



# The Leading Edge

QUARTERLY REPORT • December 2015

In this edition of *The Leading Edge* we outline the investment case for key positions in the fund's international share portfolio.

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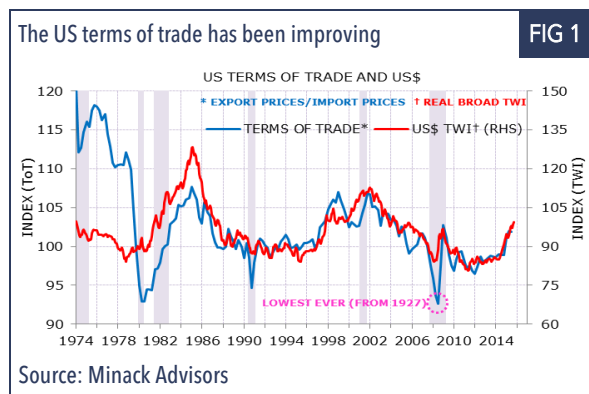


**Justin Braiting**  
Portfolio Manager

## Is this bull market coming to an end?

Policy makers globally have associated softer growth in recent decades with weakness in demand, when in fact economic activity has slowed due to excessive debt and supply side factors. Their attempts at stimulating demand through cheap money have instead led to capital misallocation and excess capacity. Surplus capacity is highly deflationary, which is evident through the extreme weakness we are seeing in commodity prices.

As the world's largest importer of manufactured goods, the US terms of trade have strengthened considerably – and coinciding with an oversupply in many product markets, this has pushed the US dollar sharply higher (**Fig 1**). Divergent monetary policies have further exacerbated this trend as policy rates are now increasing.



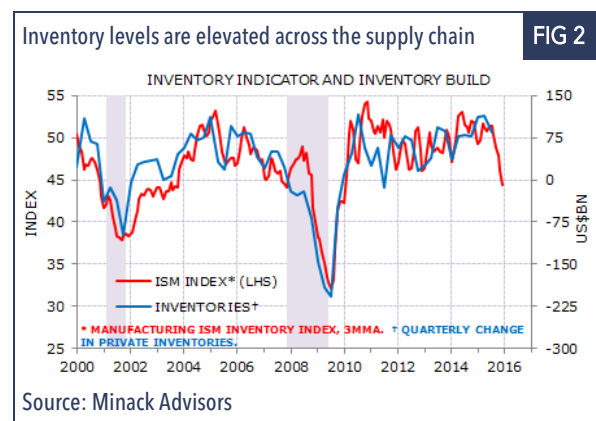
This move essentially represents a tightening of financial conditions globally, but particularly for those countries and companies that have borrowed in US dollars to fund the investment boom – and at a time when central bank liquidity is also tightening (in the US at least). Miners, manufacturers and exporters are all struggling with a stronger dollar, capital repatriation and softer end-markets. The result of all this has been a slowdown in global industrial production and trade.

China of course is at the epicentre here, accounting for much of the excess capacity in these oversupplied

industries. The rebalancing of the Chinese economy away from investment is not going as smoothly as hoped, with the prospect of a hard landing unnerving for both investors and the Chinese leadership. Supply side adjustments such as capacity closures are desperately needed, and whether this happens in China or elsewhere will depend on the level of the renminbi – which is a reason the recent devaluation has unnerved markets.

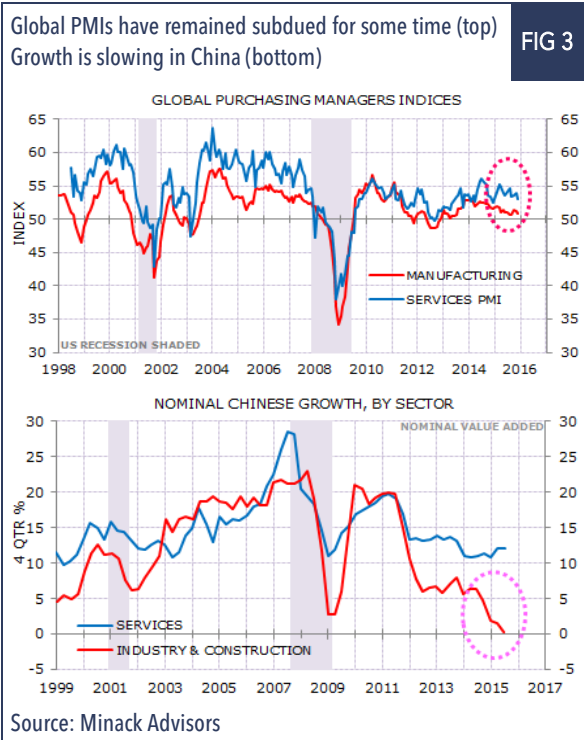
Any further depreciation of the renminbi should be seen as a setback in the rebalancing process, as it would transfer wealth from households to exporters and state-owned enterprises. Similarly, an easing in fiscal and credit conditions is undesirable as it will add to a growing debt burden that is looking unsustainable.

To complicate matters, activity across the OECD was weak in the second half of 2015 in contrast to a second half uplift that occurred during the prior two years. Lower energy prices also failed to boost spending as expected. This has left inventories in the supply chain well above desired levels (**Fig 2**).



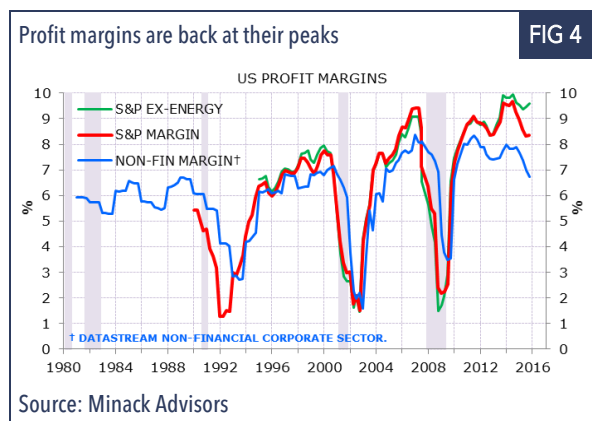
Industrial production is slowing to redress this overhang. This is evident in the US where manufacturers are looking to slash inventories (which the ISM inventory index shows in **Fig 2**), and as an indicator that is normally seen ahead of recession it is further spooking the market.

Investors are wondering whether the global economy can withstand a downturn in industrial production, possibly coinciding with a hard landing in China. Thankfully, the industrial economy is only part of the story given that the services economy is twice its size and has been growing faster in recent years. **Fig 3** shows both at a global level and in China, the sharp weakening in leading indicators of industrial production while the services sector has seen sustained growth. This trend also holds true for the US, where growth in service industries has been strong enough to support labour markets and household income growth.



In short, there is no sign of a recession outside of a handful of emerging economies. It is unlikely that this downturn in industrial activity which may only last a few quarters is enough to kill the ongoing recovery, albeit next year may be more challenging as the cycle matures further.

Indeed, given how far into the cycle we currently stand, asset markets appear increasingly vulnerable to a slowing in activity. The current expansion is looking mature and tired on many fronts. Corporate profits and share valuations are inflated, particularly in the US. Profit growth has slowed to a trickle even after excluding the drag from the energy sector. As the US labour market continues to tighten and the economy moves back to full employment, wages will accelerate from their current record low share of the economy and this will place further pressure on profit margins that are back at cyclical highs (Fig 4).



With earnings stalling and valuations at elevated levels, any upside for the US share market is limited. These trends are evident in the technical indicators as well: the bull market looks tired and has been losing internal strength for over a year as the leadership has narrowed. Whilst the economy will probably hold together for another year or so, the market is losing the upward momentum from earnings and liquidity that have pushed it higher so far this cycle.

Volatility had also moved to unsustainably low levels as investors became overly reliant on monetary policy support. With policy now normalising, risk margins are increasing. Higher volatility has returned, and is most likely here to stay as regulators have limited scope to placate market concerns the way they have in the past.

I am more concerned with the outlook for the Australian economy, where the next six months will be pivotal. Activity has been remarkably resilient given the downturn in mining, again due to growth in the services sector. Employment and consumer spending have remained buoyant despite woeful income growth. Strong asset markets, particularly a booming property sector, are bolstering activity. With asset markets - including property - now losing momentum, we are left with little support as a further round of income and investment shocks hit the economy.

Financial conditions also appear to be tightening at the margin, with funding costs inching higher. We have seen an uptick in plant closures across a range of industries, not just in mining. The two largest auto assemblers have already announced they will be exiting Australia later this year. The labour market is the key indicator to watch here, and we would expect to see unemployment move higher in the year ahead.

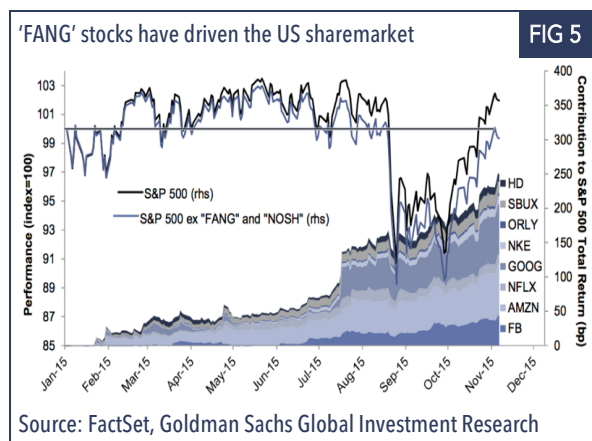
We have talked extensively about the challenges facing many of our leading public companies. Most of these are highly profitably leaders in concentrated industries. In many instances, the high returns on offer are attracting new competition, with challengers often employing disruptive technologies to gain a foothold. This is playing out in grocery retailing, telecom, banking, insurance, media and energy markets. The industry concentration is replicated in the share market, with the largest ten companies accounting for half of the share market by value. As we expect limited growth ahead for many of these companies, returns from investing in Australian shares are also likely to be low in the medium term.

