The Leading Edge

QUARTERLY REPORT • **June 2020**

Level 23, Governor Phillip Tower, Sydney NSW 2000

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

This report has been prepared by Watermark Funds Management Pty Limited.

Justin Braitling
Portfolio Manager

Message from the CIO

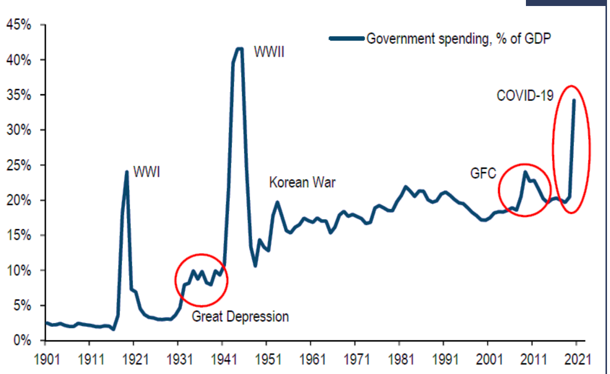
What to do when the fundamental outlook is poor, yet the share market is likely to move higher?

Many experienced investors are perplexed by the strength of the share market given the poor economic outlook. The gap between 'Wall street' and 'Main street' has never been so wide. This is reflected in the fundamental picture for shares. Expectations for profits in the medium term have fallen sharply, while the share market is only down modestly so far this year, leaving valuations above where they were in January before the health crisis began.

Vaccine or no vaccine, the medium-term outlook for growth is poor. We saw this in the aftermath of the financial crisis, it took a full decade for the share market to return to prior highs as profit growth was so weak. With recent losses, the share market is now at the same level it was 14 years ago.

Policymakers have doubled down on the same cocktail of monetary and fiscal stimulus, increasing public and private sector indebtedness further to buttress growth and inflate asset values. With these measures, they have once again locked in a cycle of sub-optimal growth. With bigger public sector (Fig 1) debt imbalances building and globalisation reversing, it is easy to see why growth will be slower in the years ahead.

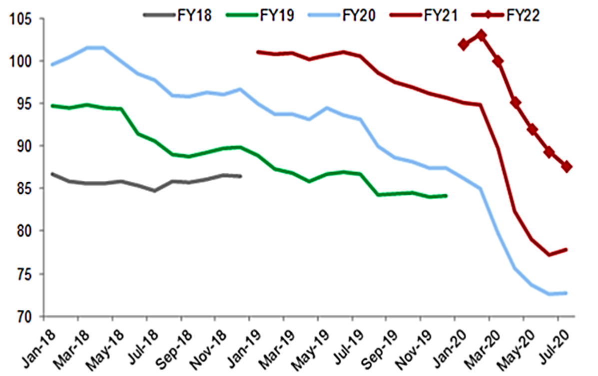
US Government Spending As A % Of GDP Since 1901 FIG 1



Source: BofA Research Investment & Global Financial Data

This leaves us with a challenged fundamental picture for shares. In Fig 2, profit expectations have fallen sharply across the medium-term horizon. With 2022 profit forecasts (flat over 4 years) having fallen by more than the value of shares, the market is more expensive today on recovered earnings than it was before the crisis

Profit Forecasts Have Fallen Sharply FIG 2



Source: Goldman Sachs Global Investment Research

If we were to invest purely on fundamentals, then this market would be an outright short. Shares are not being priced on fundamentals though. Asset values are being propped up by central bank liquidity and unsustainable fiscal largess from governments. Consider this, the S&P 500 Index has increased in value by $3 trillion since the depths of the health crisis, the US Federal Reserve's Balance Sheet coincidentally has increased by the same amount as they have bought up all manner of private and public securities, from treasuries through to 'fallen angel' corporate bonds.

It's a game of bluff and investors 'fight the Fed' at their peril. While this is most obvious in sovereign and corporate bond markets, it is playing out in equities as well. They have pumped the bubble right back up again.

The value of sovereign bonds offering negative yields has risen to $14 trillion. US 10 year treasury break evens (TIPs) are at -1%, German Bunds and British Gilts are lower still. How do pension funds justify an investment in these securities to their clients? Surely this is the greater fool theory playing out. You buy a bond and hold to maturity, and you are guaranteed to lose money after inflation, so buy equities instead!

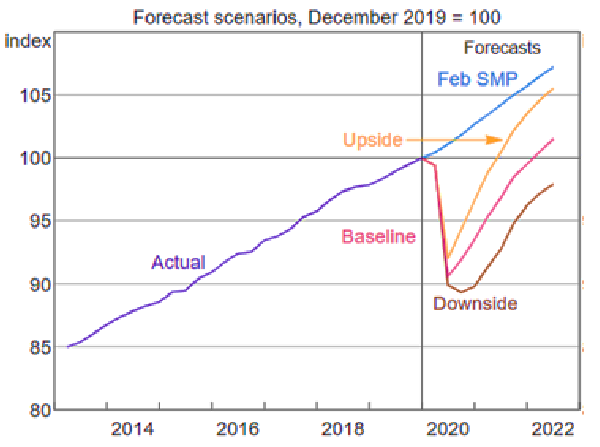
I suspect this argument will hold for some time, as positioning is still light with a market full of bears. The share market probably floats higher on a wave of excess liquidity. This time next year, the economy will probably still be on policy life support and investors will be buying industrial shares (ex-banks) on 30 times earnings because they look cheap versus a 5-year bond yielding 30bpts, held down by the RBA through yield curve control (YCC).

We are certainly not about to buy into this greater fool theory - make no mistake you are investing in an iron lung, if the machine is turned off, asset values will collapse. Until value is restored, we will retain our fully hedged settings and look to add value through stock selection.

These are the RBA's forecasts (Fig 3). Versus the base case pre COVID (blue line), we are now on a trajectory that will take 5 years to get back to that path. The economy is due to shrink 6% this year on the banks' forecast with unemployment peaking at 10%. As this is the first recession in 30 years, companies everywhere are using this crisis to restructure and drive costs (people) out of their businesses. It will take years for the economy to return to normal, unemployment will stay stubbornly high, yet the share market has merely 'corrected' (down 10%) year to date.

