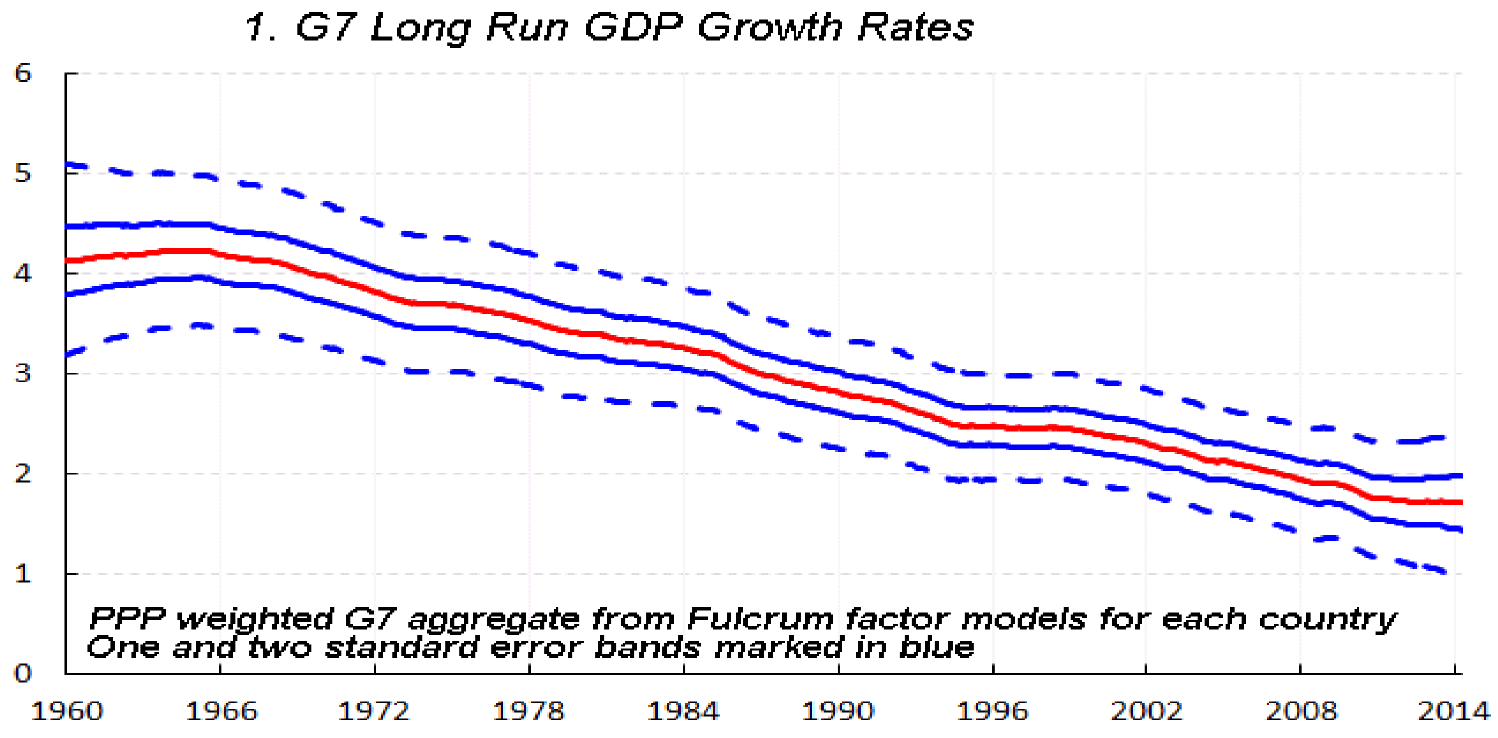
WATERMARK
FUNDS MANAGEMENT

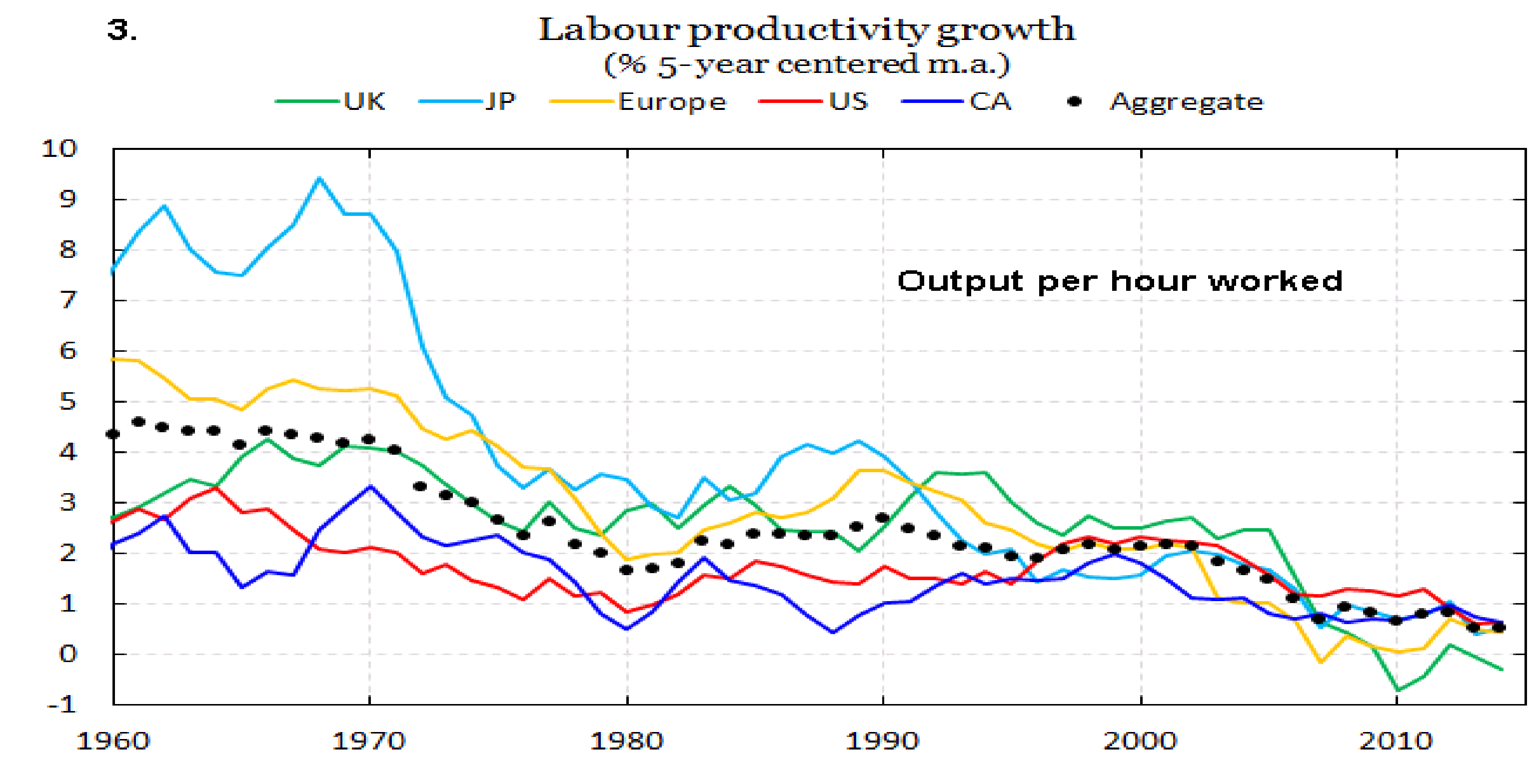
Investor Update

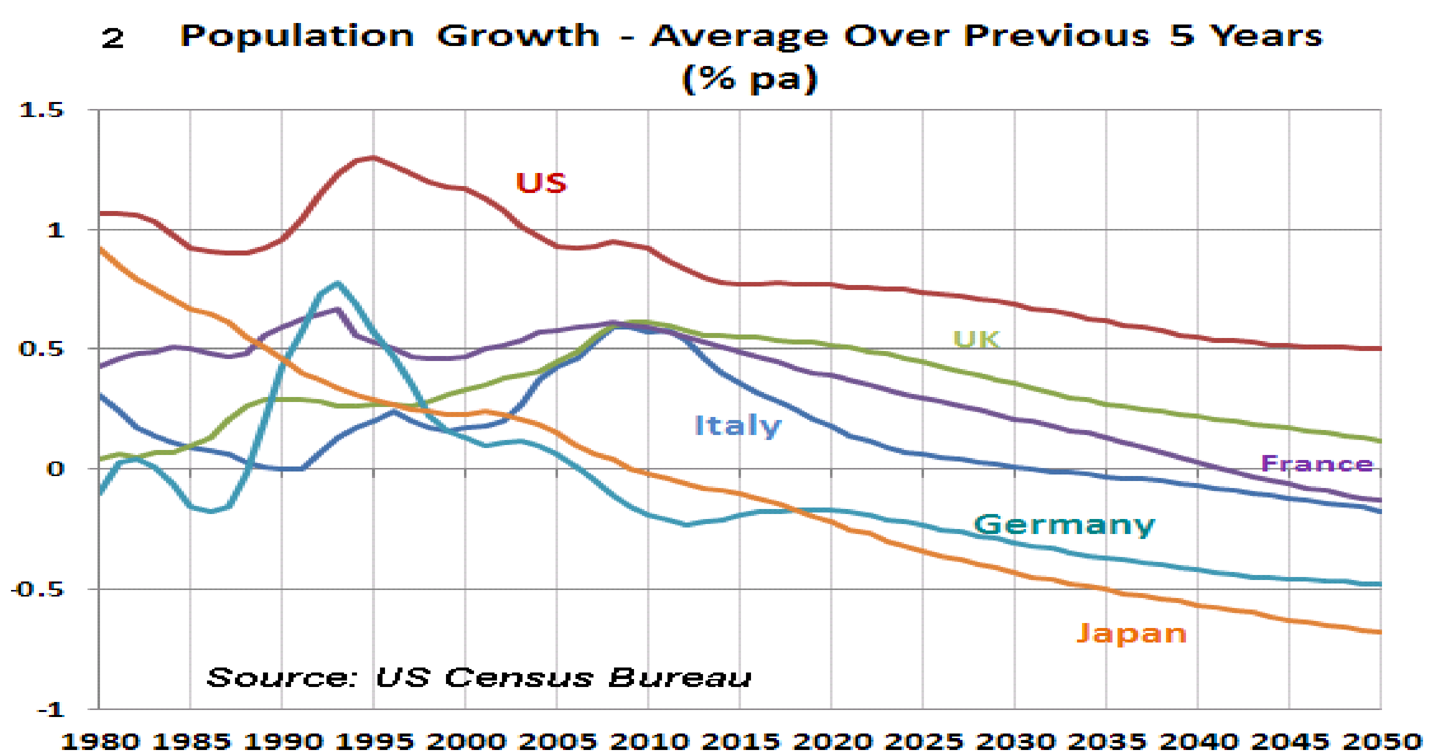
November 2014

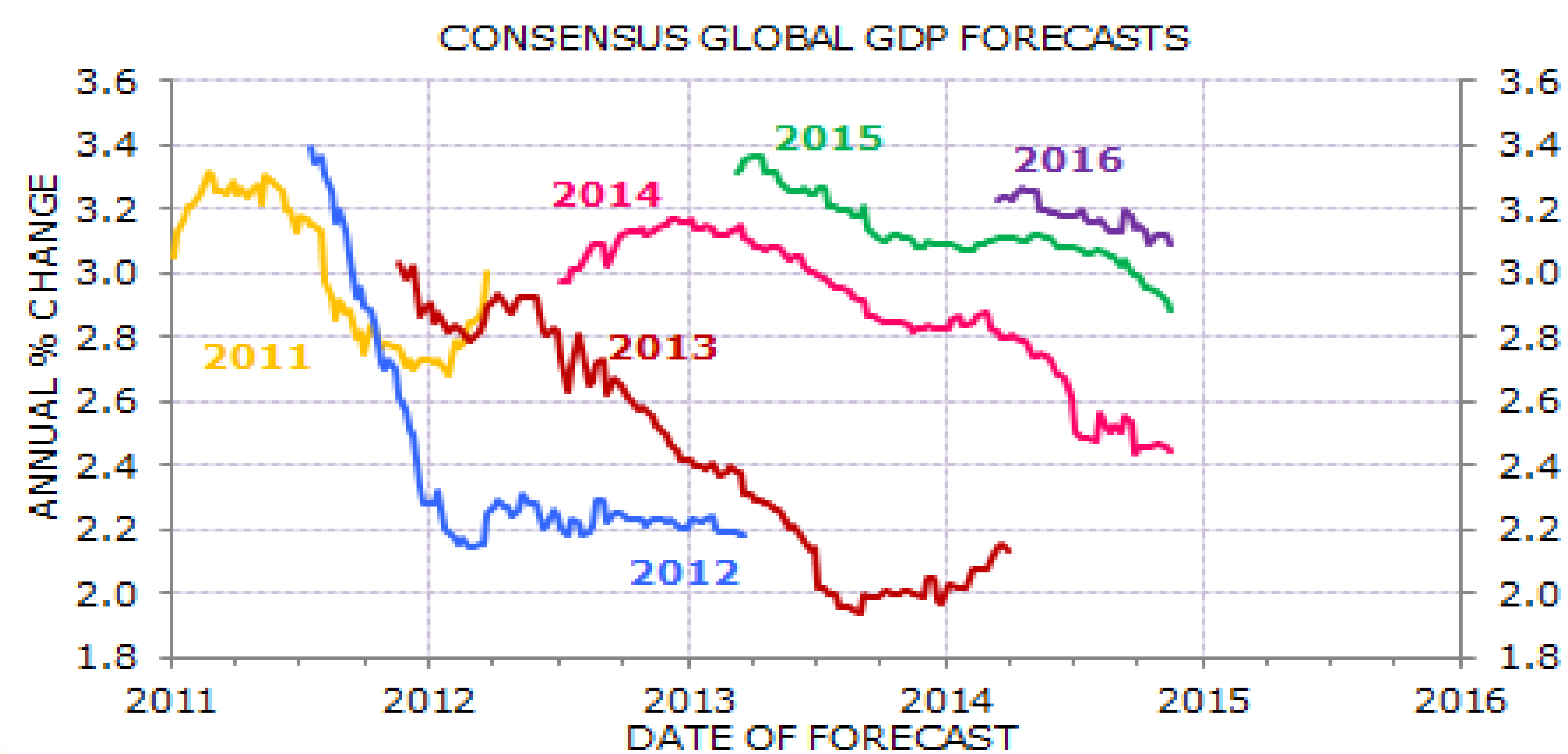
Market Update

This is what secular stagnation looks like

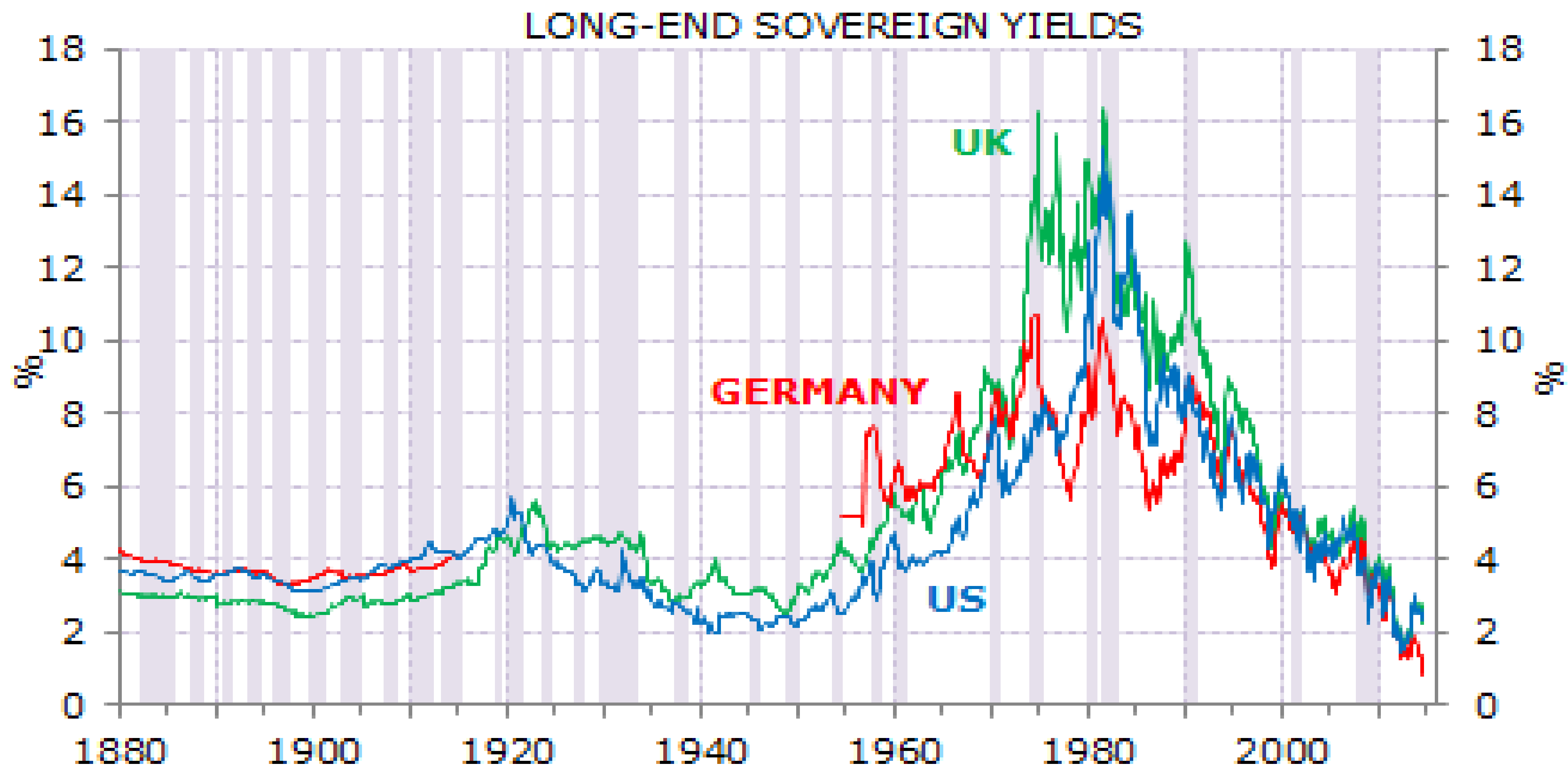




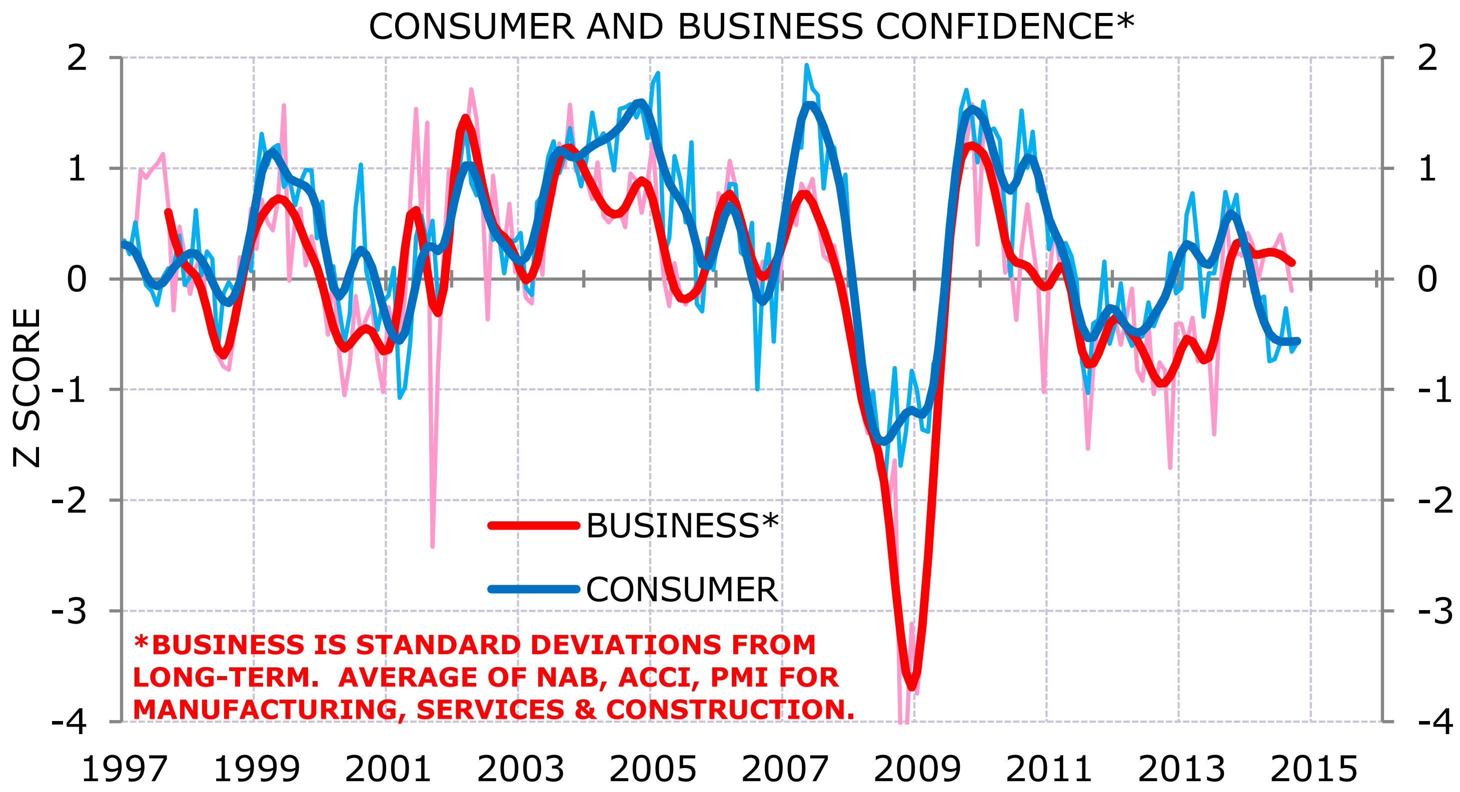


