[3]



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	-0.39	-0.75	0.34	-1.14	1.00	0.69	**1.65**

[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.

Market Neutral Fund Ltd

WATERMARK FUNDS MANAGEMENT

Fund at a Glance – December 2017

ASX Code	WMK
Fund Size	AU$80.7m
Fund Strategy	Equity Market Neutral
Share Price	$0.88
Shares on Issue	87.3m
Dividend (FY17 Annual)	2.5 cents
Dividend Yield (annualised)	5.7%

Net Tangible Asset (NTA) Backing

	Nov 17	Dec 17
NTA Before Tax	$0.95	$0.95
NTA After Tax	$0.96	$0.96

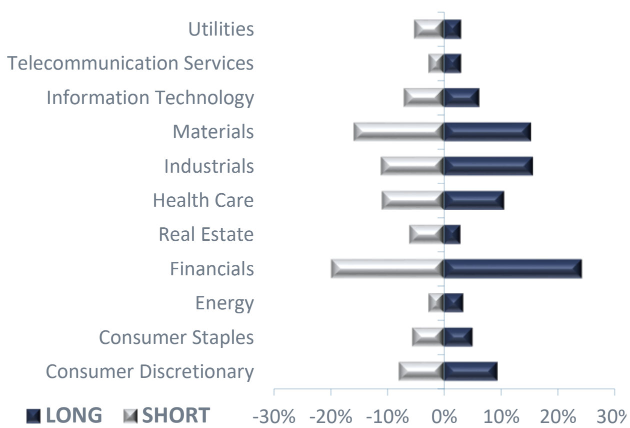
Gross Portfolio Structure

	Nov 17	Dec 17
Long Exposure	91.7%	98.7%
Short Exposure	-83.1%	-95.4%
Gross Exposure	174.8%	194.1%
Cash	91.4%	96.7%

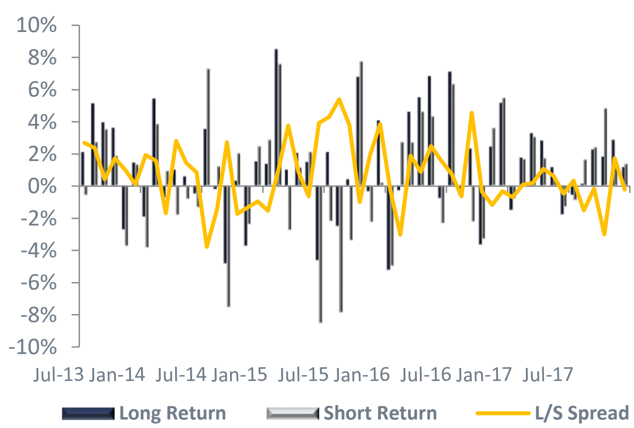
WMK Performance

	1 Mth	3 Mths	1 Yr	2 Yrs (pa)	3 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	-0.1%	-2.1%	-3.4%	-0.2%	6.3%	5.0%
RBA Cash Rate	0.1%	0.4%	1.5%	1.6%	1.8%	2.0%
Outperformance (net)	-0.2%	-2.5%	-4.9%	-1.8%	4.5%	3.0%

Sector Exposures

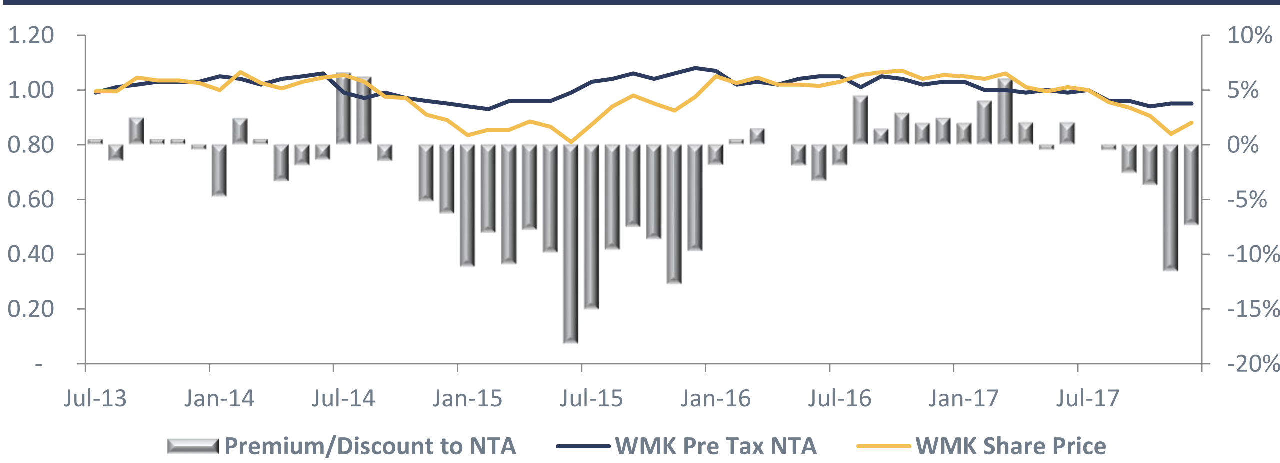


Long Short Spread*



* 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



WATERMARK FUNDS MANAGEMENT

Global Leaders Fund Ltd

Fund at a Glance – December 2017

ASX Code	WGF
ASX Code Options	WGFO
Fund Size	AU$85.0m
Fund Strategy	Global Market Neutral
Share Price	$0.93
Shares on Issue	81.5m
Option Price	0.3 cents