RBA's Forecasts

FIG 3



Source: ABS & RBA

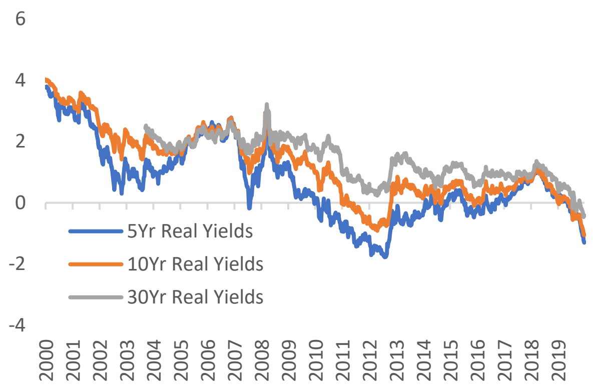
Portfolio Construction

The market is following a classic reflation playbook, with the US dollar falling, commodity prices rallying and cyclical shares and markets leading. Against this backdrop, it is disconcerting to see defensive assets such as gold and bonds performing so well. Clearly, bond investors do not share the enthusiasm equity investors have for the recovery.

The collapse in 'real' bond yields is also a strong signal, suggesting we should be moving out of financial assets and into hard assets such as commodities. Financial companies typically borrow short and lend long capturing a margin - lower yields and the loss of a term premium is a headwind for these businesses. Commodities on the other hand, that offer no running yield are relatively more attractive in this environment.

Bond Yields

FIG 4

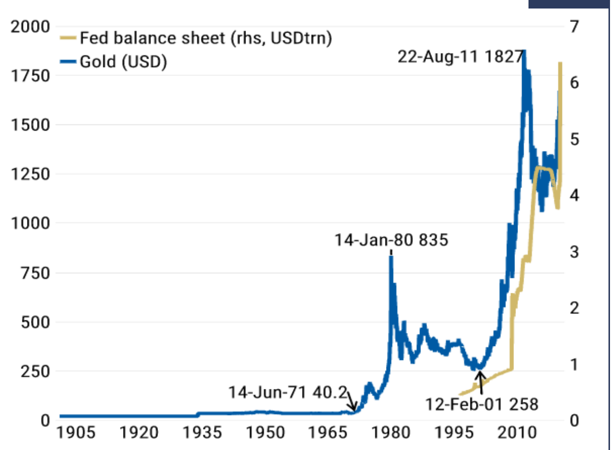


Source: Bloomberg

Gold is a clear example of this. As an alternate store of value, gold should also re-rate versus fiat currencies where base money is increasing with unconventional policies (money printing). In Fig 5 you can see this relationship clearly driving gold prices higher.

US Fed Balance Sheet Vs Gold Prices

FIG 5

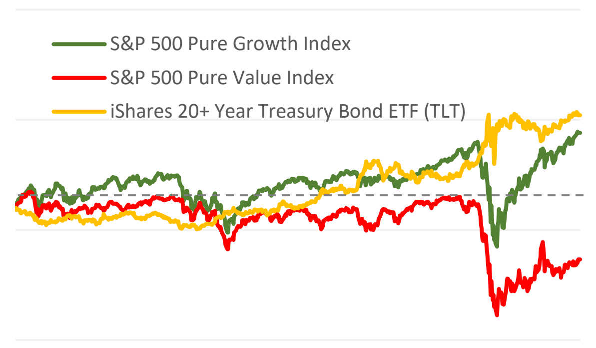


Source: Macrobond & Morgan Stanley Research

Growth shares are long duration assets like bonds and are relatively more attractive as bond yields fall (the price rises). The message bond markets are sending is clear - growth is going to be anaemic in the medium term, a clear reason why companies that offer growth are worth relatively more. This leadership of growth companies has been further validated by the health crisis where the value in technology platforms like online shopping and cloud computing has become more evident. You can see this in Fig 6 below, where growth shares have performed in line with a basket of bonds (TLT). The value basket on the other hand made up of banks; cyclical; and cheap defensive shares, have underperformed.

Growth Shares Have Performed In Line With A Basket Of Bonds

FIG 6



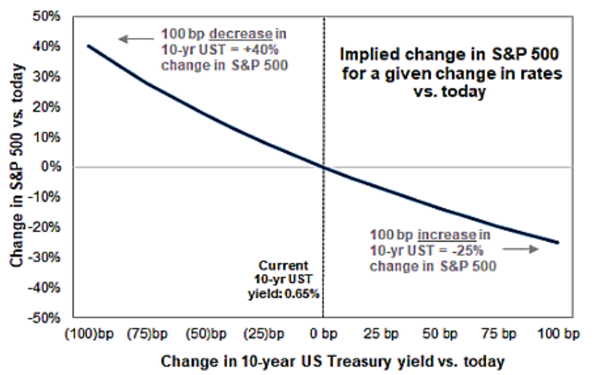
Source: Cornerstone Macro

So long as central banks continue to support asset markets and deflationary forces from the health crisis linger, bond prices and growth shares are likely to lead. Importantly, as yields approach zero, the valuations of growth shares are more leveraged to the upside than to the downside. You can see this in Fig 7 below a 100bpts reduction in yield has twice the impact on valuation as a 100bpts increase in yield. With technology companies exceeding expectations in this crisis and valuations leveraged to the upside in a declining yield environment, we believe we are in the final stages of a 'melt-up' in bonds and growth shares.

As the broader share market grinds higher in the year ahead, growth will continue to lead with a replay of the Dot Com boom in Technology is highly likely. Cyclical shares will also participate so long as businesses and households are supported by stimulus and a recovery is on the horizon. A barbell strategy of growth and cyclical shares is probably the winning combination in the year ahead.

Valuations Of Growth Shares Are More Leveraged To The Upside Than To The Downside

FIG 7



Source: Goldman Sachs Global Investment Research

As occurred in the dot com boom, our share market, which has a distinctive 'value' flavour will go up but underperform its offshore peers.

All is not lost for the Australian market. Mining shares are the deepest of cyclical sectors. China, the key source of demand for commodities, has emerged from this crisis in relatively good shape and supply-side disruptions are keeping commodity markets very tight. We could be in for a replay of the Tech bubble where an acute under investment in mine development led to a resurgence in commodity prices. Particularly in base metals and gold where there is no pipeline of new world scale projects to talk of.

If it plays out this way, the real bear market for shares probably starts in the second half of next year when bonds peak as inflation expectations return and the bubble in growth stocks bursts. Around the same time, hope in a sustainable recovery will fade along with a tapering of stimulus that has obvious limits.

