



The Leading Edge

QUARTERLY REPORT • December 2019

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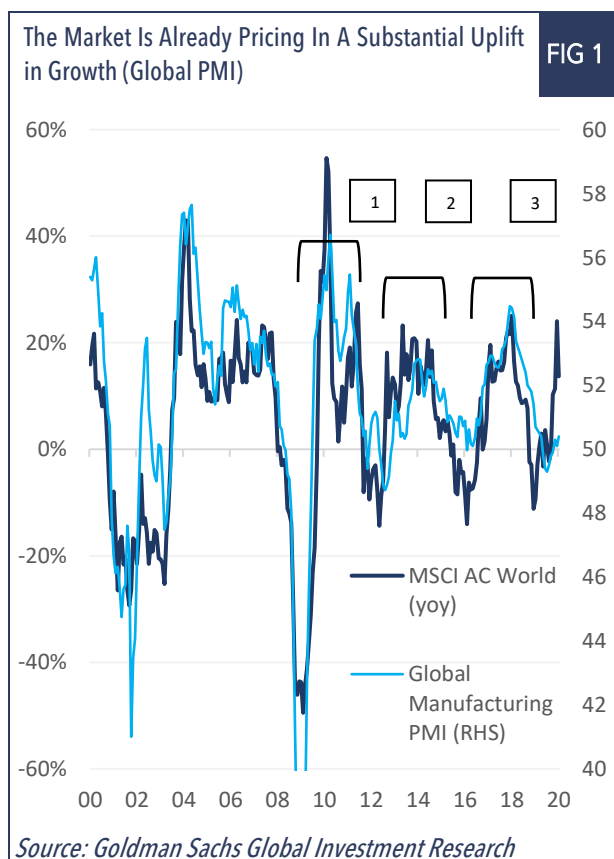


Justin Braitling
Portfolio Manager

Message from the CIO

In our last quarterly report, we suggested share markets were poised to move higher as leading indicators were pointing toward a reacceleration in global growth in 2020. Trade and manufacturing activity bottomed at the end of last year following an easing in policy rates across the major economies; a reversal in US dollar strength and an end to inventory destocking. A moderation in trade tensions between the US and China, and a favourable UK election outcome has buoyed confidence further.

While this is constructive for shares, much of the recovery now looks to be priced in, given the significant rally we have seen already. Below in Fig 1, you can see we are moving into the 4th mini-cycle of this business expansion—they typically last for 3 years.



So long as the Coronavirus outbreak doesn't undermine this nascent recovery, with manufacturing and export orders picking up again, we should turn our attention to the likely strength and duration of this mini-cycle and the risks to it.

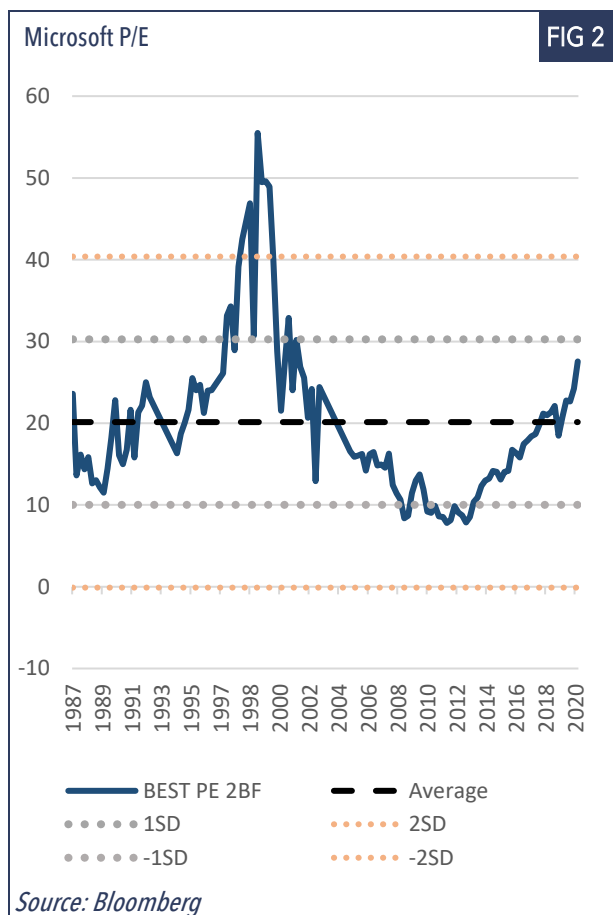
As the US economy is late cycle and China is still trying to de-lever its credit and investment bubbles, we are unlikely to see a recovery as strong as the last one in 2016/17. Activity is likely to peak in the second half of the year, leaving investors once again to contemplate the prospects of a downturn as the year closes.

There are many risks to consider, such as a re-escalation in the trade war with China (unlikely until after the US election); the impact of Coronavirus on EM demand; a rise in geopolitical tensions (Iran) and the emergence of late-cycle challenges in the US (inflation pressures). These are more likely risk factors for next year. Between now and then, the path of least resistance for the share market, for the first half of the year is at least, is upward.

We have a green light on the policy front also, with both the US Federal Reserve and the ECB indicating they are on hold given core inflation is comfortably below target levels. We would need a couple of rate hikes at least, before worrying about a Fed induced bear market.

Only time will tell whether or not this will be the last leg up in this cycle. Many are drawing comparisons with 1998 when the US Federal Reserve cut rates pre-emptively, extending that cycle a few extra years ultimately manifesting in runaway asset inflation and the tech bubble. It's no coincidence the top five stocks in the S&P 500 (Apple, Microsoft, Alphabet, Amazon, and Facebook) now comprise 18% of the market's value, Apple and Microsoft alone now represent 10%, a higher share than the largest companies at the height of the dot com boom. Fully 2/3rds of the market gain so far this year has come from these 5 shares. At the same time, almost half of the S&P by number of shares (43%) are down year to date. This level of concentration around technology is unhealthy- the re-rating of this sector has been significant- we are almost certainly in the midst of a new tech bubble which will inevitably unwind. The MSFT P/E chart is disturbing, if this bubble inflates the US market will probably reach for 4000 on the S&P 500 by early 2021 or up 20% from here. The Australian market I suspect will get to 7400-7500 on the ASX 200, up 7-10% under this

scenario. We are targeting a return consistent with this, so hopefully we can keep up. Thinking about what the other side may look like when the market eventually rolls, we would expect a minimum downside target of 6000 (down 20%) but more likely the market finds support at 5000 (down 30%). With a fully hedged balance sheet, if we are successful in stock selection, the fund should keep increasing in value through this sell off.

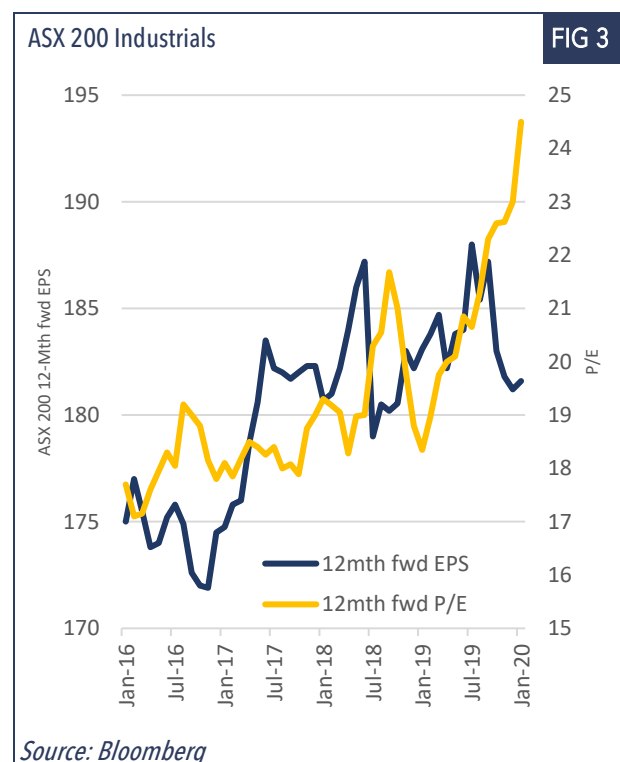


Even though this business cycle is well past its due date, policy makers have shown they will go to almost any lengths to avoid the next recession, given the trouble they went through to dig the global economy out of the last one. If they do manage to keep this cycle going for longer, as valuations are very stretched and revenue and profit trends are sub-par, we suspect returns are likely to be quite low at best.