With this backdrop of limited upside in key offshore markets and challenges ahead for the Australian economy, we maintain our fully hedged position across all funds with minimal exposure to the broader share market.

## Media & Internet

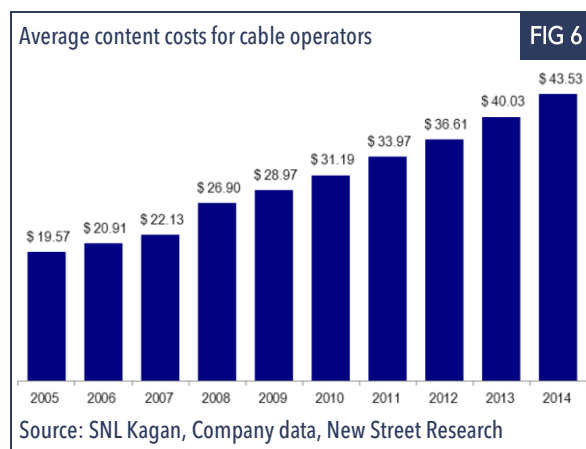
In a previous edition of *The Leading Edge* we described how technology is changing the global media landscape. Consumers now absorb content from numerous sources on multiple devices. This disintermediation of viewership is a challenge to advertisers seeking effective reach and targeted messaging. The massive shift to mobile by consumers over the last few years has forced business models to adapt – even digital ones. While the demise of newspapers and magazines is well understood, leakage of eyeballs from TV and other traditional media has only just begun.

With these changes impacting a large swath of media companies, it is hardly surprising that advertisers and investors are congregating around a narrow group of proven models with strong franchises. The ‘FANG’ group of companies – Facebook, Amazon, Netflix and Google – have become bellwether stocks for not only the media sector but the broader share market, due to their strong performance in 2015 (**Fig 5**). Their success has been to the detriment of others, as their pilfering of ad dollars from competitors has seen second-tier digital companies such as Twitter, Yahoo and Zillow being deserted by investors. While we continue to investigate these market leaders and perhaps look for an opportunity to invest, to date our focus has been on companies that we believe will struggle in this new environment.

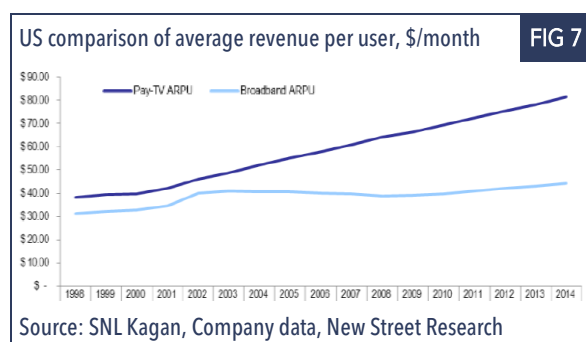


The US Pay-TV ecosystem has grown rapidly over the past few decades from roughly 50 million households in 1994 to 100 million by 2008. The number of cable channels grew from 30 to more than 100 over the same period, thrusting content on consumers under the ‘all you can eat’ distribution model. Content providers began charging Pay-TV operators ever-increasing license fees, and ultimately these costs were passed through to consumers at highly inflated rates (**Fig 6**). Protecting the margins of the Pay-TV operators was the

rapid uptake of broadband services and mobile telephony that was bundled alongside it. This industry became fat and happy.



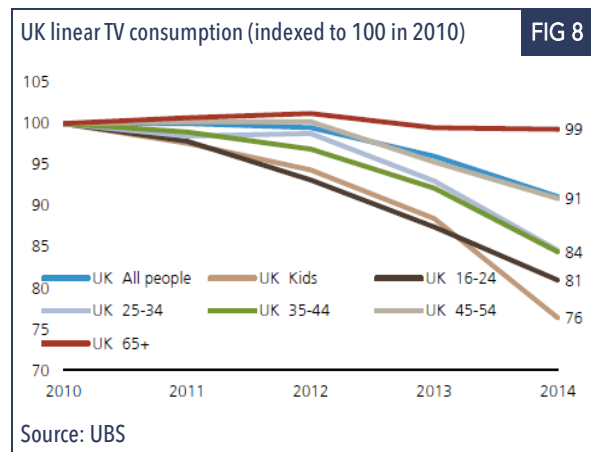
However such rampant content inflation is coming to an end as online streaming gains prominence. Consumers, fed up with higher and higher charges for bundled Pay-TV, have begun ‘cord-cutting’ and in many instances are subscribing to much cheaper streaming services. Recognising this discontent, Pay-TV operators are pushing back on licensing fees and are launching their own ‘skinny bundles’ which allow consumers greater choice of channels. Importantly for the Pay-TV operators, online consumption continues to rise, hence enabling a profit shift from video to broadband. Interestingly, despite this shift in consumption patterns, Pay-TV costs have more than doubled over the last two decades while the price of broadband is broadly flat (**Fig 7**).



With this dynamic in mind we are short Dish Network, which is a direct broadcast satellite (DBS) subscription television business. Satellite broadcasting emerged as a lucrative distribution means to regional cities in the 1990s. Importantly though, DBS operators do not have the luxury of large scale broadband offerings and rely solely on video subscriptions for revenue. Not only is this revenue stream under threat as consumers shift to lower priced streaming services, but even if consumers remain on Pay-TV subscriptions Dish’s margins will be under pressure from

rising content costs. With net debt of \$12 billion that has funded ambitious and questionable spectrum acquisitions, we believe the company's outlook is worrying.

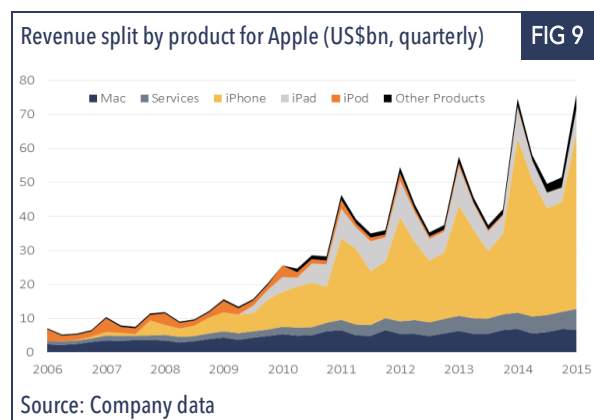
We have also explored this thematic globally. ITV is the dominant Free-To-Air broadcaster in the UK. The company has performed exceptionally well since the financial crisis: keeping content costs managed to zero inflation, investing in international studios and building distribution. However, we believe a fragmentation of audiences is emerging with linear viewership down 10% since 2010, including younger demographics being down significantly more. Not only are absolute audiences declining, but ITV's share of viewership is at a 5 year low. We believe this is as a result of reduced content spend and ultimately not attracting audiences (**Fig 8**). While a strong UK ad market and limited mass-reach alternatives are driving strong results this year, we believe the growing gap between viewership and ad spend will inevitably close.



## Technology: Apple Inc.

### Introduction to Apple

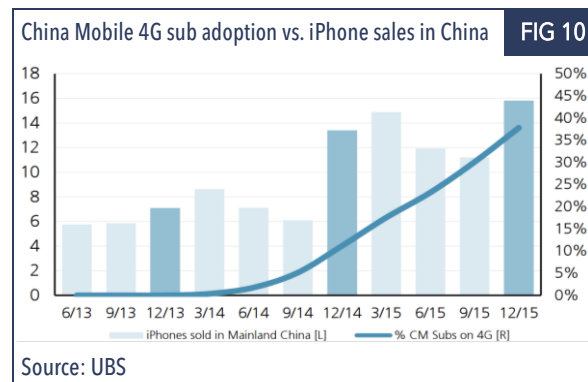
Most readers would probably not be surprised to hear that Apple is the largest company in the world. What many may not know is that Apple earns approximately  $\frac{3}{4}$  of its gross profits from the iPhone, with the remainder more or less evenly distributed amongst iPads, Macs, "Services" (which includes AppStore revenues) and "Other Products" (which includes iPods, the Apple Watch and Apple TV). Indeed, iPad sales have been slowing in recent years due to heightened competition from cheaper Android tablets, Mac sales are broadly stable, iPods are a declining product given much of the functionality has now been replicated by smartphones and the Apple Watches and TVs are yet to reach meaningful scale. This means that all of Apple's growth is currently being driven by sales of the iPhone and to a lesser extent Services revenue, which while still small in magnitude is growing steadily (**Fig 9**). Over time the smartphone has become an indispensable aid so we take no immediate issue to this – in fact as we will outline in this piece, the market's fears that Apple is a 'one-trick pony' also appear misplaced.



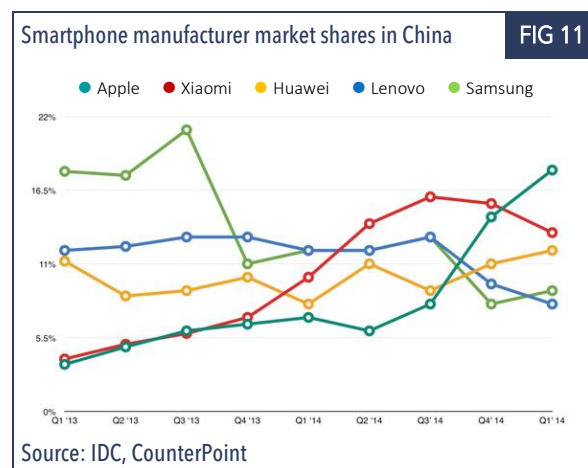
### The Great Opportunity of China

Income growth and investments in mobile infrastructure in emerging markets such as China and India present Apple with a previously untapped market for the iPhone, which launched in China to great fervour in 2009. One issue with this was that the largest Chinese mobile carrier, China Mobile – which is in fact the largest mobile carrier in the world with 830 million customers (compared to Telstra's 17 million) – was relying on a proprietary 3G technology that was incompatible with iPhone handsets. Opportunistically, in mid-2014 Apple began selling the 4G-enabled iPhone 6 on China Mobile just as the carrier was launching the first 4G network in China. It is evident that China Mobile has seen

considerable subscriber momentum on the back of this, which Apple has benefitted from (**Fig 10**). Apple's sales in Greater China are now 25% of its total sales and contribute half of the growth in total sales after growing a massive 100% year-on-year during recent quarters; albeit this has slowed slightly due to softer macroeconomic conditions.