Under this scenario, the US market makes new highs (the S&P is already up for the year). Australian shares may or may not return to the prior the highs reached earlier this year, as we are still 18% away. Either way, the 2-3 year outlook for shares is far less appealing - with little medium term earnings growth and extended valuations, returns are likely to be much lower than shareholders have experienced in the past. I would expect the share market to be broadly flat over this time horizon. We made the same call 5 years ago when we moved to a fully hedged position and the market today is at the same level it was at in Q1'2015.

Against this difficult backdrop, the case for active investment strategies with the ability to hedge market risks is as compelling as it has been for some time. While we expect the underlying 'beta' return for the share market to be low in the medium-term, opportunities remain for active investors to build portfolios which are tailored to the current trends, adding value with tactical sector and thematic skews, and by picking winners and losers at a stock level. This will be an important differentiator of long/short strategies such as ALF.

We have set out our base case for the share market above. With risk assets on life-support provided by governments and central banks, the risk of another major set-back remains very real. The massive global policy response to the COVID 19 pandemic has fuelled a rapid recovery since the March lows. However, experiences from the Dotcom bust and post the GFC have demonstrated how long it can take to recover from a major market crash. There remain very few ways to avoid loss in such a scenario, other than holding high levels of cash, or by hedging market risks. ALF is in a strong position to protect capital, and even to flourish should we see another major setback for the share market.

According to the Morningstar Institutional Sector Survey of 50 Australian equity managers from May 2020, the top quartile of funds delivered 9.6% per annum or better over the previous 10 years. In the same period, ALF's portfolio also delivered 9.6% p.a. but with an average net exposure to the share market of just 23%. This includes a 3-year period where our failed international strategy weighted heavily on returns. ALF has delivered top quartile performance with significantly less risk.

ALF has an investment strategy that is well-suited for the challenging period ahead and a pedigree that is amongst the best managers in Australia.

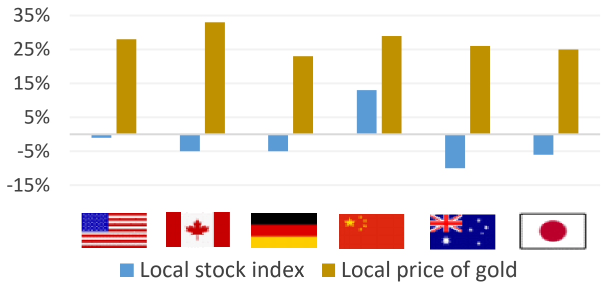
PORTFOLIO REVIEW

Basic Industries

Gold

Gold has been the standout metal for 2020, up 28% YTD, hitting an all-time high and reaching towards US$2000/oz. When compared to major financial markets globally, the metal, in local dollars, has outperformed each of the stock indices this year.

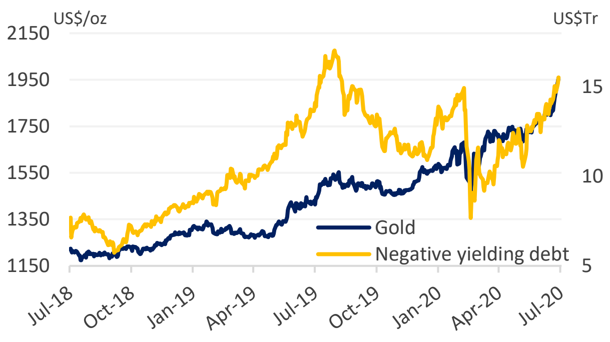
Gold Returns In Local Currency vs Underlying Share Market FIG 8



Source: Watermark Funds Management & Bloomberg

Throughout the March COVID panic, USD gold generally behaved in line with risk assets. However, due to a flight to the safety of the USD, there was minimal impact to local currency gold prices. In the aftermath of the crash, gold has traded strongly on fears of continued instability to the global economy; a sharp increase in the momentum of monetary growth; inflation expectations; real interest rates; credit spreads; USD currency trends; and commodity price trending. As we highlighted a year ago, the amount of negative-yielding debt globally has provided a useful reference for the direction of the gold price and support for the price to move higher. We expect this trend to continue given central banks have been greenlit to provide liquidity and increase money supply while required by governments globally.

Negative Yielding Debt Underpins Golds Strength FIG 9



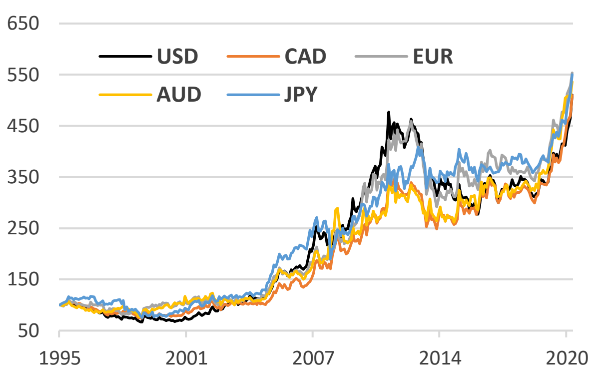
Source: Watermark Funds Management & Bloomberg

Aside from jewellery demand, gold has little industrial use and most of the global output is mined, refined and then stored back underground. Commentators often point to this lack of utility and return as a reason gold should not feature in an investment portfolio. However, since the start of the modern monetary era in August 1971, gold has returned 10% per year on average. After adjusting for inflation, gold still delivered an average return of 6% per annum.

As with most markets, there are periods where gold has strongly performed such as the late 70's and 2000-12 and then periods where gold retraced and tracked sideways (80's and 90's and 2013-16). Periods of advance are usually associated with a loosening of fiscal policy, an expansion in the monetary base and destabilised markets. Periods, where there has been market stability and rising rates have tended to coincide with lower gold prices, however this doesn't necessarily follow for all currencies. As seen below, the pullback in USD pricing from 2013 did not result in as large a pullback for the JPY, CAD or AUD pricing. Ultimately this set the scene for the run in the Australian gold miners from 2013, when the US majors divested assets, presenting opportunities for Evolution Mining (EVN) and Northern Star Resources (NST) to buy large scale assets at (now) cheap prices.