In our last update, we also suggested Australian shares would move higher in 2020 but lag the gains in offshore markets. For the same reasons Australian shares outperformed in 2019, they would underperform in 2020. As a low growth, defensive market we benefited in 2019 as global growth slowed. With the reflation cycle in full swing, allocators (particularly those managing Asia-

Pacific Portfolios) are now looking to invest in the recovery taking place elsewhere.

With regard to the broader Australian economy, we would expect a continuation of the lacklustre trends we have seen recently, evident in the latest NAB Business survey where confidence is running at a 7-year low. Even with the benefit of the RBA rate cuts and the government tax cuts, consumer spending, housing investment and business investment have all continued to slide. Outside of mining, our economy is not that exposed to the recovery taking place offshore, so it is hard to see us fully participating.



Compositionally, the Australian share market also has some headwinds which will restrain our participation in any rally. The Australian Banks and Industrial companies operating offshore, together account for half of the value of the Australian share market. Both these groups are challenged, but for different reasons.

The Australian banks have failed to generate profit growth now for the last 2 years, and we would expect these trends to continue in the medium term. While the banks represent value in an expensive market, returns will be challenged further by low-interest rates, which may fall further. Our banks are heading for a similar quagmire of zero rates that have undermined returns for banks in Europe and Japan (Fig 4).

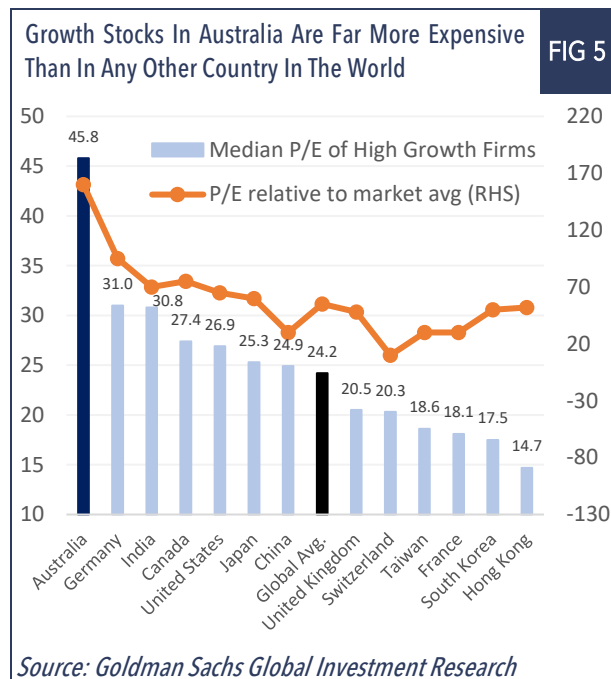


Industrial companies operating offshore will see profit growth crimped by a stronger Australian dollar. We expect a reversal of the leadership shown by the US economy and the US dollar relative to the rest of the world, as a recovery in trade and manufacturing will favour countries outside of the US. In contrast, the Australian dollar as a commodity currency linked to Chinese growth should strengthen. A stronger Australian dollar will be a headwind for the economy and for those listed companies that generate their income offshore.

The two sectors that look well positioned for a resumption in growth and commodity prices are mining and energy. They are all the more appealing because they have not seen the significant re-rating evident amongst industrial companies. Mining and energy shares are relatively cheap in an expensive market.

Defensive shares, including bond proxies (utilities, infrastructure, REITs and staples) performed very well in 2019. They are likely to struggle this year as investors look to shift into companies with cyclical exposure. It will be best to revisit these sectors later in the year when growth concerns re-emerge.

Growth shares have re-rated as interest rates have fallen. As there are relatively fewer growth companies in Australia, valuations have been pushed to extremes. Fig 5 would suggest we have the most expensive growth shares in the world. Needless to say, there is little opportunity left in this sector.



How Expensive is the Share Market?

We have noted many times before, shares are very expensive on historic measures Fig 6 (3 standard deviations above the mean P/E multiple). We have indicated on the chart below when we moved to a fully hedged position (zero beta at 2 SD). With these settings, we should be fully protected from a market downturn when it eventually comes.



As a reminder to investors based on historic experience, you should expect the share market to fall by at least 30% in a bear market. As interest rates and bond yields have moved lower in recent years, shares have re-rated higher again, pushing outside of their historical range (now 3 Stand Dev. points above historic average). (Note this is for Industrial shares Ex-Banks and Real Estate - Fig 6).

We have moved into uncharted waters. It may be useful to delve a little deeper into standard valuation methodologies to understand what is happening here. I don't want to bore you with excessive details other than to say, the value of a share is the present value of future profits. These future profits are discounted back to today's terms, using a discount factor that is the sum of the government bond plus an equity risk premium.

The three key drivers:

1) Current profits and how they are expected to grow in future (5% p.a historically);

Discounted by the sum of:

2) The risk-free rate- the 10-year Commonwealth Government Bond (6.5% historical average)

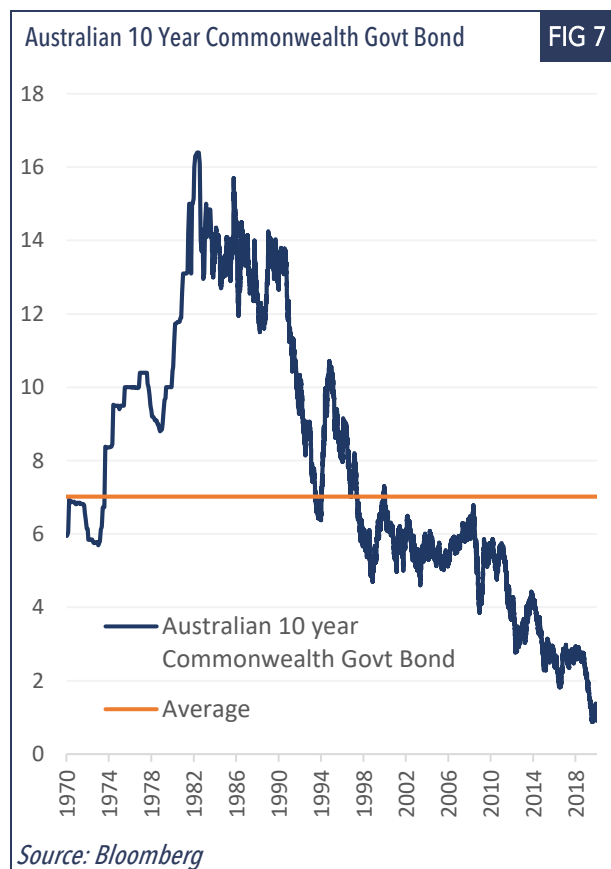
3) The risk premium investors require to hold shares (5% historically).

Market bulls will point to government bond yields at record lows Fig 7 and suggest shares are cheap relative to bonds. While this is almost certainly true, with fully ¼ of the world's sovereign bonds now trading at negative interest rates, most investors recognise that bond prices are being highly manipulated by central bank intervention and are grossly overvalued.

Australia's own 10-year government bond has slipped below 1% in anticipation of large-scale bond purchases (QE) by the RBA. I would ask you, does 1% seem like an adequate return to lock your money up for 10 years? Should you use this as a proxy to value shares?

This argument in no way diminishes the risks in holding shares. It does demonstrate how excessive liquidity from central banks action is finding its way into all asset classes, including shares. While bond yields have been falling for 40 years since inflation peaked in the late 1970's, this argument has only recently emerged in the last few years

to justify the move higher in share market values. Through the last business cycle in 2001-2008, bond yields also halved but the market P/E stayed in the historic range.



Keeping all other metrics the same, if we were to put the spot bond (1%) into our valuation model, the market P/E could theoretically double to 47 times earnings, suggesting the market could double from here!

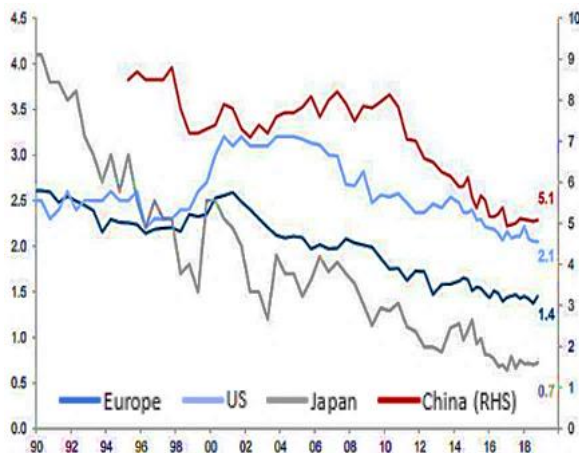
For a start, no one expects bond yields to stay as low as they are. No one would have guessed 3 years ago that Australian bonds would trade on a 1% yield. Likewise, we cannot accurately forecast where they will trade in 3 years - it is pure guesswork.

