WATERMARK FUNDS MANAGEMENT

The Leading Edge

QUARTERLY REPORT • December 2018

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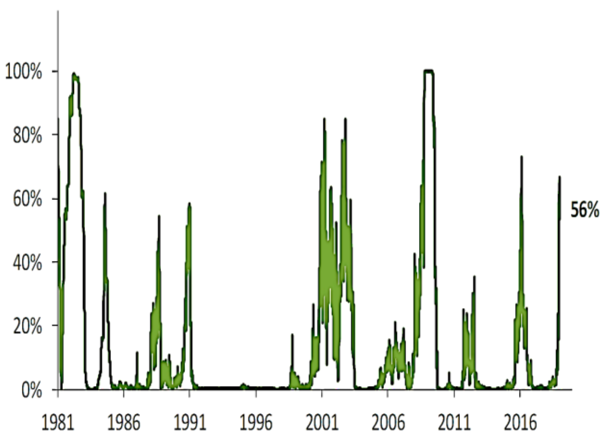
Message from the CIO

Shares fell sharply in the closing stages of 2018 and bottomed on Christmas Eve, before recovering most of their December losses in January. Many share markets around the world have moved decisively into bear territory as investors contemplate a confluence of slowing growth, rising inflation and restrictive monetary policy.

Economist's use various market indicators to predict recessions *(Fig 1)*, these indicators have all spiked higher recently, presaging a downturn given yield curves have flattened, and the value of shares, commodities and corporate bonds have all fallen together.

Implied US Recession Profitability Index FIG 1



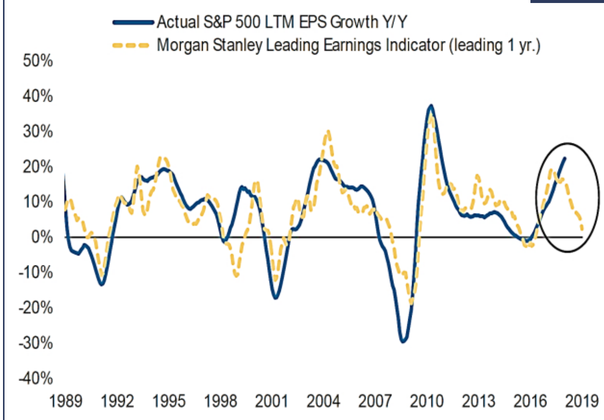
Source: Cornerstone Macro

Activity indicators have slowed, with Europe, in particular, having a very weak final quarter to 2018 and China slowing faster than expected. Leading indicators in the US are holding steady. While we may end up seeing a small contraction in global industrial production in the quarters ahead, a broader economic downturn is not on the immediate horizon.

Shares were oversold going into Christmas. With the US Federal Reserve softening its stance on interest rates and trade tensions with China easing, shares have staged a strong recovery early in 2019. The key question now is whether this is simply a throw-back rally in a new bear market or a correction with the market yet to advance to new highs in the year ahead.

I suspect the answer lies somewhere in between, with 2019 looking much like 2018 where shares move sideways to down as the year progresses. We are running out of runway in this cycle, the prospect of another final rally diminishes as time slips by. With activity slowing, profit forecasts are too high and will have to be lowered, ensuring profit downgrades in the medium term *(Fig 2)*.

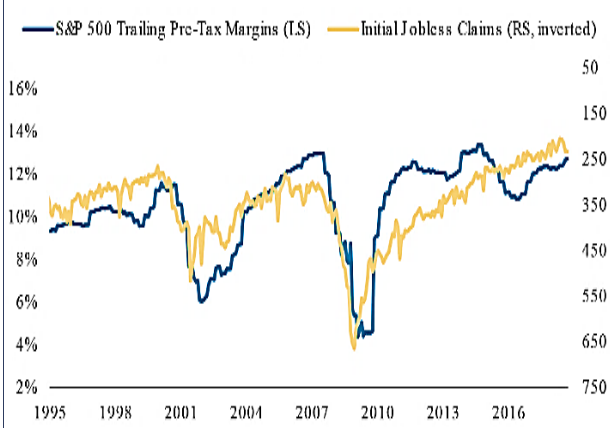
Profit Growth is Set to Slow Rapidly FIG 2



Source: Morgan Stanley Research

In Europe, for example, there will be no profit growth reported for the final quarter of 2018. It appears we could be in for an earnings hiatus not unlike the two years from 2014 through to 2016 when profit growth stalled on a stronger US dollar and falling oil prices. These cycles typically last a few years and don't resolve quickly. We have a similar matrix now of slowing activity and rising costs, squeezing margins which look to have peaked *(Fig 3)*.

Profit Margins have Peaked FIG 3



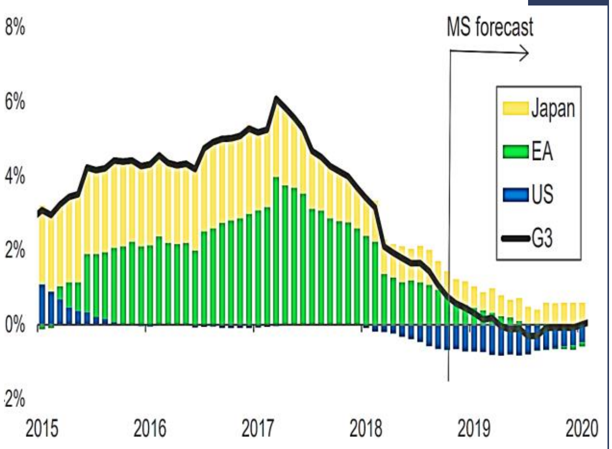
Source: Morgan Stanley Research

While we are not looking for a downturn on the immediate horizon, we may see an 'earnings recession' where profits fall for a quarter or two given the inflated level of corporate profits which have tripled from GFC lows a decade ago. It is hard to see how shares can sustain a rally with this backdrop.

Incorporating some modest downgrades to 2019 profit forecasts for the S&P 500 Index, at 2750 the US market is trading at 16.5 times (P/E) forecast earnings, this looks fully valued at this late stage of the cycle.