Prices Of Gold In Major Currencies Shows Broad Devaluation Of Global Currencies

FIG 10

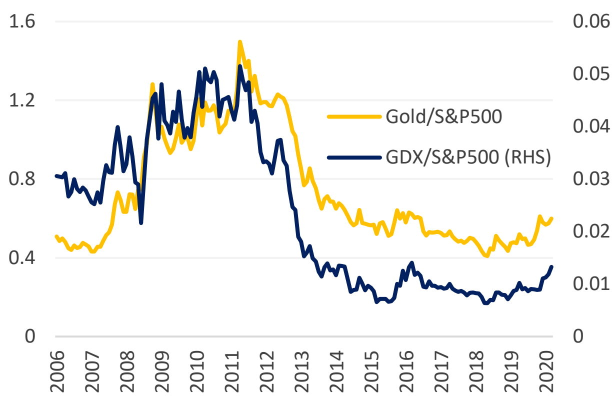


Source: Watermark Funds Management & Bloomberg

We continue to be constructive on gold in the future, given the global macro outlook and continued under allocation by major investor groups. In terms of relative valuation there is still upside when looking at the gold to S&P500 index ratio and the GDX (gold miners ETF) to S&P index. Ultimately, strength in the gold price will translate to higher earnings for gold miners. This is particularly appealing considering the uncertainty around corporate earnings that we are seeing across the broader economy.

Gold & GDX (Gold Equity ETF) Relative To S&P500

FIG 11

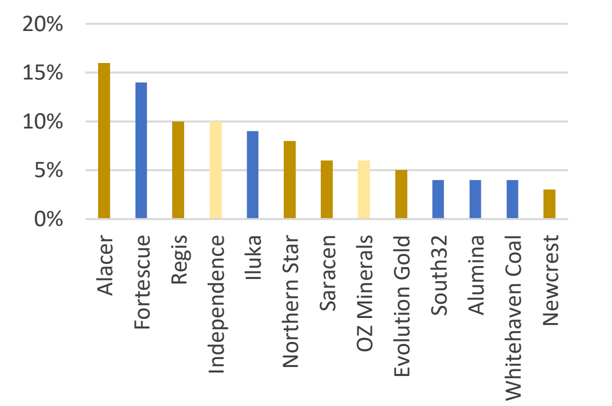


Source: Watermark Funds Management & Bloomberg

While the run in many of these shares has been significant, much of it can be attributed to the gold price, i.e. stocks are trading as a function of gold prices rather than underlying businesses. One metric worth considering is the Free Cash Flow (FCF) yield. This represents the cash a business will deliver during a period divided by the market capitalisation. Looking at the mid-cap miners, we can see gold shares feature prominently despite the appreciation in the share prices. If we include IGO and OZ Minerals (which have gold earnings), the top half of the peer group is dominated by companies that produce either gold or iron ore (Fortescue Metals Group & Iluka Resources).

FCF Yield Expectations Of The Mid Cap Miners

FIG 12



Source: Watermark Funds Management & Bloomberg

We believe it continues to be a good time to invest in the gold space, especially in businesses generating high levels of cash flow and sound production outlooks. We like Saracen and Regis given production growth profiles and strong cashflow. While we think NST and EVN have done great jobs building successful businesses, they may have a period of consolidation as new assets are bedded in and older assets move past peak production.

TMT/Healthcare

Sonic Healthcare

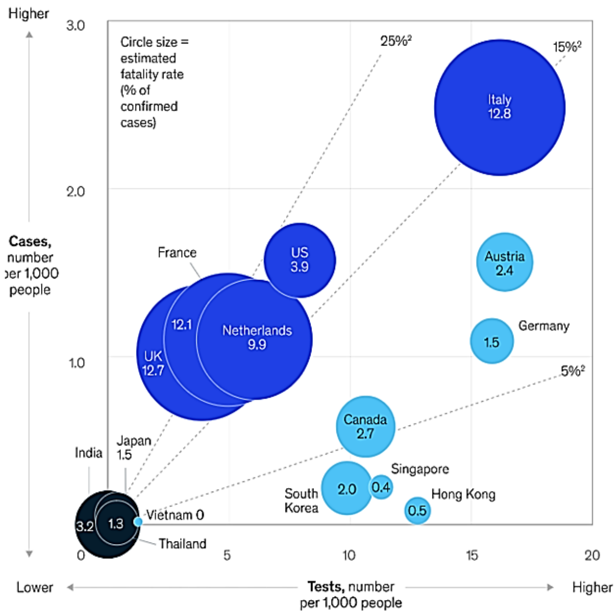
Sonic Healthcare (SHL) is one of the largest pathology services groups in the world. Even though Sonic provides diagnostic imaging and primary care services in Australia, the core (c.85%) of its earnings come from pathology laboratories across seven countries. These include the USA (28%), Australia (28%) and Germany (24%). In Australia, Sonic is known for its laboratory brands: Douglass Hanly Moir, Sullivan Nicolaides, Melbourne Pathology and Clinipath, among others.

At the beginning of the COVID 19 pandemic, Sonic shares were severely hit (down 36% peak to trough) as the demand for its services, like many other utilisation-driven healthcare models, suddenly fell off a cliff due to lockdowns. Pathology volumes were down around 30-40% in late March and throughout April. With a predominantly fixed cost base (rents and collection/laboratory staff), the sudden drop in volumes meant profits quickly vanished for those months of peak declines. Therefore, the strength of the balance sheet (2.1x leverage in December-19) became a potential concern depending on the duration of the decline.

As its key geographies started to come out of severe lockdowns in April and May, Sonic shares started to recover, pricing in an eventual normalisation of the trading environment and return towards normal levels of activity. Unlike overseas holidays or out of home dining, pathology work is usually less discretionary in nature. Some of it can be postponed or even foregone, however, a significant part of it is related to chronic conditions that require ongoing monitoring (diabetes, cancer) or acute episodes that must have laboratory work done urgently (surgeries). By late May and early June, a different aspect of the pandemic became a key driver of SHL shares: the testing opportunity.

Testing has a central role to play in policymakers response to COVID, particularly in the absence of an effective vaccine. Comparison of a cross-section of countries (Fig 13) has shown that those that test their population widely have been better able to contain the mortality rate. Surely, testing is just part of the overall response, together with contact tracing, targeted quarantines and enhanced hygiene. Still, testing plays a fundamental role in helping localise and contain hotspots without blanket shutdowns of the economy at a high cost to both Government and taxpayers.