Most strategists are expecting bond yields to normalise over time, shifting higher again. A survey of buy-side investors has most using 3.5% as a long bond assumption for valuation purposes.

It is important to understand why bond yields are so low. There is a direct relationship between bond yields and the structural growth rate of the economy. Bond yields are so low because trend growth has slowed markedly across the OECD (Fig 8). There are numerous reasons for this: lack of investment, poor productivity, along with demographic factors.

Long Term Real Global GDP Growth Forecast Is At A Historical Low

FIG 8

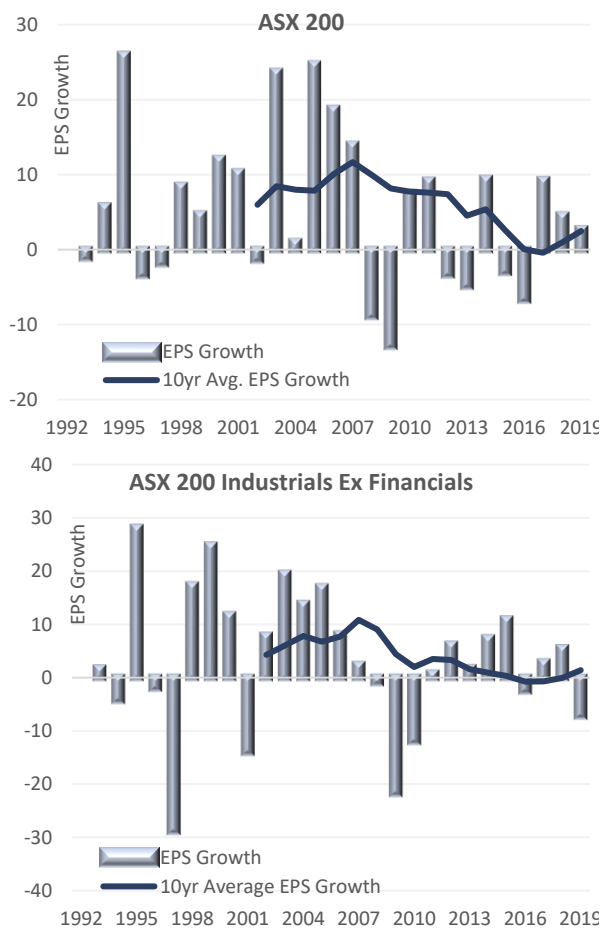


Source: Goldman Sachs Global Investment Research

When we look at how this translates into profit growth for public companies you can see how in Fig 9 profit growth (which averaged 6% before the financial crisis) has fallen to just 2% in the last decade. Companies are investing less and distributing more (the average dividend payout ratio increased from 55% pre-crisis to 75% today).

Profit Growth For Australian Public Companies

FIG 9

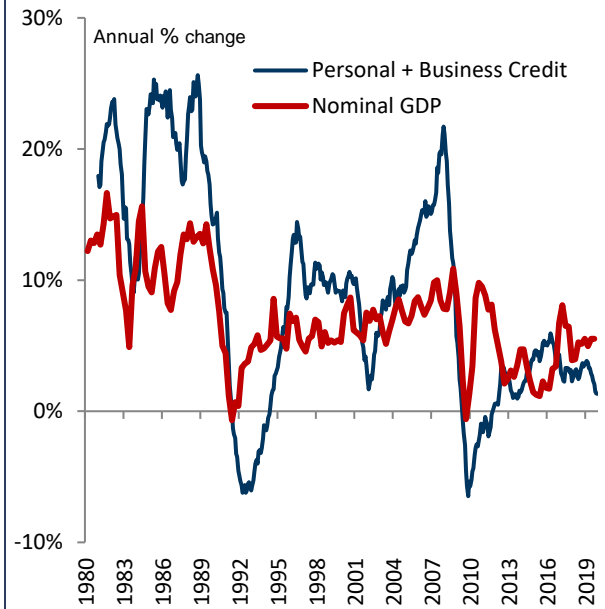


Source: Goldman Sachs Global Investment Research

A key driver of profit growth pre-financial crisis was leverage. Fig 10 shows how credit was growing well in excess of the economy, buttressing growth. With leverage moving to unsustainable levels, ultimately creating the crisis, it has now become a constraint, particularly in the household sector.

Personal & Business Credit

FIG 10

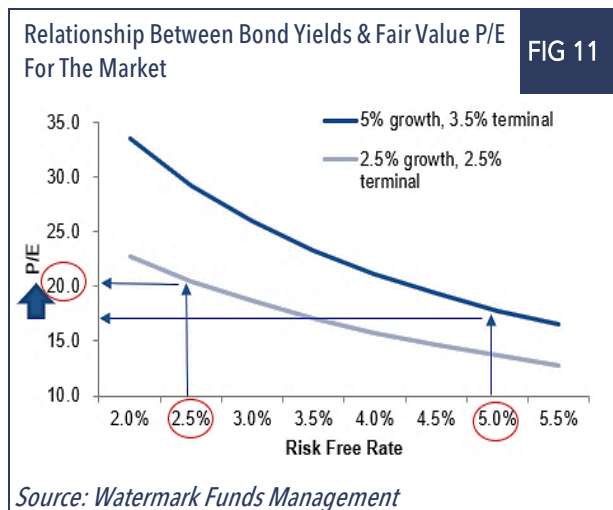


Source: Goldman Sachs Global Investment Research

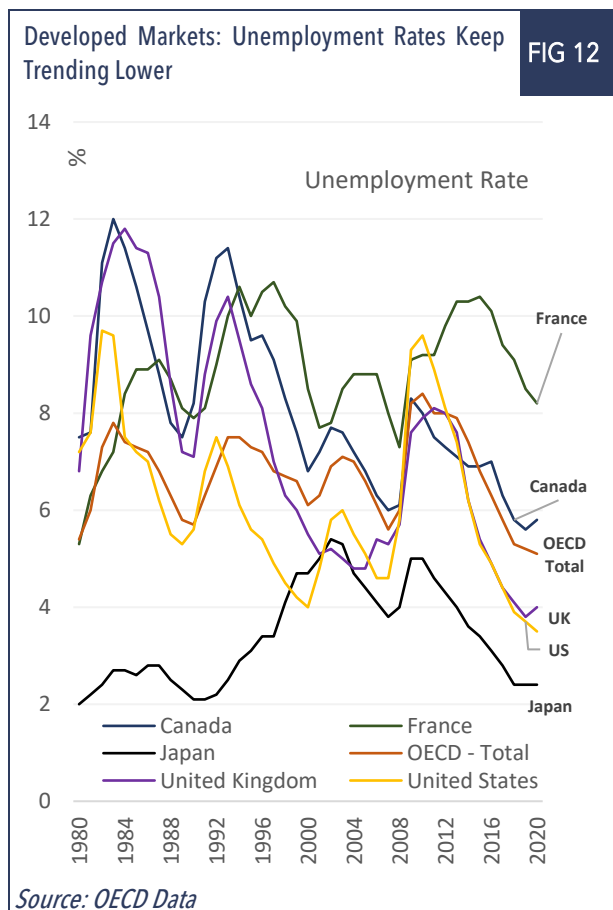
Turning to the future, we should assume these softer profit trends will continue. We also need to factor in a downturn which cannot be too far away.

With credit spreads largely unchanged over time, we can assume the equity risk premium (which we cannot observe directly) is also largely unchanged.

Updating our valuation model for lower bond yields and for slower profit growth, we see modest scope for a re-rating of shares versus historic measures. In Fig 11, we show the relationship between bond yields and the fair value P/E for the market under two growth scenarios A (2.5% growth) and B (5% growth). The modelling suggests that if bond yields were to be sustained at 2.5% and earnings growth at 2.5%, market P/E's could increase slightly versus history (20 times Vs 17 times). What we have gained by way of a lower discount rate has been largely given up by lower growth expectations. Because we cannot observe future growth directly, this only becomes obvious over time as profit growth disappoints. With industrial shares (Ex-Banks) trading on 24 times earnings, the market is still 15-20% overvalued under this scenario.