There is some good news however, in so far as interest rates will increase more slowly than many feared, as the US Federal Reserve steps back from the abyss. Share markets will still be challenged through 2019 however as all G4 Central Banks will either be raising interest rates or withdrawing liquidity through 'Quantitative Tightening' (unwinding QE), a first for this cycle *(Fig 4).*

Central Banks Balance Sheets (% of GDP 12M chg) FIG 4



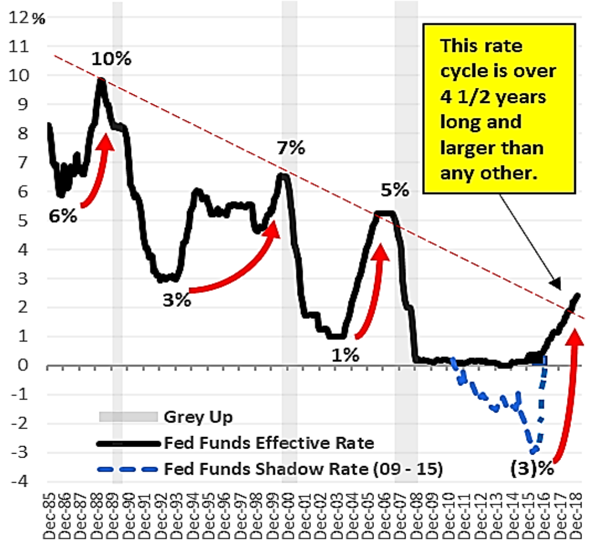
Source: Morgan Stanley Research & Haver Analytics

No one fully understands the sensitivity of the economy to interest rates. There are many who believe policy in the US has already been tightened too far- while US interest rates are now at 'neutral' levels, because they have been below neutral for so long, market stresses are likely to emerge sooner.

In *Fig 5* below, you can see how contrary to convention wisdom, a different interpretation would suggest policy tightening has been underway for more than 4 years. The starting point was not when interest rates increased above the zero bound, but when the 'shadow rate' bottomed at minus 2%. (As the Fed policy rate cannot go below zero, the "Shadow Rate" adjusts for the impact of QE -as measured by the Atlanta Federal Reserve).

If we accept that policy was most accommodative half way through 2014, then the extent and duration of the subsequent tightening has been the most significant of the last four cycles. Furthermore, with each cycle, as the debt burden has increased, policy has become more restrictive as interest rates approach the neutral rate.

Fed Fund Actual Rate with Atlanta Fed Shadow Rate FIG 5

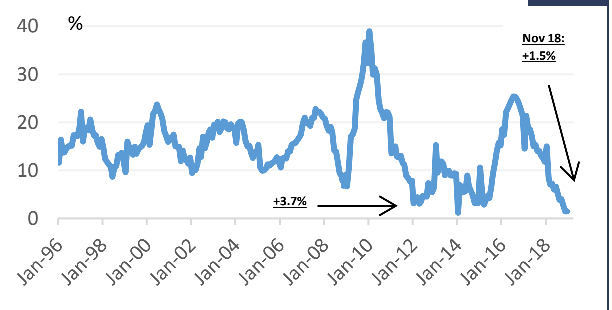


Source: Stifel

This thesis would suggest that monetary policy has already been tightened to the maximum extent before stresses emerge in the economy - this would certainly explain the upheaval in debt and equity markets in recent months, risk markets have sent a very clear signal here. The US Federal Reserve is still guiding to further rate increases this year and next, though they appear less committed to these following recent developments.

For shares to rally to new highs, we would need to see a return to synchronised growth as occurred in 2016/2017. This is unlikely as the world's second-largest economy China is decelerating quickly as credit to the shadow banking sector was removed last year *(Fig 6).*

M1 Growth (Credit Growth Proxy) FIG 6



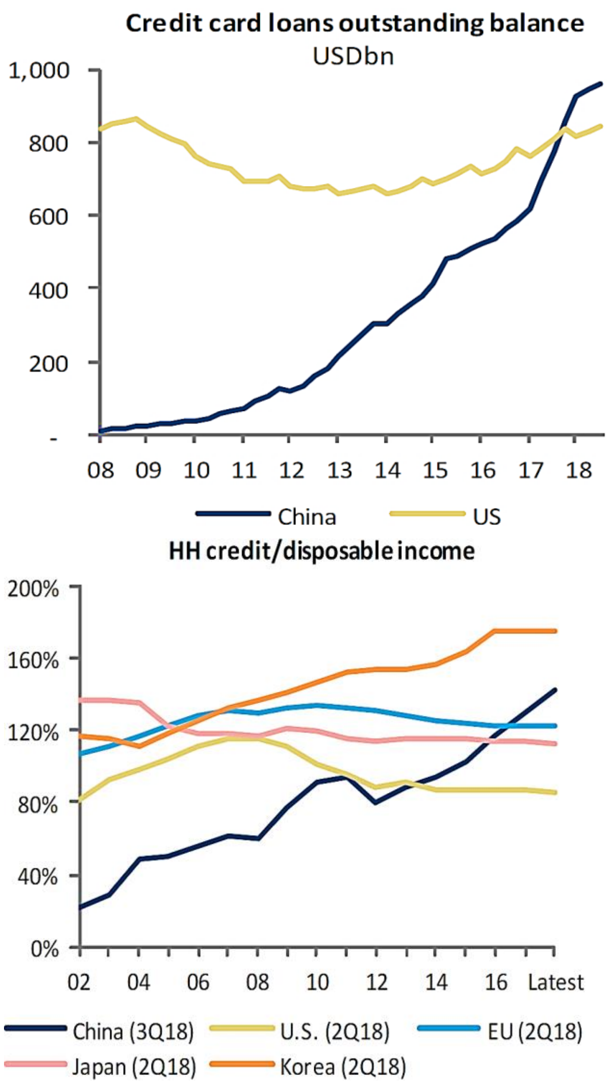
Source: Bloomberg

Consumer spending and trade have contracted in recent months, and while the property sector has held up surprisingly well, it is likely to fall later this year given weaker orders held by major developers. The central government is well progressed in re-stimulating the economy by cutting interest rates and taxes while lifting infrastructure spending. This is unlikely to boost activity until later in the year.

The extent of the slowdown in Chinese consumer spending has surprised many (auto sales as an example fell 20% in the second half of 2018). The importance of this should not be missed, as capital formation in China matures, growth in Chinese household consumption has become the largest single contributor to global growth.

This could be a blind spot for economists, who have come to presume growth in Chinese consumption will continue at elevated levels. With the rapid growth in access to debt, household leverage has accelerated, doubling in the last decade. Household debt/disposable income in China- the best measure of debt serviceability is already above the levels of Europe and the US *(Fig 7)*. Taking credit cards alone (ex-store cards), the outstanding credit card debt in China now exceeds the credit card debt of the US, an economy that is 50% larger.

Household Credit in China is Fully Deployed FIG 7



Source: Autonomous Research

The other major factor undermining confidence last year was the capriciousness of the Trump administration. This will only get worse as we approach the 2020 presidential contest, with new far-left ideas set to unsettle markets further.

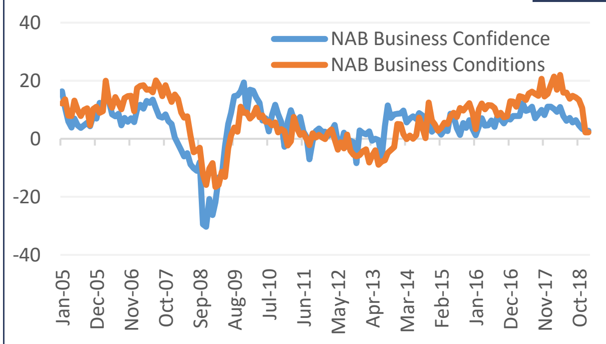
Turning to Australia, a slowing Chinese economy will be pivotal given the importance of the trade relationship. Growth in export volumes and commodity prices have been a tailwind for our economy in recent years but this is now waning. The outlook for domestic demand is mixed. There is good news, we are finally seeing some modest growth in household income which has been absent in recent years.