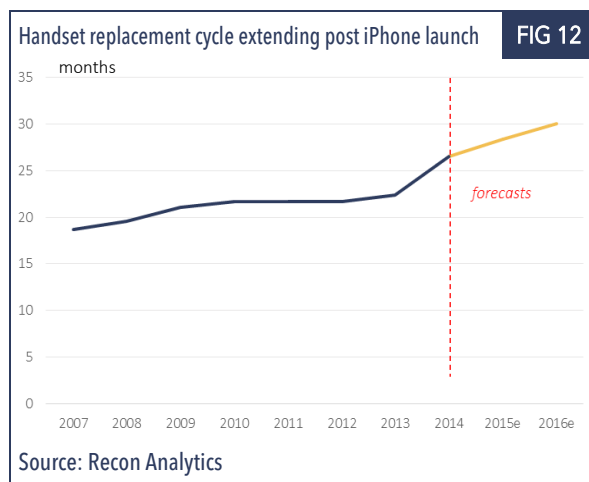
Nonetheless, the market opportunity here is clear. China is the world's most populous nation at 1.57 billion people. Smartphone handset shipments are currently running at around 400 million units per year, which Apple currently leads with a 15% market share (**Fig 11**). However, historically this has been a market dominated by cheaper low and mid-range 3G handsets from the likes of Chinese manufacturers such as Xiaomi and Huawei (who take second and third place in market share respectively). 4G penetration in China is currently only ~25%, and as Chinese consumers (including a growing middle and upper class) churn onto more expensive 4G handsets Apple will continue to take share. A recent consumer survey conducted by BofA Merrill Lynch found that although only 24% of respondents currently owned iPhones, 39% expected to buy an iPhone when they next purchase a smartphone. More interestingly, 50% of respondents who currently own an iPhone expected to buy a new iPhone within the next year – which feeds into the next part of our investment thesis.





## Is the handset replacement cycle stabilising?

One headwind faced by the iPhone is an ever-extending handset replacement cycle, which measures how often on average consumers will upgrade their phones. **Fig 12** shows that in the US while this period was historically just below the typical 2-year contract length at around 19 months, it is on track to nearly double as newer handsets are incrementally less innovative and consumers are happy to hold onto their older handsets for longer. However there has been a fundamental shift in the industry which is likely to play out to the benefit of handset manufacturers.



Traditionally wireless carriers have subsidised the price of a handset on contracted plans to encourage locking customers into generally 2-year commitments. US carriers are all no longer offering subsidised contracts to new customers, and led the disruption of this model into one which separates the service component to the price of a handset which is now entirely borne by the customer over the life of their contract. There has also been an introduction of early upgrade options – so in exchange for a higher service fee per month, the carrier will provide you with a new phone every specified period (usually 12 – 24 months) if you trade in your old one. Last quarter Apple announced the launch of their own iPhone Upgrade Program in the US, where for a monthly ‘rental’ fee Apple will let you trade in your old iPhone for a new one every year. These so-called leasing plans are more profitable for carriers as they eliminate subsidies and are priced higher, while providing the illusion of flexibility to the consumer.

The real beauty in these plans is that they are also beneficial to handset manufacturers such as Apple since they will shorten the handset replacement cycle for consumers adopting them. One of the key issues in Apple’s latest financial result was that the iPhone 6S release brought only incremental upgrades to prior models and existing iPhone

users found little reason to upgrade. In fact, 50% of iPhone sales are currently going to new users – which is a healthy metric as it shows Apple have not yet reached saturation in market share and there is still interest in the product. Consumers’ decision to purchase a new smartphone is typically either a biannual event as their carrier contract expires, or requires a high upfront expense if purchasing a handset outright. As the handset replacement cycle shortens, the mindset will shift such that a monthly ‘handset fee’ becomes just another item on the household budget alongside paying the wireless carrier for their service. In this world, even if the upgrades are incremental, who wouldn’t pay a few dollars extra a month to be given a brand new iPhone every year?

Aside from increasing demand for Apple’s products, this will reduce the cyclical nature associated with selling hardware as on a leasing plan consumers will predictably require a new phone each year. Which brings us to our next point...

## Apple as an annuity business

The iPhone constitutes  $\frac{2}{3}$  of Apple’s sales and  $\frac{3}{4}$  of its gross profits, so the performance of this division is understandably at the forefront of investors’ minds. However it’s important to understand that Apple does not only sell hardware, but it sells an ecosystem. Apple’s not just selling you a smartphone, but one which provides you with access to millions of apps on its AppStore, lets you connect to music through the iTunes Store or Apple Music, control your Apple TV, transfer files wirelessly to your Macbook and sync your personal accounts with those on your iPad. Consumers who own more Apple products and own them for longer will become further entrenched in this ecosystem, and statistically will both spend more on Apple products going forward as well as being less likely to move to another ecosystem. Research by Morgan Stanley showed that Apple’s brand retention is the strongest in the industry, with 90% of existing iPhone users likely to buy an iPhone again. It comes as no surprise that Apple is the world’s most valuable and recognisable brand (Forbes, Interbrand 2015).

The result is that instead of being viewed as a cyclical hardware business, Apple starts to look like a more defensive annuity business selling services to a (perhaps more slowly) growing userbase (Apple announced its active installed base of devices reached 1 billion at its recent quarterly result). Apple’s Services segment is healthily growing revenues at 15% a year, while the transactional revenues generated through the use of Apple devices is growing 25%. The fact that Services revenues are growing faster than device sales is a positive as it indicates Apple is

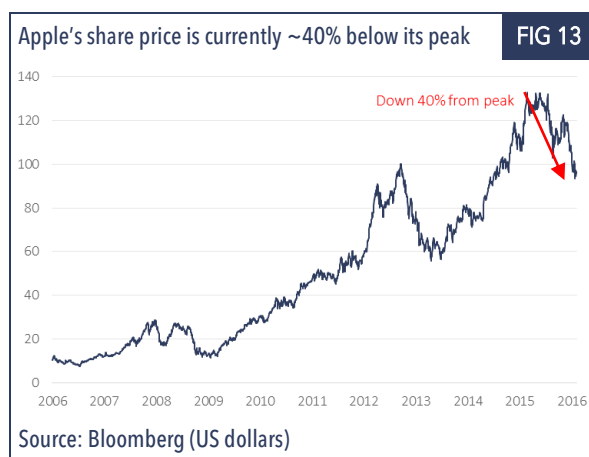


doing better at monetising its existing customer base. Furthermore, with the aforementioned shift to leasing plans from the carriers, consumers will purchase new smartphones on a more regular and frequent cycle as opposed to the generally 'major' purchasing decision a new smartphone might be today.

It's also prudent to mention that Apple's ever-growing cash balance (currently at US\$215 billion - or equivalent to a third of the market cap) will provide opportunities for Apple to invest in new products (rumoured: virtual reality, or electric cars) for future growth.

### Why is Apple so cheap?

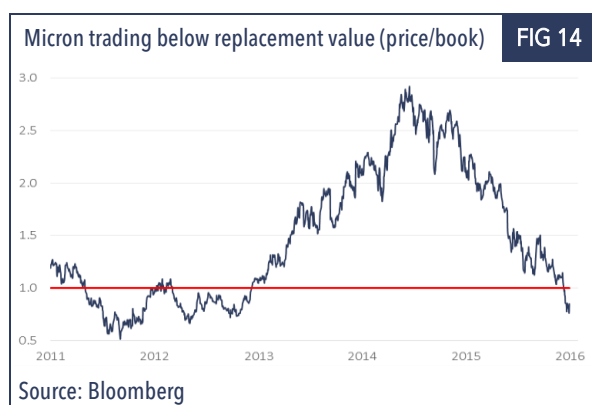
Since the launch of the iPhone in 2007, Apple has grown its sales tenfold. Apple shares have also performed strongly during this period, however sentiment around the company has recently mellowed as concerns arose over whether Apple and the iPhone in particular can sustain this growth. Apple's current share price is 42% below its peak (**Fig 13**), and implies that cash flows generated by the business will decline at ~8%/year into perpetuity. We believe it is clear that the market's short-term focus around quarterly iPhone sales is underestimating the opportunities we have presented above. Apple is currently trading at an 8.5x 1-year forward P/E, near a historical low for the company over the last 10 years. We note that there are any few companies in the ASX 100 to be found at such attractive valuations, much less a company with such a proven track record of value creation and innovation as Apple, and see this as an excellent entry point into the stock.



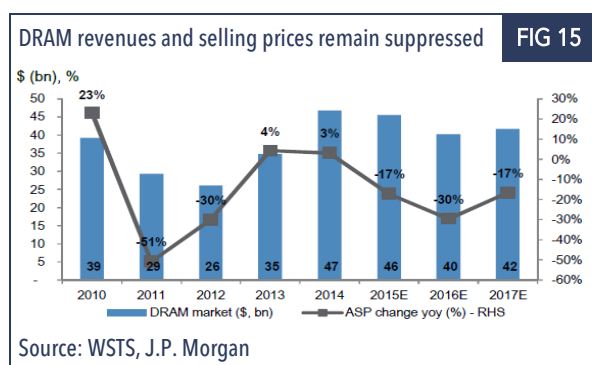
## Technology: Micron Technology

Over the last month we have opportunistically acquired shares of Micron Technologies, a global leader in memory semiconductors. The company develops and manufactures memory chips and products such as Dynamic Random Access Memory (DRAM) which manages storage for applications and NAND Flash memory which is where files are physically stored. Key consumer and enterprise end-markets include mobile handsets, PCs and solid-state drives for storage. The company is a leader in the development of next generation memory technologies, and we believe the current share price significantly undervalues the strategic importance of these future products.