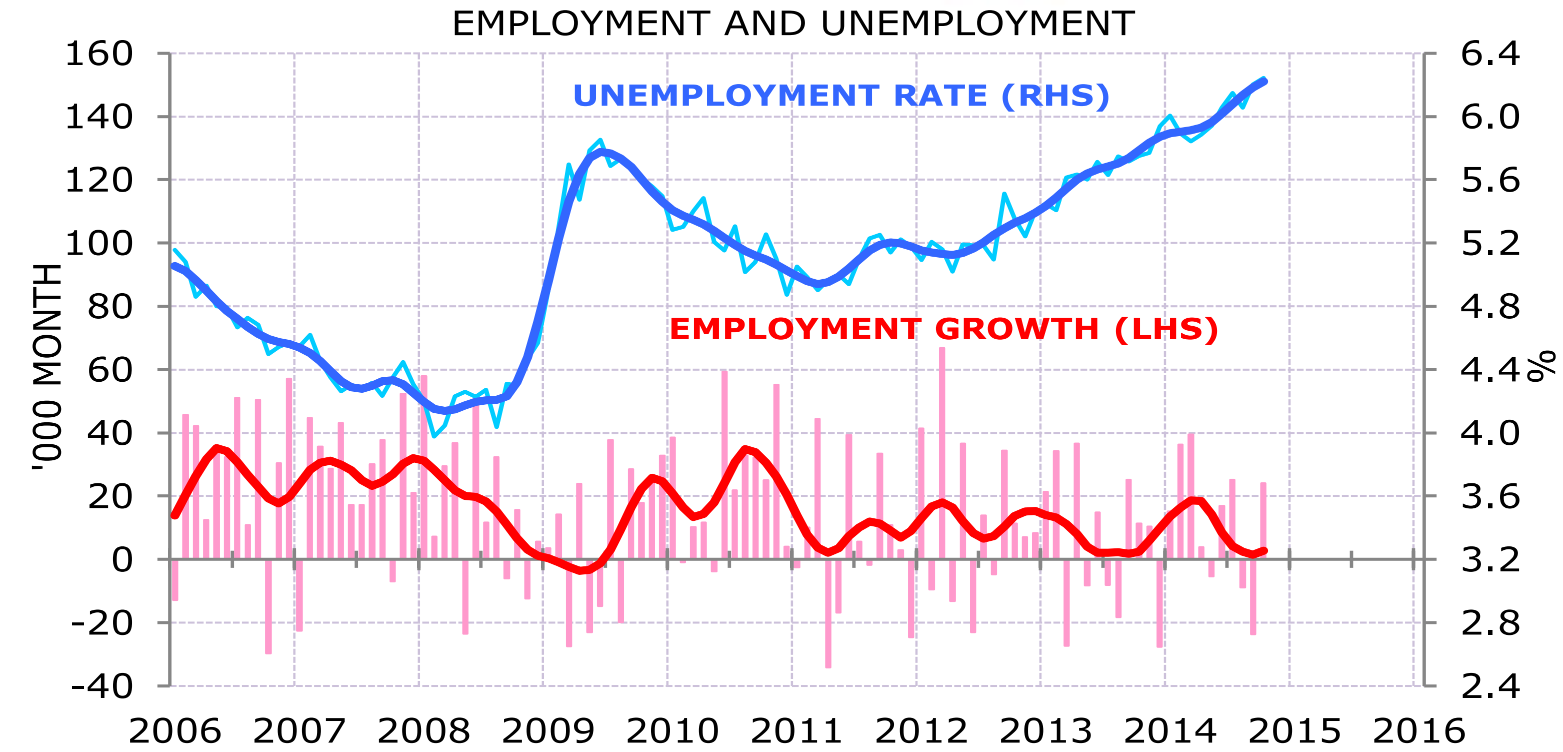


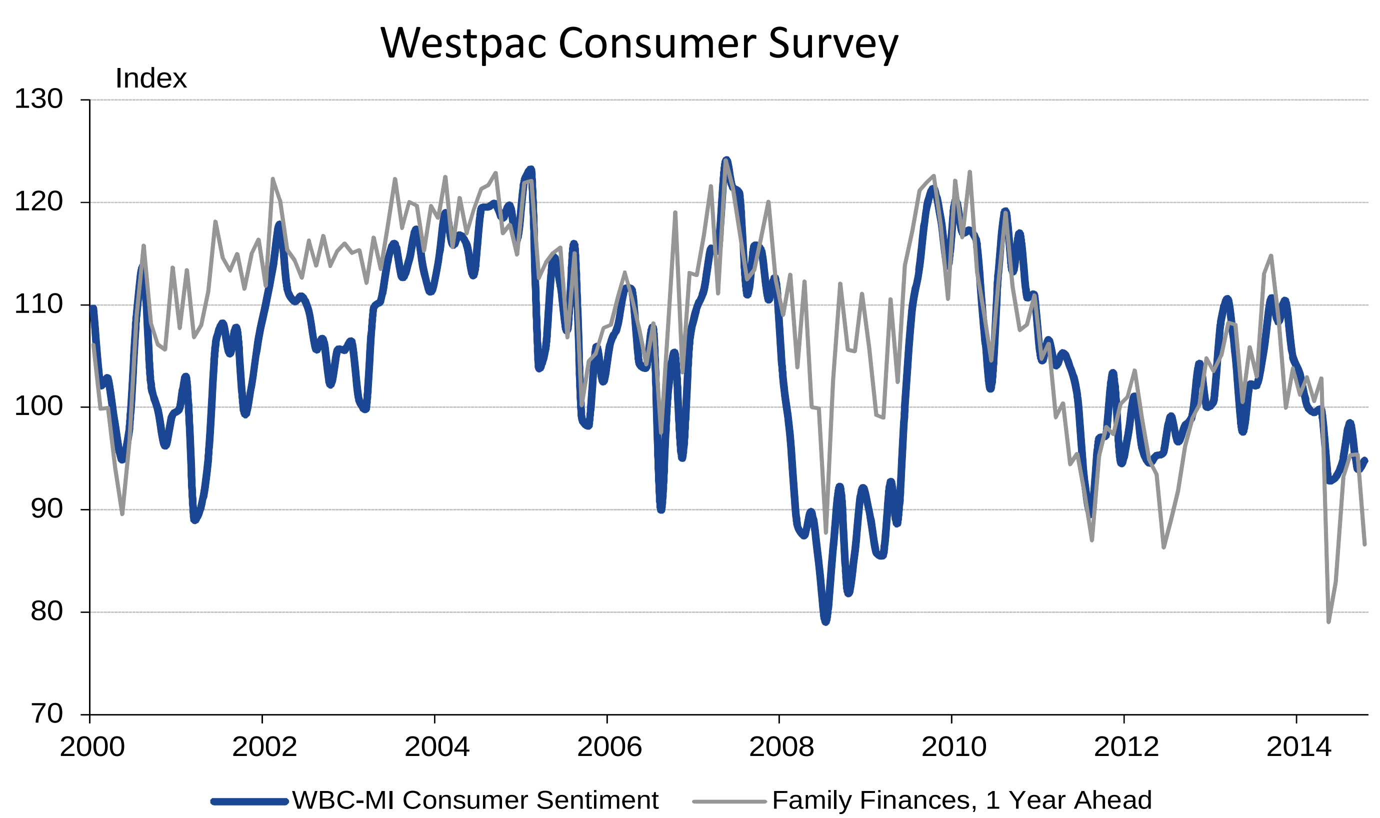
Secular stagnation

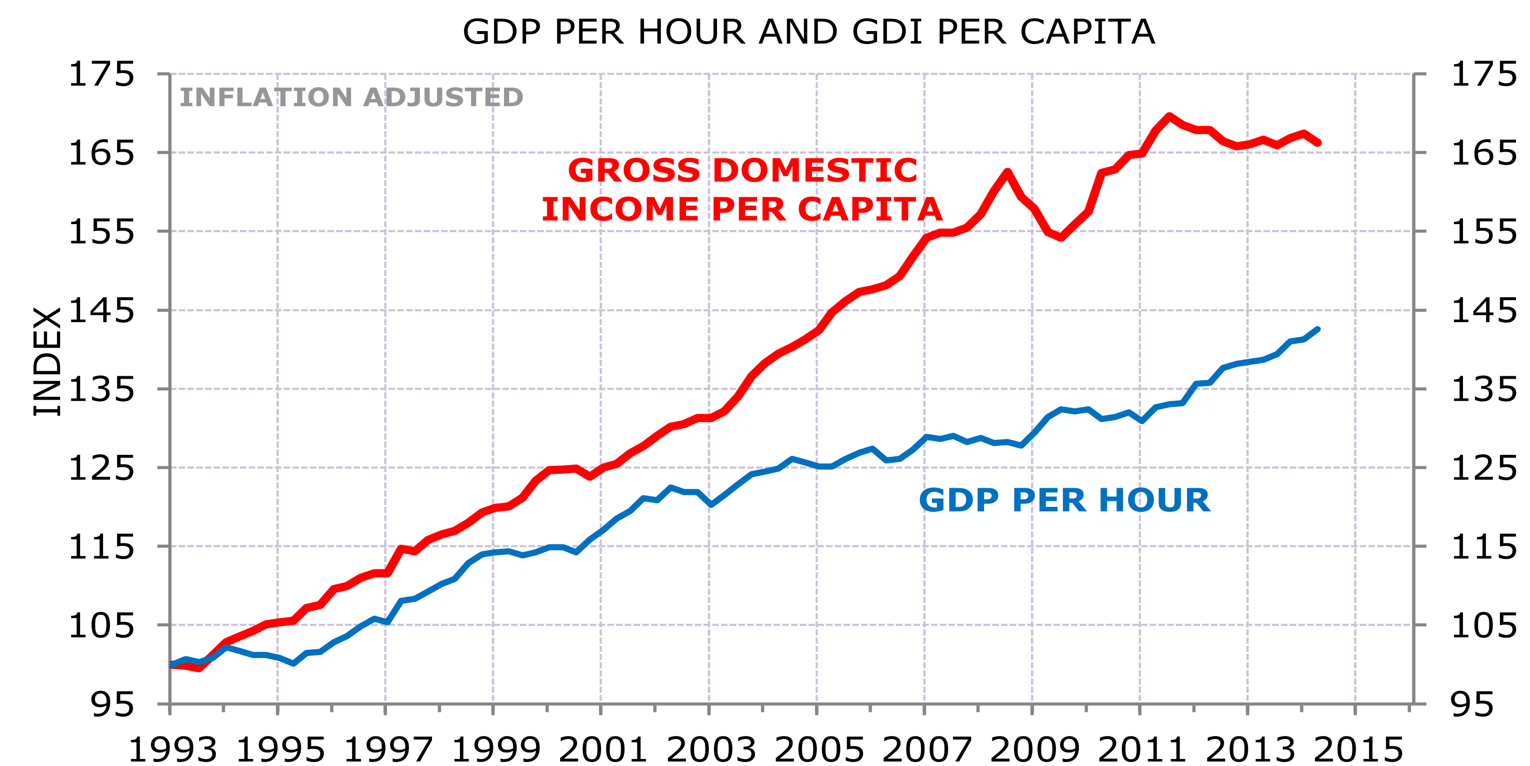


The Australian Economy is losing momentum









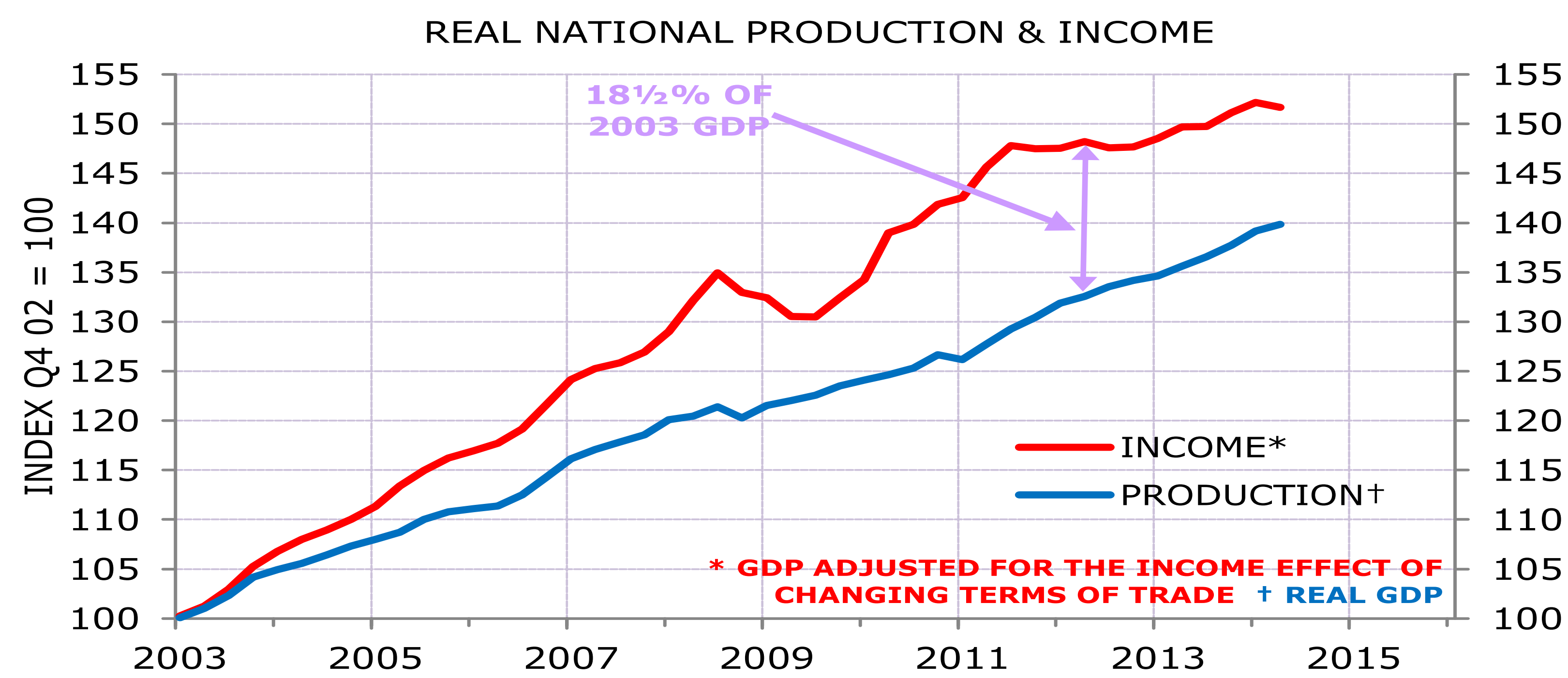
Closing the gap

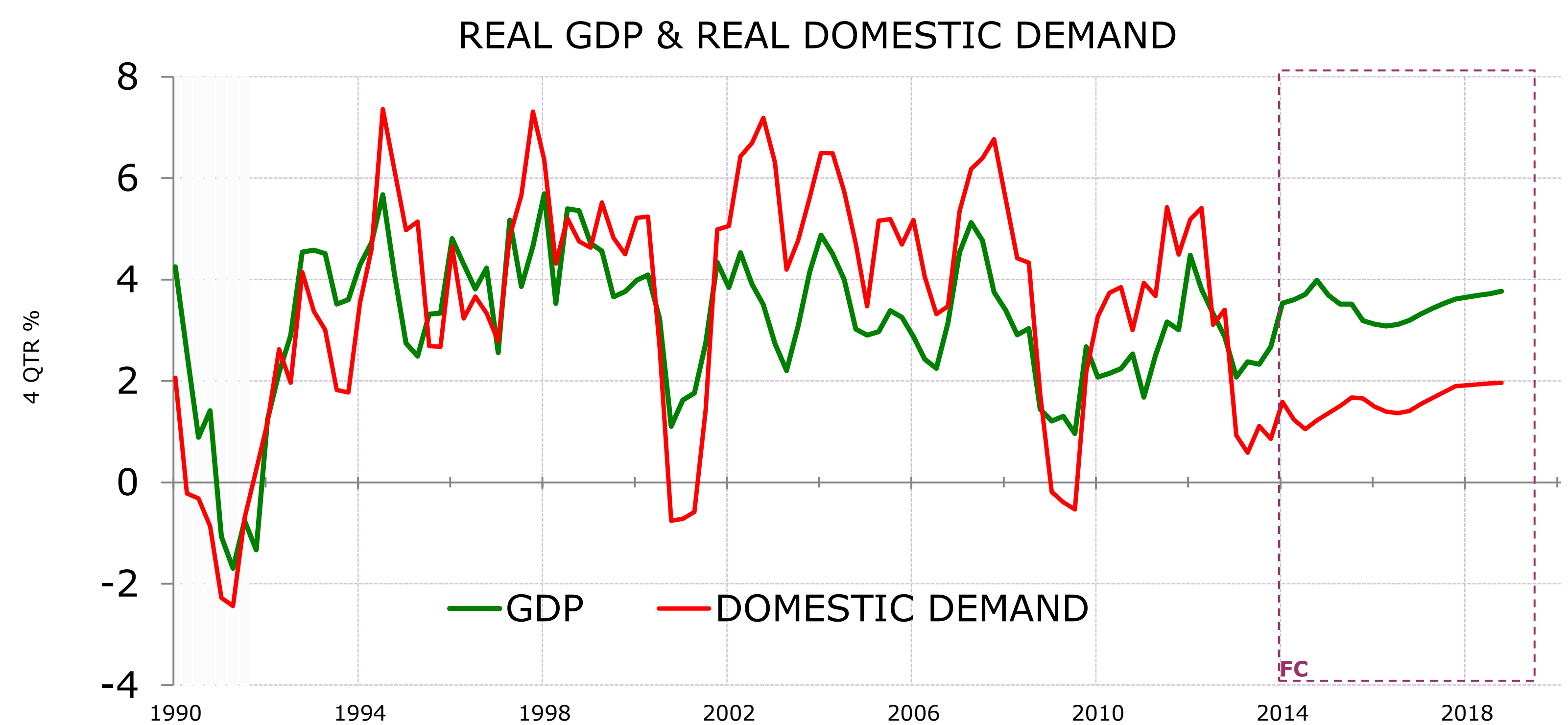
A strong terms of trade has seen income grow well ahead of production through the mining boom.