Countries With The Widest Testing Tend To Have The Fewest Cases Per 1000 People FIG 13



Source: McKinsey & Company

Initially dismissed by some as a sideshow to the core business, COVID 19 testing has the potential to become a meaningful driver of earnings going forward. The virus has become so prevalent across Sonic's footprint (especially in the USA, with some states like Texas reporting a c.30% positive testing rate) that in the absence of a vaccine or effective treatment, testing has become part of the first line of defence. As a result, testing volumes are proving much higher than many anticipated. The US was running c.150,000 tests per day back in April when the pandemic was focused in the tri-state area (New York, New Jersey and Connecticut). Currently, with the pandemic exploding throughout the rest of the country, particularly in the populous southern states of California, Texas and Florida, the US is running around 800,000 tests per day. Debate still rages in health and political circles over what the right number of tests per day may be. Experts are arguing for anywhere from 6 million tests per week (economy partially reopened) to 20 million a day (if the economy is to be fully reopened while still controlling outbreaks). In most scenarios, the number of tests per day will keep increasing by some margin.

At a price per test of $100 (Medicare level, with private payors slightly below), that represents a revenue pool of $80 million per day or over $20 billion per year (assuming

800,000 tests/day). If Sonic just managed to replicate its average pathology market share in that pool (low- to mid-single digits of the commercial market), it would represent an opportunity almost as big as its core business pre-COVID (3-4% of $20bn = $600-800m vs pre-COVID US revenue of around $1.2bn post-Aurora acquisition). From a margin perspective, the incremental cost associated with the test (consumables in the form testing equipment and reagents) is a fraction of the $100 price tag, making each incremental test highly accretive to the bottom line.

Naturally, there are offsets to that revenue and profit estimate. To begin with, core pathology businesses are still down year on year as elective surgeries and non-urgent work get postponed. According to Sonic's American peers Quest Diagnostics and Labcorp (who just reported Q2 earnings), core pathology businesses are down mid- to high-single digits towards the end of June (average volumes down c.30% year on year for the April to June quarter) and with a softening in July as COVID cases spike post re-opening of the economy in several states. With so much uncertainty as to how the pandemic plays out, companies are being cautious in how they guide market expectations. The low end of Quest FY earnings guidance assumes 20% declines in core volumes through to year end. Obviously, high operating gearing (the fixed cost base) cuts both ways and, if volumes were indeed down 20%, profits would be down significantly more than that. There does seem to be some consensus amongst analysts that a 20% decline is likely to be a conservative estimate at this point, barring another severe bout of nationwide lockdowns. Volumes too are likely somewhere in the range from June/July, anywhere from flat to down 5%-10% year on year.

Another point of contention is the pricing or reimbursement rate for COVID tests. Currently, molecular testing (checking whether an individual has the virus) is reimbursed at a rate of $100 per test, but that number is automatically halving in late October unless more funding is made available (the price was supposed to be cut in late July but was extended in light of the ongoing pandemic). Without a widely available vaccine, it is likely that pervasive testing will still be required by then and for some time. Many small labs outside of Quest, Labcorp and Sonic struggle to make testing economic at $50 per test. Even if cut to this level, we are still talking about a $10bn incremental market opportunity (assuming 800,000 tests/day) that adds to the routine pathology market, and with little incremental costs, hence accretive margins.

A similar analysis holds true for Sonic's other key geographies, Germany and Australia. We haven't included in this analysis the potential upside from serology testing for COVID (i.e. testing for the presence of antibodies) which is yet to fully take off, but which might become more relevant at a later stage and with a vaccine.

What does all this mean for a potential investment in Sonic shares? Before the onset of the pandemic, sell-side analysts were expecting Sonic to post a $1.45bn EBITDA in FY21. That market estimate declined to $1.30bn in mid-May and has since recovered right back to where it was before the pandemic in March. Based on pathology exit rates described above for the June quarter (down mid- to high-single digits, both in USA and Australia, as confirmed by peer Healius in their pre-announcement on July 27th), core routine businesses are unlikely to be down materially in FY21 (barring, of course, a severe second wave and ensuing shutdowns). Yet the upside from COVID testing (mostly PCR/molecular but also serology) is bound to be quite sizeable as discussed above. Hence the upside to earnings estimates looks both considerable and reasonably certain. Perhaps the final question is how much of that can and should be capitalised into the shares. There is no clear-cut answer to that. Ultimately the market will decide, but with the shares back to where they were before COVID struck in February; lower discount rates lower; and earnings estimates significantly higher, we see clear upside for the business under most scenarios.

Financials

Sezzle

We recently highlighted Sezzle (ASX:SZL) as our top pick within the Financials portfolio in our recent investor update. We have been long-time fans of the company since participating in the company's IPO. We saw many similarities between it and Afterpay with a simple, 'four fortnightly payments - buy now pay later model' (BNPL). We continue to hold it as a North American pure-play in BNPL and are benefitting from the structural shift into Ecommerce. The two lynchpins of this investment are the acceleration of Ecommerce and the frequency with which customers use the product.

Ecommerce explosion

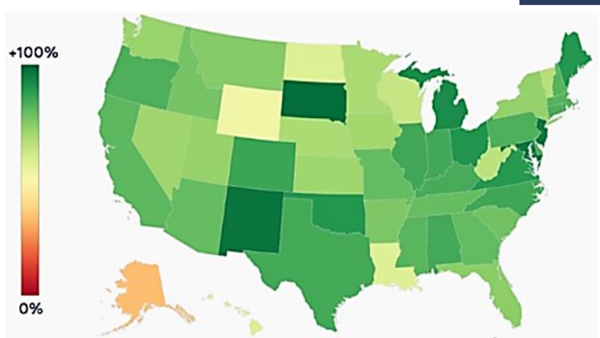
Ecommerce has accelerated penetration for BNPL's. As coronavirus hit, large populations were homebound and went shopping online, stimulus cheques in hand. This saw US online spending up as much 80% vs May in 2019. This trend has not slowed and has accelerated during the recent "second wave" that is going through the US. The benefit for BNPL's is two-fold:

1) You gather swathes of new customers who are purchasing online and are accelerating online habits.

2) You are gathering merchants who now have immediacy in offering a BNPL option in the US.

As a result of this, Sezzle's sales have grown by 60% quarter on quarter, delivering an annual growth rate of more than 6x.

Ecommerce Spending – YoY Change In Sales By State FIG 14



Source: Sezzle

Frequency

Crucial to the success and scalability of a BNPL provider is the frequency with which the customer uses the product. Afterpay started releasing frequency data in February 2020, and it became the cornerstone of our investment thesis. Rather than losing interest in years 2 and 3; customers were actually increasing their frequency of use. Sezzle recently published its frequency data for the first time. While it did not better Afterpay's best in show numbers (22x at year 3), it showed an impressive trend and outperformed some peers who we do not see as having fully scalable operating models. Customers who use the product with higher frequency see the business scale quicker. They have a fixed cost to serve, are less likely to default and therefore have a higher lifetime value.