Micron shares have fallen by more than 60% over the last year and are cheap on all valuation metrics. The shares are trading well below replacement value (Fig 14). We are also comforted by the fact that last July Micron received takeover interest from Chinese tech firm Tsinghua Unigroup, with the current enterprise value of Micron nearly half of the reported bid price.

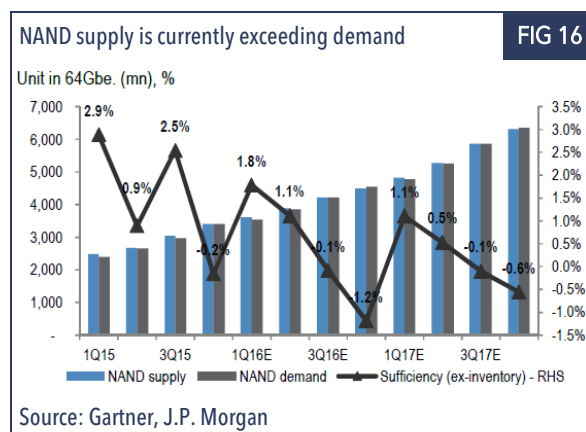


Micron is currently working through a low point in the cycle and is towards the end of an intensive investment period. Weak demand for NAND and DRAM memory has been driven by soft PC sales and maturing growth in smartphones. Oversupply of memory inventory at distributors led to significant declines in DRAM and NAND prices (Fig 15).



While it is hard to determine exactly how far we are through the inventory channel correction, we believe that overall this cycle will not be as severe and protracted as seen in past cycles.

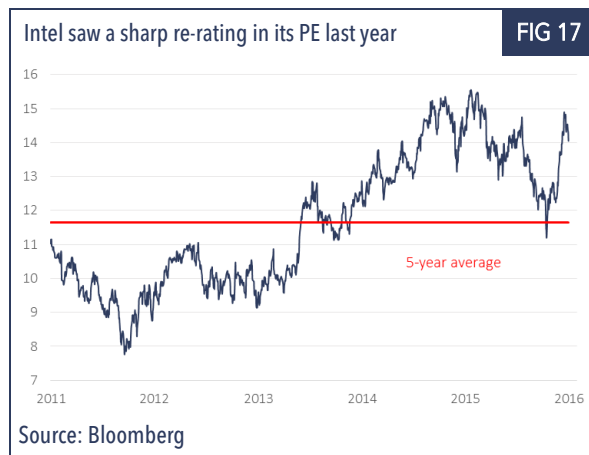
The DRAM industry is significantly more consolidated compared to previous cycles and we expect disciplined behaviour from manufacturers. Additionally, Micron's DRAM focus is shifting more towards higher-end and next generation products. Following the steep price declines we have already seen, we believe there will be a less protracted memory cycle as device manufacturers are producing a greater proportion of high-end DRAM content across PCs, mobile and servers. Similarly, we believe that recent price declines in NAND should spur greater demand growth for mobile and solid-state drives. Unlike with DRAM, the NAND industry remains highly fragmented and further consolidation is highly likely under the current stressed market conditions (Fig 16).



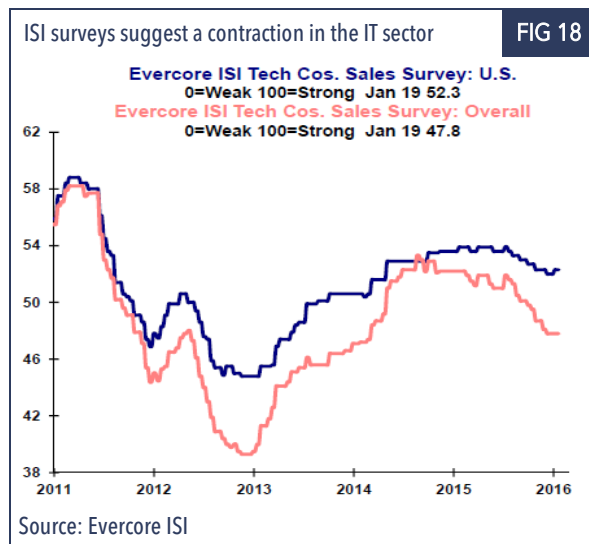
At trough valuation levels the investment risk profile is becoming more favourable, and so we expect to keep opportunistically adding to Micron.

## Technology: Intel Corporation

Intel is a global leader in integrated circuit design and manufacturing – and one with a lot to lose. Intel chips hold strong positions in notebooks, PCs, tablets and less so in smartphones and wireless connectivity devices. Intel became a core short position following a sharp re-rating in its shares late last year (**Fig 17**).



Intel's valuation does not align with the sector trends in its major end markets, given declining PC and tablets sales, a maturing smartphones market and a weak enterprise IT spending outlook. Recent industry surveys of technology companies' sales outlooks indicate that the sector is contracting, particularly outside of the US (**Fig 18**).



The capital investment required for Intel to maintain its market leading position in bleeding edge technology chips is accelerating. Technical difficulties and execution risks are also more pronounced relative to history, meaning there is an increased risk of Intel destroying value in its attempts to push the technology curve forward.

Intel's dominance of the server market, with ~98% share, also is under threat from ARM Holdings, which has announced its intent to regain share in this profitable market.

We have also noticed the emergence of a number of accounting and management 'red flags'. The company's recent quarterly results were weak and of poor quality in our view. Management's decision to extend the useful life of equipment overstates earnings which would otherwise have been lower going forward. Recent changes to segmental reporting now make analysis of pricing trends difficult, suggesting pricing pressures may be building.

Given the numerous risks to Intel's business, we believe Intel shares should be de-rated.



## Healthcare sector

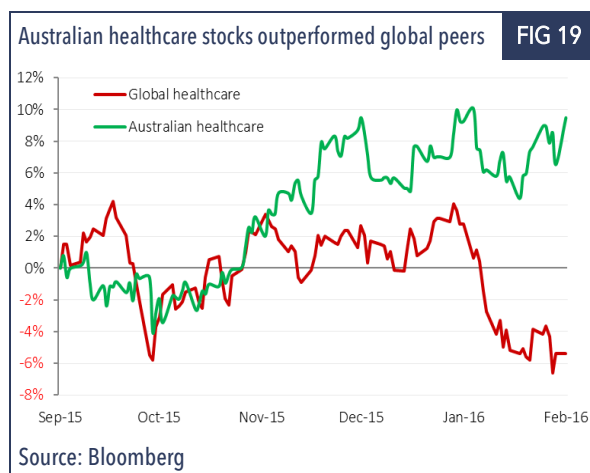
### Trends in global pharmaceuticals

Following a significant re-rating post the GFC, global healthcare shares entered a period of increased volatility in the latter half of 2015. Biotechnology and specialty pharmaceutical shares were key drivers of the post-GFC recovery, however their stellar run came to an end in September when drug pricing and affordability were thrust into the spotlight.

Hillary Clinton famously accused Turing Pharmaceuticals on Twitter of 'outrageous' price gouging following its decision to raise prices of a 62-year-old drug (Daraprim) to \$750 per tablet from \$13.50. Her comments sparked a sell-off in biotechnology and specialty pharmaceutical shares. Drug pricing is now an election campaign issue in the US with some candidates talking of price regulation.

At a similar time, the dubious business practices of specialty drug-maker Valent Pharmaceuticals became a subject of intense public scrutiny leading to a congressional investigation; Valeant shares have more than halved since. In response, pharmaceutical executives argue that price hikes are rarely realised in full by the manufacturer (with the majority given away through rebates) and reflect the high risk, high costs and long timeframes associated with developing new drugs.

Interestingly Australian healthcare shares did not react to the same issues (Fig 19), and were driven by more stock-specific moves.



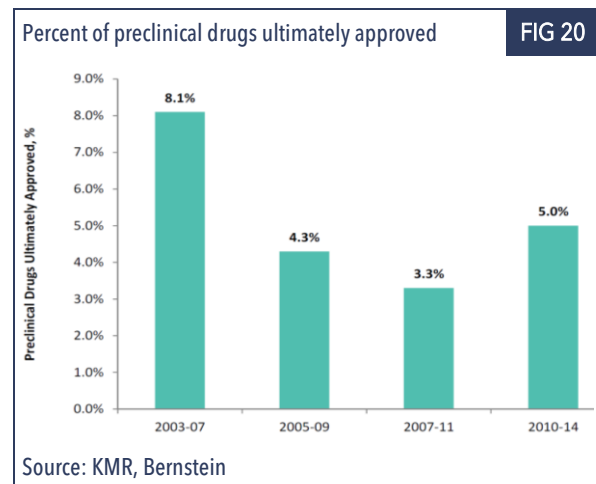
With a large proportion of earnings derived offshore, the weaker A\$ has benefitted domestic healthcare shares. In addition, more money has flowed into domestic healthcare given it is one of the few remaining pockets of growth in our share market. As a result, the domestic sector currently

trades at historically high valuations versus offshore peers. However, given Australian healthcare companies face many of the same risks as their international peers, we are finding better opportunities to invest offshore.