With this now reversing, production growth will lift with mining output but national income will be far softer.

It is National Income (GNI) not production (GDP) that drives profitability and the share market.

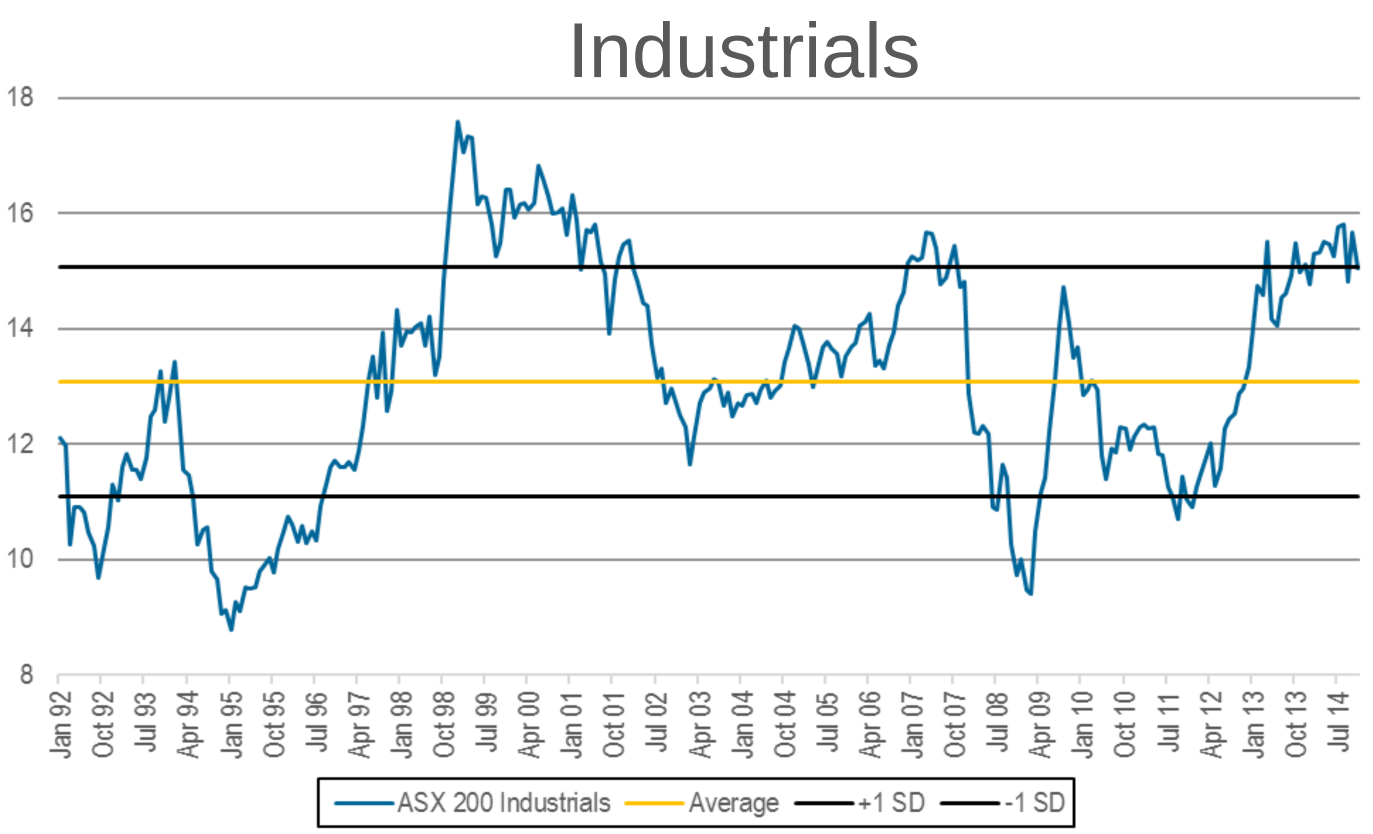
While official GDP reports may look healthy this may belie an income recession.