The bad news is the positive impulse from public spending and the mining recovery is peaking, while a contraction in credit is deflating an overvalued housing sector and creating stresses in some indebted sections of the economy. Consumption, the dominant force in the economy, has been supported in recent years by a reduction in the savings rate as income growth has been anaemic. The savings rate is now low and unlikely to fall further however, so we need to see an increase in wages to sustain growth in spending from here.

Australian household indebtedness is high for a developed economy and credit will no longer be a source of support, particularly as banks tighten unsecured lending. Consumer confidence is the critical swing factor and falling house prices don't help. Recent weakness in retail sales and discretionary spending would suggest households are becoming more cautious. State and federal elections this year are likely to dampen spending further and disrupt business continuity.

For the optimists on the economic outlook, who have pointed to a recovery in business investment, a cursory look at the latest NAB business survey of business confidence would be alarming *(Fig 8)*.

NAB Business Survey FIG 8

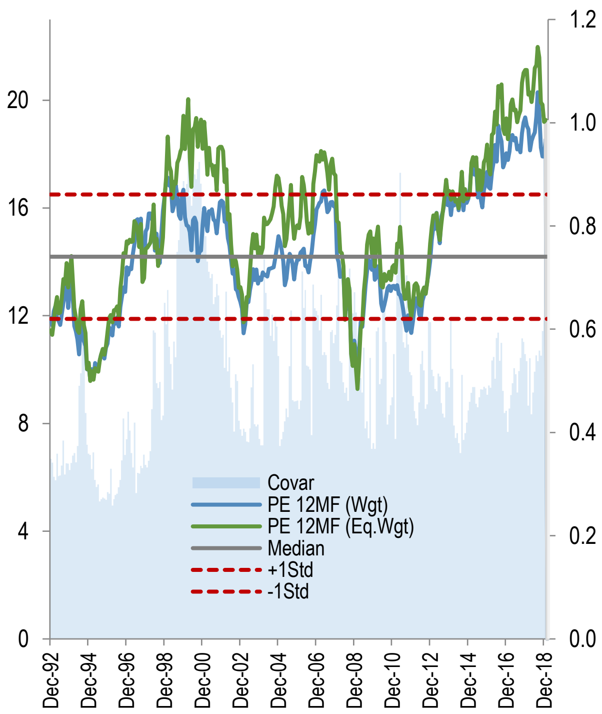


Source: Bloomberg & CLSA

On balance we suspect the economy will lose momentum this year, absent an external shock or disorderly deflation of the housing bubble, we are unlikely to see an outright contraction in activity any time soon as a new Federal Labour Government is likely to boost spending and wages buttressing domestic demand.

As for the share market- I am firmly in the Bear camp. I cannot see shares making a new high any time soon; we could however very well see the market test new lows later this year or early next year. Key sections of the market are challenged - profits are unlikely to grow for the major banks in the medium term; this is also true for defensive sectors such as telecom and utilities. Mining companies have held up remarkably well given the slowdown in China and will most likely trade sideways from here. This leaves the broader industrial market where growth is still overvalued *(Fig 9)* despite the recent pullback, and profit expectations are likely to be paired back as the economy slows.

Industrial Shares are Still Expensive Despite Pullback FIG 9



Source: Bloomberg

The funds are overweight the defensive segments of the market: infrastructure, regulated utilities, property, general insurance and staples; while maintaining shorts in housing and retail. The portfolio is neutral in mining, with shorts in the bulk commodity producers and longs in base metals and gold. We are in a bear market for oil, given the weaker demand backdrop and are defensively positioned in this sector.

Overall, we retain our fully hedged position which has served us well in recent months though stock selection has detracted from performance.

PORTFOLIO REVIEW

Basic Industries

The oil market has been rebalancing since mid-2018 as OPEC has maintained supply cuts and robust demand has pushed prices higher. Iranian sanctions imposed by the US potentially placed a further 2.5 million barrels of oil per day (mbpd) at risk, pushing the oil price higher in Q4 2018.

These concerns were unfounded, with the price of oil decreasing by 40% following a series of events. In August the production numbers released from the US showed a staggering 2.1mbpd increase, year over year. The growth in shale oil production showed no sign of slowing and led to increased expectations for supply in 2019. OPEC countries and Russia ramped up production earlier in the year anticipating Iranian losses and felt minimal supply disruption. The nail in the coffin for oil markets in 2018 was the slow-down of the global economy, which created fresh concerns over demand. We were caught off guard by this rapid decline, and while we had reduced exposure to oil producers, our holding in Origin Energy suffered. We maintained the position as the company has a flexible generation portfolio and APLNG will generate strong cash flows even with lower oil prices.

Chinese economic data continued to soften, weighing on mining shares. Despite the emerging concerns of a global slow down, the resources sector outperformed major indices. This is a function of mining companies' balance sheet strength, capital management and high iron ore and coal prices. We exited our core holding in BHP through the quarter which had performed well. We added exposure to industrial metal miners which suffered large falls; Independence Group, Southern Copper and Iluka.

Building materials companies hit new lows in the quarter as a wave of downgrades in housing were exposed, and construction companies also struggled with poor weather. US-based companies faced a similar treatment as interest rate increases created a 'pause' amongst home buyers, leading investors to question the sustainability of this cycle. We have reduced our short positions in the Australian building materials sector following significant price declines. With further credit impacts and price falls expected in 2019 the outlook is unlikely to improve; however valuations now reflect this environment. Our positions in James Hardie and Reliance Worldwide suffered as US housing growth slowed. We have maintained exposures to these high-quality companies in the portfolio.

Base Metals

Legendary macroeconomic traders such as Paul Tudor Jones and Jeffrey Gundlach were espousing that inflation was set to explode, the Fed would raise rates, bonds were dead and that commodities were the one asset class that would perform well in this environment. We saw a wave of financial buying in early 2018 across the base metals group most notably in copper.