### Falling off the patent cliff?

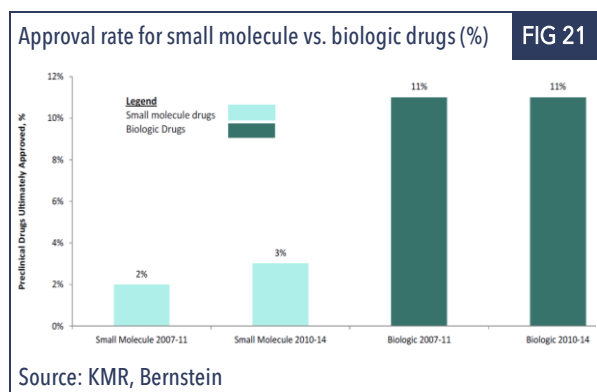
The 'patent cliff' refers to a period between 2003 and 2013 when drug patents that protected many of the highest selling drugs in history from competition expired. The industry reacted by undertaking a wave of M&A deals while also increasing investment in lower risk drug development ('biologics') to diversify. A period of recovery and improved R&D productivity ensued.

A more subtle driver of the previous cycle was a decline in R&D productivity, which has improved since then through higher investments in lower risk drug development. Fig 20 shows that the probability of success in developing new 'small molecule' drugs was in clear decline between 2003 and 2011, meaning companies had to conduct more trials with more drug candidates to get drugs approved. Recent data shows a reversal of this trend from 2010 to 2014, coinciding with a recovery in pharmaceutical valuations.



In our view, the more relevant and striking driver of productivity improvement has been the development of a new drug class called biologics. The data in Fig 21 shows that biologics carry a dramatically higher likelihood of success in being developed compared to small molecule drugs, and so those companies developing more biologic drugs are more likely to have a greater number of successful products. Small molecule drugs are synthetically produced chemicals where the drug chemistry and structure is known but often carry less favourable side effects. Biologics on the other hand are treatments made by manipulating naturally occurring systems. Because they mimic naturally occurring

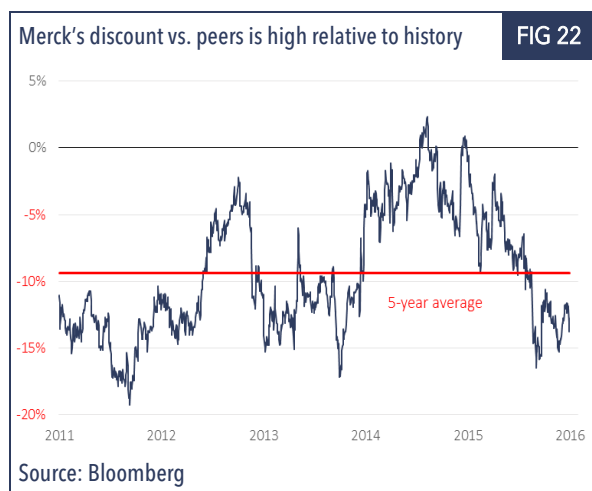
pathways in the body, and are typically composed of either sugars, proteins, DNA or living tissues, they tend to have less off-target effects with outcomes that are more predictable.



Our focus in looking for suitable investments is on diversified pharmaceutical shares with breadth in treatments for more favourable diseases and weighted to biologics – such as Merck & Co. We will avoid shares that have exposure to the pricing issues highlighted earlier including generic competition – diabetes as an example strikes us as a market that will come under intense pricing and competitive pressures from generics.

#### Investment case: Merck & Co.

Merck & Co. is a highly diversified global healthcare company that develops and markets prescription medicines, vaccines, biologic therapies and animal health products. Merck has been out of favour following a series of expensive litigation cases, a lack of strategic focus and years of neglect. Multiple ill-conceived acquisitions and a relatively poor product development track record also drove a decline in earnings, which resulted in Merck shares trading at depressed levels compared to peers (Fig 22).



Merck is now 2 years into an extensive restructure program including cost reduction, asset sales and refocusing their large product pipeline.

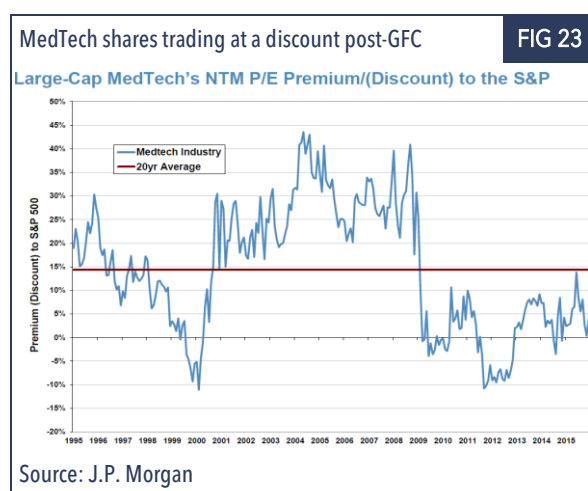
We are encouraged by Merck's early-mover advantage in immuno-oncology, which is an emerging treatment for cancer that re-invigorates the immune system to target and attack the disease. Merck has a strong product pipeline in immuno-oncology and will continue to broaden its product base in cancers other than melanoma and lung where it is currently successful.

Merck's prospects in other core areas of diabetes, hepatitis C, neurology, vaccines, antibiotics and animal health are also attractive and arguably underappreciated by the market. We back the track record of key hire Dr Roger Perlmutter as head of R&D, who has re-focused the R&D pipeline, and hence we expect the company's product commercialisation rate to improve.

We believe improvements in efficiency and pipeline success to be reflected in a stronger share price for Merck, as the shares re-rate to levels in line with peers.

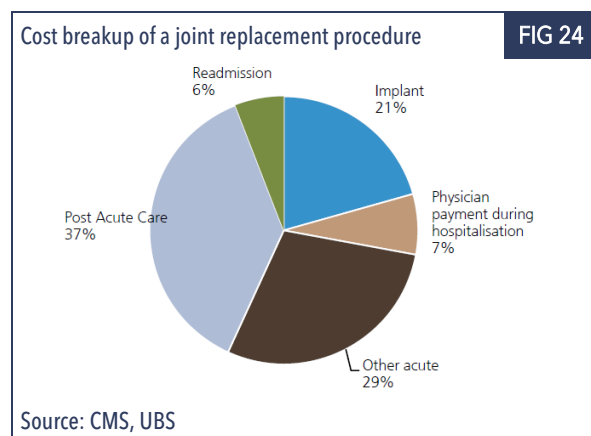
#### Sweeping changes in the MedTech industry

Global medical technology stocks have modestly underperformed the broader healthcare sector since the GFC, and valuations remain below historic levels (Fig 23). This industry has undergone significant consolidation over the last decade and growth rates have matured. In major developed markets, significant changes are being considered to healthcare reimbursement. This is the system whereby hospitals and doctors are paid for treatments – including the use of medical devices – by insurers and the government.



The dominant reimbursement model for funding healthcare services is currently fee-for-service, which is where hospitals and doctors receive payment for each service provided (e.g. each visit). This can incentivise a focus on quantity over quality of care without rewarding better outcomes for patients. As a result, over-utilisation has been identified as one of the largest drivers of growing healthcare costs. Payers of healthcare services (health insurers and governments) are now seeking to implement 'value-based' or 'capitated' funding models which incentivise better patient outcomes and greater efficiency. 'Value/outcomes-based' reimbursement put simply is where a provider of a service or therapy is not paid unless the patient achieves a pre-specified outcome. 'Capitated' reimbursement models involve a single bulk payment for treating a condition which covers all expenses including doctor fees, medical device costs, rehabilitation and follow-up doctor visits. Implementation of these models has been underway in major markets such as the US for the last few years and is now becoming more widely adopted, with material implications for both medical device makers and hospital operators.

An example of a 'capitated' reimbursement model is currently being trialled in the US which involves a bundled payment model for patients undergoing lower-body joint replacement surgeries (e.g. knee joint replacements). Analysis from this pilot (**Fig 24**) suggests the medical device represents only 21% of the total cost of care, with the major cost buckets being post-procedural care (37%) and other rehabilitation services (29%), suggesting the greater risk will be borne by hospitals and doctors. Re-admissions (where a patient needs to return to hospital because of a poor treatment outcome or infection) are also being targeted, by not paying hospitals for re-admitted patients under certain new rules.



That said, the onus is on both providers and medical device manufacturers to come up with more efficient operating and business models respectively.

## Investment case: Medtronic

Medtronic is a global leader in medical devices, surgical technologies and provision of specialised hospital services. Its products and services target high-value areas in cardiovascular, orthopaedics, neurosurgery, diabetes and minimally invasive surgery. The company acquired competitor Covidien in 2015 to enhance its offerings in advanced surgical and peripheral vascular disease, resulting in unrivalled scale and product breadth in the hospital operating theatre setting. With Medtronic's comprehensive coverage they are now directly managing operating theatres, in the process improving efficiency and profitability for hospitals. This integrated model places Medtronic in a unique position to gain and protect market share and proactively manage potential changes to hospital reimbursement such as bundled payments in future.

During the recent sell-off an opportunity arose to acquire Medtronic shares at attractive prices. We are impressed by management's execution and expect more synergies to come from the Covidien acquisition. The integrated business model strategically places the company in a better position relative to competitors as healthcare funding models evolve over the next decade. We believe there is also significant value to be created from rationalising Medtronic's large manufacturing footprint. Finally, we believe the market is underappreciating the level of differentiation offered by Medtronic's MRI-compatible implantable heart devices, which we expect will result in continued market share gains in the medium term.



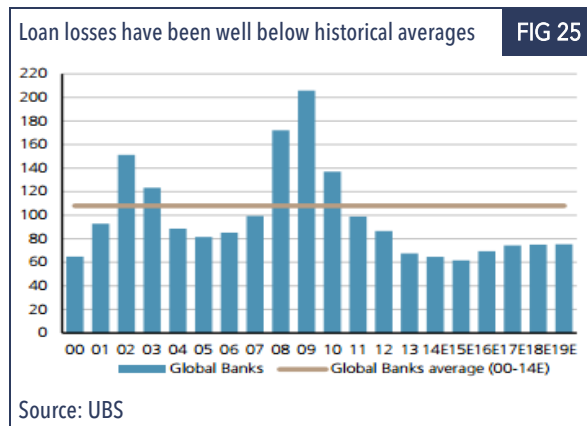
## Financial sector

In the aftermath of the financial crisis, capital markets have been awash with liquidity. This has been a favourable environment for banks generally as asset values have moved higher and financial stress has eased along with interest rates. We are now moving into a phase where policy globally is diverging as monetary conditions tighten in the US and UK. This will likely see many of these favourable trends for the banks reverse. As the business cycle matures, credit risks are also set to rise.