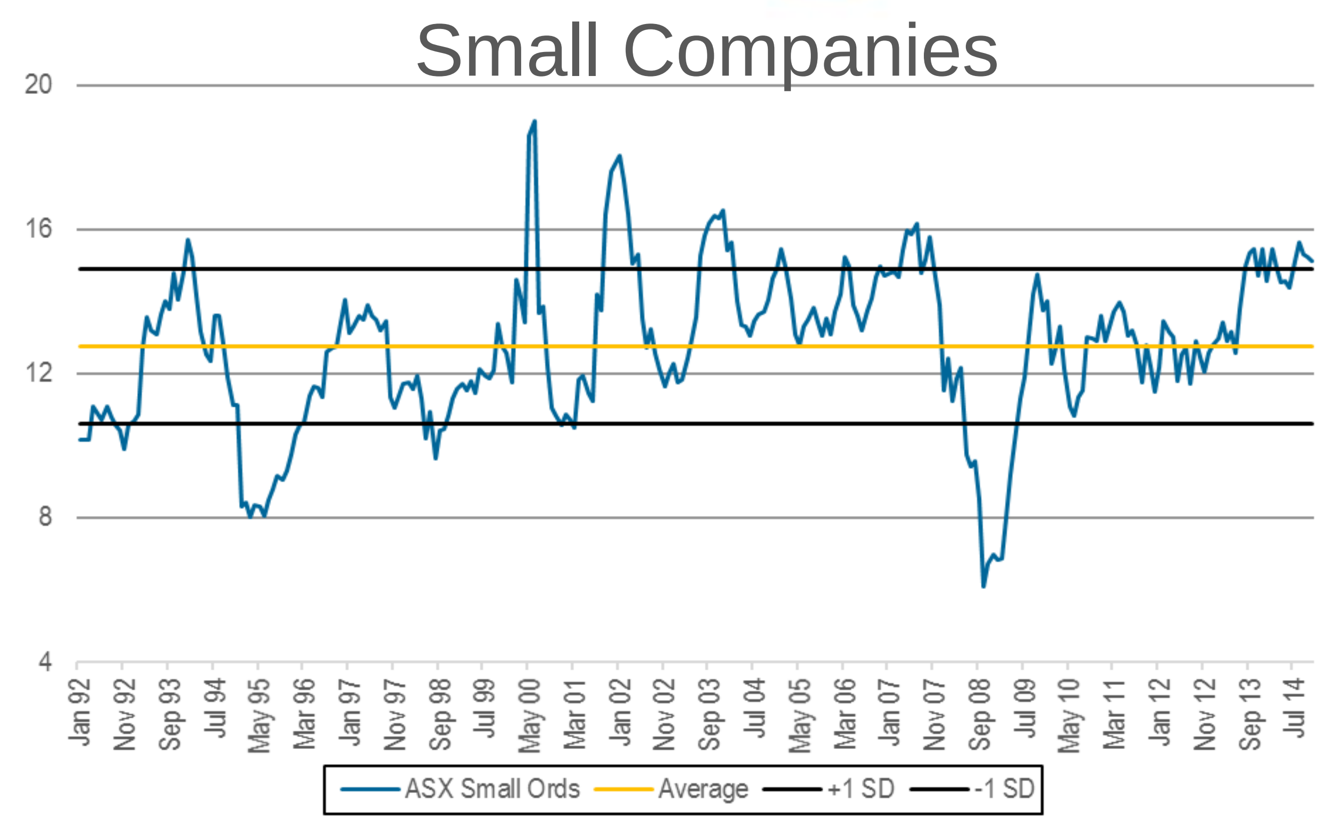


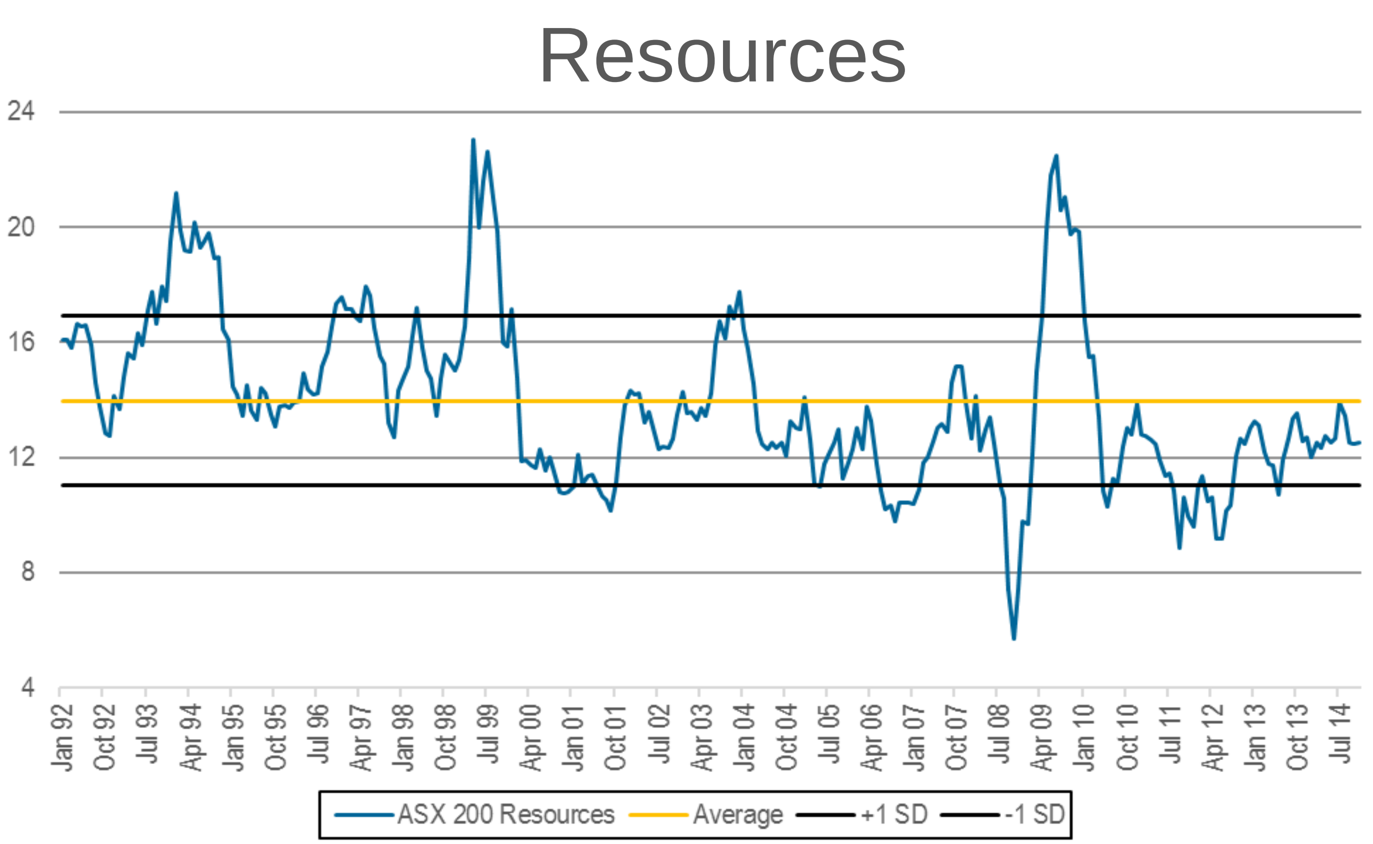


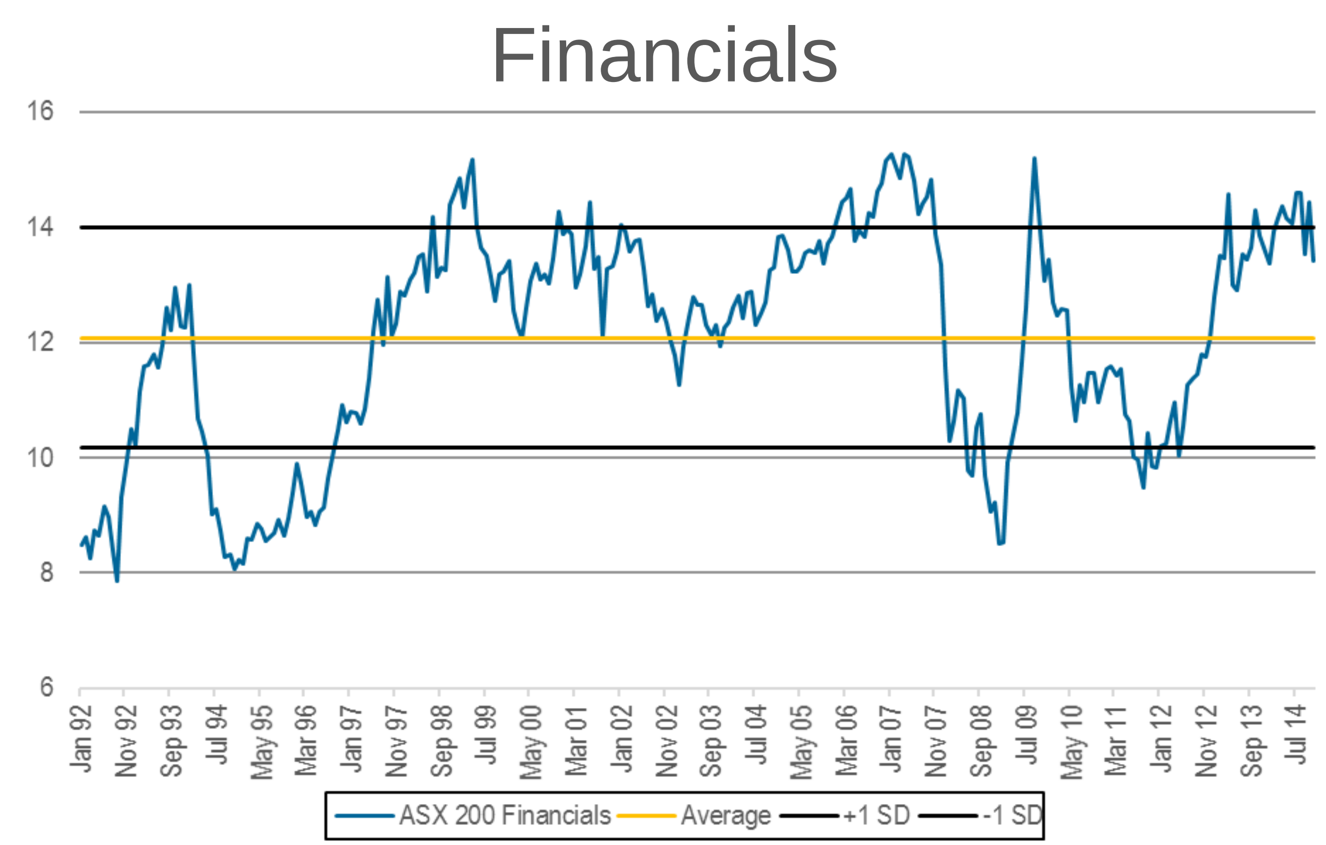
Minack Advisors

Valuations look full - the bulls are exhausted









Risks and imbalances accumulating

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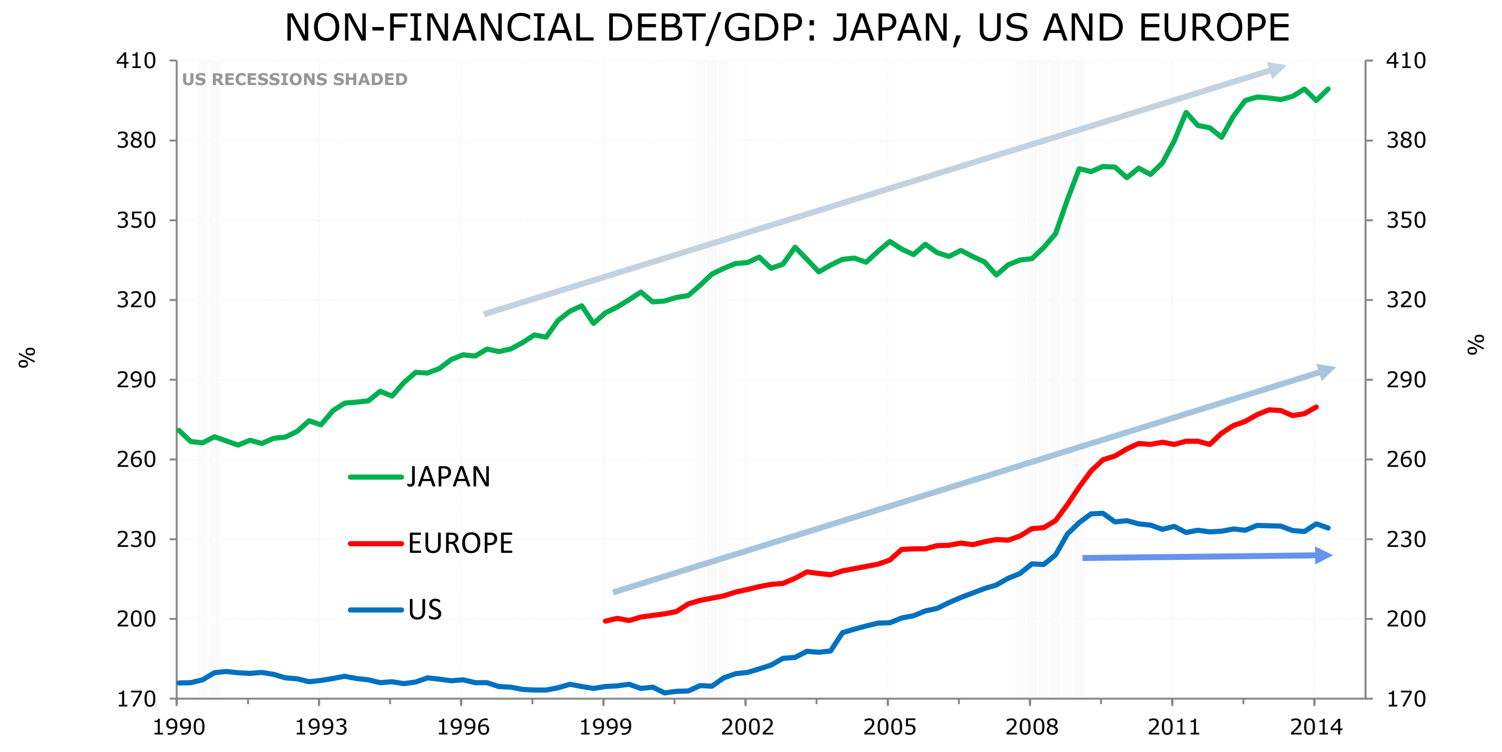
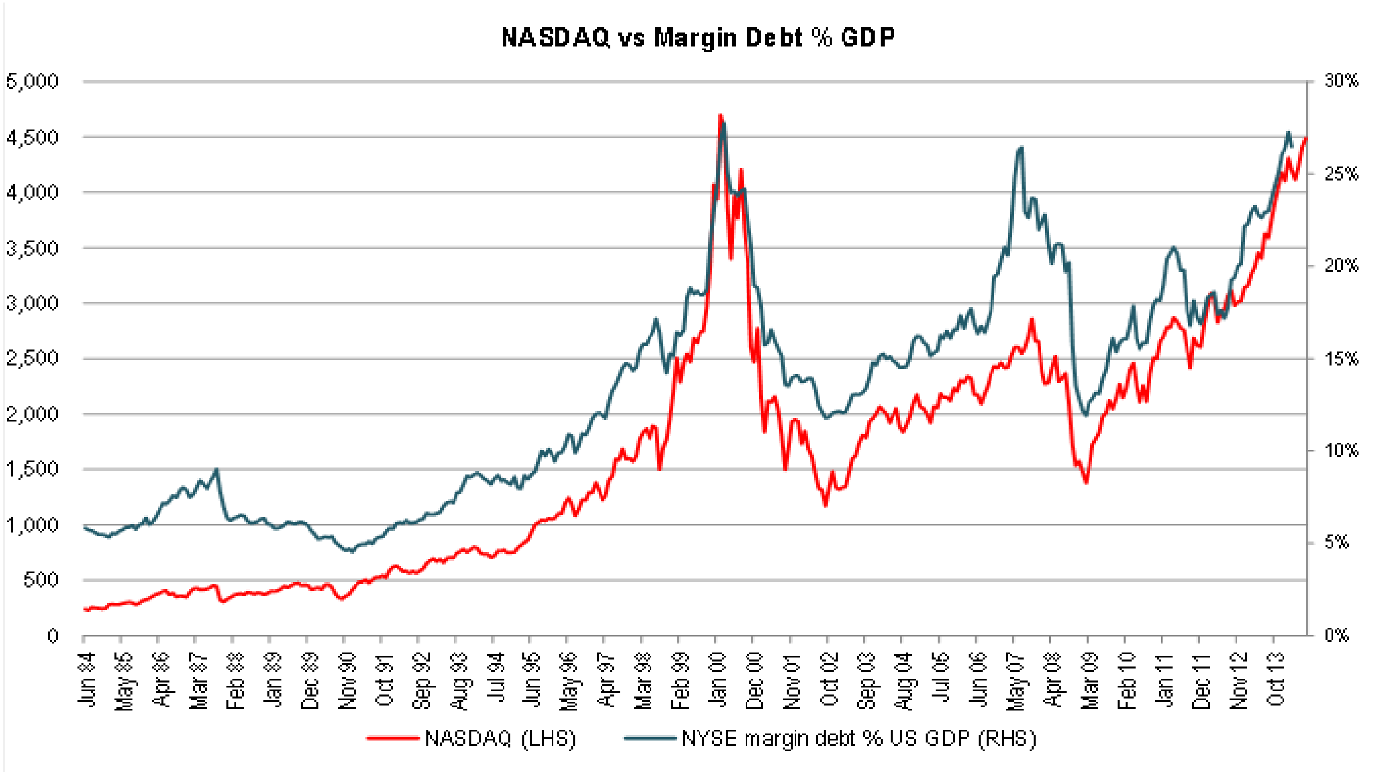
Volatility is likely to return as most of the imbalances that existed before the financial crisis are still in place:

- ➢Household leverage
- ➢Government debt
- ➢Global trade imbalances
- ➢Financial leverage

Leveraged investors have rarely had it so good. Very low funding costs and volatility along with high returns



Source: IMF



Expect far lower returns from shares in medium term

WATERMARK FUNDS MANAGEMENT

- Given a backdrop of weaker growth in advanced economies and Australia in particular, profit growth will be low by historic standards. Valuations on the other hand are elevated by historic standards five years into a bull market.

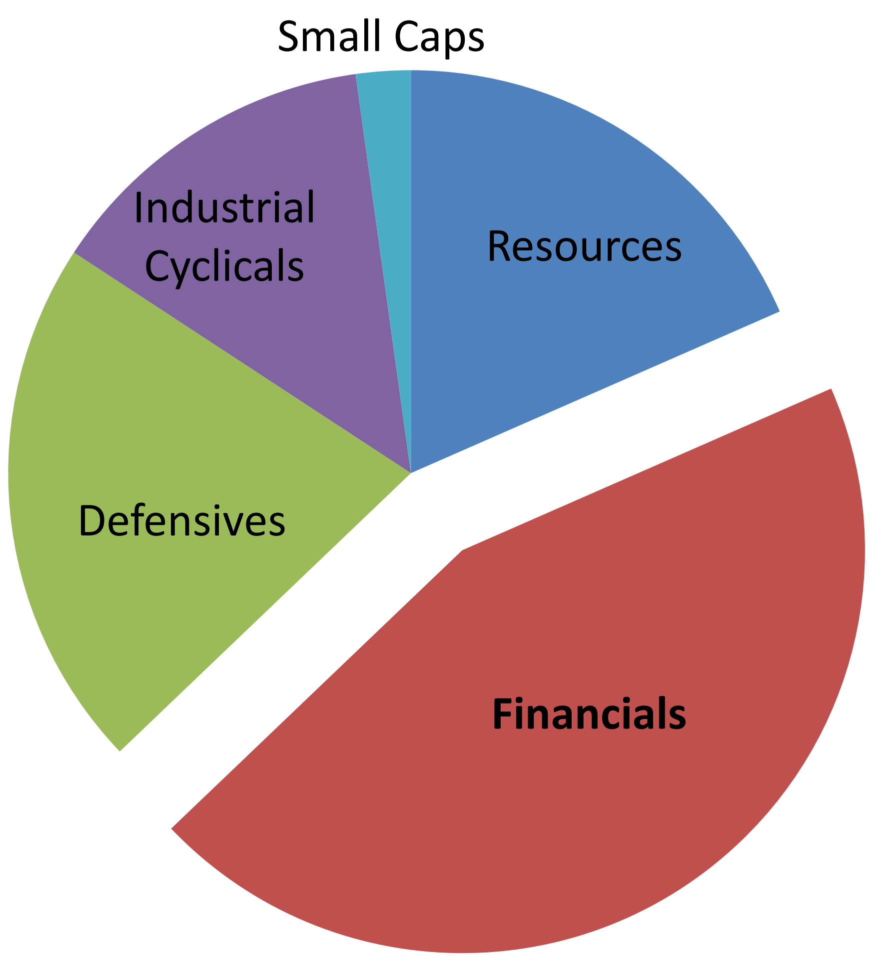
- Risks also remain elevated not just in asset prices but also through debt and trade imbalances that are still to be resolved.

- With this less than favourable balance of risk and return, investors should consider ways of reducing market risk. With policy makers pushing investors to take on more risk, hedging strategies such as those employed by Watermark are one of the few ways of mitigating these risks while still taking advantage of investment opportunities in the share market.

Australian Share Market Review

FINANCIALS

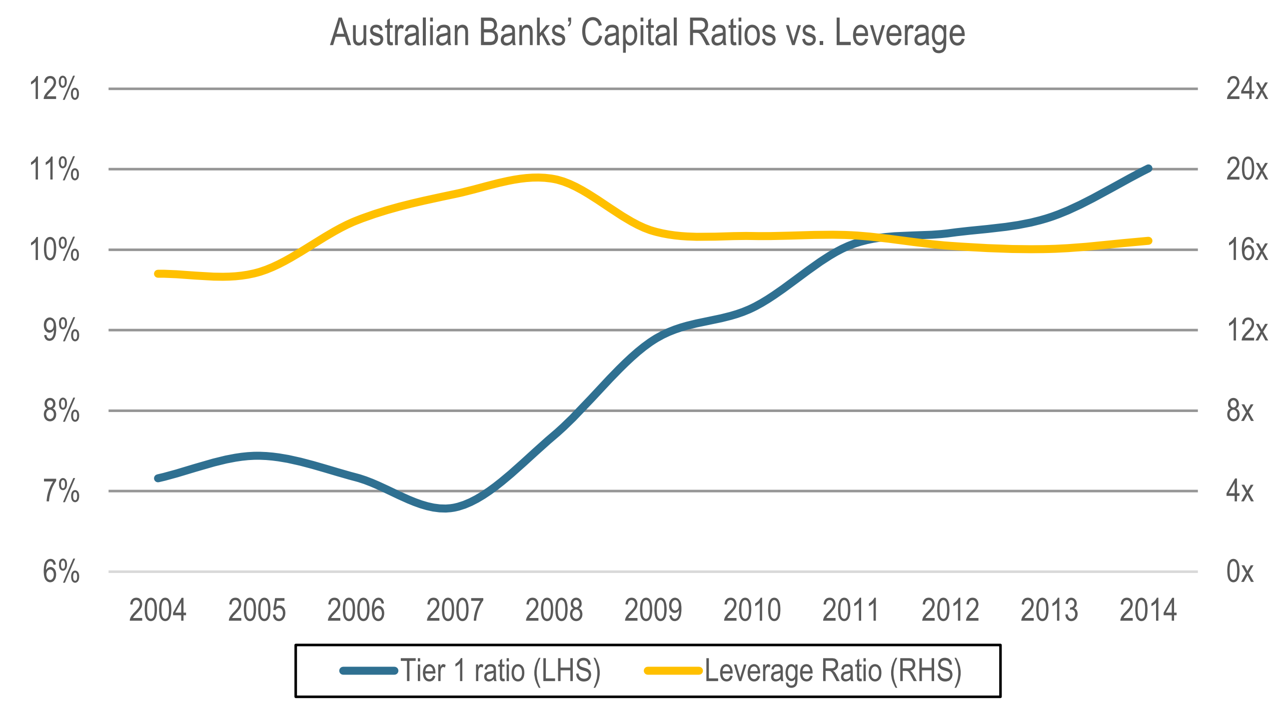
“Should you still own Australian Bank shares?”