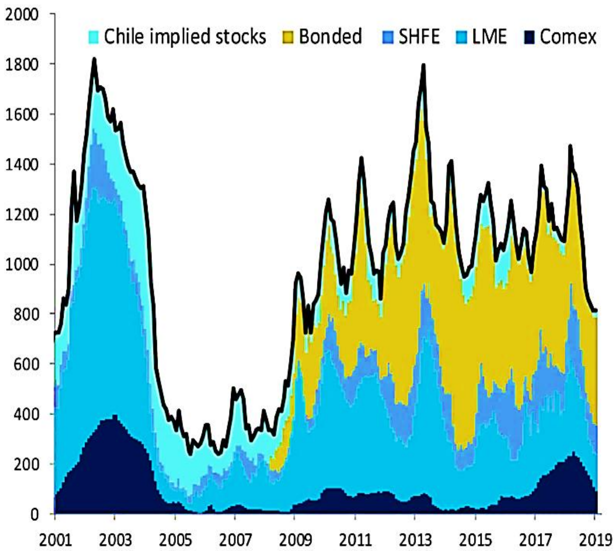
Also, driving demand for base metals was the emergence of the Electric Vehicle (EV) phenomenon. The usage of copper, nickel and aluminium in EVs is many times higher than standard combustion engines. EV production could account for 20% of demand for nickel in the long term. This new source of demand was not accounted for, and markets for these metals appear to be in deficit in future years.

Copper has been receiving additional attention with 40% of the worlds mined supply undergoing labour negotiations in 2018. A vast number of these negotiations occurring in Chile where a new labour code inflated worker pay expectations. As we entered 2018, there was a significant risk of workplace strikes and substantial supply outages. However, despite this rosy picture presented for 2018, the year unfolded vastly differently. The US dollar rallied which weighed heavily on emerging markets. EV production disappointed, most notably in China after subsidies were reduced and despite the numerous union negotiations, virtually no copper supply was disrupted. Ultimately this led to a frustrating year for investors in copper and base metals.

In the background, iron ore and coal prices drifted upwards. While levels of Chinese demand were weaker on several fronts, property starts surprised with a 17% year over year increase. This supported demand for iron ore, while restrained production by the major producers supported the market. Coal continued to benefit from government enforced mine closures and environmental restrictions. This helped the Australian coal producers who have higher quality coal. Heading into 2019, we could see a reversal of 2018, with base metals set to outperform bulks. Most notable was the continued drop in inventory of base metals through 2018. Usually in commodities, we associate falling prices with rising inventories, but an anomaly occurred last year with falling inventories and falling prices. This suggests that underlying demand levels have remained healthy, but investors have reduced positions given an uncertain economic outlook. The chart below shows the copper inventory position spiking at the beginning of 2018 as financial players entered the market, only to be withdrawn through the course of the year. Charts for nickel, zinc and aluminium all show significant reductions in inventory.

Large Draws of Copper Inventory

FIG 10



Source: Citi Research

Chinese demand for metals should pick up in 2019 after a lacklustre 2018, following consumer weakness, tight credit conditions and soft infrastructure spend. Whitegoods are an important demand source for base metals. Their production declined 2% in China last year. This was also evident in Auto demand, where auto sales retreated 5% for the year. The government has announced a wave of measures aimed at supporting disposable incomes which may support these sectors in 2019.

In the second half of 2018 as the US-China trade war escalated, China began announcing a raft of stimulus packages targeting infrastructure investment. This will be highly supportive for base metals after infrastructure investment weighed on the economy in 2018. The Federal Reserve is likely to slow the rise in interest rates which could lead to a softer US dollar, supporting emerging markets. Base metals could become fashionable in 2019 one again.

TMT/Healthcare

Within TMT each sub-sector continues to be driven by specific thematics, as well as its perceived "beta" or sensitivity to economic conditions amid heightened concerns of a slow-down.

Australian Technology names tend to be software-related businesses that continue to be supported by solid fundamentals. However, many of these shares have re-rated to very expensive valuations that fully discount an optimistic earnings outlook going forward, leaving little room for disappointment.

Media names have recently suffered from a bout of cyclical concerns regarding the economy, especially those more geared to the advertising cycle like outdoor and TV. Internet names have proven to be more resilient given they have other levers to pull to mitigate potentially disappointing volumes (i.e. price and depth of premium listings).

The outlook for Telecommunications shares in 2019 hinges to a large extent on the future of the Vodafone / TPG merger, currently being reviewed by the ACCC. If the merger was to be blocked, the rollout of a fourth mobile network could prove highly disruptive to mobile pricing. On the other hand, if the deal goes ahead, a combined TPG / Vodafone would result in a stronger competitor against Telstra but may also create a benign pricing environment. Another development to watch will be the progress of 5G technologies and their impact in driving consumption of data, as well as potentially substituting NBN connections with wireless broadband.

The Healthcare sector has seen a wide divergence in performance and valuation between large globally exposed Med Tech / Pharma companies like Resmed, Cochlear, Fisher & Paykel, and CSL, and facilities operators like hospitals and laboratories. With the exception of Healius and Healthscope, both under offer, hospitals and laboratories have all been dragged down by concerns surrounding decreasing participation in private health insurance and slowing policy premiums, a thematic we see continuing in 2019. At the same time, while we appreciate the long-term growth potential of the Med Tech names, we remain concerned about the valuations people are prepared to pay for them.

Our portfolio is positioned defensively in anticipation of a volatile 2019. Our long portfolio is focused on defensive businesses with solid earnings outlooks and attractive valuations. On the other side, our short portfolio is skewed to shares that are priced for perfection, leaving little room for negative surprises. Even though we appreciate the quality of many of the business models in tech, we remain concerned about the high degree of complacency exhibited by the investor community, reflected in exorbitant valuations. We believe this will be tested in 2019 and hence wait for a better entry point into attractive long-term secular stories.

CSL Seqirus

In our last two editions of "The Leading Edge" we focused on the core plasma business of CSL. In this note, we focus on Seqirus, its influenza vaccine division, which we expect to play an important role in driving profits higher in the coming years.

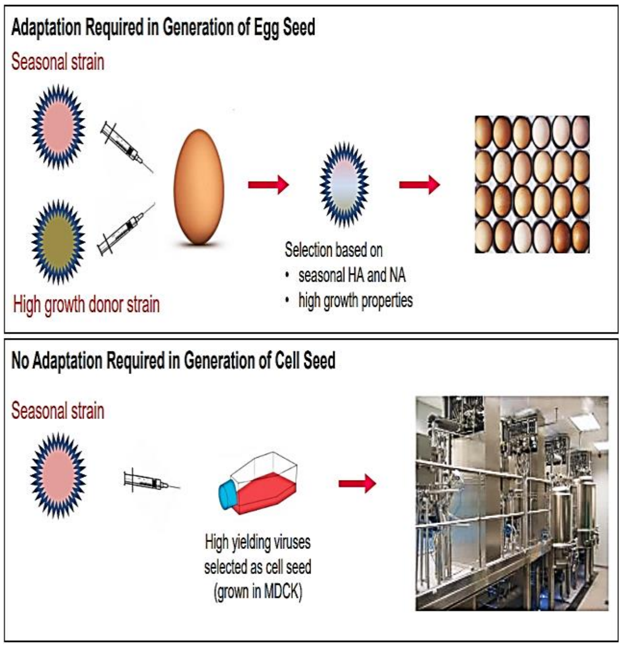
The global market for influenza vaccines is worth c.$3bn and is dominated by three players: Sanofi (60% share), GSK and CSL both with c.20% share each. Influenza, commonly known as the flu, is a highly infectious disease caused by the influenza virus. For most people the flu, represents only a mild inconvenience that runs its course in 4 or 5 days. For the "at risk" population (the young, elderly and those with compromised immune systems) it can represent a serious threat to life. The US Centre for Disease Control (CDC) estimates that in the '17/'18 season the virus affected 49 million people, resulted in 960,000 hospitalisations and 79,000 deaths in the USA alone. The best way to prevent the disease is by getting the vaccine on time.