Purchase Frequency By Cohort FIG 15

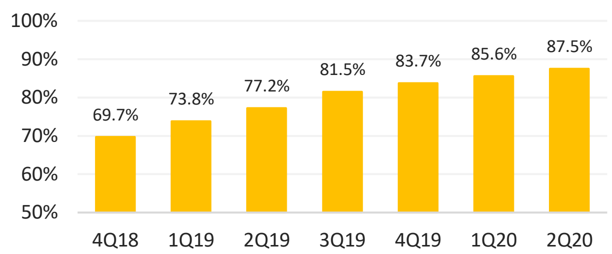
Cohort	As of 31 May 2020
2018 Cohort	~15x per year
2019 Cohort	~9x per year
2020 Cohort	~5x per year

Source: Sezzle

Sezzle's June 2020 Quarter

In the June quarter, SZL had approximately 1.5m active customers in the US (Afterpay sits at 5.6m). In other terms, Afterpay is 3.8x bigger, and while we have to factor in Afterpay's UK and Australian businesses, the market cap is still ~13x larger than Sezzle's. This is impressive and gives us confidence in Sezzle emerging as a solid number 2 in the US. Sezzle also guided to a target of USD $1bn of annualised merchant sales going through the platform by the December quarter.

Active Consumer Repeat Usage FIG 16



Source: Sezzle

In summary, we are big believers of the BNPL revolution. We can see the US reaching an inflection point for the likes of Afterpay and Sezzle, particularly with their high frequency of use models. The penetration of Ecommerce due to COVID19 sees their business plans advance 1-2 years. Even with recent run-ups in share prices, the Australian BNPL (APT, Z1P, SZL) market's capitalisation of ~$US17bn remains cheap considering the opportunity set and given we estimate Australian players to account for a majority of BNPL transactions.

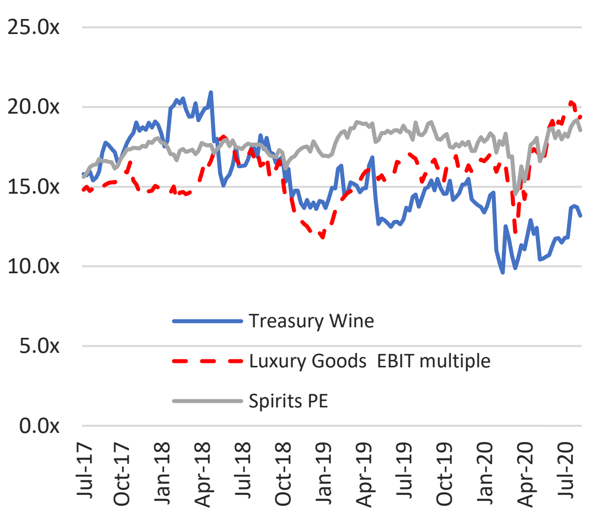
Consumer/Industrial

Treasury Wine Estates

Treasury Wine Estates (TWE) has lost around 40% of its value since its 2020 peak, failing to recover like many other 'luxury' and 'drinks' companies have in recent months. As seen in the chart below, many of these are now trading near 12-month highs.

TWE Is Lagging Peer Momentum

FIG 17



Source: Refinitiv Datastream & Credit Suisse

The poor share price performance has reflected earnings downgrades, the risk of tariffs in China but also a CEO changeover that took place on 30 June. Outgoing CEO Michael Clark is known for having an autocratic management style, which can create additional risk for a leadership transition. In our view, the market was right to be cautious. Moving forward, incoming CEO Tim Ford has now delivered his first solo earnings announcement and his first attempt at re-basing earnings. While this may not be the last rebasing event, we believe it is time to consider the risk/reward of buying shares in TWE now. The key questions are: how much of this earnings pain has been driven by cyclical factors like the US wine oversupply and short-term demand disruption from COVID 19; and how much is structural? To answer these questions, we look into TWE's two most topical regions, Asia and the Americas.

Asia regional outlook

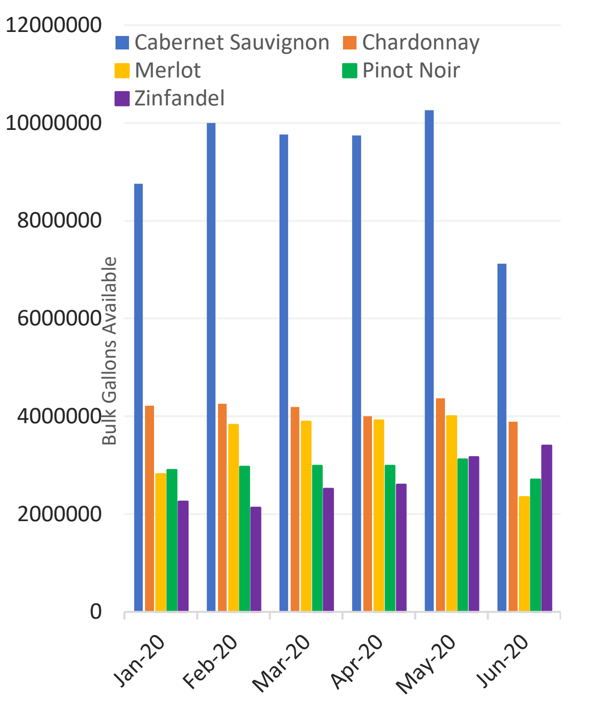
Firstly, the Asian business remains the jewel in the crown for TWE and demand for the Penfolds brand is strong irrespective of short-term COVID 19 impacts. This business represents >50% of our valuation for the TWE Group. In our view, the debate on the Asian outlook is largely around how quickly the earnings base can rebound. The positive takeaway from the recent earnings update was that retail sales of TWE products were back to growth for the months of April, May and June. While this may not be sustainable in the near-term, it was a positive step, as was the commentary that current inventory holdings by customers are below the level of the same time last year. This gives us comfort that FY21 could yet be a decent year for TWE in Asia if demand continues to recover. Luxury inventory available for release in FY21 has the capacity to be ~20% larger than FY20, reflecting the bumper vintage in 2018 that is now due for release. The key caveat to this is the risk of the Aus/China trade dispute impacting the wine sector. While the initial claims of 'dumping' seem absurd, given 85% of TWE's Asian volume is high-margin premium wine, it suggests this issue is more about politics than market equality. Nonetheless, if a tariff is to be put in place, the best guide would be one close to 14% which was the tariff in place up to 2015 prior to the current free trade agreement. In this event we would be comfortable as the Penfolds brand has historically shown strong price elasticity, regularly taking increases of 5-10% per annum in the past.