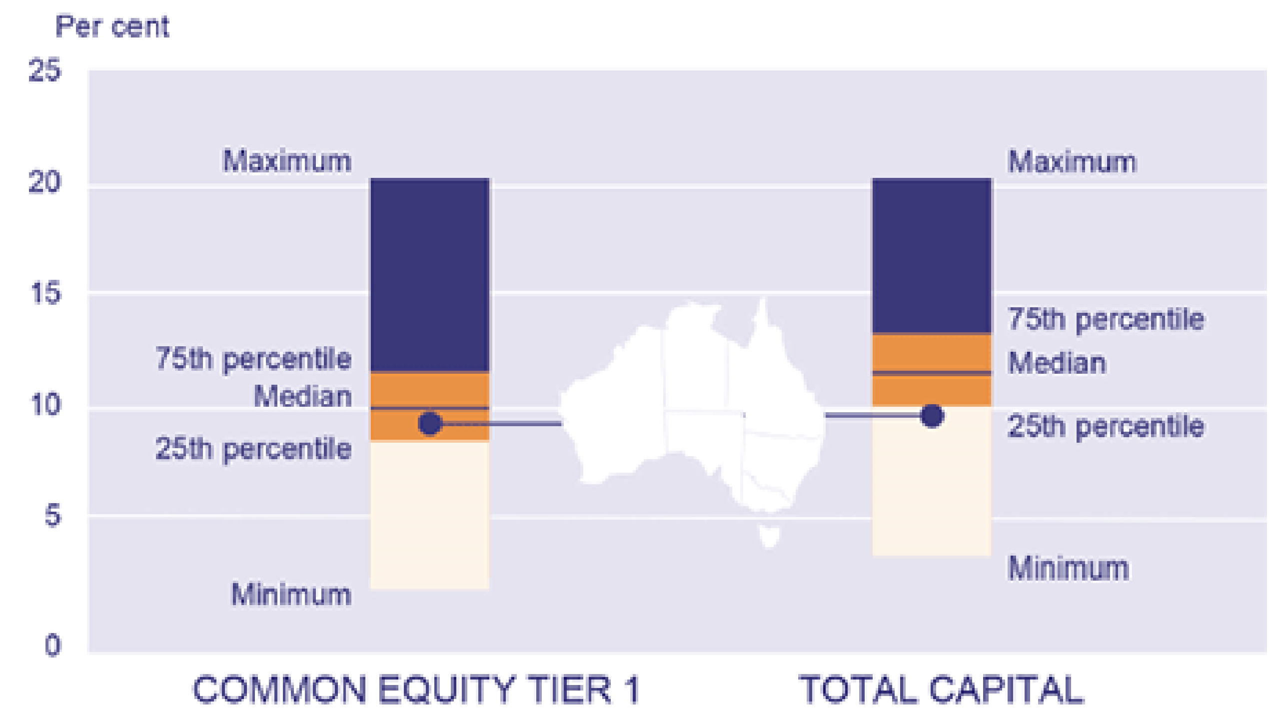
Omkar Joshi
Investment Analyst

Are the banks well capitalised?

- Since the crisis, the major banks have derisked but not deleveraged
- Capital ratios have improved due to greater housing lending which has lower capital requirements
- Global peers have closed the gap in terms of capital ratios
- “Australian banks are roughly ‘middle of the pack’ in terms of common equity tier 1 capital ratios” – David Murray AO, Chair of the FSI
- “Largest Australian banks are broadly in the middle of third quartile” – Wayne Byres, APRA Chairman



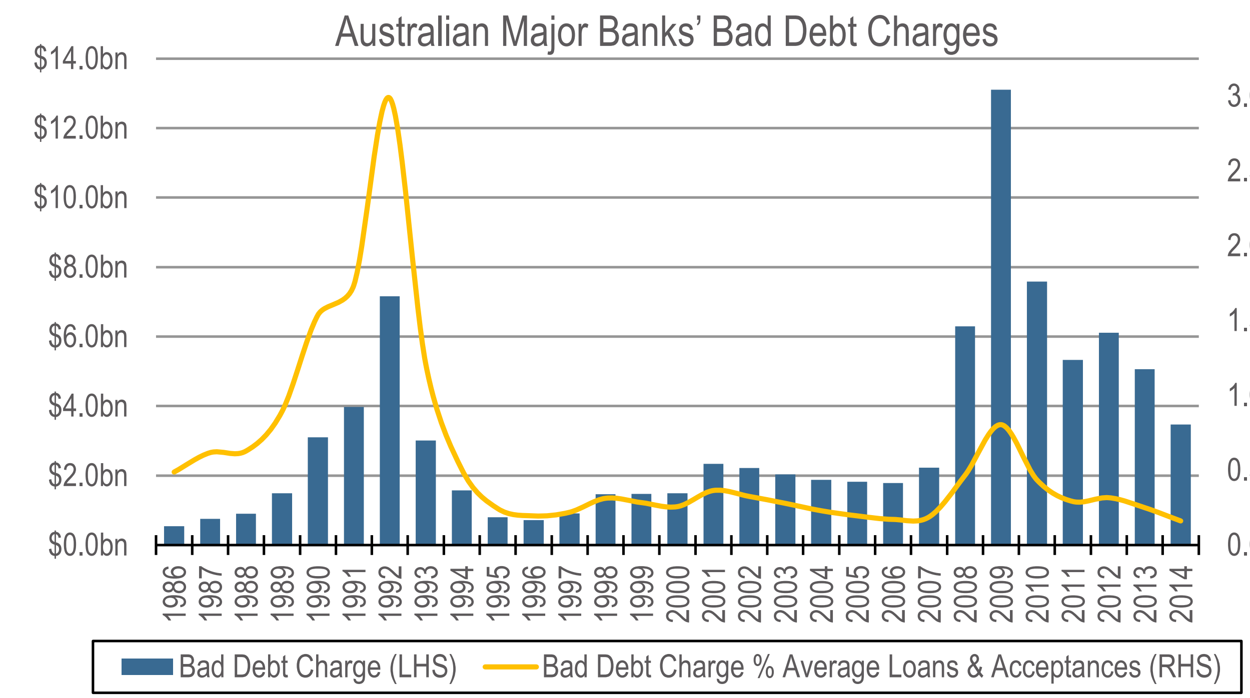
Source: UBS, Watermark Funds Management estimates



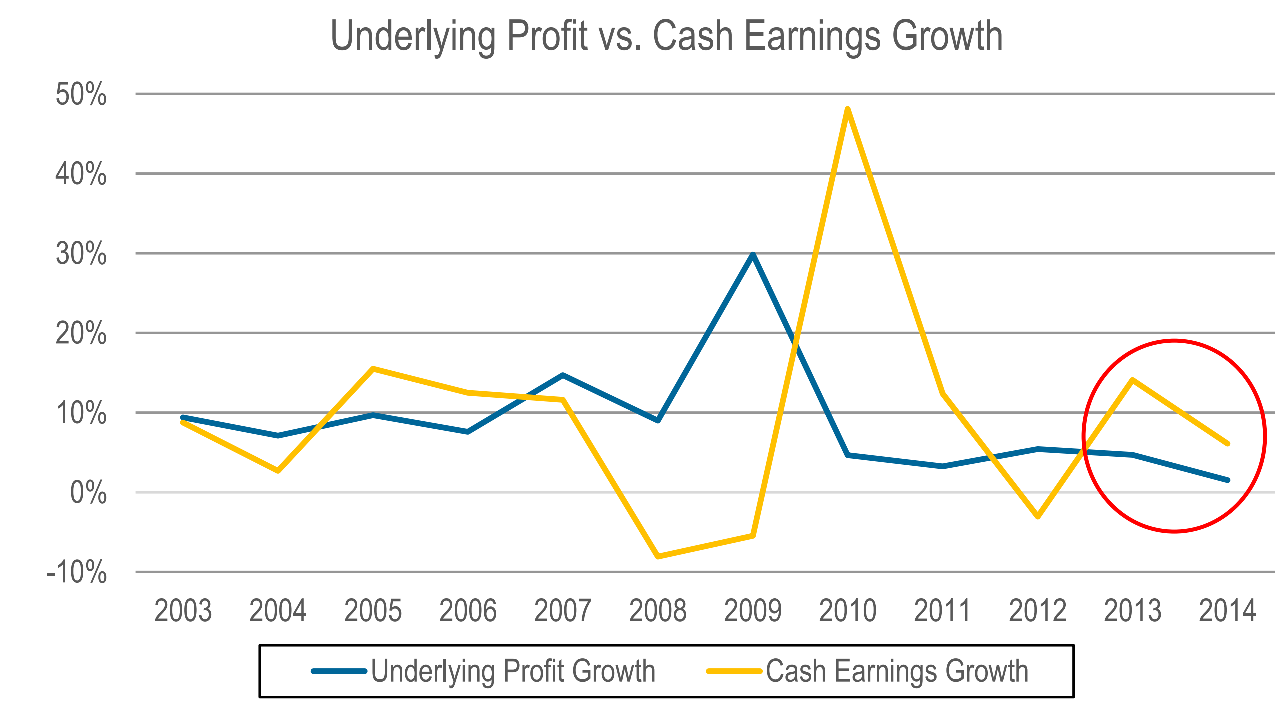
Source: Financial System Inquiry Interim Report

Banking on lower bad debts?

- Bad debt charges appear to have reached a cyclical low point
- Rising net-write-offs have been funded through declining provision coverage
- Bad debt charges have benefited from provision write-backs as asset quality has improved
- Underlying profit growth has lagged cash earnings growth for the last two years



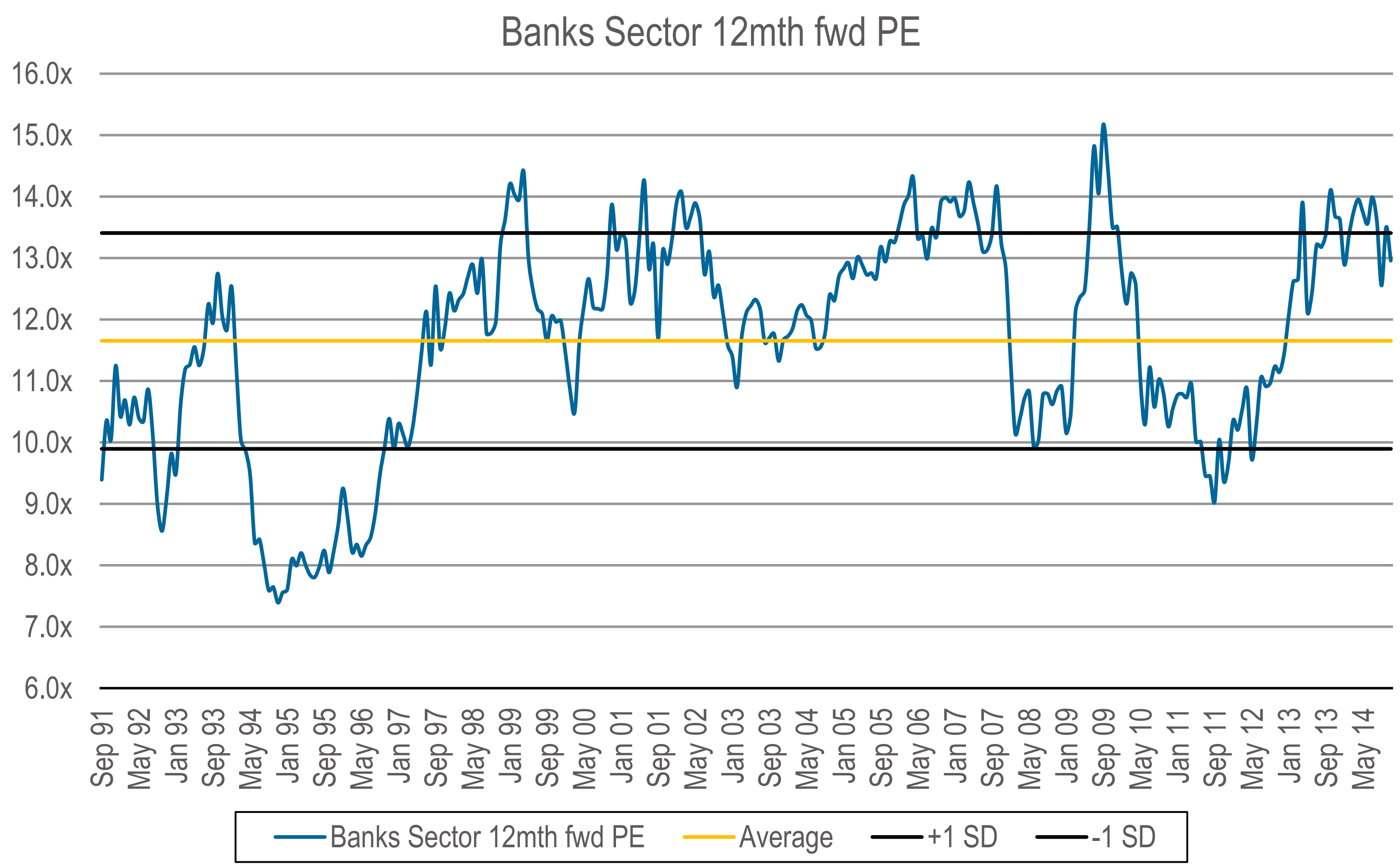
Source: Credit Suisse



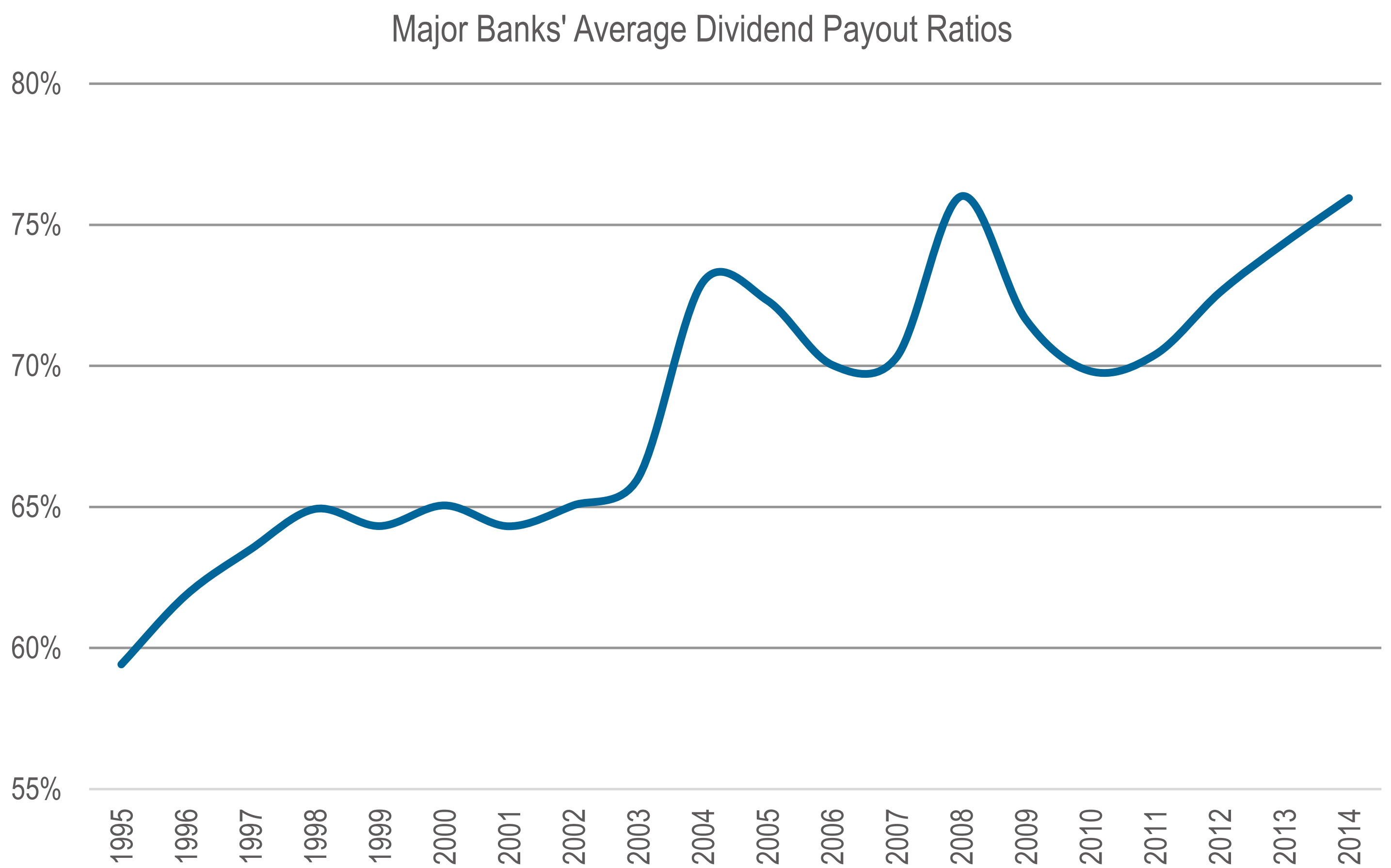
Source: UBS

Banks now appear expensive

- Banks have re-rated significantly and are now trading at historically high P/E multiples
- Higher capital requirements would likely hurt the ability of the banks to continue delivering high dividends to shareholders
- Risks of dividend interruption do not appear to be fully appreciated in current share prices