The problem with flu vaccines is that there are several different strains of the virus, and the strains mutate often. The virus can "drift", small gradual changes over time, or "shift", which represents an abrupt major change. Shifts are typically responsible for pandemics (bird flu in 2004, swine flu in 2009). Every year the World Health Organisation (WHO) estimates what the prevailing strains will be in the coming winter, and 3 to 4 of those strains get incorporated into a vaccine.

This forecasting problem gets compounded by the prevailing method for manufacturing the vaccine. The culture of the virus in embryonated chicken eggs is prone to adaptive mutations while developing. On the other hand, cell-based vaccines, recently approved by the FDA, will result in a closer resemblance between the inactivated virus and the virus in circulation. This result has been supported by recent studies that have shown 36% higher effectiveness of cell-based vaccines compared to standard egg-based vaccines.

Vaccine Seeds Adapts to Grow in Eggs

FIG 11



Source: CSL - R&D Investor Briefing (December 2018)

Seqirus is the leader in the development of cell-based flu vaccines. The recent upgrade of its manufacturing facility in North Carolina will double its production capacity from 20 to 40 million units. The increase in size, combined with higher pricing derived from improved effectiveness of cell-based vaccines, underpins the company's ambition to triple the profitability of this division over the next couple of years. In our estimate, Seqirus will contribute around one-third of total profit growth for CSL between FY18 and FY20.

Financials

The financials sector continues to face headwinds on numerous fronts; a slowing housing market; higher scrutiny on lending practices; weaker consumer demand; and an uncertain economic backdrop for the Australian economy. The Royal Commission handed down its final recommendations on the 4th of February. The outcomes for banks are manageable given actions taken to date and diminishing exposures to wealth management businesses. However, outcomes for pure-play wealth managers and commission-based brokers remain uncertain. Opportunity also awaits disruptors, as incumbents are either disintermediated or lose focus on core businesses. By the same token, disruptors trade at lofty valuations which may not fully capture the potentially competitive landscape ahead. We remain cautious on the sector given the uncertainties in the market and have taken a balanced approach with our exposures.

Our short portfolio has been focused on companies that have exposures to market-linked businesses. December saw the S&P500 decline 19.8% from its peak, and whilst the rally in the new year has alleviated some concerns, market-exposed businesses may still be prone to volatility as their results are delivered in February. Issues relating to share market volatility were felt most notably for companies such as Challenger Financial, which relies on investment returns to fund its annuities. Challenger, with a new CEO at the helm, downgraded its full-year guidance, which saw the shares fall 17% sharply.

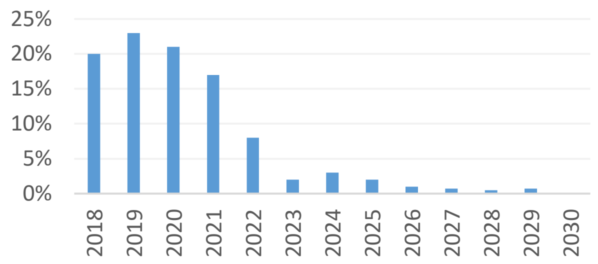
For our long portfolio, we retain a defensive skew, focusing on businesses with strong earnings visibility such as general insurers and shareholder registries. General insurers have historically outperformed during times of volatility, as observed through the global financial crisis. Beyond the defensive attributes, premium increases remain supportive for both personal and business lines.

Tightening credit and implications for the housing market

Market experts can't seem to agree on what led to the slowdown in mortgage lending. Was it the housing market rolling over, regulatory restrictions on interest-only lending or the increased scrutiny on lending practices via the Royal Commission? Whatever the case, we see further risk to the downside given the prevalence of interest-only loans that will revert to principal and interest, more stringent expense scrutiny for borrowers in the future.

Interest- Only Period Expiry

FIG 12

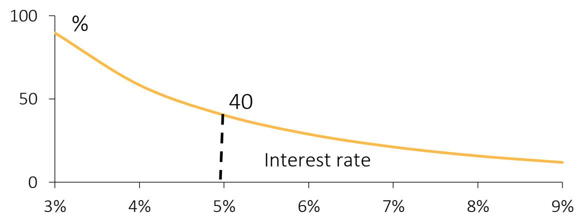


Source: RBA Securitisation Database

2019 remains the peak year for expiry of interest only loans, which means that borrowers must either begin to repay both the principal and interest (a step up of 40% for an interest rate of 5%), refinance an interest only loan under tighter lending conditions; or if unable to complete the first two options, sell the property and repay the mortgage.

Step Up in Payments & Corresponding Interest Rate

FIG 13

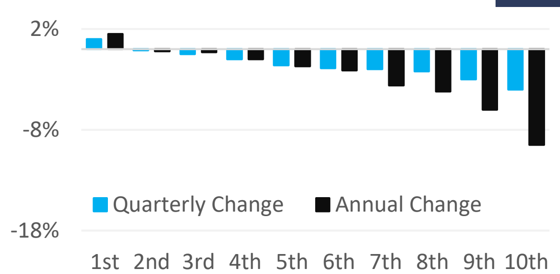


Source: Watermark Funds Management

For most of 2018, interest-only borrowers who reached termination of the interest-only period were able to sell into a broadly stable and liquid property market. House prices have continued to soften into January and turnover has slowed significantly year on year. The risk remaining is that forced sellers exacerbate a downturn, a scenario which we have not seen before given the unique regulatory backdrop.

Quarterly & Annual Change in Dwelling Values

FIG 14



Source: CoreLogic

The velocity of credit provided to mortgage lending plays into numerous parts of the economy via lenders, builders and suppliers to the building industry, retailers and the hip pockets of Australian consumers.

Consumer

The major cyclical headwind facing Australian consumers is weaker housing activity and prices, spilling over into consumer spending. While discretionary spending has already slowed, we expect this to accelerate over the next 12-months. Another, consideration for several listed companies is the impact of a slowing Chinese consumer.

The Consumer portfolio is currently positioned towards businesses with defensive cash flows or high-quality growth businesses that have been caught up in the market selloff. Woolworths and Tabcorp are examples of core portfolio holdings that display strong defensive characteristics. While many retailers are trading on valuation multiples that look attractive through-the-cycle, we are not prepared to invest in businesses on valuation alone. We will selectively look for high-quality retailers that have the potential to grow earnings outside market swings.