There are two outcomes to consider here. Either, structural growth keeps slowing (bonds and interest rates will move closer to zero- like Japan) or inflationary pressures return as output gaps across OECD countries close. It is worth considering Fig 12 below, employment markets have never been this tight across the OECD - inflation has to return, particularly in late cycle economies such as the US. If inflation moves back above target levels, interest rates will have to rise and the heavens will fall in on inflated asset markets.



Performance Review

ALF's average market exposure (beta) for the 10 years since the financial crisis, has been just 30% (Fig 13 yellow line). The difference between gross fund returns and the contribution captured from the limited market exposure retained is the 'alpha' the Manager has added through stock selection - the blue bars in Fig 13.

Sophisticated investors will typically only pay for alpha; if you want beta, invest in an ETF where the fees are negligible. According to the latest Morningstar survey, the best institutional managers in Australian shares (the top quartile of 15 managers) have on average contributed 4% of alpha before fees over 10 years. (This assumes they were fully invested with minimal cash weightings and fees were on average 70bps). In a Long/Short fund like ALF, the short portfolio is both a form of leverage (shorts are a liability on balance sheet) and a hedge reducing market risk (beta). The strategy works by leveraging up the alpha the Manager can create to generate an acceptable return, without having to rely on the market (beta), the predominant source of return for traditional funds.

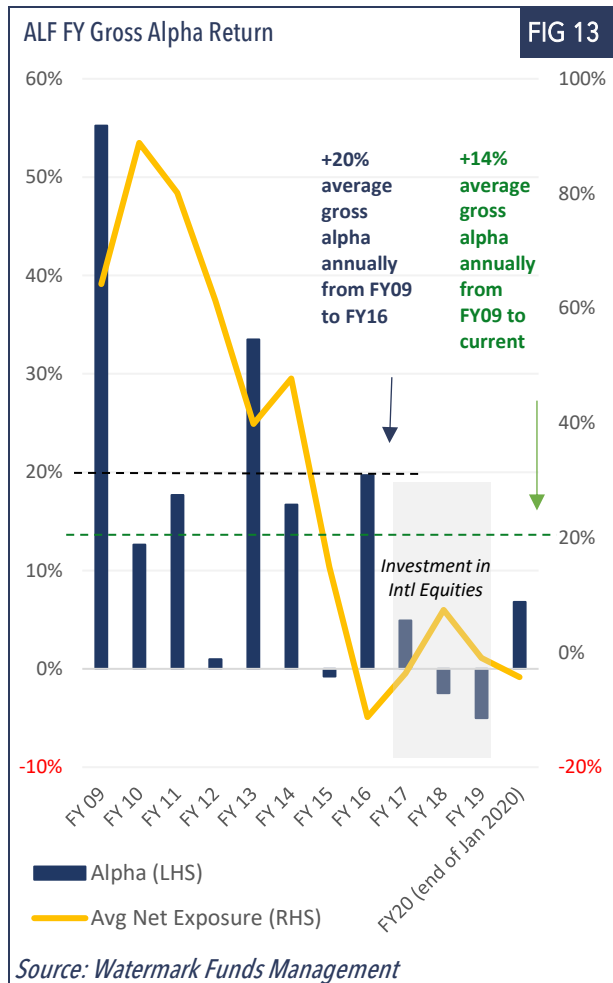
After stripping out the contribution to returns coming from ALF's modest market exposure, you can see the Manager has contributed 14% p.a.¹ of gross alpha over 10 years even including the poor performance of the last 3 years. For a fair comparison with traditional funds, we need to adjust for the leverage (gross assets/capital), which brings us back to an unlevered alpha contribution of 5.3% p.a.¹ The easiest way to appreciate this is to consider the performance of an unhedged ALF or simply the long portfolio return which has been 14.9%¹ versus 7.1%¹ for the market over the 10 years.

We moved early to a fully hedged portfolio, given the share market was expensive on historic measures, in the belief we could continue to contribute this level of alpha. The international share strategy compromised this outcome and we have lost 3 years where the Manager has not generated alpha for investors.

The Manager addressed this back at the end of 2018, taking the necessary remedial action, rebuilding the investment team and returning to its core focus on the Australian market. While it is disappointing to have lost

¹ Data includes Jan 2020 performance.

these years, I am pleased to report the Manager is back operating at their full capability.



So far, this financial year the fund has added 7%² of alpha, keeping up with a strong market even though the fund has retained no net exposure and received no dividends (dividends received are paid out on hedges), putting us on track for our 10-12% gross return target for the year. We are keeping up with a strong bull market while fully hedged; this is not easy to do.

² Data includes Jan 2020 performance.

PORTFOLIO REVIEW

Basic Industries

The materials sector began to show signs of bottoming in the December quarter. Bulk commodity prices were largely stable while base metals were mixed. Copper rallied into the end of the year (+9% QoQ), nickel returned from its mid-year highs (-19% QoQ) and precious metals continued to pull back from September highs until December, when gold rallied 4%. The oil price also rallied throughout the quarter, gaining 13%.

The largest contributors to performance were NRW Holdings (NWH) and Northern Star Resources (NST) following strongly supported acquisitions, Karoon (KAR), Iluka (ILU) and Saracen (SAR).

Detractors during the quarter came from our hedges and production downgrades. Nickel Mines (NIC) and our mid-cap gold exposures traded lower with pricing. The ongoing drought impacted Whitehaven Coal (WHC), and Metals X (MLX) gave up early gains after downgrading due to poor operational performance.

We expect 2020 to be a strong year for resources however, we remain aware that while the overall backdrop appears positive, the Australian names are already pricing in higher expectations. On this basis, we continue to tilt the portfolio to the long side looking for opportunities to hedge where commodity exposures are unfavourable, or where valuations are stretched. The gold sector (other than the small caps) has given up most of last year's gains, however prices are 20% higher than the start of 2019 on an AUD basis and we believe this presents opportunities for outsized returns while gold holds current levels.

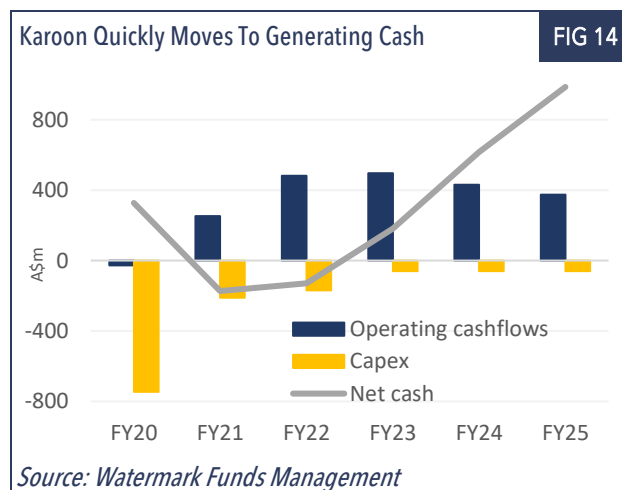
Karoon Energy

Karoon Energy (KAR) is an oil and gas explorer with a primary focus on offshore Brazilian assets. The Company has a history of successful exploration, discovering the Poseidon gas field in the Browse Basin WA; however, the deposit was sold to Origin for US\$600m. Following the sale, Karoon sought to develop two discoveries it made in Brazil (Neon and Goia). An opportunity to acquire the producing Bauna oil field presented itself in 2016, shifting the Company's focus. Ultimately the first iteration of the

transaction fell through in 2017, but the Company persisted and in 2019 it signed a binding sale and purchase agreement to acquire the project. We expect the transformational acquisition to be finalised in early 2020 and for the share to re-rate materially.

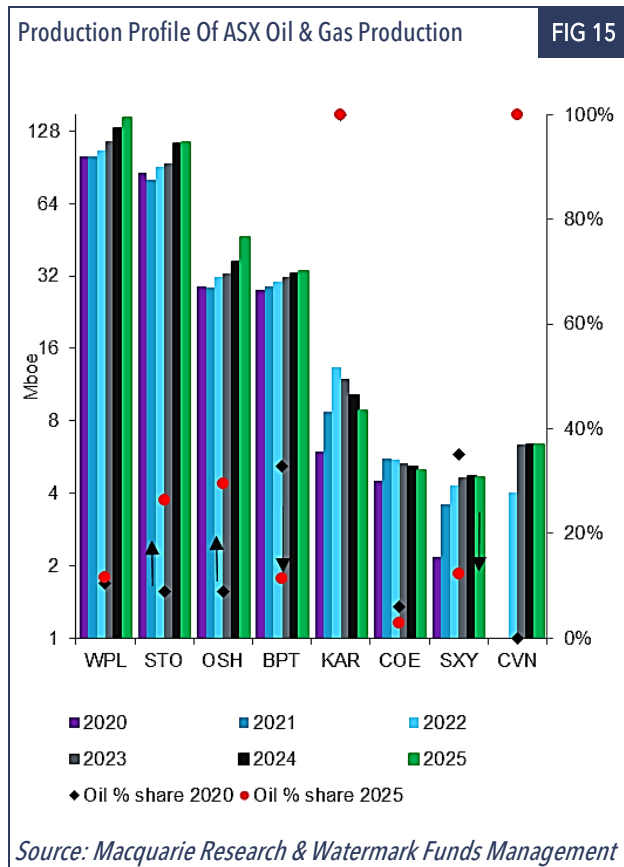
The asset was acquired for US\$665m and depending on timing, this will be reduced by approximately US\$200m as the acquisition is effective 1 Jan 2019 and the asset generates excess free cash flow. The deal effectively transforms Karoon over-night from an explorer to a producer with a platform to grow production.