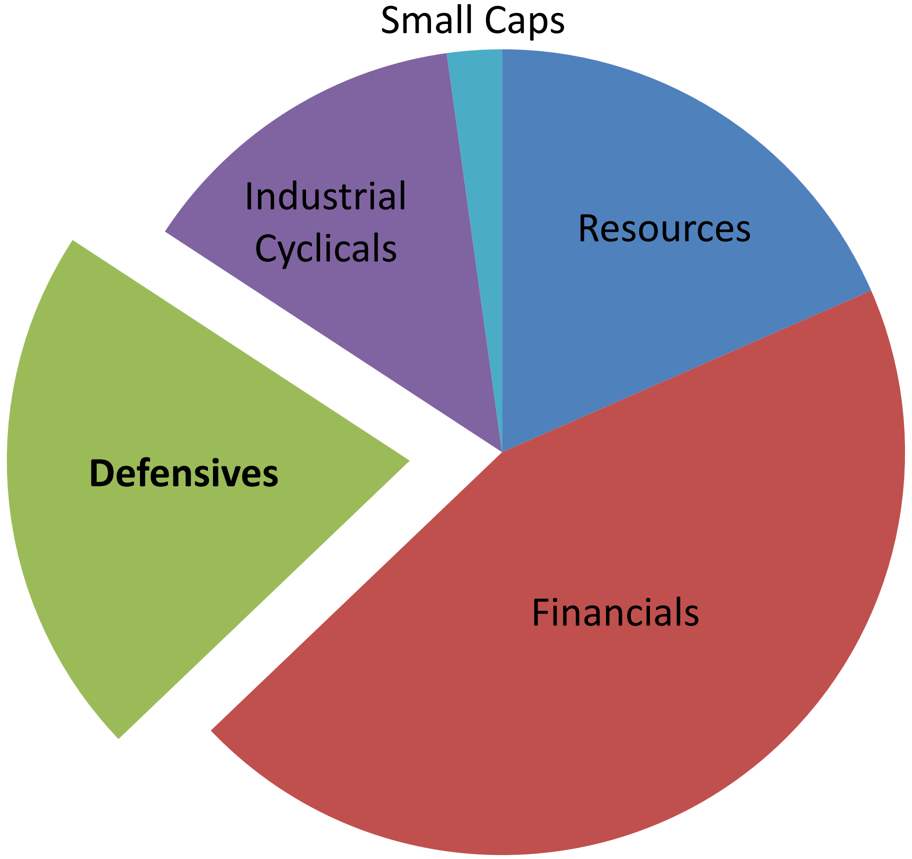


Source: IBES, Reuters



Source: Reuters, Watermark Funds Management estimates

DEFENSIVES

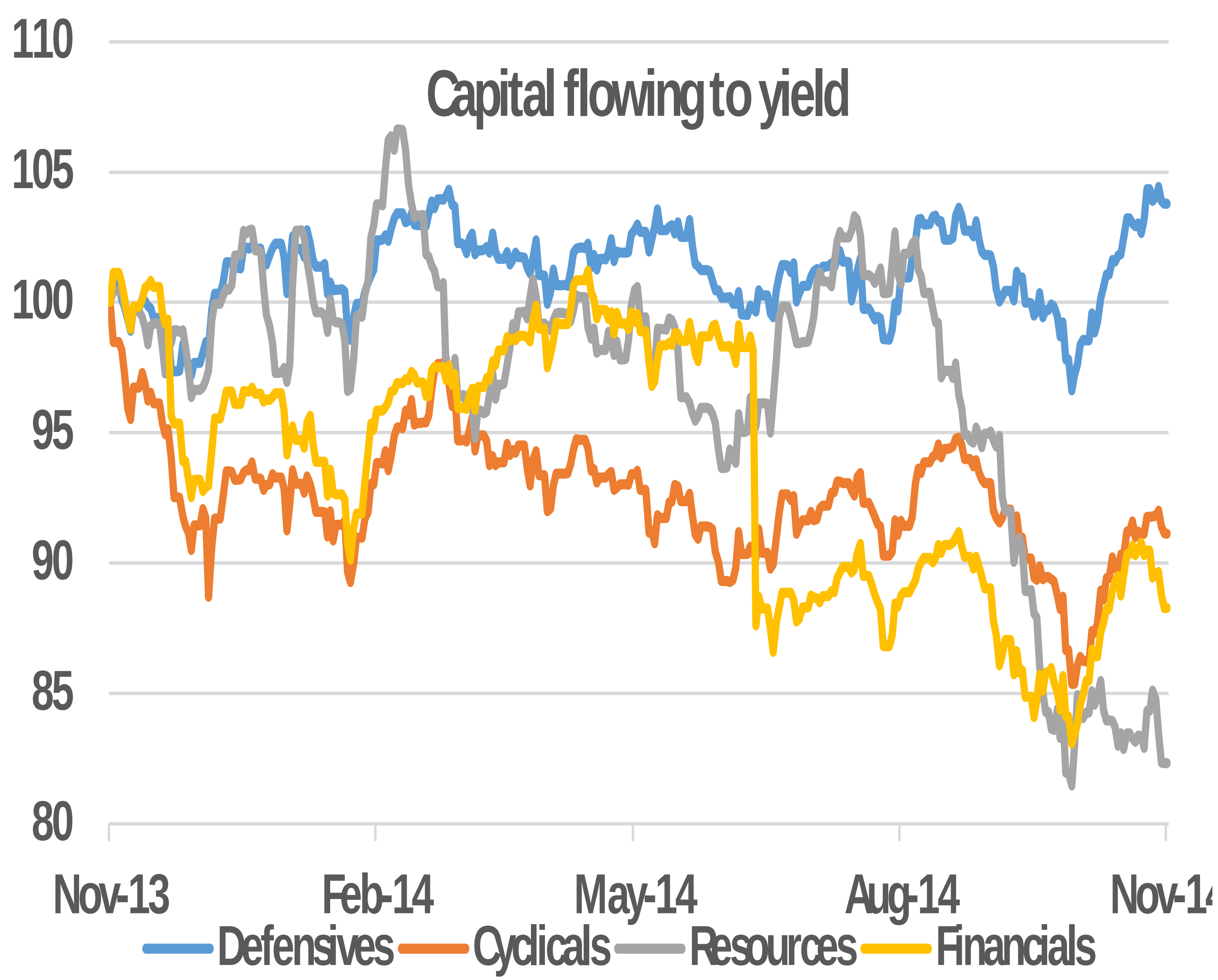


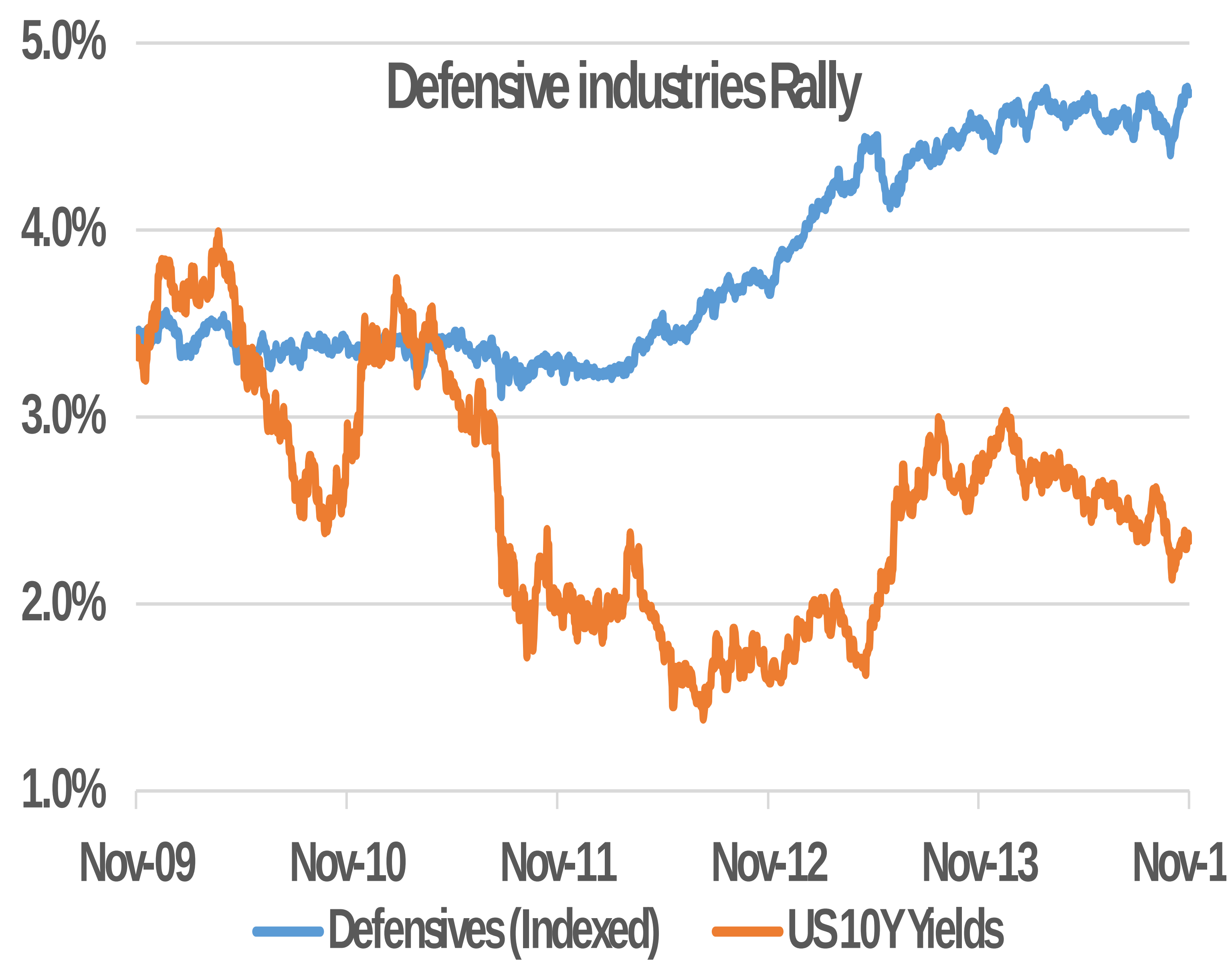
"Have defensive shares run too hard?"

Joshua Ross
Investment Analyst

Low Bond Yields Pushing Defensives Higher

With bond prices rallying, investors are chasing defensive earnings and yield in equity markets.

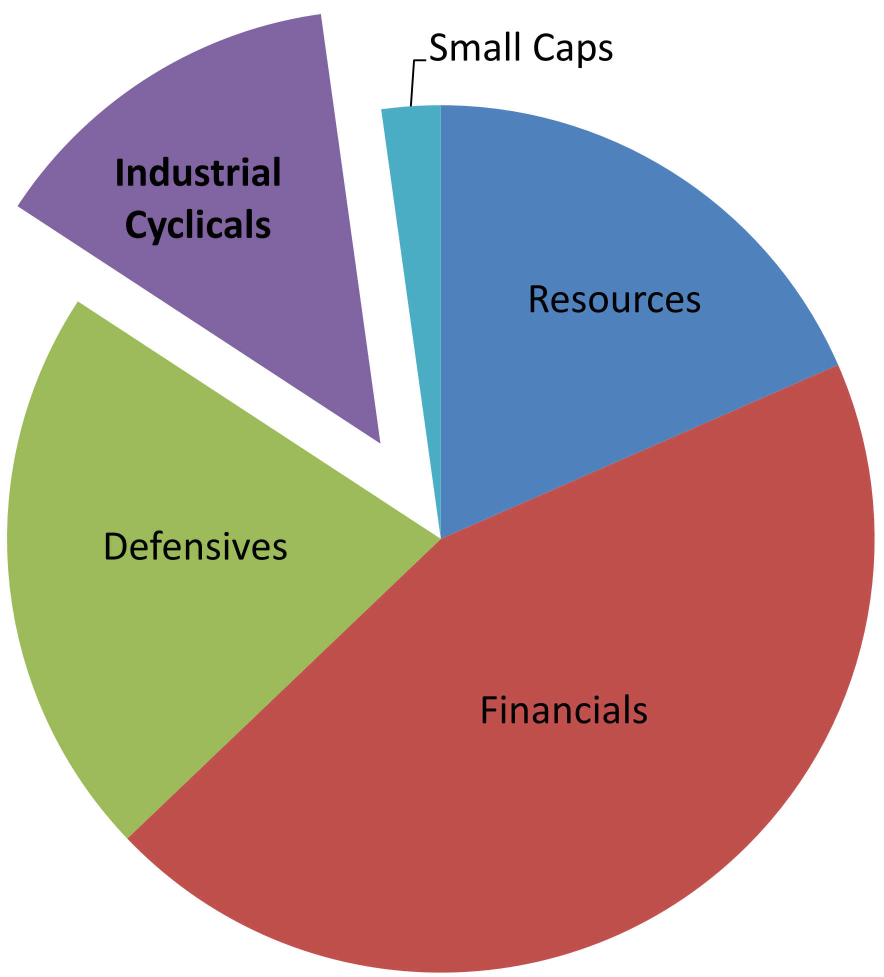




Portfolio exposure to defensives

- Utilities: Large exposure to AGL and Origin, 2-3 years of intense retail competition resulting in margins at a cyclical low, undemanding valuation vs peers.
- Telecom: Large exposure through NextDC, data-centre provider benefiting from trends of the digital economy, recently turned cash-flow positive.
- Retailing Staples: Short the industry due to structural headwinds emerging, in particular the growing market-share of Aldi and its value proposition.
- Healthcare: Aged care emerging as a new sub-industry, attractive industry fundamentals. Resmed is a key investment, launch of new flow-generator a key driver in short-medium term earnings growth.
- Gaming: Large investment in Tatts, attractive lotteries business and turnaround opportunity in underperforming wagering division.