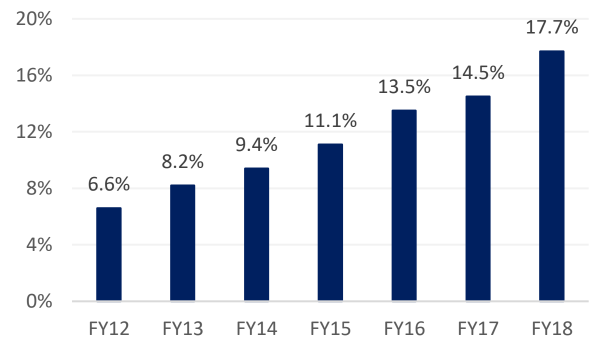
Within our short portfolio, there is no shortage of troubled stocks in the consumer sector. However, the most obvious short opportunities played out months ago in the initial stages of the market correction. The portfolio is now positioned towards companies that may have been incorrectly classified as 'defensive' and therefore escaped the early sell-off. Two areas of interest this reporting season will be the performance of the listed casino's as well as shares in the auto distribution and maintenance channel. We believe the defensive characteristics of these businesses will be tested. The recent sell-down of Costa Group demonstrates the compounding risk of paying a high multiple for supposedly defensive earnings.

Tabcorp

Tabcorp is a diversified wagering, lotteries and gaming operator. The company was formed via the merger of Tabcorp (TAH) and Tatts Group in December 2017, creating Australia's largest non-casino gaming operation. Through the merger, TAH has assembled businesses with dominant market shares across all three of its vertical segments. While Tabcorp is exposed to defensive spending, it is also a business entering a period of 'positive change'. The lotteries business is in the early stages of a switch to digital, while a structural change in the once-troubled wagering business should see it start to compete on a level playing field.

Tabcorp's lotteries business is the jewel in the crown as Australia's sole non-government-owned lottery operator, with 3800 retail outlets. Lotteries have historically proven to be a defensive business, with a 20-year turnover CAGR of 3%. The key opportunity for Tabcorp however, is with the migration of its existing business to the online channel. The transition to online is positive for Tabcorp, in that direct online sales avoid commission payments to agents (at 9% of turnover). Agents include newsagents when buying the ticket in person, or Jumbo Interactive (provides access to jackpot and charity lotteries) when buying the ticket online. As digital migration is currently happening at a rate of ~3% per annum and accelerating, margin expansion is likely to be an ongoing feature of this business.

Digital Share of Lottery Sales **FIG 15**



Source: Morgan Stanley Research

Tabcorp's Wagering business has historically been problematic; from our perspective, it is now entering a new operating environment. For several years Tabcorp has seen its market share leadership erode, with its legacy bricks-and-mortar network lose out to low-cost pure-play online bookmakers.

The fundamental competitive advantage of the online corporate bookmakers is the favourable tax structure achieved via exploitation of a taxation loophole. Regulatory intervention is seeing this inequity closed, with wagering revenue to be taxed at the point of consumption rather than the point of domicile. Removal of the cost differential will allow Tabcorp's online wagering segment to compete head-to-head and the business can pivot away as being structurally challenged

For example, Tabcorp's (Tab.com) is the only wagering app in Australia to have a live video feed, via access to +300 racetracks through exclusive access to Sky Racing.

While earnings from the wagering division may be choppy near-term, early indications are that TAH should see steadying market share and margin expansion as competitors attempt to pass higher tax through to consumers.

Tabcorp offers investors defensive earnings. Consequently, and through the successful execution of the merger, we see the potential for the combined group to be rerated over time.

Performance Review

At the end of December, the Boards of Watermark Market Neutral Fund Limited (ASX:WMK) and Watermark Global Leaders Fund Limited (ASX:WGF) announced their intention to restructure both companies, by way of a Scheme of Arrangement (Scheme), to become a single unlisted trust. The proposed Scheme is intended to address the relatively low liquidity and high operating costs faced by the companies due to their sub-optimal size. Shareholders will be asked to vote on the Scheme at a meeting, to be held on April 1, 2019. Once they are issued with units in the new fund, Shareholders will have the ability to redeem all or part of their investment at the NAV of the Fund on the initial withdrawal date, and monthly thereafter. As part of this restructure of our product suite, we have announced that we will be withdrawing from international investments. We have been progressively liquidating our international exposures across all funds in recent weeks. Each of the three funds we offer going forward will focus predominantly on the Australian share market and follow one of two key strategies: Variable Beta or Equity Market Neutral.

The last quarter of 2018 saw the All Ordinaries Accumulation index fall by 8.98%, finishing the year down 3.35%. All Watermark Funds also struggled through the period. October and November were particularly difficult months, with the Funds posting losses, concentrated predominantly within the long portfolios, as the Australian market sold off in sympathy with risk assets offshore. Historically, our Funds have performed well during 'risk off' periods for share markets, making losses in the period particularly disappointing.

Weak Fund returns in the period were driven predominantly by stock specific issues, with a handful of high-quality investments in core holdings such as Clydesdale Bank, Janus Henderson, James Hardie and Aristocrat all suffering significant falls. On the short side, positive contributions came from shorts in the energy and building materials sectors and some successful short exposures in healthcare, which was the best performing sector of the portfolio. In aggregate, the Funds fell between 4-6% in the quarter (net of all fees).

Quarterly Performance by Sector

Sector	Domestic Portfolio *
TMT	-0.69
Healthcare	0.06
Consumer	-1.58
Industrials	-0.31
Basic Industries	-1.27
Financials	-1.97

*Domestic portfolio data is for Australian positions in Watermark Market Neutral Trust.

Fund at a Glance – December 2018

ASX Code	ALF
Fund Size	AU$280.5
Fund Strategy	Variable Beta
Share Price	$0.97
Shares on Issue	255.9m
Net Exposure	4.0%