Americas regional outlook

The recent earnings results from TWE's America division have been poor and have been attracting a lot of attention from investors. While TWE's Americas division represents a smaller 15% of our valuation, it does drive investor sentiment in the company. The key drivers of the recent earnings drop have been a poor performing commercial brand portfolio; an oversupply of wine in North America; and the impact of COVID 19 on demand for luxury wine. While COVID 19 demand impact should rectify itself with time, the other two factors require some discussion. Firstly on the wine oversupply, this problem appears to be resolving itself. Perversely, while COVID 19 has reduced demand for luxury wine, it has driven a step-change in demand for entry-level wine for home consumption. This has seen a rapid drawdown of excess commercial wine inventories in the last 3-months, as seen in data below provided by one of the largest US wine brokers - Ciatti. Prices for low-end bulk wine have now stabilised and should provide a more solid footing for TWE heading into FY21. While this will go some way to addressing TWE's outlook, its core issues in the US stem from having commercial brands that are losing relevance and are in decline. This is a structural issue and something harder to remedy. Promisingly, the company has recognised this and has recently detailed its plans to restructure this business. While it is still uncertain whether this restructure will work long-term, cost reductions should support the earnings outlook for FY21.

California Bulk Wine Inventory

FIG 18



Source: Ciatti Company

Reflecting the above analysis, we have taken a small long position in TWE post its result. We acknowledge that we may be too early; in which case we will look to average down our entry price. Either way, TWE remains a high-quality, branded business with exposure to key growth markets and downside risk will likely be limited by the presence of M&A interest.

Fund at a Glance – July 2020

ASX Code	ALF
Fund Size	AU$201.1
Fund Strategy	Variable Beta
Share Price	$0.87
Shares on Issue	192.4m
Net Exposure	-4.4%

*The After-Tax NTA includes a $0.09 per share deferred tax asset, which is net of tax liabilities accrued in FY21. **Deferred Tax Asset (DTA) is comprised of prior years' tax losses. Current Tax Liability (CTL) is tax payable on profits generated in FY21.

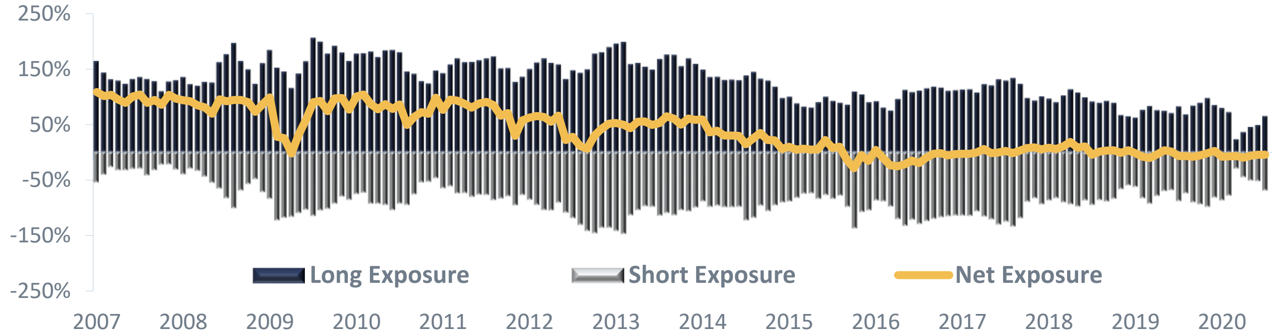
Net Tangible Asset (NTA) Backing

	Jun 20	Jul 20
NTA Before Tax	**$1.12**	**$1.14**
NTA After Tax *	$1.12	$1.13
NTA After Tax & DTA/CTL**	$1.04	$1.04

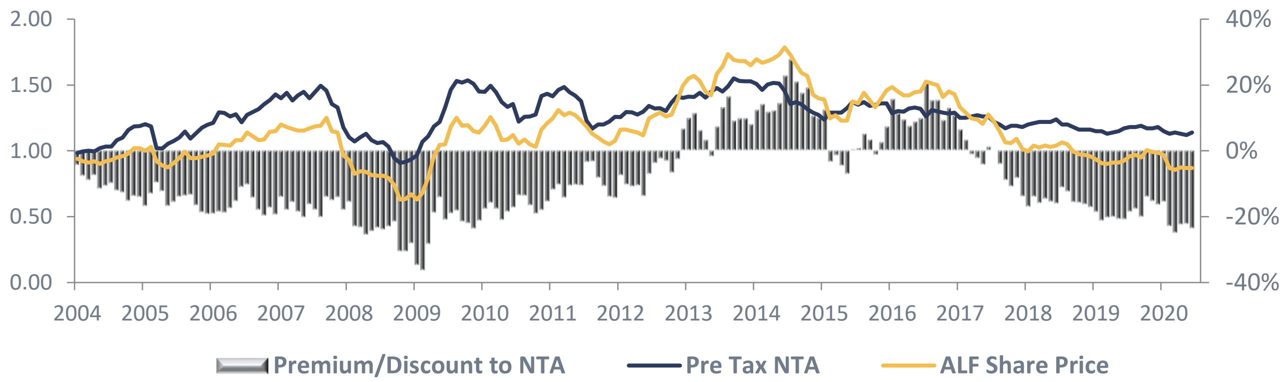
Gross Portfolio Structure

	Jun 20	Jul 20
Long Exposure	48.5%	65.1%
Short Exposure	-52.7%	-69.4%
Gross Exposure	101.2%	134.5%
Cash	104.2%	104.4%