The economics of the field will result in KAR generating EBITDA of cA\$200m (>25% FCF yield) in 2021 lifting to over A\$400m in 2023-24 once a workover campaign is completed. A critical step for full value to be realised from the Bauna field is the replacement of several pumps that have failed; tying in the nearby Patola field. We expect this to occur in CY21-22 and while it will reduce free cash flow, we expect to see production lift to around 10Mbbls. The field is expected to produce until 2030, giving the Company time to assess extensions and investigate lifting recoveries.



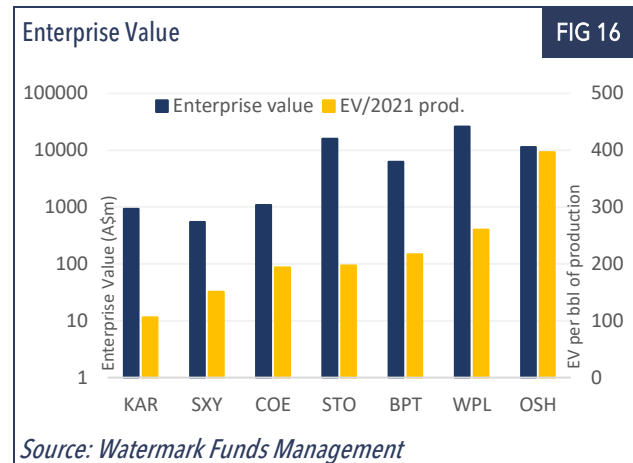
The Australian oil and gas sector is focused on LNG and gas producers with four ASX100 companies and a grouping of sub A\$1bn market cap junior developer/producers and explorers. The acquisition will lift Karoon to be the 5th largest oil and gas producer on total BOE basis (Barrel of Oil Equivalent) and the 3rd largest by crude production in 2021. It will also be one of two pure-play oil producers alongside CVN, providing leverage to oil prices and diversification away from the oversupplied LNG market. Amongst the majors STO and OSH will lift oil production share to c.30% in 2025 from a base of 10% this year, while BPT will fall from 30% down

to 10%, providing a clear differentiation for Karoon at 100%.



A gap has now opened on the ASX between large-cap ASX 100 companies over A\$6bn and the next closest peers: Cooper Energy (A\$900m) and Karoon (A\$700m). We believe this presents an opportunity for these companies given mid-cap producers, can significantly enhance portfolios through acquisitions, development and exploration. On an enterprise value to production metric, the majors carry a premium for their size and portfolio scale. KAR screens as having value on this metric, along with our other key pick in the sector, Cooper Energy. We expect KAR to backfill the production profile by expanding the resource at Bauna, developing the nearby Neon and Goia discoveries or leveraging any exploration success.

Karoon continues to explore in frontier basins, drilling the Marina-1 well off the coast of Peru. While we assign no valuation (an include the cost), it has the potential to open a new oil and gas province and is targeting 250mbbls of oil. Results from the well should be received in early 2020.



TMT/Healthcare

Australian technology shares remained subdued as investors rotated capital out of the sector. Unfavourable macroeconomic conditions were compounded by stretched valuations and an AGM season which saw most technology companies report financial results in-line with expectations. Our position in Bravura Solutions was one of the big winners, a combination of earnings upgrades and a benign Brexit resolution. An investment in Appen also benefited from an earnings upgrade at the time of its AGM. Several shorts in over-valued companies with questionable business models also paid off handsomely. As we roll into 2020 and post a strong rally in the first few weeks, the sector looks ripe for consolidation based on positioning, valuations and macro settings.

Performance within the telecommunications sector was more disperse. Telstra shares continued to drift higher as investors digest a more benign domestic environment where Optus is not as aggressive in mobile as it used to be, providing Telstra with a line of sight to better pricing and average returns per user. At the same time, TPG and Vodafone remained in a holding pattern awaiting the verdict on their merger case against the ACCC (results due any moment now). It is worth noting that Telstra shares could be vulnerable in the near-term should Vodafone/TPG prevail in their merger case, even though in the long-term a consolidated three-player market is more beneficial to Telstra than one where a weak third or fourth player are forced into acting like a disruptive maverick. In New Zealand, our position in Chorus benefited from the release of more benign assumptions by the regulatory authorities.

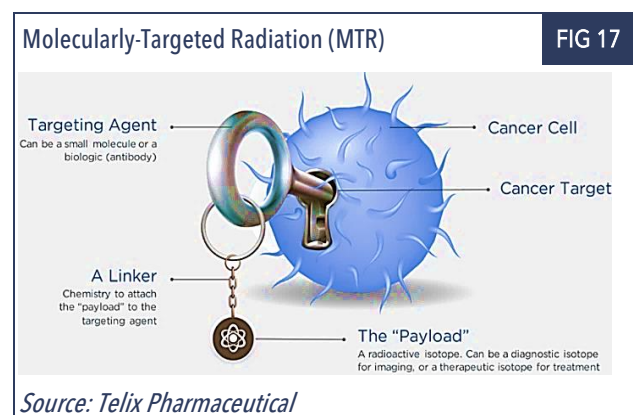
Old media companies continue to be plagued by volatility as advertising markets weakened into year-end across the board (TV, radio, out of home and even digital). Southern Cross was the latest victim, providing a weak trading update in October that took the shares down 30% on a c.15% cut to FY20 EBITDA. We expect a severe bushfire season around the turn the year to have an impact on regional budgets, adding another brick to the wall of worry that old media shares have to climb in 2020. On the flip side, Internet names had a very good quarter as markets seemed more willing to look through a softer short-term outlook, whether in car sales, real estate listings or job listings.

In Healthcare, we saw divergence across the sector as Med-Tech names continued the trend of grinding higher, supported by benign end-market dynamics and compelling secular growth profiles (CSL, Resmed, Fisher & Paykel, Cochlear). On the other hand, high growth emerging healthcare businesses, much like technology names, struggled against the trifecta of stretched valuations, crowded positioning and sector rotation in a quarter that was lacking in share specific catalysts (i.e. no earnings reports).

Telix Pharmaceuticals

Telix Pharmaceuticals focuses on the development of molecularly targeted radiation (MTR) drugs to diagnose and treat cancer. MTR enables precise imaging of cancer, which allows for an accurate diagnosis of the stage and location of the disease and hence leads to a more personalised therapy, adjusting dosing to meet the patient's cancer burden and mitigate potential side effects from the radiation.

An MTR drug consists of a combination of a small molecule or antibody that binds to a specific type of cancer cell and a radioactive isotope, effectively the "payload", that will address the cancer cell. The MTR drug is administered via the bloodstream and binds to a specific target on the cancer cells, wherever they are, including small metastases. Low doses may be used to image the patient's cancer (diagnostic function) and higher doses to destroy the cancer cells (therapeutic function).



The company's clinical pipeline consists of three programs for the diagnosis and treatment of three types of cancer: Prostate, Kidney and Brain. Each programme consists of a diagnostic or imaging agent and a treatment agent. As of December 2019, Telix has 55m in net cash;

in our opinion, this is more than adequate funding to see it through to the commercial launch of its first product in the next 12 months.

The prostate programme (TLX591) is the most advanced. On the imaging side (CDx), its product TLX591CDx, commercially branded Illumet, has completed Phase III trials and is expected to be commercial in late 2020/early 2021. The therapeutic programme has completed Phase II trials and is moving on to the design of Phase III for regulatory submission. The kidney programme (TLX250) is on Phase III for the imaging agent (currently recruiting patients with the completion of enrolment expected for Q2 2020) and on the design stage of Phase II for the treatment drug. The brain programme (TLX101) is in early stages, with Phase I ongoing in European sites and a Phase II portion of the study expected to commence mid-2020.

