The Leading Edge

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In this edition of *The Leading Edge* we introduce the giants of the Internet, and pick winners and losers in this new digital age.

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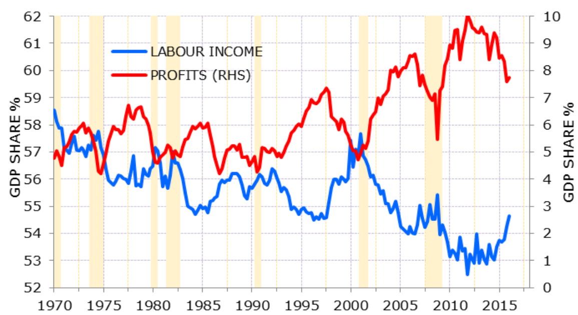
Justin Braitling
Portfolio Manager

Message from the CIO

Economic rationalism – in other words a belief in free markets, deregulation, and globalisation – has been a hallmark of progressive governments in the West since the demise of socialism. While these policies have sustained productivity and growth, the spoils have not been evenly shared as living standards in low and middle income households have stagnated in many developed countries. The median income for an American male is unchanged in real teams over four decades. The promise of open markets and capitalism has sadly failed the middle class and their dissident voice is becoming louder.

You can see this in **Fig 1** a clear divergence emerging in the share of incremental growth going to labour versus capital by way of profit share.

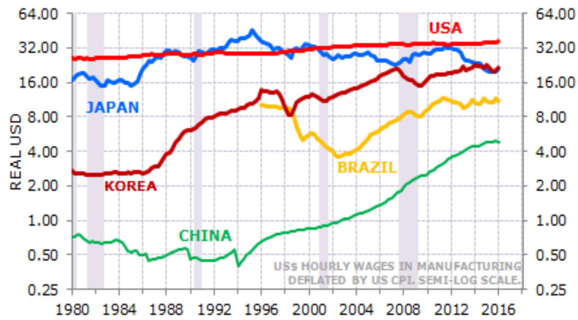
US labour income and profit share — FIG 1



Source: Minack Advisors

Owners of capital – the wealthy – have benefited tremendously as returns on capital have soared. Real wages on the other hand have lagged well behind productivity improvements. The impact of globalisation on low skilled jobs has been an important contributor here. As capital has shifted to lower labour cost destinations, the owners of capital have benefited from the immediate uplift in productivity, while the workers that have been displaced have seen living standards fall. In **Fig 2** you can see the ten-fold increase in real wages in China versus stagnation in the US and Japan.

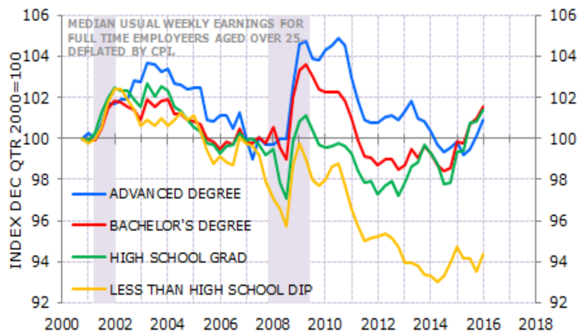
Manufacturing hourly pay, real US$ terms — FIG 2



Source: Minack Advisors

Migration and open borders, another feature of globalisation and political union, has intensified this threat to job security. In **Fig 3** you can see how immigration has put downward pressure on the real wages of unskilled workers in the US. Austerity policies in the aftermath of the financial crisis have further stressed households dependent on social services. To them it seems so unfair, the banks get bailed out yet they pay the cost through austerity.

US weekly median pay by education level — FIG 3



Source: Minack Advisors

Falling interest rates, another feature of the 'great moderation' of the last twenty years, have only exacerbated this trend toward inequality. The wealthy who own most of the assets have captured a disproportionate share, as assets have been bolstered by lower interest rates. The asset poor have missed out, while real wages have fallen.

The disenfranchised, who have not participated, are rejecting these liberal beliefs, giving rise to the nationalist and extremist views that are gaining popularity in many western countries. The unexpected Brexit result in the UK, the ascendancy of Donald Trump in the US and the rebuke to the LNP in the Australian election are all manifestations of this. The political class appear detached from this shift in public opinion. Financial markets, where the true acolytes of the neoliberal church reside, are even further removed. A consequence is the ongoing failure of markets to recognise the importance of this protest vote and the potential impact on favourable policies that have been tremendously beneficial to investors.

The shift in political mood and the prospect of a reversal in these market friendly policies are a clear negative for the market outlook. The political establishment also seem a long way from recognising the problem. Consider the retribution to Brexit voters the European Commission is calling for? A long way from a workable solution.

Make no mistake, this is a very loud voice, a voice that will become louder until we see a reversal in the divergent trends in **Fig 3** above. In the meantime, the political risks will build, unsettling financial markets.