Net Tangible Asset (NTA) Backing

	Nov 17	Dec 17
NTA Before Tax	$1.06	$1.06
NTA After Tax	$1.06	$1.06

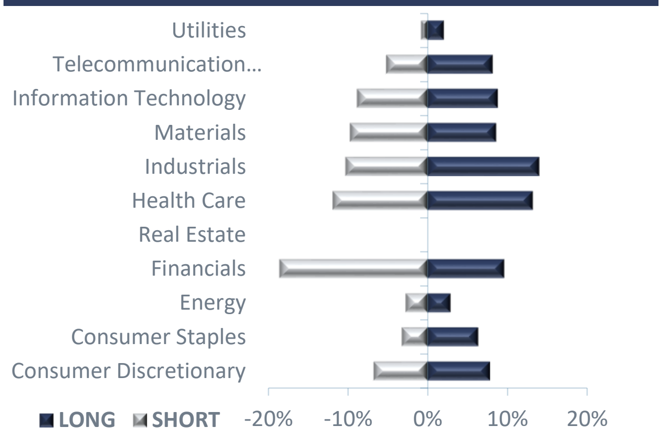
Gross Portfolio Structure

	Nov 17	Dec 17
Long Exposure	88.4%	81.5%
Short Exposure	-73.4%	-78.5%
Gross Exposure	161.8%	160.0%
Cash	85.0%	96.9%

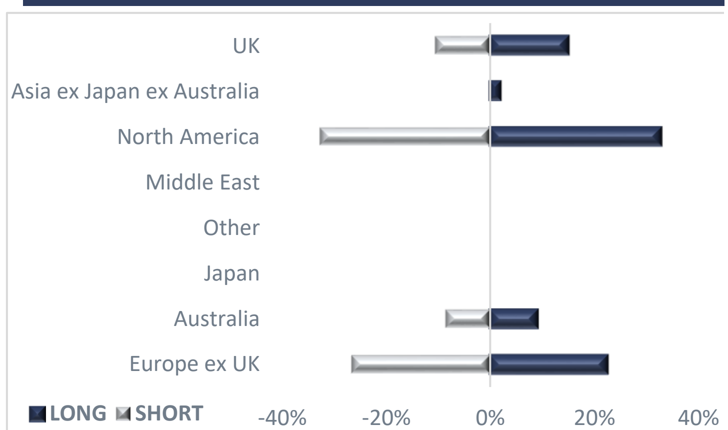
Performance

	1 Mth	3 Mths	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I. (pa)
Portfolio (net return)	0.0%	-2.7%	-3.5%	-3.5%	-2.7%	-	-2.7%
RBA Cash Rate	0.1%	0.4%	0.8%	0.8%	1.5%	-	1.5%
Outperformance	-0.1%	-3.1%	-4.3%	-4.3%	-4.2%	-	-4.2%

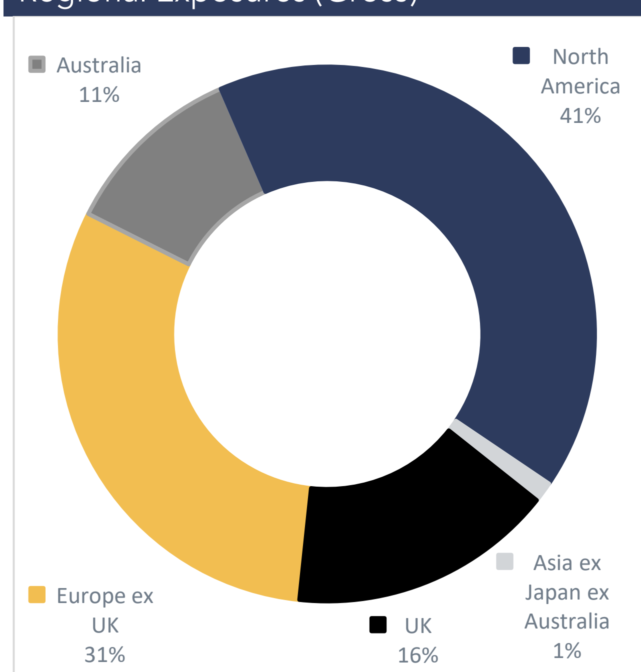
Sector Exposures



Regional Exposures (Net)



Regional Exposures (Gross)



Contributors/Detractors

Top 3 Contributors	
BHP Billiton Limited	0.3%
PPL Corporation	0.3%
Innogy SE	0.2%
Top 3 Detractors	
Allergan plc	-0.2%
Glencore plc	-0.2%
South32 Ltd.	-0.1%

Notes

Notes

Notes

Notes

WATERMARK
FUNDS MANAGEMENT

Level 23, Governor Phillip Tower, Sydney NSW 2000

TEL (02) 9252 0225 • FAX (02) 9252 1220 • info@wfunds.com.au • www.wfunds.com.au