Investing in biotechnology is normally quite hard with large companies generating little to no revenues and huge R&D budgets, that regularly require fundraising from shareholders. Unlike most biotech's though, Telix already has a proven product in the field (treated around 10,000 patients in 2019) and, if approved by the FDA, will soon be able to make a commercial return on the R&D investment it already invested. At the end of 2019, the company submitted a complete clinical briefing package to the US FDA for 591CDx per guidance received from its pre-NDA meeting. An amended Drug Master File (DMF) will be filed with the FDA during January, hopefully finalising the NDA submission process with the FDA. Once completed, we expect the FDA to approve Illumet in the 2H of 2020 or early 2021. Approval should translate to higher utilisation rates within hospitals and a significant effective price increase to Telix, effectively becoming its first commercial product and a significant source of revenue and cashflows.

Currently, there are around 300,000 patients diagnosed annually with prostate cancer in the US and EU, of which 20% are at a high risk of having advanced prostate cancer. Detecting early metastatic disease is a major unmet need which supports an elevated price point (the company is talking around USD 4,000 per dose at launch). This implies potentially a USD 500m market for prostate imaging across multiple indications in the US alone. For a company currently making less than AUD 10m of revenue and with a market capitalisation of AUD 400m, any decent

share of that addressable market is quite meaningful and currently not reflected in the share price (we believe Telix has a good chance of achieving a sizeable percentage of that market).

Another attraction of Telix is the high level of corporate interest in a sector with a limited number of players. Novartis acquired Advanced Accelerator Applications in January 2018 for USD 3.9bn having a very limited pipeline, with most of the valuation based on a single orphan program for neuroendocrine cancer. They also acquired Endocyte in December 2018 for USD 2.1bn while it was completing its phase III in prostate cancer programme. In November 2018 Boston Scientific announced a recommended USD 4.2bn offer for BTG with most of the valuation attributed to its Interventional Medicine business including both interventional oncology and vascular portfolio. Progenics (USD 500m market cap) is in the process of being acquired by Lantheus. Sirtex was acquired by Chinese CDH in September 2018 for AUD 1.9bn after outbidding Varian Medical Systems. Blue Earth Diagnostics, a privately held UK company whose products Telix is successfully displacing, was acquired by Bracco in June 2019 for USD 450m.

In summary, we expect this to be a pivotal year for Telix. The company starts 2020 with a market capitalisation just shy of AUD 400m (AUD 345m excluding cash on hand), a potential addressable market of USD 500m only on its first commercial launch, several shots on goal across its pipeline, in a sector characterised by high corporate interest and scarcity of players. Against this background, management could choose to pursue the development of its pipeline by itself, meeting all its funding needs and keeping all the potential rewards. Or farm out different programmes to strategic partners in the oncology field or sell the company should they receive a compelling enough proposal. We think this is an appealing risk/reward in an exuberant bull market plagued by unattractive investment opportunities.

Financials

Overall the contribution from the Financials portfolio was positive for December quarter; however, performance varied by subsector. Banks made a positive contribution as a weak reporting season resulted in price falls, supporting our short positions. We have moved to a more balanced position in the banks. While earnings risk remains, we see value in majors (ex-CBA), particularly given the run on the market to date and the attractive dividend yield.

Outside the commercial banks, we have maintained a core investment in Macquarie Group. Given relatively lower earnings risk relative to its commercial counterparts, it has participated in the market rally. We have recently undertaken a deep dive on Macquarie's domestic consumer banking division. We believe this will be another earnings engine for the group in the years to come. As the majors have retreated in mortgages, Macquarie takes 6x its current market share in new loans. It has become a true leader in the mortgage broker channel in terms of turnaround times and efficiencies in processing through to approval.

Our key investment in Afterpay was a detractor from performance. Afterpay delivered a solid AGM update followed by impressive black Friday trading metrics. Unfortunately, it was caught up in a global selloff in growth tech stocks. With a growing number of international investors on the register, it becomes more susceptible to top-down global market trends. The share price has retraced most of this weakness in the first month of 2020.

QBE downgraded its guidance in December, driven by its abnormal year in the crop portfolio. We believe the crop portfolio is a sound business but will always be exposed to irregular weather events. North America saw unusually cool growing conditions and heightened instances of hail, which drove the business into a loss. The share price was underperforming the market prior to the announcement with many anticipating the downgrade. Whilst the stock was down slightly on the day, investors saw through the near-term earnings impact through to the more positive outlook for FY21, operationally and for investment returns. This subsequently saw QBE outperform the market in the weeks following. We maintain our confidence in the QBE investment thesis. The

company's CEO Pat Regan has taken significant action to remedy weaker operating factors in the business and is now focused on excelling in all remaining divisions.

Amongst the wealth managers, our overweight position in IFL continued to bear fruit as it announced a recut of the ANZ platforms acquisition deal at a lower price. The sunset date on the deal terms also extended. With the transaction sure to proceed, the stock added ~70% over the quarter. We have now exited the position given the relatively full valuation and a backdrop of multiple headwinds for the wealth management industry.

EML update - PFS - Transformational Acquisition

EML physically or electronically generates "cards" that enable businesses to facilitate payments to counterparties, be it customers, employees or suppliers. EML operates across a multitude of industries with numerous customers within these industries.

There are three types of payment structures EML facilitates:

1. General Purpose Reloadable - Wagering payouts, salary packaging, staff cards/lending.
2. Gifts and incentives - Gift cards and cash backs for retailers
3. VANS (Virtual Account Numbers) - EML facilitates large batch payment processing for businesses in the US where direct debit services are tardy and time consuming.

In December 2019 EML announced a transformational acquisition of PFS using both debt and equity which is expected to be 25% accretive post synergies. Watermark participated in the raising and was highly supportive of the transaction.

Prepaid Financial Services (PFS)

PFS operates in the reloadable space that EML calls general purpose reloadable. The group has been growing for 11 consecutive years and delivered compounded revenue growth of 33% p.a. between FY16 and FY19. Growth has come from a continuation of new contract wins alongside material growth within existing clients. A key driver of this is the services provided to

digital banking and the structural shift towards electronic payments and cards across Europe. In particular, PFS is leveraged to the neo-banking/challenger bank revolution taking place across Europe. As these new banks rely heavily on outsourcing such function as card management.

PFS key products are:

- Digital banking & current accounts.
- Consumer pre-paid cards.
- Virtual pre-paid cards.

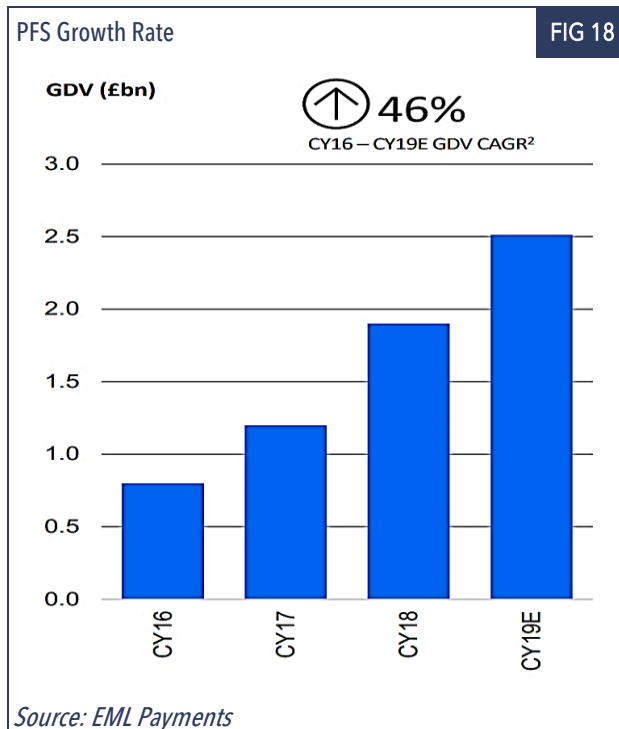
We like the PFS transactions for multiple reasons:

- *Deepens EMLs product offering.* The transaction broadens geographical footprint by increasing the of countries it services and cash loading points. It also allows access to these facilities and opens new functionality for existing EML products.

- *Increases operational leverage.* We have continued to highlight the benefits of EML scaling, with SAAS like GP margins (75% and climbing) and a well-managed fixed cost base, additional earnings are highly accretive at an EBITDA level. On current forecasts given EML's ~\$50m FY20 fixed cost base, a 5% increase in revenue amounts to more than 10% increase in EBITDA. Additionally, there are \$6m of synergies outlined to be achieved post FY21.