We have talked at length previously of the secular slowing in global growth. Shifting demographics, weak productivity and deleveraging are all features of this deceleration. The precipitous fall in bond yields in recent weeks reflects this outlook, with many bonds now trading below the zero bound. Our own 10 year government bond rate has slipped to 1.8%, fractionally above the cash rate. With the yield structure so flat and no carry or compensation for duration, it is hard to see any scenario where bonds can deliver anything but horrible returns in the medium term. Investors have been left with few choices, explaining the resilience of shares in the face of disturbing developments both politically and economically.

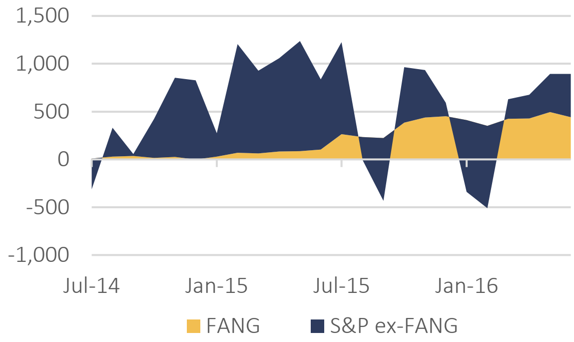
We feel more confident than ever in the merits of hedging strategies like those employed by Watermark. Bond yields are telling us the outlook for growth is as weak as it has been in a generation. There is no carry; a passive, buy and hold strategy will deliver low returns at best. Only an active strategy that can deliver enhanced returns through security selection stands a chance of delivering acceptable returns in this climate.

Shaping the future: Giants of the Internet

In this edition of *The Leading Edge* we introduce the giants of the internet. While interesting in their own right, these disruptors will frame many industries beyond their current influence. In this first of a two-part series, we explore why they are so dominant and provide insights into the strengths and weaknesses of their models. In our next edition we will present a window into the future, highlighting winners and losers as the digital landscape evolves.

In a world with low growth and inflated valuations, the digital economy is a beacon of hope for value creation. Such is the dynamism of Facebook, Amazon, Netflix and Google, that an acronym FANG has been coined. Over the past two years these four companies alone have captured half of the $900 billion of incremental value created by the US share market (**Fig 4**).

Value creation of US sharemarket ($bn) FIG 4



Source: Bloomberg

Investors are backing these companies to dominate the digital world in a winner takes all race into the future. This has already played out in search; social media; and online shopping. More recently Uber and Airbnb have emerged as key players in shared services.

Dominance is largely a result of the network effect. Emerging platforms quickly become ubiquitous and are only usurped when a better product comes along, as occurred when Google displaced Yahoo in search. Once the baton has passed, value can erode quickly.

In this ephemeral world, constant innovation is required to maintain leadership. The engineering resources of these firms are enormous. Cumulatively, Amazon, Facebook and Google are investing over US$35 billion a year on research and development, twice the total amount spent on R&D in Australia by all companies and research organisations combined (ABS: A$20bn in 2014).

The investment spend extends well beyond R&D however, once acquisitions are considered. Investors have extended a clear and broad mandate to these companies, to employ their substantial financial resources in acquiring and incubating new technologies with few limits. With thousands of engineers, these behemoths are able to quickly identify threats and acquire at an early stage. New technologies rarely reach the public share markets these days; instead they are quickly gobbled up.

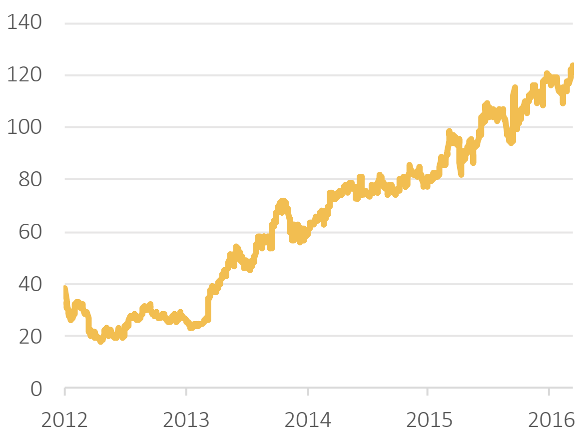
These companies will shape our future. From artificial intelligence to 'chatbots', they are racing for the high ground. With seemingly unlimited financial constraints and visionary, controlling shareholders there will inevitably be winners and losers in the race ahead.

Facebook

The origins of Facebook are well documented, most notably in Aaron Sorkin's film *The Social Network*. Perhaps less understood are the failed IPO and the significant challenges faced by the company before it emerged as a dominant social platform with economics that flow from that position.

In 2012, after only eight years in existence Facebook was set to launch a record-breaking IPO, valuing the company at more than $100 billion. With a rapidly growing global user base and advertisers scrambling for presence, the company was in high demand. Nonetheless, the rapid shift from the desktop to smartphones threatened the business model. As the prospectus stated: "*Growth in use of Facebook through our Mobile products, where our ability to monetise is unproven, as a substitute for use on personal computers may negatively affect our revenue and financial results.*" Days before the IPO, the company softened its expectations for annual revenue. Unsurprisingly, the days and weeks following the launch saw $50 billion in value evaporate as investors fled the seemingly fragile business model. In September that year the share price fell below $18, less than half the original price. The IPO was quickly tagged "Face plant".