While the regulatory environment remains challenging, there are some signs of pragmatism emerging from regulators. The Financial Conduct Authority in the UK for instance has not called for additional capital or caps on lending following the recent stress tests, as many had feared. In the US, we have also seen concessions, with JP Morgan recently announcing reduced capital surcharges.

Recent jitters in credit markets have pushed wholesale funding costs higher. Commonwealth Bank recently raised funds at 115 basis points over the benchmark, 30 points above the rate on the same paper last year. Credit default swaps, a gauge of credit risk and a proxy for bank funding costs have also shot up in recent months. The days of banks receiving a windfall from cheaper wholesale funding have passed. Ultimately, the banks will have to reprice either loans or deposits if they are to protect their margins. The outcome here will depend on the competitive environment, which is looking tougher by the day.

Given slower growth and the late stage of the credit cycle, delinquency risk is rising for banks exposed to emerging markets. The market has recently been focused on two countries, China and Brazil, where a period of rapid credit growth has coincided with weaker economic activity, but delinquency trends are also worsening elsewhere. While we are not envisaging a full-blown credit cycle, further loss provisions will be required.

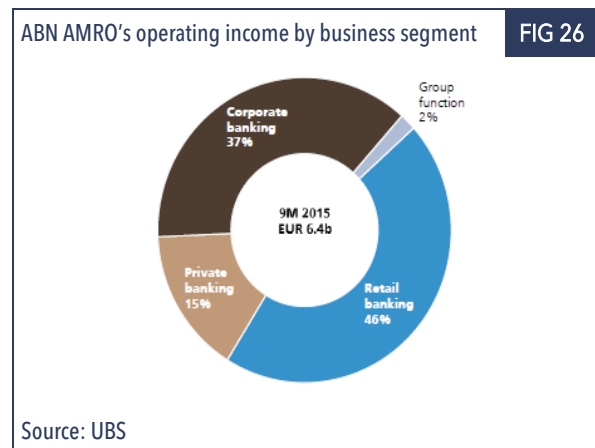


## Investment case: ABN AMRO

We recently participated in the Dutch government sell down of ABN. In terms of asset quality, profitability and financial strength ABN is as strong as any of the Australian banks. ABN could be considered the Commonwealth Bank of the Netherlands. The retail bank is as profitable as the highly rated Australian peers, yet their shares trade at a discount. We believe ABN offers better value than both the other domestic Dutch peers and the global peers we follow.

Following the demise of ABN through the GFC, the Dutch government seized control of the core retail bank unencumbered by the less desirable investment bank. What we are left with here is a full-service retail, commercial and private bank, with a primary focus on the Netherlands. More than 80% of group revenues are currently generated in the Netherlands with c60% of its lending book in mortgages. Importantly, ABN has no emerging markets exposure.

ABN's retail banking business is focused on the domestic market, with market shares of c.20-25% across the main product lines. The business has c5 million retail clients and 300,000 small business clients. This is a high return franchise partly due to lower capital requirements given strong asset quality.

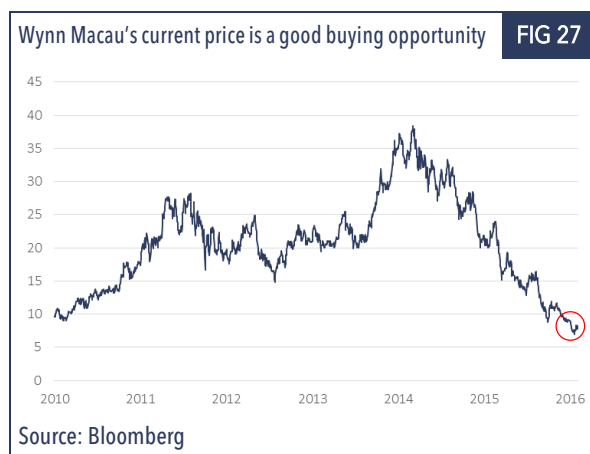


ABN's margins should be supported in the medium term as pre-crisis mortgages are refinanced, while the pressure on re-investment yields should be offset through deposit re-pricing.

ABN originated c€31bn of new mortgages in 2006-07, equivalent to c20% of the current mortgage book. As these loans were written on very low margins, interest income will be bolstered as this low spread business is refinanced. It is estimated that margins have widened c1.5% since the crisis period which will prove to be a significant tailwind for the company in years ahead.

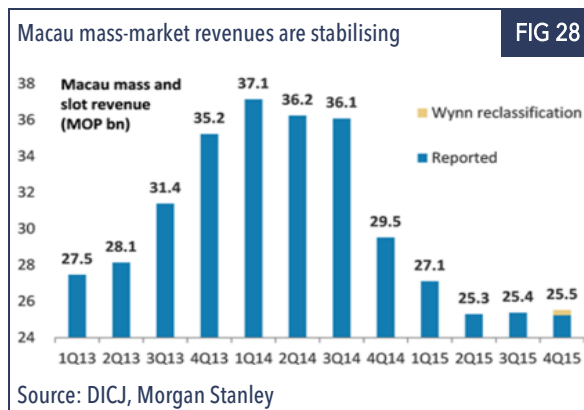
## Gaming & Leisure: Has the Macau bubble burst?

Gross gaming revenues in Macau have fallen for 19 consecutive months to their lowest levels since 2010, triggered by a China-wide corruption crackdown. To put this into perspective, the magnitude of the fall is equivalent to twice Las Vegas' total annual gaming revenue. Whilst challenged in the short-term we believe the underlying fundamentals for Macau are sound, and that the share price collapse of casino operators in the region offers an attractive entry point.



A number of new casinos and hotels are currently in development or opening over the next 12-18 months, and the poor timing has further dragged on the share performance of the operators. Although this new supply will take 1-3 years to settle, operators are not planning any expansions beyond what is already under construction. We draw confidence from the fact that visitation to Macau has not materially changed – roughly 21 million Chinese still visit every year (in fact visitation was up 4% in December year-on-year) and hotel occupancy remains stubbornly high, albeit the quality of visitors has reduced. Our expectation is that the corruption crackdown will continue however.

The largest driver of the downtrend in Macau gaming revenues has been from the VIP market, which constitutes roughly half of the industry's revenue today but at a low margin due to inducements offered to high-rollers. Expectations are for VIP revenues to fall a further 15% in 2016, albeit this would be less than the decline in 2015. The other half of the industry is mass-market, which is much more profitable. The key consideration in our positive outlook for Macau gaming revenues is the stabilisation in mass-market revenues in recent months (**Fig 28**), such that we now expect them to grow marginally in 2016.



Given China is a highly regulated market, policymakers hold great influence over casinos in Macau. We have seen more supportive policy actions recently, including the relaxation of visa rules for mainland Chinese visitors and deferral of a smoking ban across casinos that was scheduled for early 2016.

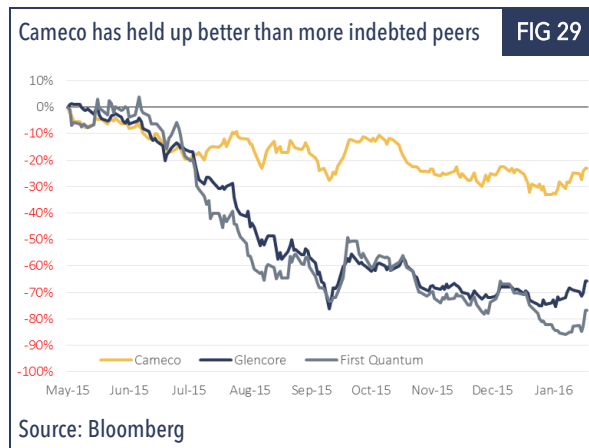
During this month we have been building a position in Wynn Macau, which is a world-leading casino operator with excellent management and asset quality. Wynn Macau has a large mass-market exposure, whereas we believe the VIP drag is already reflected in the share price after a disastrous 2015. We also draw comfort from signals of insider buying, where over the past two months the CEO Steve Wynn has personally invested close to US \$100 million into Wynn Resorts, which owns 70% of Wynn Macau (he can't directly add to his Wynn Macau position due to ownership restrictions) – today we are buying Wynn Macau at even lower prices (**Fig 27**).

## Mining & Energy sector

In the previous edition of *The Leading Edge* we outlined our views on commodity markets and the challenges facing mining and energy companies. Our thinking is largely framed by the three Ds – Deflation, Debt and Demand.

Our research suggested that the current downturn in commodity markets will continue for a long period. Rampant cost inflation through the boom will take many years to unwind, demand is set to remain weak in both emerging and developed markets, and leverage across the industry has created ‘zombie miners’ incapable of rationalising production. Despite our belief that this cycle will remain protracted, the price adjustment for mining companies has occurred quickly. We have a neutral exposure to mining companies and are looking selectively at opportunities to invest given the large moves in price. However, in order to do so we need to see significant closures which is something we are watching for particularly in China.

Our international investments in mining companies have been highly profitable, and perhaps unsurprisingly dominated by successful short positions. Our analysis has continued to highlight that the Australian mining companies, while under duress, generally have stronger balance sheets than international peers. Two successful shorts for the funds were Glencore and First Quantum Minerals, relative to an investment in uranium miner Cameco that was largely unchanged in price over the same time (Fig 29).



We initiated our short position in Glencore in May 2015. At that time, the company was revered by investors with CEO Ivan Glasenberg perceived as an astute leader for navigating through mining cycles. However we identified significant risks, namely their combination with Xstrata and the structure of the balance sheet.