- *High historical growth rate.* This is supported by earn-out targets above 30% revenue growth. One-quarter of the acquisition consideration requires PFS to reach these targets. Management appears confident in this, given its pipeline of new contracts and rapidly growing back book. A contract we estimate will increase revenue by 12% was announced by PFS the first week of January.

The acquisition continues to drive scale benefits for the wider EML group. It offers to continue growth drivers on a standalone basis and through cross-selling. We continue to have high conviction in EML and expect it to deliver results.



Consumer/Industrial

The Consumer and Industrials sectors delivered strong returns in the December quarter. The largest contributors to performance came from holdings in Ardent Leisure (ALG), Aristocrat (ALL), Qantas (QAN) and PointsBet Holdings (PBH).

There were no notable detractors except for our position in vehicle smash repair operator, AMA Group (AMA), which downgraded in late December. The company will have a busy 2020 extracting synergies from its recent Capital Smart acquisition. We believe the synergy targets provided to the market are conservative and that the share price should recover as this becomes apparent. Post the acquisition; AMA is now the only large -smash repair operator in the country. The business currently holds a significant cost advantage over all other operators and hence provides a strong and improving customer proposition. We expect increasing demand for its services, particularly from tier-2 motor insurers.

In terms of tilts within the sector, we are long cheap cyclical such as Star Entertainment, Qantas and Webjet. We are short a basket of 'expensive defensives'. In a rate cut environment, the hunt for yield drove investors into defensive interest rate proxies such as the supermarkets. However, with the US Fed signalling a pause in its easing cycle in late September, we are positioned for an ongoing cyclical rally.

Carbon Revolution

Carbon Revolution (CBR) is a recent addition to the portfolio following its IPO in December 2019. The company is based in Victoria and designs, manufactures and markets single-piece carbon fibre wheels, primarily for high-end sports cars. The company is the undisputed market leader globally, in what is cutting-edge technology. The business is in the early stage of a ramp-up phase into a sizeable addressable market.

The key to investing in this type of business is to identify competitive advantage and to gain comfort that it is sustainable. If an advantage cannot be sustained, then a competitor could encroach before the project can be monetised. In the case of Carbon Revolution, our research suggests the competitive advantage is significant and that the barriers to entry are such that even

a well-funded global parts manufacturer would find it very difficult to enter the carbon wheel market. In our view, the three key drivers of competitive advantage are as follows: 1) Product IP, 2) Manufacturing Process IP, and 3) the value of CBR's existing customer contracts with major car manufacturers (OEMs).

Firstly, regarding product IP, carbon wheel technology provides many performance benefits over traditional alloy wheels, including weight-saving and higher stiffness. These qualities increase accelerating/braking performance and lead to improved handling. Importantly, Carbon fibre is much more complicated to design than a simple casting process for an alloy wheel, and CBR has developed in-house software to design and measure the performance of its wheels. Since the company was formed in 2007, it has registered 42 patents. As such, it has a significant base of corporate knowledge that would be very difficult for a competitor to replicate quickly.

Secondly, CBR signed its first OEM contract in 2014 (Ford), and at this stage, it is the only carbon wheel maker to have contracted with a mainstream OEM. Since then, CBR has also contracted with Ferrari, Renault and most recently Jaguar Land Rover. Breaking into the 'OEM approved' club is no mean feat and is a strong endorsement of the company. Importantly, OEM approval also brings a significant barrier-to-entry given the onerous testing required. For a component to be approved by an OEM it must undergo significant field testing, typically over a period of 2 years. Wheels are considered a 'critical component', and therefore undergo even more rigorous testing.

Reduction in unit costs will be the key driver of success for the business. The quicker CBR can reduce its unit costs, the faster it can enter more 'mass' markets. CBR is already progressing plans for the advanced production process to produce up to 600k units per annum, 26 times larger than its FY20 forecast. Therefore, if they get this right, the CBR share price could multiply several times.

CBR differs from ASX listed peer PWR Holdings (the maker of high-performance radiators), due to the nature of the product it produces. While both companies can claim to be global leaders in their respective fields, wheels, as opposed to radiators, are a highly visible option for a vehicle. This is important because these are

both discretionary products. Owners of performance cars want their next-door neighbours to know their vehicle has been customised and will likely choose a wheel upgrade over a radiator upgrade. In our view, the market opportunity for CBR is therefore much larger than for PWR, and the shares should be valued accordingly.

The key catalyst for CBR going forward is the signing of new OEM contracts. If CBR is able to crack into the German luxury OEM market, this would be a material share price driver. We see this as highly likely given competing OEMs, Jaguar Land Rover and Renault will soon release vehicles with carbon wheel options.

Fund Review

All Watermark funds posted modest gains in the quarter. After a solid start to the period in October, alpha was harder to come by in the final two months of the year. For most of the December quarter, the portfolios were positioned with a tilt towards cyclical exposures and away from defensives. This worked well early in the quarter, as investor sentiment lifted on the promise of an easing in trade tensions and the prospect of a return to growth in 2020. The rotation by investors away from defensive yield and high growth names in favour of value and cyclical exposures reversed somewhat in November and December, and it was defensives and growth that led the market higher into the end of the year.

At a sector level, the Funds were net long in fintech, mining contractors and energy names, along with IT and biotechnology. Key short tilts were in banking, bulk commodities, supermarkets and REITs. The strongest returns came from the consumer portfolio, with investments in the leisure and consumer discretionary sectors performing well. A solid contribution also came from the transportation sector.

The portfolios continue to be well-hedged in terms of risk factors, with a small bias for value over momentum arising from the cyclical vs defensive positioning discussed above.

Quarterly Performance by Sector

Sector	Portfolio
TMT	-0.34
Healthcare	0.13
Consumer	1.21
Industrials	0.84
Basic Industries	-0.91
Financials	0.32

Portfolio data is for positions in Watermark Market Neutral Trust.

Fund at a Glance - December 2019

ASX Code	ALF
Fund Size	AU\$259.2
Fund Strategy	Variable Beta
Share Price	\$0.99
Shares on Issue	237.9m
Net Exposure	2.8%

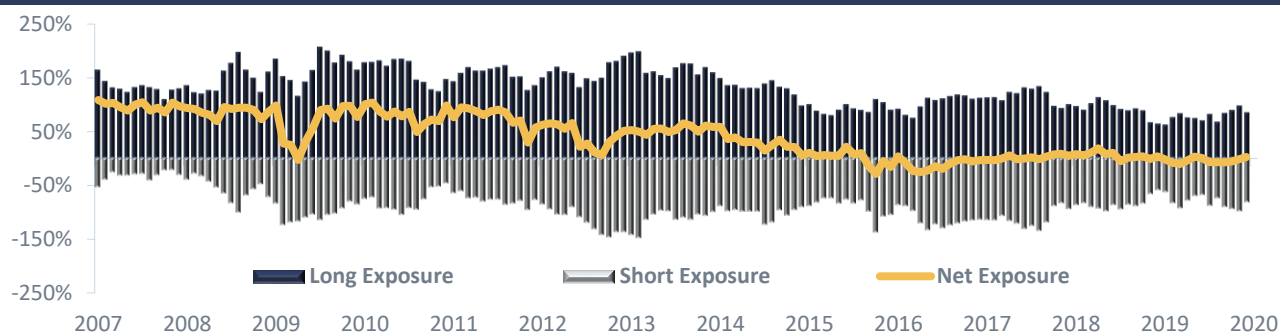
Net Tangible Asset (NTA) Backing

	Nov 19	Dec 19
NTA Before Tax	\$1.17	\$1.17
NTA After Tax	\$1.15	\$1.15

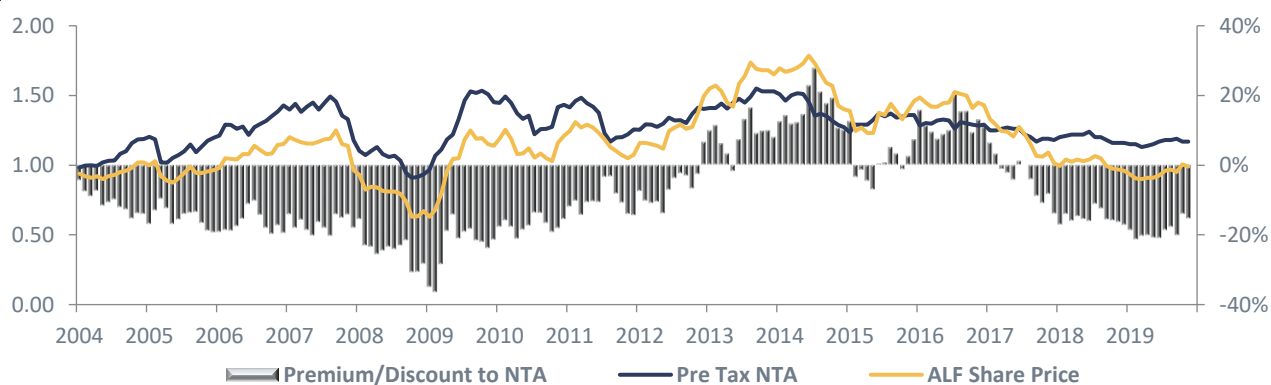
Gross Portfolio Structure

Long Exposure	97.6%	84.9%
Short Exposure	-99.0%	-82.1%
Gross Exposure	196.6%	167.0%
Cash	101.4%	97.2%