Net Tangible Asset (NTA) Backing

	Nov 18	Dec 18
NTA Before Tax	$1.16	$1.16
NTA After Tax	$1.17	$1.16

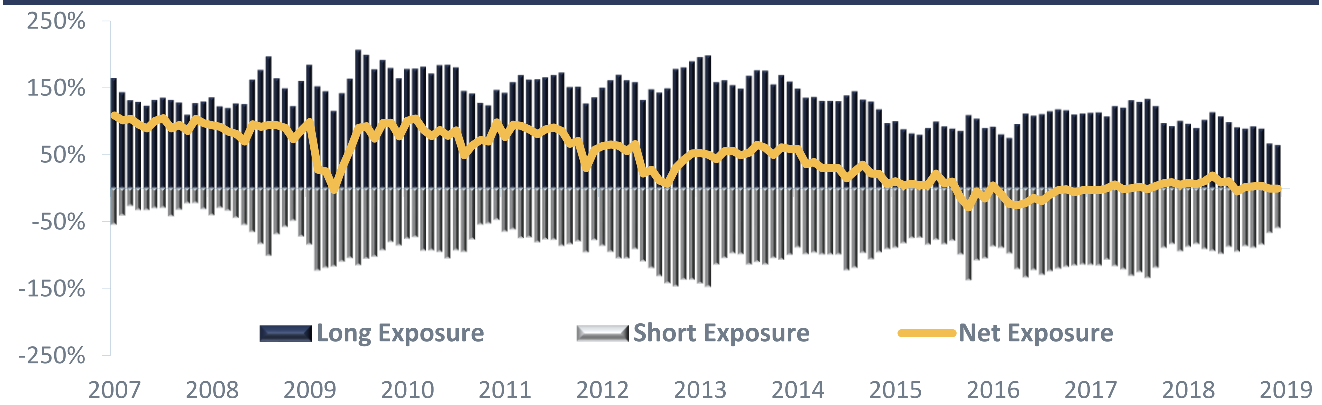
Gross Portfolio Structure

Long Exposure	66.7%	64.3%
Short Exposure	-67.3%	-60.3%
Gross Exposure	134.0%	124.6%
Cash	100.6%	96.0%

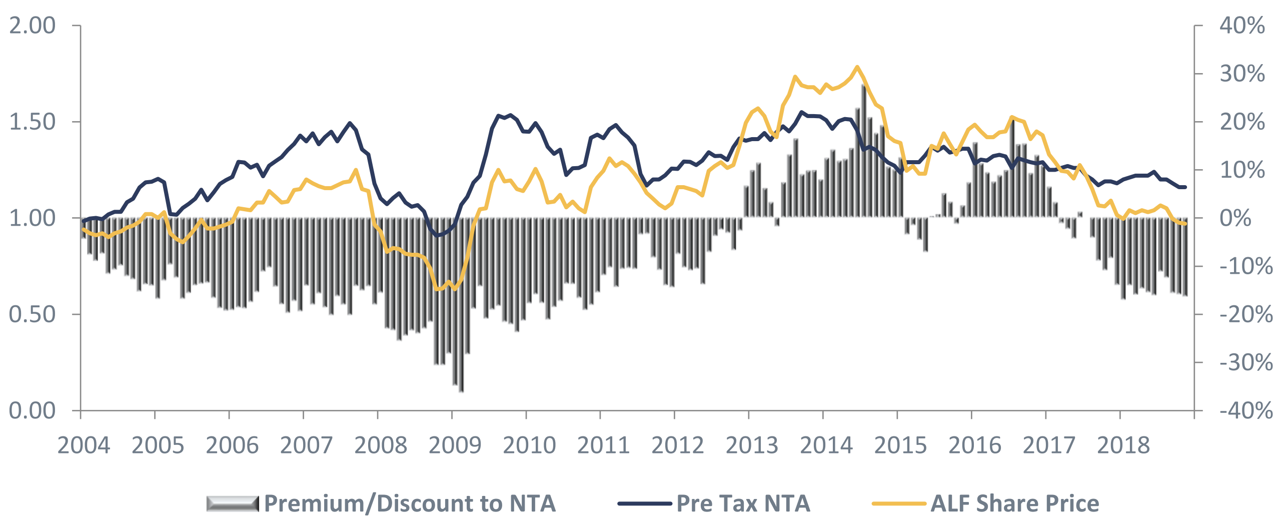
ALF Performance

	1 Mth	3 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	-1.4%	-6.2%	-3.7%	-1.2%	1.6%	9.3%	11.0%
All Ords Accum Index	-0.4%	-9.0%	-3.5%	6.6%	5.7%	9.4%	8.3%
Outperformance (net)	-1.0%	2.8%	-0.2%	-7.8%	-4.1%	-0.1%	2.7%

Net Equity Exposure



Historical Premium/Discount to NTA History



Market Neutral Fund Ltd

Fund at a Glance – December 2018

ASX Code	WMK
Fund Size	AU$70.7m
Fund Strategy	Equity Market Neutral
Shares Price	$0.83
Shares on Issue	81.4m

Net Tangible Asset (NTA) Backing

	Nov 18	Dec 18
NTA Before Tax	$0.92	$0.91
NTA After Tax	$0.93	$0.92

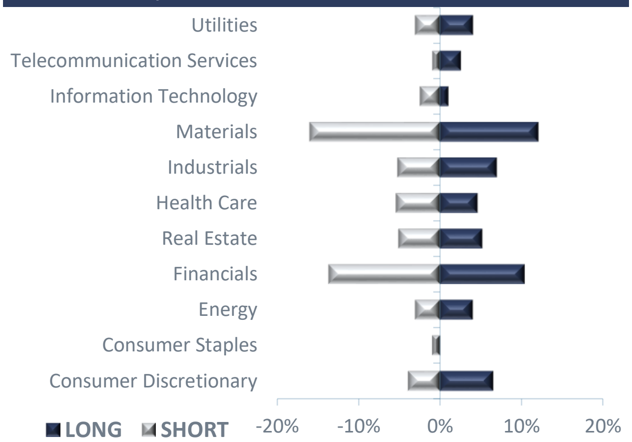
Gross Portfolio Structure

	Nov 18	Dec 18
Long Exposure	66.5%	58.7%
Short Exposure	-67.0%	-59.8%
Gross Exposure	133.6%	118.5%
Cash	100.5%	101.1%

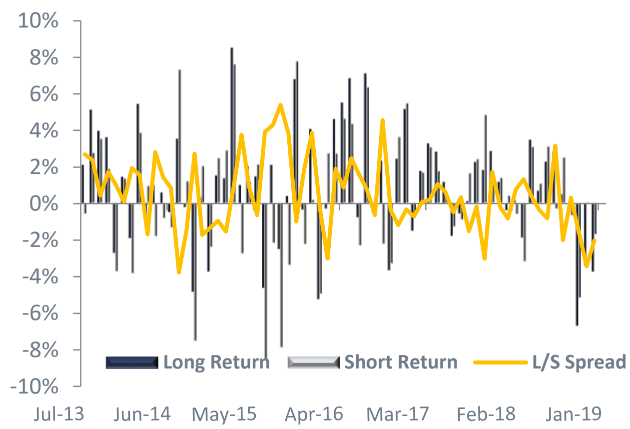
WMK Performance

	1 Mth	3 Mths	1 Yr	2 Yrs (pa)	3 Yrs (pa)	S.I. (pa)
Portfolio Return (net)	-1.3%	-6.0%	-5.1%	-4.3%	-1.8%	3.1%
RBA Cash Rate	0.1%	0.4%	1.5%	1.5%	1.6%	1.9%
Outperformance (net)	-1.4%	-6.4%	-6.6%	-5.8%	-3.4%	1.2%