In May 2013 Glencore completed an aggressive takeover of Xstrata creating a \$65 billion behemoth. Originally planned

as a merger of equals, the combination brought together the mining assets of Xstrata with the marketing business of Glencore intent on “capturing value at every stage of the supply chain”. While it is easy to understand the strategic intent, we questioned the quality of mining assets in the Xstrata portfolio. Xstrata had been highly successful through the 2000s acquiring largely second-tier assets which became more valuable as commodity prices rose. Glencore purchased these assets at their peak however, and they have since become a noose as the pricing cycle has turned.

Mining and marketing are vastly different businesses and their financing structure should reflect this unequal risk profile. A highly cyclical company such as Xstrata should have very low leverage, capable of withstanding downturns, while a marketing business can benefit from leverage on a low profit margin. In this transaction however there was no distinction in debt between the businesses, as evident in May when we took our position and the company had gross debt of \$50 billion. It’s worth noting that investors and ratings agencies are presented with a ‘normalised’ balance sheet that excludes \$20 billion of Readily Marketable Inventories or RMIs, which are commodity holdings largely backed with a sale or contract. This is despite the fact that marketing earnings require an ongoing level of inventory and even though one could theoretically liquidate the inventory at full value it would also remove the associated \$2.5 billion in earnings. As such, even after the recent capital raising the company is still over leveraged which will require asset sales at the bottom of the cycle to resolve.

While oil markets have shared many similar traits to hard commodities over the last two decades, the natural decline of oil reservoirs gives us hope for a faster rebalance. Higher US shale production and OPEC’s renewed focus on sustaining market share through increased output have caused a large short-term oversupply that has driven oil to an unsustainable level below US\$30/barrel. While it is clear that the price will need to be higher in order to incentivise producers to maintain current production levels, the profile of this recovery is unclear.

Unlike hard commodity miners that continue to produce volumes with very little incremental capital expenditure, the shale oil business requires ongoing investment. If spending ceases, well production will fall by 40-50% the following year. Credit markets might not be available in such a low oil price environment, and given their high levels of accumulated debt, US shale producers will not be able to reinvest which could help to rebalance supply. Only in the last month have investors begun pricing significant risk on the debt of key oil producers (Fig 30).



CDS spread (risk measure) on debt of Pioneer Resources FIG 30



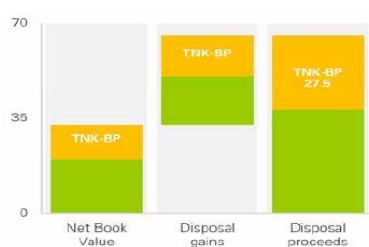
Source: Bloomberg

With oil trading at multi-year lows, and given this need for the market to rebalance, we have begun accumulating a position in BP as it has been sold down following a quarterly report which contained a number of one-off factors.

In April 2010 BP was grossly negligent in the explosion of the Deepwater Horizon oil rig in the Gulf of Mexico. Causing the largest accidental oil spill in history, the company faced unquantifiable liabilities for a number of years; it was only in July 2015 that BP announced final settlement of claims for \$18.7 billion to be paid over 18 years.

Following the disaster, the company embarked on a massive divestment program to fund their liability (Fig 31). While the \$38 billion of asset sales were initially intended to maintain liquidity during the Deepwater incident, BP unlocked value early on in the sales process which drove the company to go beyond what was necessary. At a time when many peers were making large investments in capital-heavy projects, BP groomed their portfolio and were the first to see a shift strategy to “value over volume”.

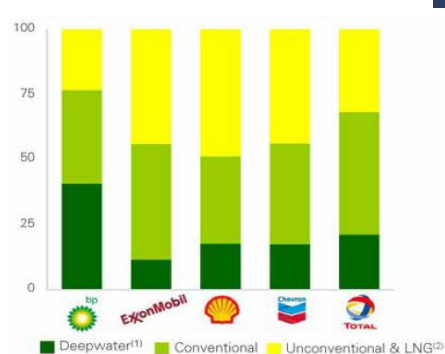
BP extracted value from their divestment program FIG 31



Source: Company presentation

Through this period, many competitors expanded their LNG businesses. The prospect of long-life assets with low decline rates producing into a commodity market with structural growth made for a compelling plan. Unfortunately, a step down in Chinese demand and a rapidly developing new export market from the US has left the LNG market horribly oversupplied for the next decade. While we believe oil markets will likely rebalance from late 2016 we are not as positive on LNG. BP's relatively low portfolio exposure to LNG and unconventional assets is attractive to us at this point in the cycle (Fig 32).

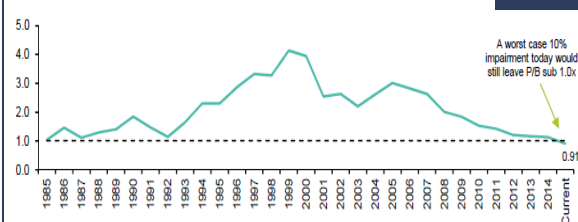
Net asset value by type of resource (%) for energy majors FIG 32



Source: Wood Mackenzie

Valuations for energy companies can vary dramatically depending on future price expectations, albeit the industry has been remarkably resilient in periods of low prices and incredibly cavalier in periods of high prices. Return on assets generated by the industry have not varied as much as one might expect considering the large changes in the oil price. It is comforting to see that BP is trading below its book value for the first time in 30 years (Fig 33), particularly since we don't see huge risk in this book value given the company's adherence to a strategy of value over volume for five years.

BP's long-term price-to-book ratio FIG 33



Source: Bernstein

Finally, it is always comforting to see insider buying for companies in our portfolio. BP Chairman Carl-Henric Svanberg acquired 1 million shares in September 2015 at a price of £3.43. The roughly £3.5 million investment is certainly an endorsement of the company's position as we enter this difficult period for energy companies.

BP shares are nearly at their Deepwater crisis lows FIG 34



Source: Bloomberg

## Performance Review

The December quarter saw continued strong performance from all Watermark funds, capping off a successful year in 2015. When markets are volatile - as was the case for much of 2015 - opportunities present themselves to position ALF's portfolio either net long or net short. We took advantage of such opportunities in the December quarter, selling into a strengthening market in October and again in December, leaving the portfolio well-placed to benefit from subsequent market falls.

The Market Neutral Funds also performed well through the quarter. Insulated against market volatility by virtue of their hedging, the Funds' performance was driven predominantly through security selection and by being positioned correctly in certain sector themes. These strategies continue to prove their value in delivering strong absolute returns while protecting investors from the risk of share market losses.

Amongst the strongest performing sectors during the quarter were Media, Retail and Professional Services. In most cases, gains were stock-specific rather than a result of broader sectoral trends. One trend that has been consistent across sectors however has been the underperformance of companies that were recently listed on the share market; particularly those that were sold out of private equity. In many cases these companies have been dressed up for sale, with very little upside left for participants in the IPO, and at worst with prospectus forecasts that have been grossly overstated. Spotless Group and Dick Smith were successful

shorts in the period that suffered precipitous share price falls. In both cases, new management teams were forced to downgrade unrealistic earnings forecasts. As a further legacy of the previous private equity owners, Dick Smith subsequently entered into administration after announcing it was no longer able to service its debts. We continue to scrutinise recent IPOs for further opportunities in this vein.

International investments made an important contribution to performance during the quarter, with new investments in Galapagos NV, Merck & Co and ABN AMRO all contributing strongly. As has been discussed earlier in this newsletter, we continue to find a myriad of interesting opportunities in offshore markets, where companies are offering stronger earnings growth and better value than their Australian peers.

We begin 2016 with a sense of excitement about the opportunities that lay ahead of us. There were numerous challenges in 2015 for investors in shares, which was a year fraught with the risk that the brittle recovery in the global economy would crack as stimulatory monetary policies that are supporting it begin to be unwound. For long/short investors, uncertainty breeds opportunity and we were able to capitalise on these opportunities in delivering such strong returns last year. With share markets likely to remain volatile and many of the same risks lingering for the year ahead, conditions are ripe for continued positive performance. We remain as focused as ever on delivering strong results for investors in 2016.

### Company at a Glance - Dec 2015

ASX Code	ALF
Fund Size	AU\$372m
Fund Strategy	Variable Beta
Shares on Issue	268.5m
Dividend (FY15 Final)	5 cents
Dividend Yield (annualised)	7.2 %

### Net Tangible Asset (NTA) Backing

	Nov 15	Dec 15
NTA Before Tax	\$1.35	\$1.36
NTA After Tax	\$1.35	\$1.37

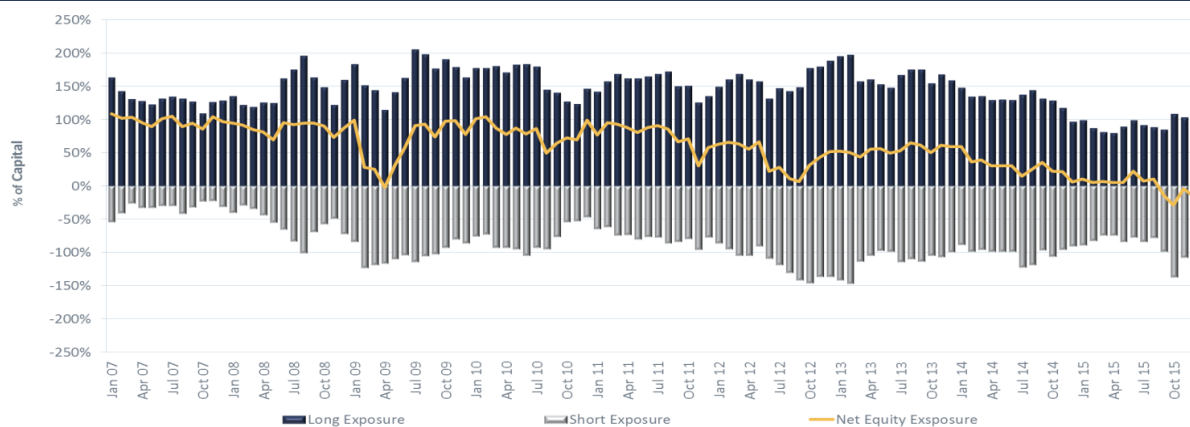
### Gross Portfolio Structure

	Nov 15	Dec 15
Long Exposure	103.6%	89.8%
Short Exposure	-108.3%	-105.3%
Gross Exposure	211.9%	195.0%
Cash	104.7%	115.5%