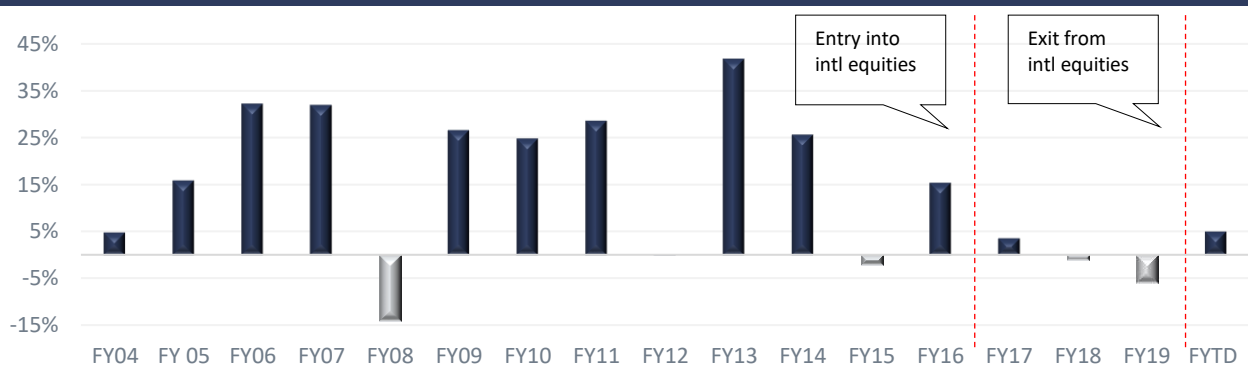
Net Equity Exposure



Historical Premium/Discount to NTA History



Gross Portfolio Return





Fund at a Glance – December 2019

Fund Size	AU\$51m
Strategy FUM	AU\$121m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

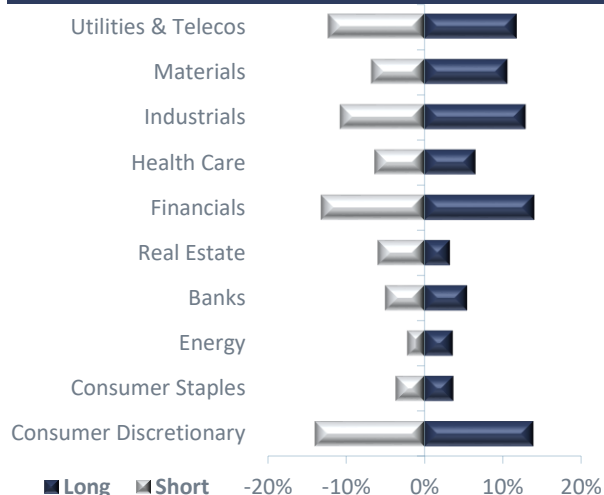
Return Characteristics

Positive Months	65%
Portfolio Beta	-0.1%
Sharpe Ratio	0.8
Sortino Ratio	2.5
Standard Deviation	6.5%
No. Long Positions	59
No. Short Positions	61
Gross Exposure	169%

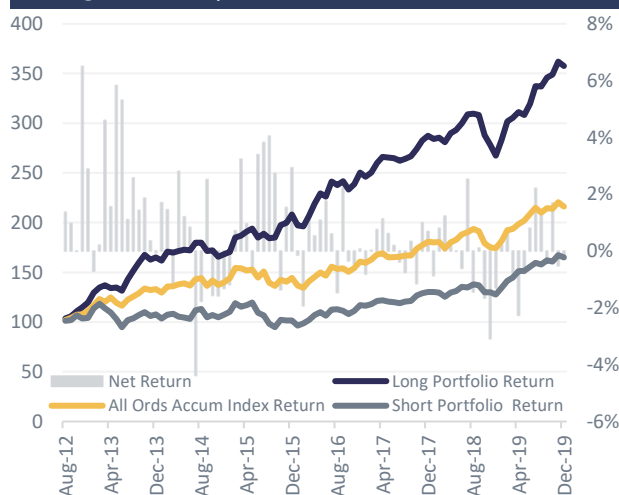
Performance

	1 Mth	FYTD	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	SI (pa)
WMNT (net return)	-0.3%	4.1%	1.7%	-0.3%	4.5%	6.5%	7.6%
RBA Cash Rate	0.1%	0.4%	1.2%	1.4%	1.6%	1.9%	2.0%
Outperformance	-0.4%	3.7%	0.5%	-1.7%	2.9%	4.6%	5.6%

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
2019	0.22	0.69	-1.00	-2.27	-0.78	0.80	2.21	1.38	-0.41	1.69	-0.51	-0.27	1.68



Fund at a Glance - December 2019

Fund Size	AU\$35m
Strategy FUM	AU\$295m
Fund Inception Date	May 2019
Fund Strategy	Variable Beta
Application/Redemption	Monthly
Benchmark	RBA Cash Rate

Return Characteristics

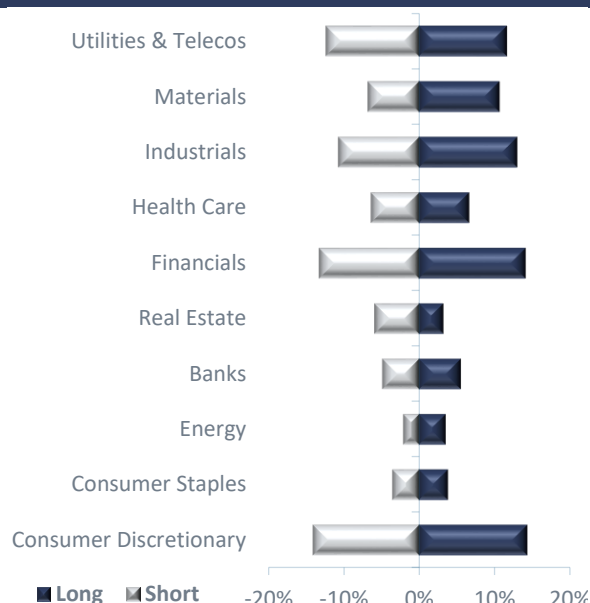
No. Long Positions	59
No. Short Positions	61
Gross Exposure	170.8%
Net Exposure	2.7%

Unit Price **\$1.0449**

Performance

	1 Mth	3 Mths	FYTD	SI
WARF (net return)	-0.1%	1.1%	4.3%	4.5%
RBA Cash Rate	0.1%	0.2%	0.4%	0.6%
Outperformance	-0.2%	0.9%	3.9%	3.9%

Sector Exposures



Gross Portfolio Structure

Investment Type	\$m	%
Listed Securities - Long	30.3	86.7
Listed Securities - Short	29.4	-84.0
Net Exposure	0.9	2.7
Cash	34.1	97.3
Capital	35	100

Managing your Investment

The Fund is priced monthly, on or around the 6th business day of each month. Boardroom Limited, who manage the unit registry for the Fund, will accept applications and redemption requests up until 2pm on the 10th business day of each month, giving investors the opportunity to review the latest unit price before deciding to apply for, or redeem units. Redemption proceeds will ordinarily be paid within 5 days of the cut off. Investors should refer to the Product Disclosure Statement for the Watermark Absolute Return Fund for details on applying for and redeeming units in the Fund.

For any queries regarding your unit holding, please contact the unit registry managed by Boardroom Limited at watermark@boardroomlited.com.au; or 1300 737 760.

Notes

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