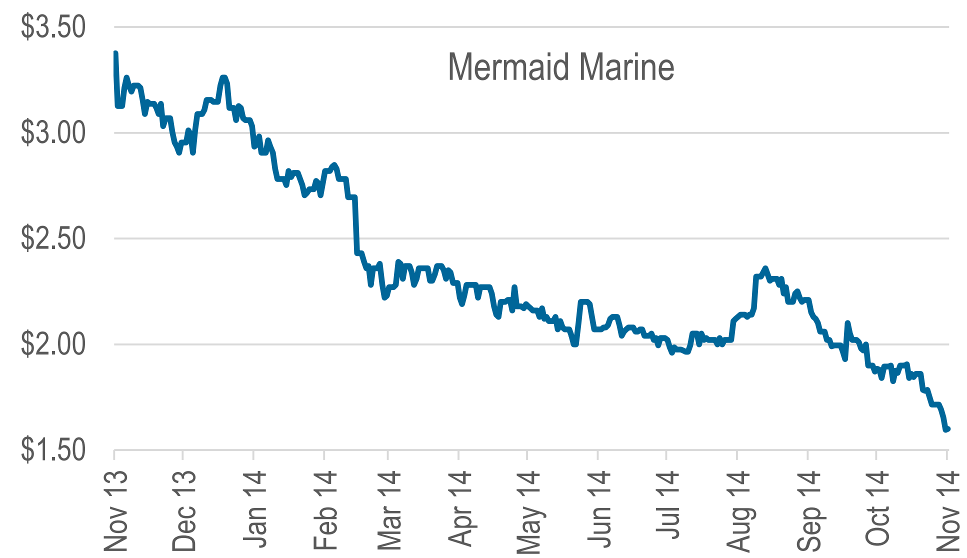
CYCLICALS

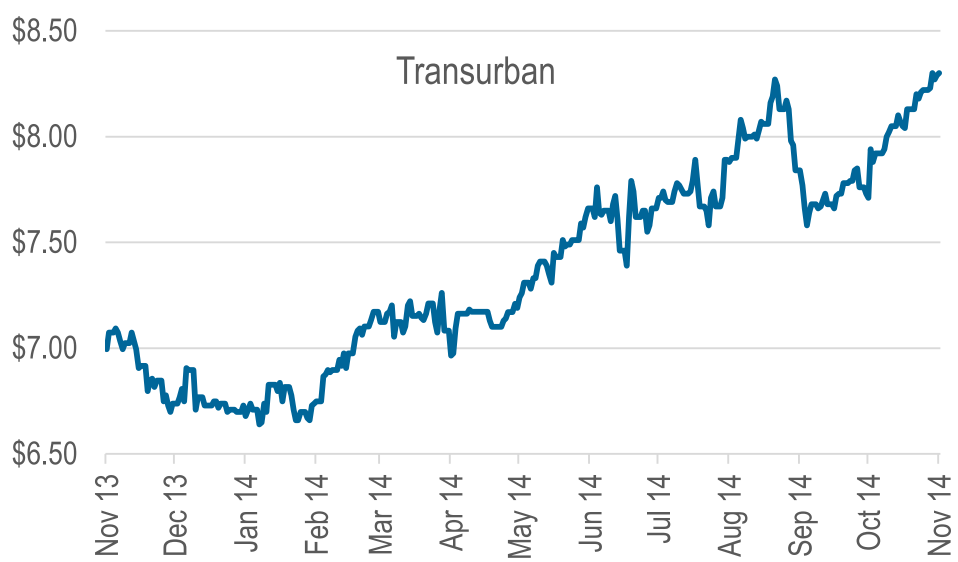


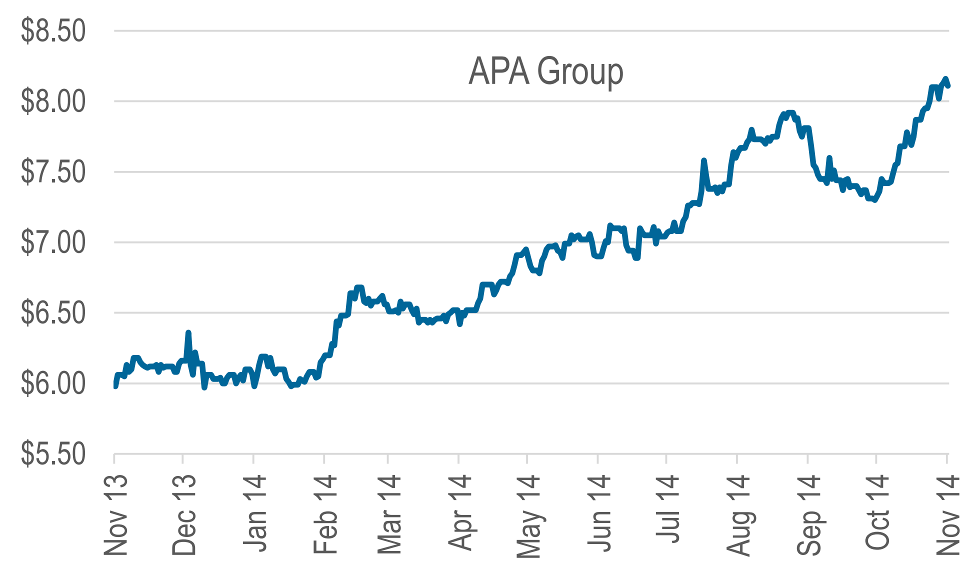
"Cyclical shares will struggle along with the economy "

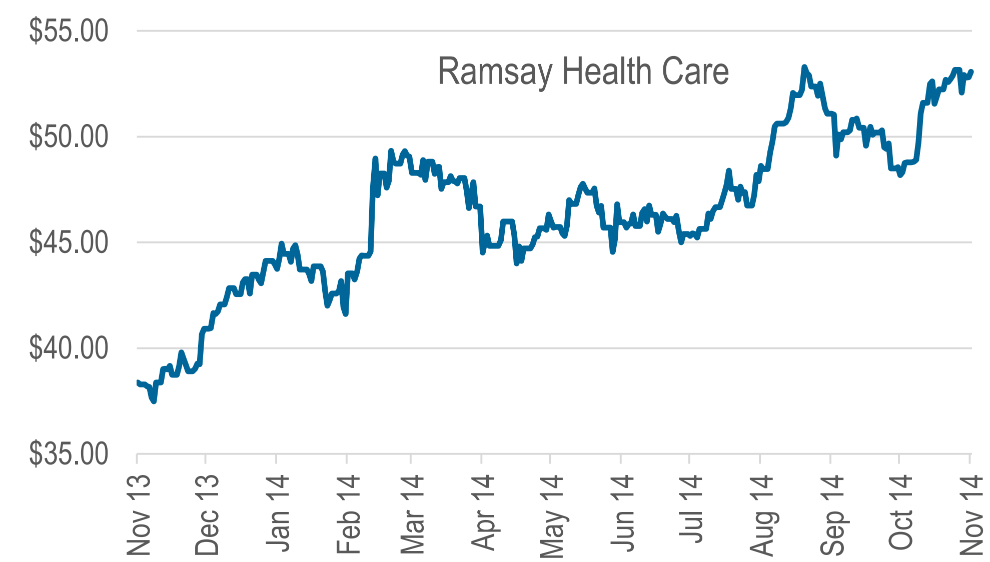
Justin Braitling
Portfolio Manager

Cyclicals vs. Defensives









Cyclical shares have been downgrading

Media

- Fairfax: “Year-to-date overall group revenues for continuing businesses are down 2% to 3% compared to the prior year”
- Seven West Media: “We now expect the TV ad market to be flat to slightly negative in the 2015 financial year”

Retail

- Breville: “Broader business conditions challenging and competitive”
- Big W: “Impacted by increased promotional activity…and ongoing price deflation”
- Super Retail Group: “Gross Margins are tracking below prior comparative period”

Transport

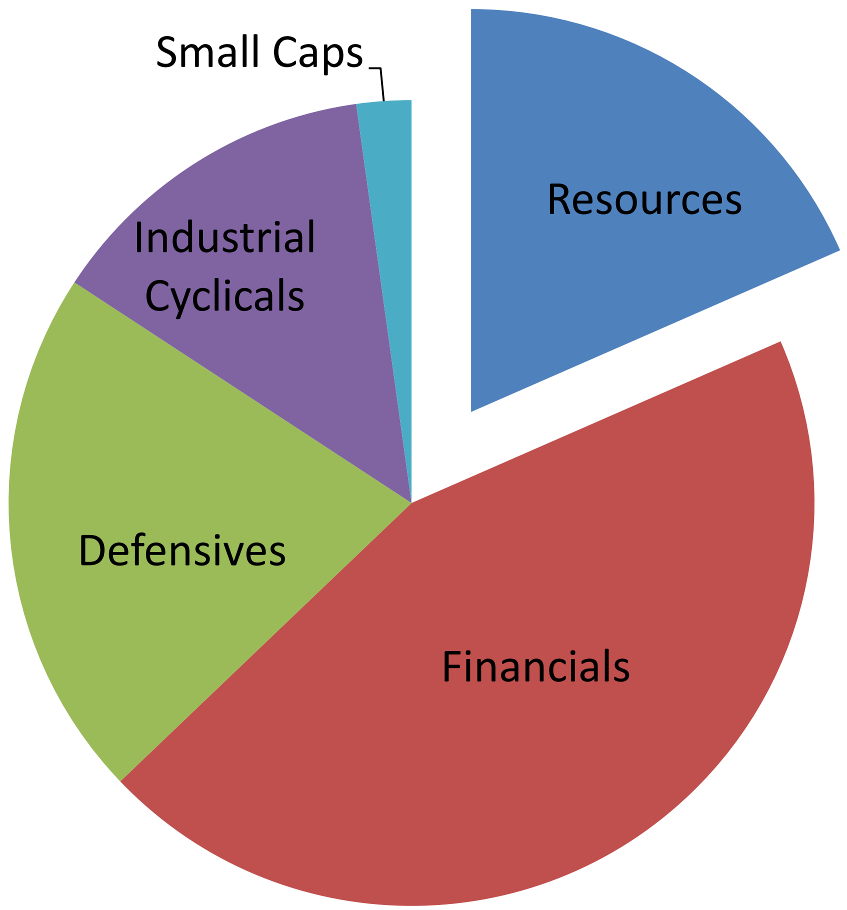
- Toll: “It has been a tough start to the year, with the first quarter weaker than we had expected”

Contractors

- RCR Tomlinson: “We are bidding on a lot of work, but boards are nervous and not awarding the work”

RESOURCES

"Are we at the bottom?"

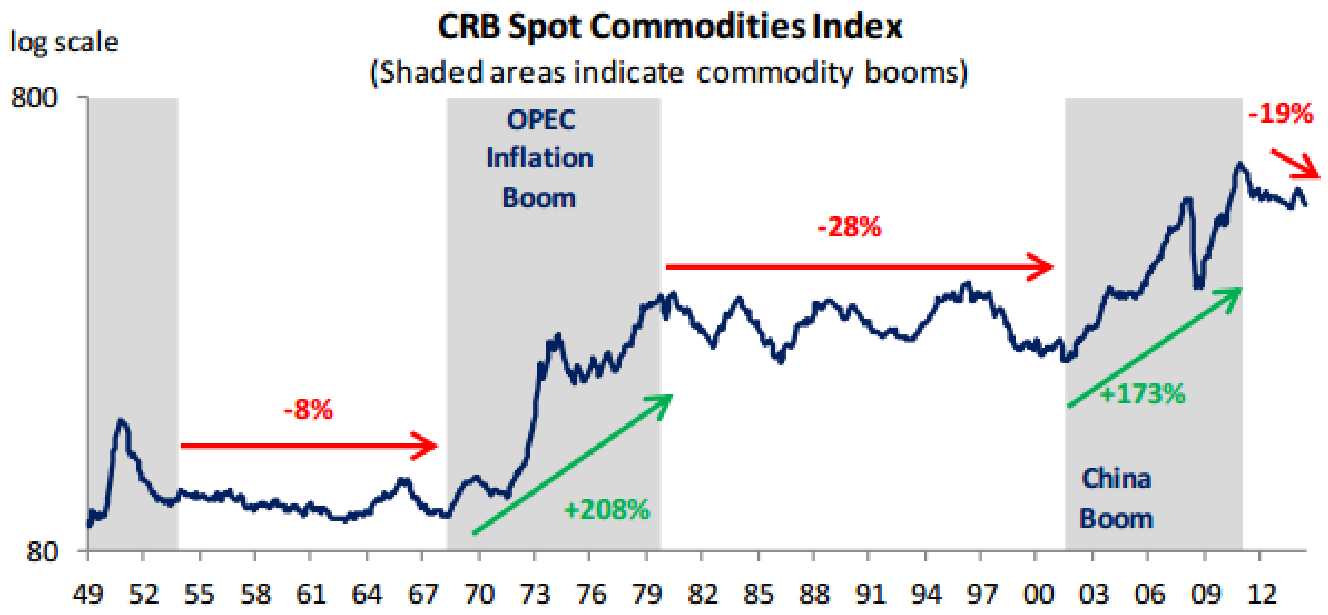


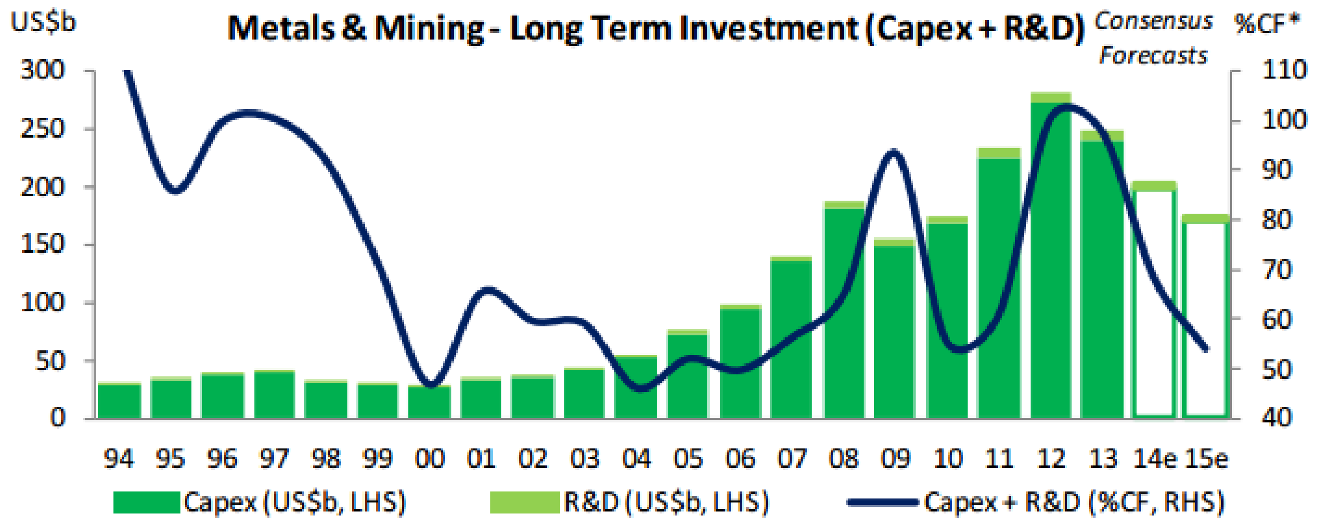
Tom Richardson
Portfolio Manager

RESOURCES

Largely oversupplied markets..

- Chinese demand continues to slow, however we are not expecting a collapse.
- Strong demand for over a decade incentivised large expansions leading to oversupplied markets. This is most prevalent in bulk commodities.
- Cost curves will be lowered in many commodities as mining companies focus on optimization rather than growth.
- The resources sector remains in a bear market trading range.