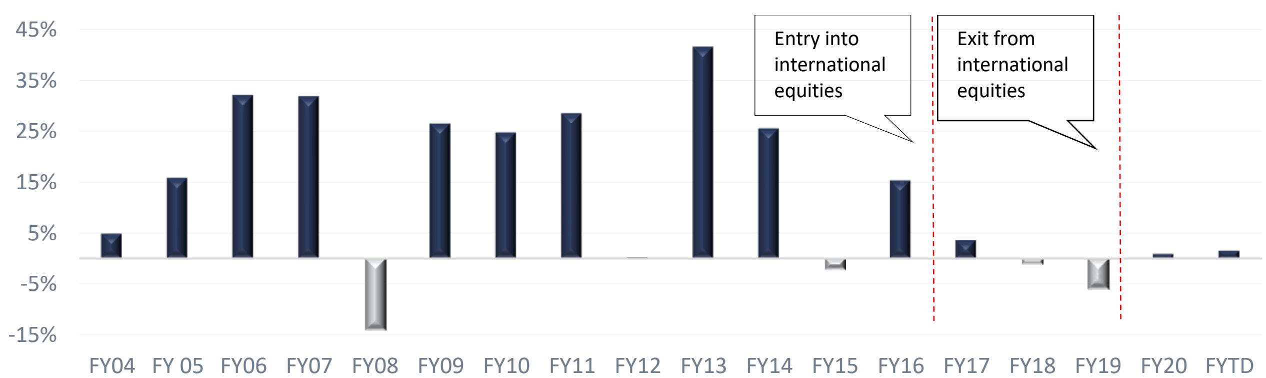
Net Equity Exposure



Historical Premium/Discount to NTA History



Gross Portfolio Return



WATERMARK FUNDS MANAGEMENT

Market Neutral Trust

APIR: WMF0001AU

Fund at a Glance – July 2020

Fund Size	AU$38m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

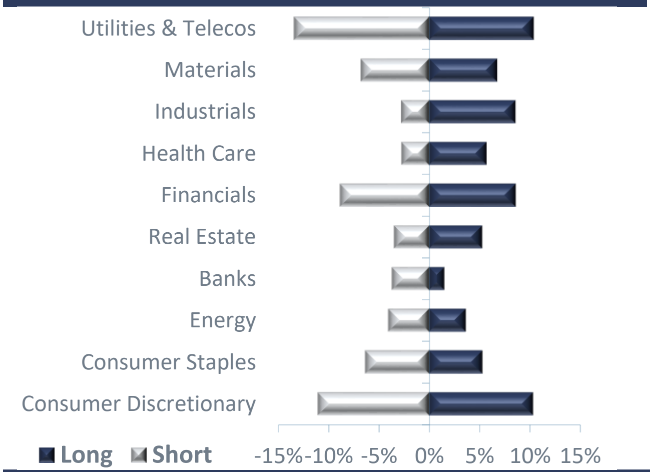
Return Characteristics

Positive Months	64%
Portfolio Beta	-0.01%
Sharpe Ratio	0.7
Sortino Ratio	2.1
Standard Deviation	6.5%
No. Long Positions	74
No. Short Positions	51
Gross Exposure	137.0%

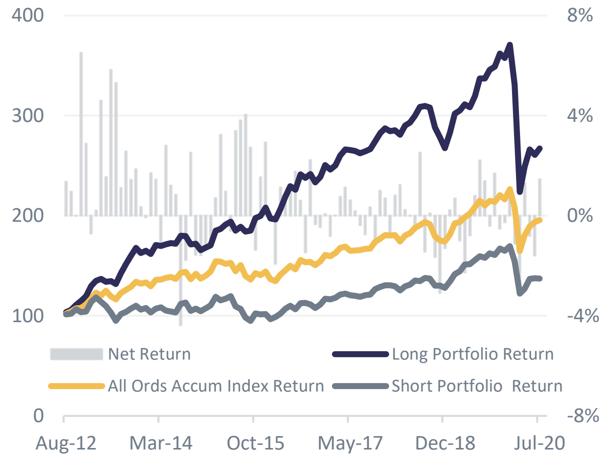
Performance

	1 Mth	FYTD	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 Yrs (pa)	SI (pa)
WMNT (net return)	1.5%	1.5%	-0.6%	-1.6%	1.9%	3.5%	6.7%
RBA Cash Rate	0.0%	0.0%	0.6%	1.2%	1.4%	1.7%	1.9%
Outperformance	**1.5%**	**1.5%**	**-1.2%**	**-2.8%**	**0.5%**	**1.8%**	**4.8%**

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**
2020	1.08	-1.12	-2.72	1.30	-0.81	-1.60	1.46						**-2.46**

WATERMARK FUNDS MANAGEMENT

Absolute Return Fund

APIR: ETL8732AU

Fund at a Glance – July 2020

Fund Size	AU$30m
Strategy FUM	AU$231m
Fund Inception Date	May 2019
Fund Strategy	Variable Beta
Application/Redemption	Monthly
Benchmark	RBA Cash Rate

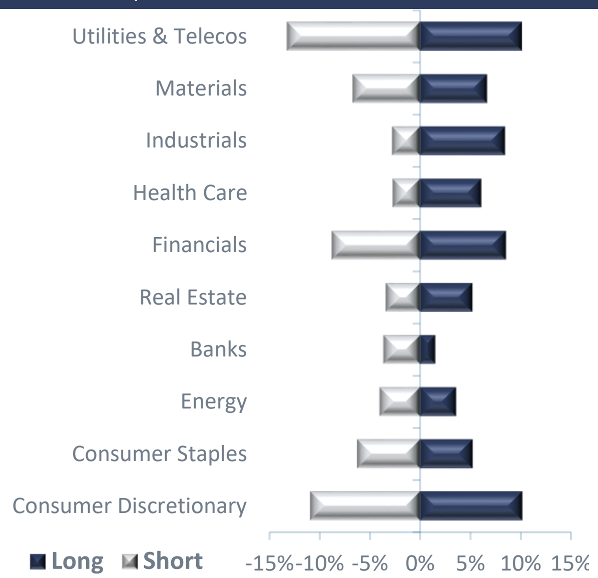
Return Characteristics

No. Long Positions	75
No. Short Positions	51
Gross Exposure	135.7%
Net Exposure	-4.0%
Unit Price	**$1.0157**

Performance

	1 Mth	3 Mths	FYTD	SI (pa)
WARF (net return)	1.2%	-0.8%	1.2%	1.4%
RBA Cash Rate	0.0%	0.1%	0.0%	0.7%
Outperformance	**1.2%**	**-0.9%**	**1.2%**	**0.7%**

Sector Exposures



Gross Portfolio Structure

Investment Type	$m	%
Listed Securities - Long	19.8	65.9
Listed Securities - Short	-20.9	-69.8
Net Exposure	**-1.2**	**-4.0**
Cash	31.2	104.0
Capital	**30**	**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

Level 23, Governor Phillip Tower, Sydney NSW 2000
TEL (02) 9252 0225 • info@wfunds.com.au • www.wfunds.com.au