Sector Exposures

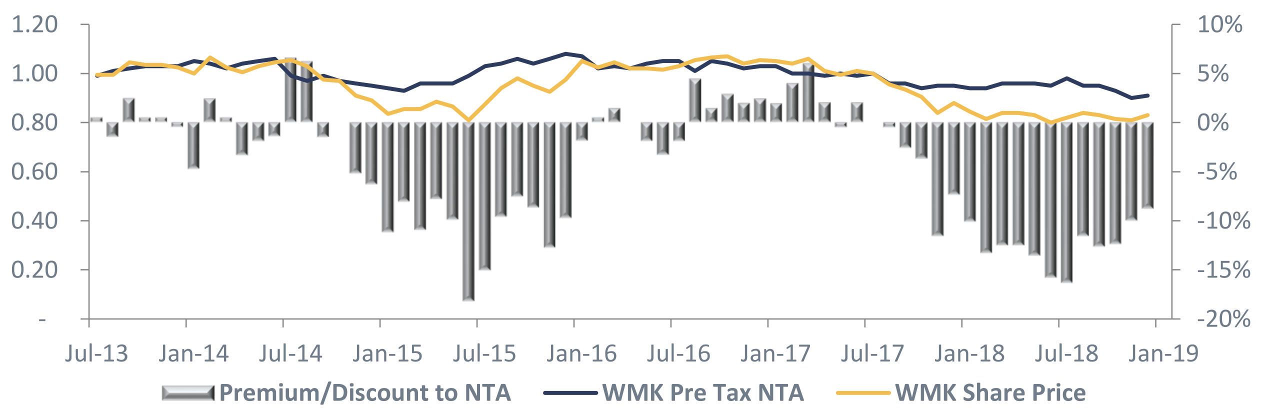


Long Short Spread*



* 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 portfoio 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



Global Leaders Fund Ltd

Fund at a Glance – December 2018

ASX Code	WGF
Fund Size	AU$73.4m
Fund Strategy	Global Market Neutral
Share Price	$0.97
Shares on Issue	73.2m

Net Tangible Asset (NTA) Backing

	Nov 18	Dec 18
NTA Before Tax	$1.04	$1.04
NTA After Tax	$1.04	$1.04

Performance

	1 Mth	3 Mths	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I. (pa)
Portfolio (net return)	-0.6%	-4.9%	-4.9%	-4.9%	-4.9%	-3.9%	-3.8%
RBA Cash Rate	0.1%	0.4%	0.8%	0.8%	1.5%	1.5%	1.6%
Outperformance	-0.7%	-5.3%	-5.7%	-5.7%	-6.4%	-5.4%	-5.4%

Month in Review

The Fund delivered a net return of -0.6% in December.

On the 19th of December 2018, the Board of WGF announced its intention to put to Shareholders, a scheme of arrangement whereby the Company would be restructured as an unlisted unit trust. Upon the successful completion of the scheme, WGF shareholders will be issued with units in a new unlisted trust. It is expected that the Responsible Entity of the new trust will appoint Watermark Funds Management as Investment Manager, operating under a new long/short investment mandate, focusing primarily on Australian shares. WGF shareholders will have the option of holding their units in the new trust, or redeeming their units pursuant to the terms of the scheme, at NAV.

In anticipation of this announcement, the Manager began a process in December of converting WGF's portfolio to cash. As at December 31, 2018, WGF had a gross exposure of 7.3%, comprised of active long and short positions in 13 securities. It is the Manager's intention to liquidate the remaining positions in the coming weeks.

![WATERMARK FUNDS MANAGEMENT]

Market Neutral Trust

APIR: WMF0001AU

Fund at a Glance – December 2018

Fund Size	AU$180m
Strategy FUM	AU$248m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

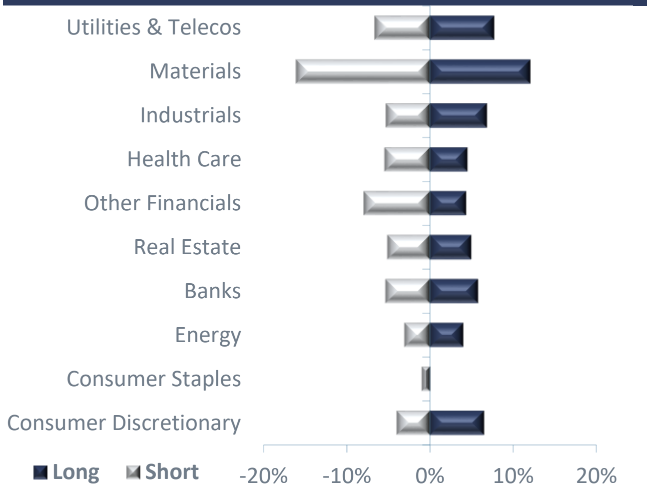
Return Characteristics[4]

Positive Months	67%
Portfolio Beta	-0.1%
Sharpe Ratio	0.9
Sortino Ratio	2.8
Standard Deviation	6.7%
No. Long Positions	47
No. Short Positions	58
Gross Exposure	118%
International Exposure (% of Gross)	2%

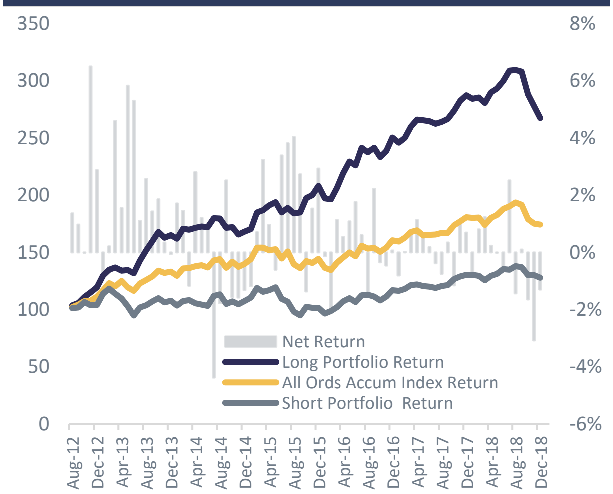
Performance

	1 Mth	1 Yr	2 Yrs (pa)	3 Yrs (pa)	4 Yrs (pa)	5 Yrs (pa)	SI (pa)
WMNT (net return)	-1.3%	-4.1%	-1.3%	0.1%	5.2%	3.8%	8.6%
RBA Cash Rate	0.1%	1.5%	1.5%	1.6%	1.7%	1.9%	2.1%
Outperformance	**-1.4%**	**-5.6%**	**-2.8%**	**-1.5%**	**3.5%**	**1.9%**	**6.5%**

Sector Exposures



Long/Short Spread



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	**12.14**
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	**26.57**
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	**-1.51**
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	**21.92**
2016	-0.14	-1.93	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	**1.62**
2018	-0.86	0.80	1.23	0.23	-0.01	-0.61	2.52	-1.44	0.10	-1.65	-3.08	-1.30	**-4.11**

Notes

Notes

WATERMARK
FUNDS MANAGEMENT

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