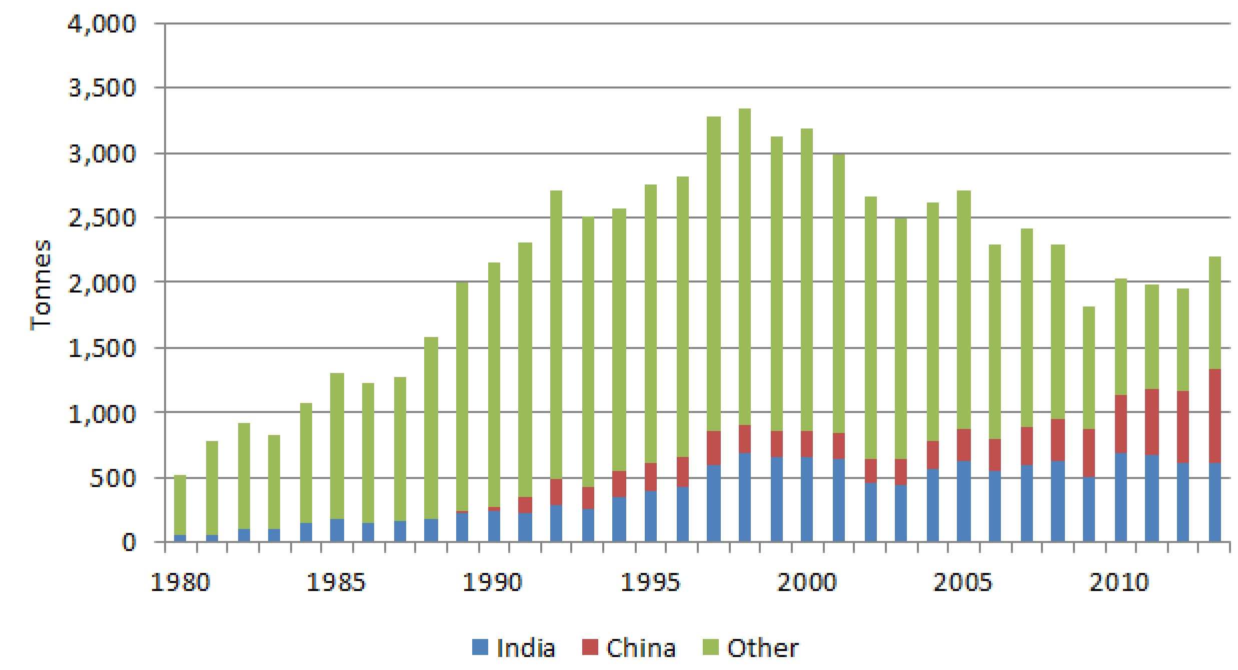


RESOURCES

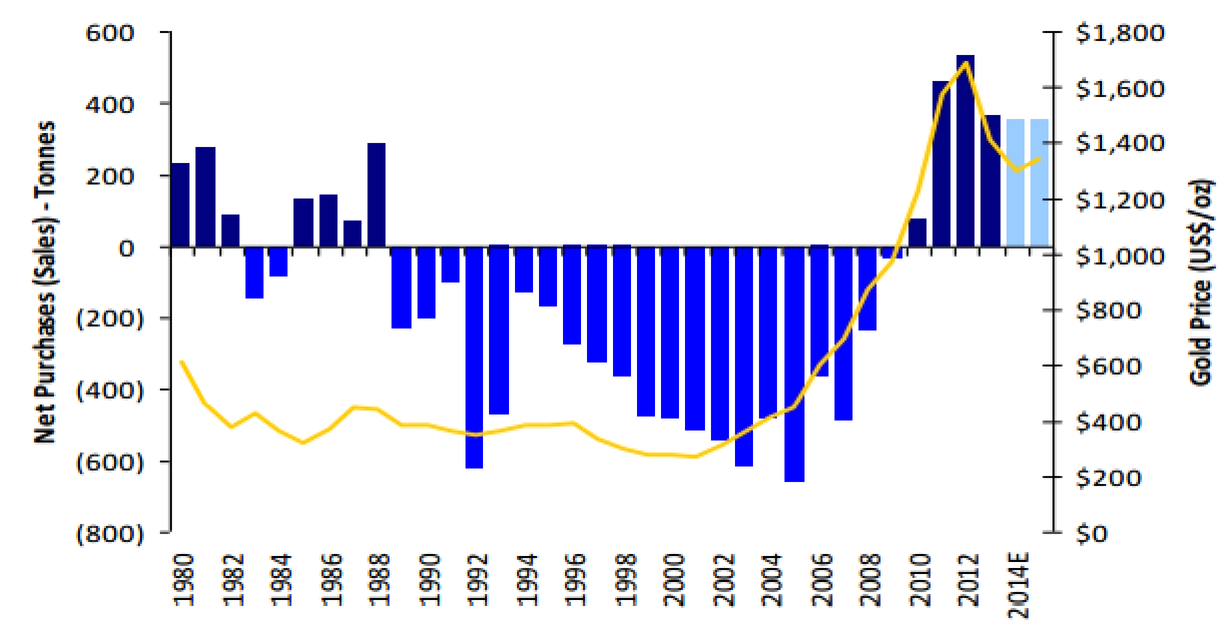
Our investment case for Gold..

- Strong physical demand continues. China and India now dominate, accounting for two-thirds of global jewellery demand and growing strongly.
- Central bank diversification strategies have seen a 20% swing in demand over the last decade. From net sellers of 400 tonnes, to net buyers of 400 tonnes per annum.
- A large amount of supply is unprofitable at the current gold price. Supply expected to reduce in 2015 in response to lower prices.
- While likely to remain highly volatile in the short term, the medium term outlook remains favourable. Value has emerged in this beaten up sector.

Global jewellery demand – China and India dominate

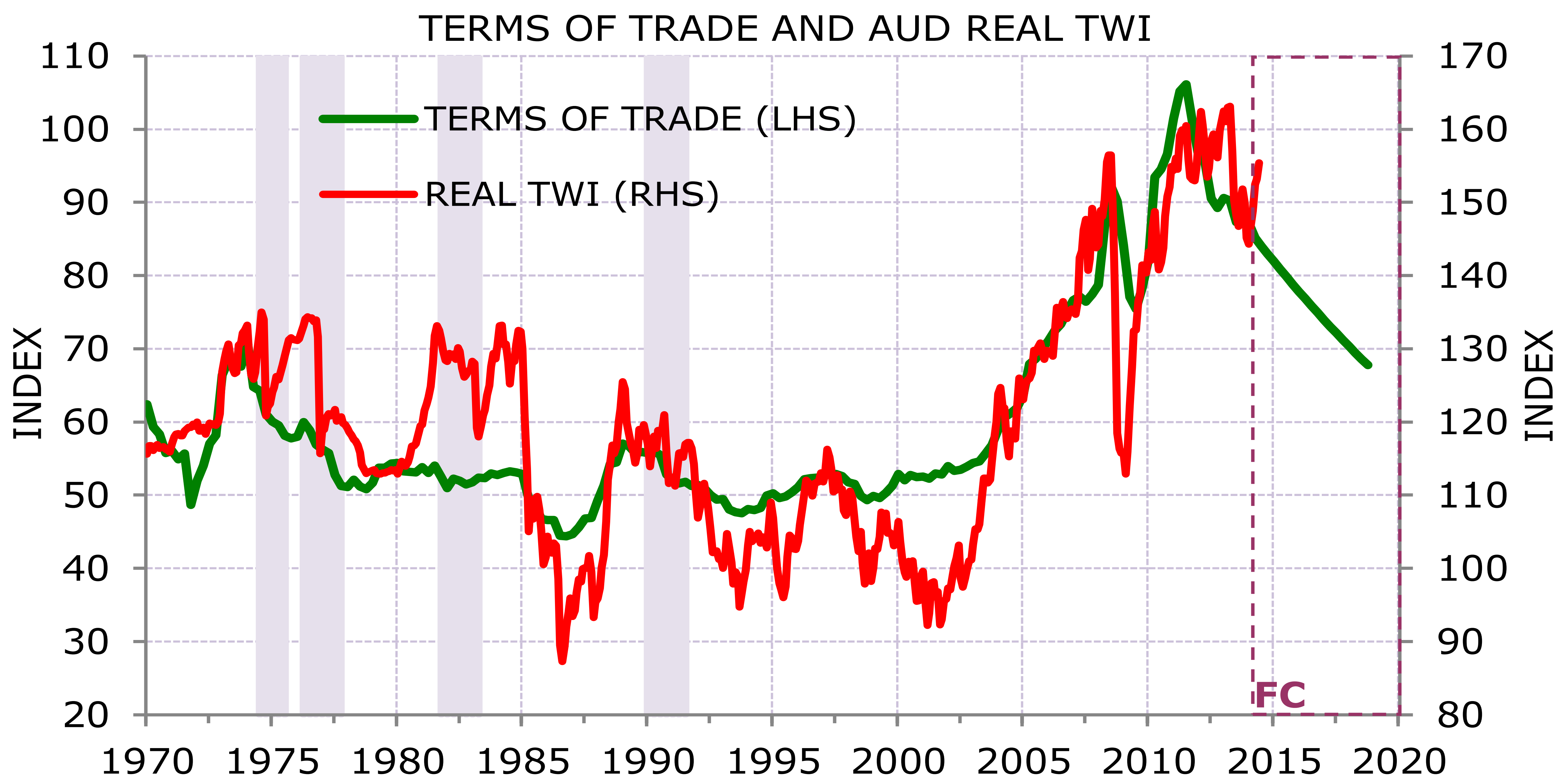


Central Bank participation in the Gold market



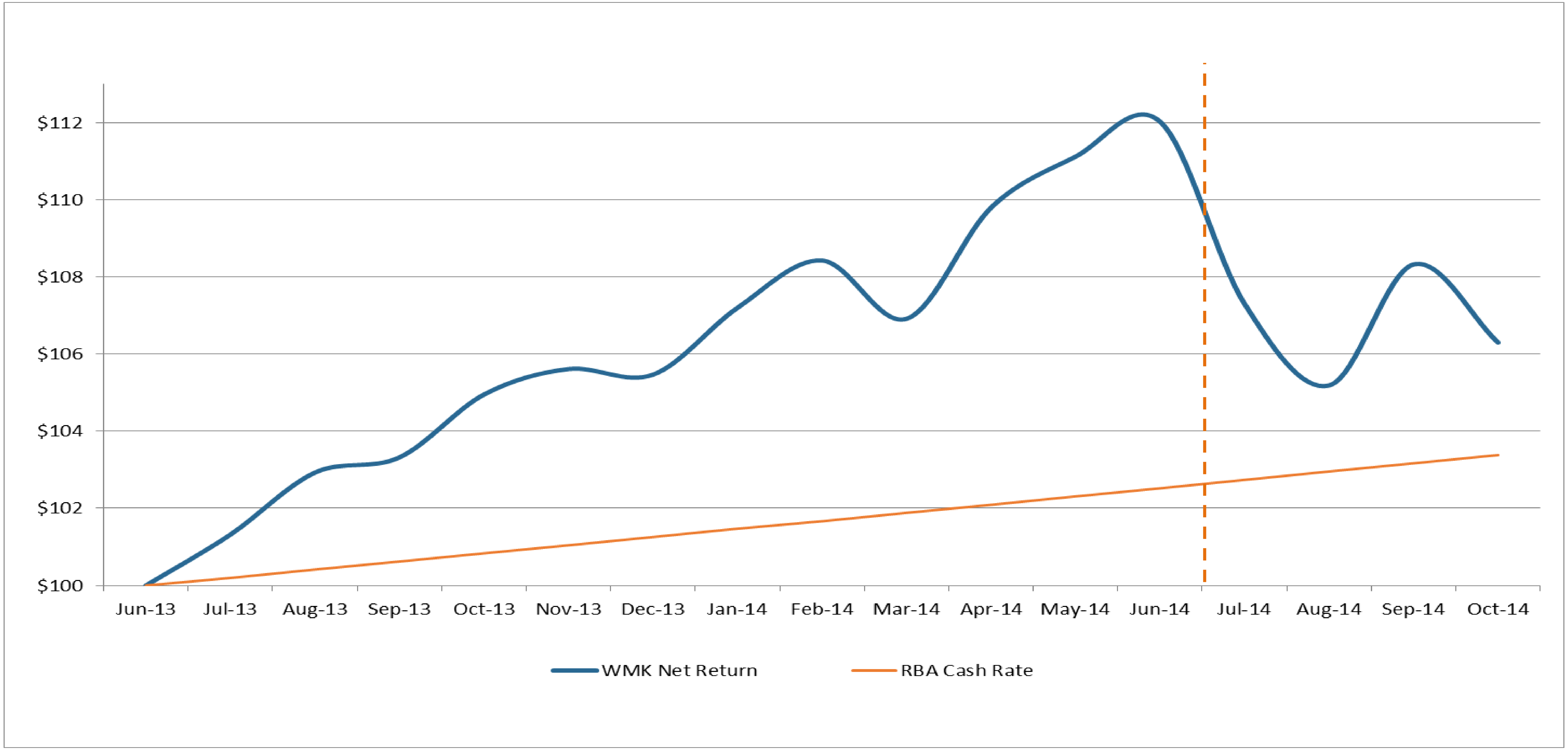
Finishing on a positive note

International Companies to benefit from a lower Australian dollar

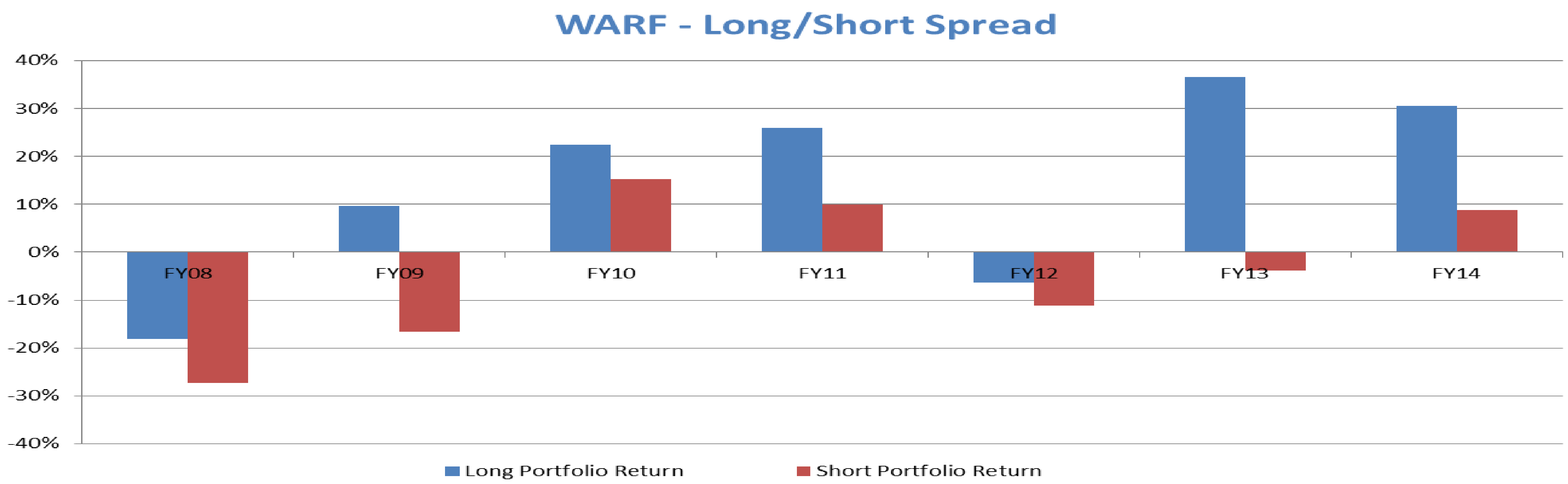


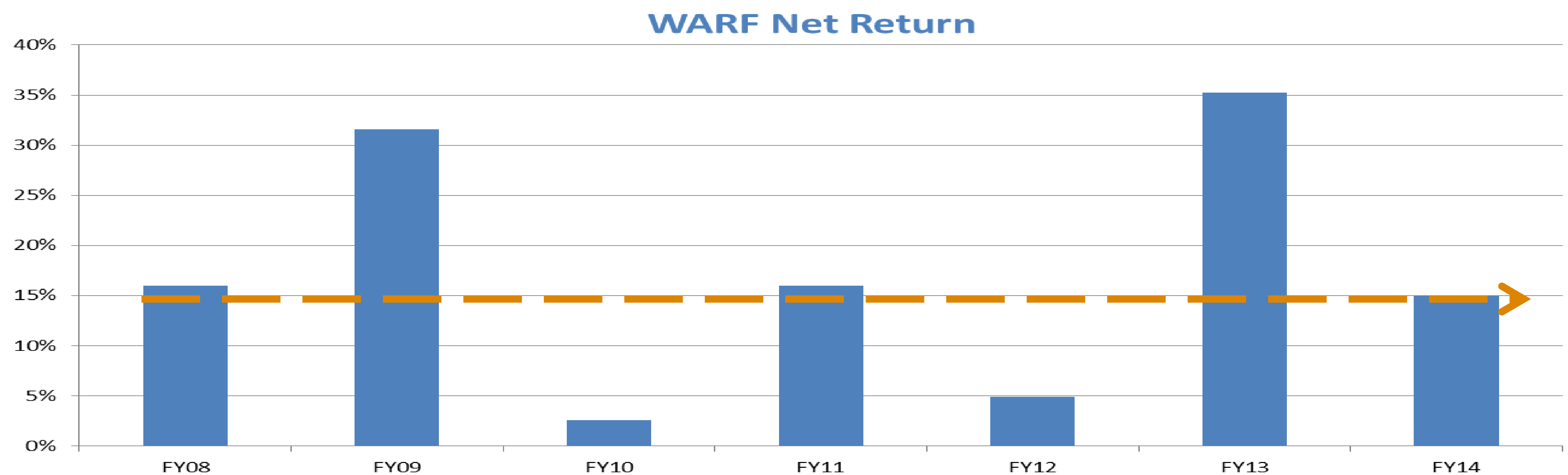
Performance Review

WMK – Net Portfolio Return vs Benchmark



Positive contribution every year





Australian Leaders Fund Ltd

Performance to 31 October 2014 (net of all fees and expenses)

	1 YEAR	3 YEARS (P.A.)	5 YEARS (P.A.)	SI* (P.A.)
Long	0.4%	16.4%	11.1%	-
Short	-2.5%	0.3%	0.6%	-
Net	-0.2%	19.8%	11.2%	14.8%
All Ords. Accum. Index	5.9%	12.9%	7.9%	9.4%
Net Outperformance	-6.2%	6.9%	3.3%	5.4%

* Australian Leaders Fund Ltd inception date is January 2004.

Watermark Market Neutral Fund Ltd

Performance to 31 October 2014 (net of all fees and expenses)

	1 MONTH	6 MONTHS	1 Year	SI* (P.A.)
Long	0.31%	-1.30%	0.95%	-
Short	2.03%	0.19%	-3.29%	-
Net	-1.87%	-3.19%	1.28%	4.72%
RBA Cash Rate	0.21%	1.27%	2.53%	2.54%
Net Outperformance	-2.08%	-4.46%	-1.25%	2.18%

* Watermark Market Neutral Fund Ltd inception date is January 2004.

QUESTIONS