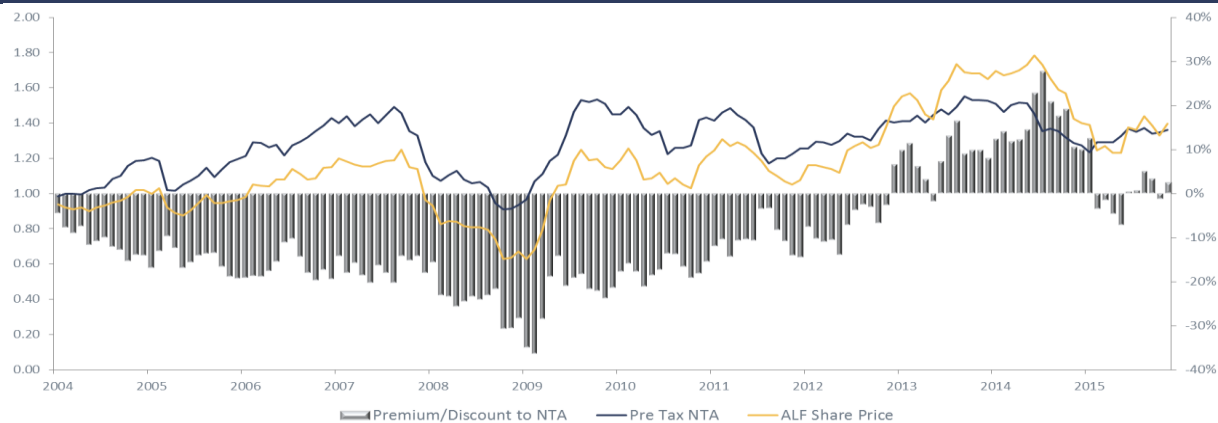
### ALF Performance

	1 Mth	6 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 yrs (pa)	S.I. (pa)
Portfolio Return (net)	2.0%	9.2%	16.2%	13.6%	12.1%	20.6%	14.4%
All Ords Accum Index	2.6%	0.4%	3.8%	9.3%	6.5%	10.2%	8.7%
Outperformance (net)	-0.6%	8.8%	12.4%	4.3%	5.6%	10.4%	5.7%

### Net Equity Exposure



### Historical Premium/Discount to NTA History





## Fund at a Glance – Dec 2015

Fund Size	AU\$43.8m
Strategy FUM	AU\$135.5m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

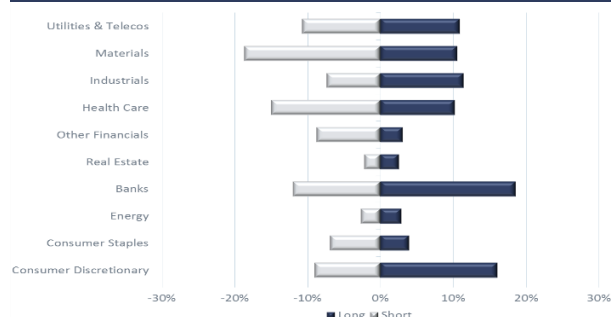
## Return Characteristics<sup>1</sup>

Positive Months	70.7%
Portfolio Beta	-0.29
Sharpe Ratio	1.81
Sortino Ratio	5.31
Standard Deviation	7.81%
No. Long Positions	59
No. Short Positions	62
Gross Exposure	183.9%

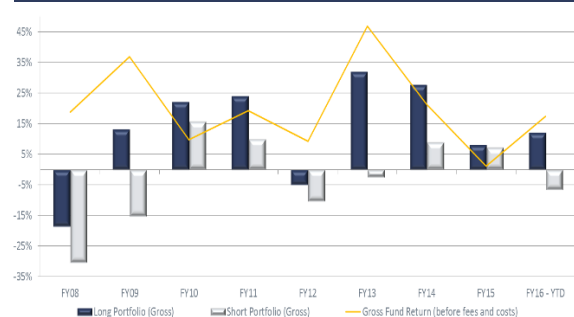
## Performance<sup>2</sup>

	1 Mth	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I (pa)
WMNT (net return)	2.9%	14.4%	14.4%	21.9%	9.6%	18.9%
RBA Cash Rate	0.2%	1.0%	1.0%	2.1%	2.3%	2.8%
<b>Outperformance</b>	<b>2.8%</b>	<b>13.4%</b>	<b>13.4%</b>	<b>19.8%</b>	<b>7.3%</b>	<b>16.1%</b>

## Sector Exposures



## Long/Short Spread<sup>3</sup>



## Monthly Net Performance (%)

Cal. Yr	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2012	-	-	-	-	-	-	-	1.36	0.97	0.00	6.51	2.88	-
2013	-0.71	0.21	4.60	1.55	5.83	5.31	1.11	2.57	1.43	1.86	0.35	-0.06	24.05
2014	1.71	1.45	-1.17	2.80	1.21	0.84	-4.38	-1.77	2.52	-1.57	-1.58	-1.32	-1.26
2015	-1.18	0.70	3.23	0.96	-0.61	3.39	3.82	4.04	2.73	-1.36	1.53	2.93	20.19

<sup>1</sup> Return Characteristics are in relation to the market neutral strategy using long/short return series recorded from April 2008

<sup>2</sup> Performance data is net of all fees and expenses. The Fund's inception date is August 2012

<sup>3</sup> Long/Short spread shows the gross performance of the long and short portfolios. The Fund makes a profit where the long portfolio outperforms the short portfolio, after the payment of fees. Returns prior to the Fund's inception date are based on return series from the long and short portfolios of the Australian Leaders Fund Ltd in a market neutral structure

## Company at a Glance - Dec 2015

ASX Code	WMK
Fund Size	AU\$91.7m
Fund Strategy	Equity Market Neutral
Shares on Issue	84.1m
Dividend (1H15)	2.5 cents
Dividend Yield (annualised)	5.1%

## Net Tangible Asset (NTA) Backing

	Nov 15	Dec 15
NTA Before Tax	\$1.06	\$1.08
NTA After Tax	\$1.05	\$1.07

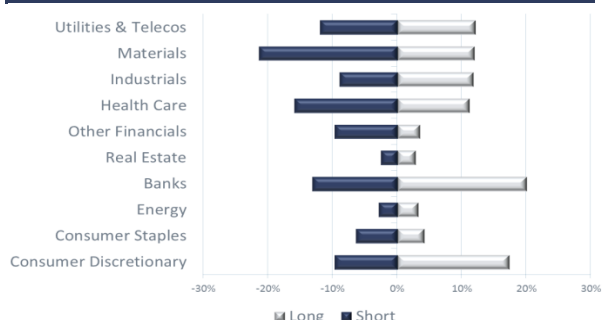
## Gross Portfolio Structure

	Nov 15	Dec 15
Long Exposure	108.0%	98.1%
Short Exposure	-105.6%	-103.2%
Gross Exposure	213.6%	201.2%
Cash	97.6%	105.1%

## WMK Performance

	1 Mth	6 Mths	1 Yr	S.I. (pa)
Portfolio Return (net)	2.9%	13.7%	20.7 %	9.4%
RBA Cash Rate	0.2%	1.0%	2.1%	2.4%
Outperformance (net)	2.7%	12.7%	18.6%	7.0%

## Sector Exposures

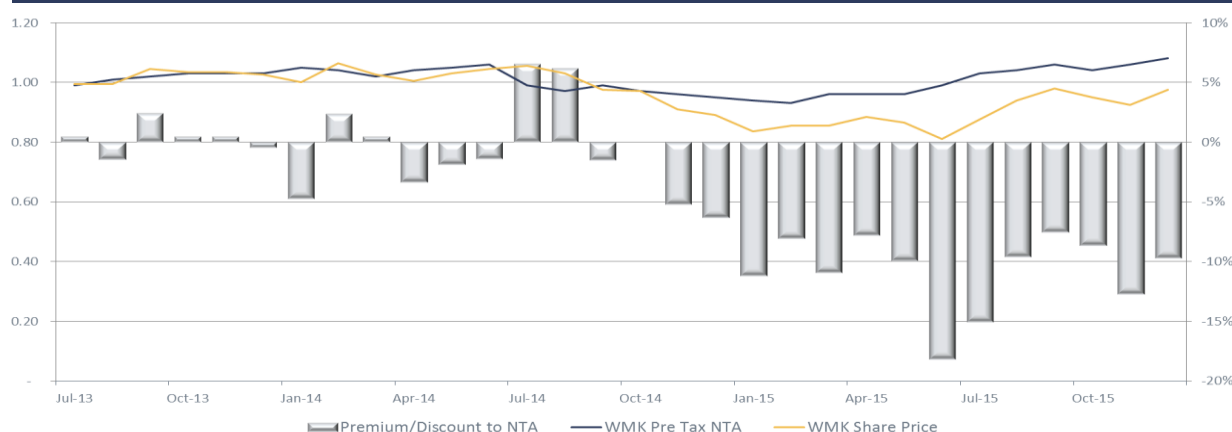


## Long Short Spread\*



\* Long Short spread shows the gross monthly performance of the Company's long and short portfolios. The difference between the two represents the gross performance of the portfolio as a whole. The company will make a profit where the long portfolio outperforms the short portfolio, after the payment of fees and expenses

## Historical Premium/Discount to NTA





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