Facebook has tripled in value since listing FIG 5



Source: Bloomberg

Founder and CEO Mark Zuckerberg charged all engineers with the challenge of migrating the advertising platform to a mobile environment. Advertisements were sprinkled through users' mobile newsfeeds and four years later the company generates 80% of revenues by this means.

Facebook has been particularly acquisitive in building its leadership position. The acquisitions of privately owned WhatsApp and Instagram are notable. Instagram now boasts over 400m daily active users and is on its way to generating $1bn in sales. WhatsApp on the other hand, acquired for $22bn, has been a commercial disaster and is being eviscerated by Facebook's own Messenger platform. While vastly different in terms of financial performance, both achieved their goal of maintaining social media dominance. Snapchat, an emerging social platform where photos and videos are effortlessly exchanged, has snubbed numerous approaches from Facebook, an indication of the threat it may yet present. Time will tell if this defensive acquisition strategy will work to maintain their stranglehold on social networking.

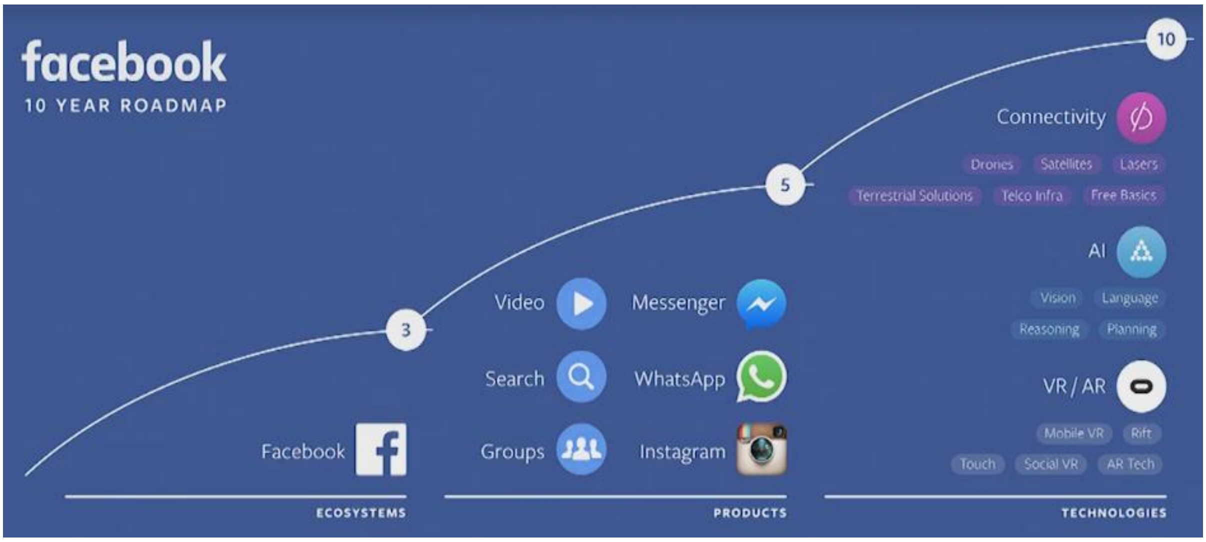
One challenge for the company is maintaining the freshness of the platform. Algorithms filter a user's newsfeed with the aim of presenting stories of interest. We note a recent announcement by the company that it will promote content posted by the family and friends of users. This may be a harbinger of weakening engagement – a statistic closely guarded by the company. The brilliance of Facebook's model is its ability to monetise free content. It has however begun to pay for content, signing 140 media companies and celebrities to create videos for its live-streaming service. Will Facebook have to invest in content to maintain the platform's strength? The economics of their business would change considerably.

Facebook derives its revenue from advertising. The drivers behind this are the number of users, their level of engagement with the platform, the price of each advertisement, and ad load (how frequently ads are presented). This last metric is completely at the discretion of Facebook. Our analysis suggests that ad load has increased dramatically and is now at 10%. This means one in ten items on a user's newsfeed is now an advertisement. If this continued to increase, the utility of the platform would diminish.

In 2016, Facebook is expected to generate $26 billion in sales and earnings above $16 billion. With this level of profitability and no dividends to pay shareholders, it is no surprise that the company has ambitions to grow significantly outside of their core social platform. A 10-year roadmap was presented at its recent F8 developer conference outlining the broad range of industries that the company will target (Fig 6). From drones and telecom infrastructure to virtual reality, Facebook will expand into many new industries. Unlike their monopolistic position in social, these businesses will be highly competitive, with returns likely to remain low for some time.

Facebook holds high ambitions for future products

FIG 6



Source: Facebook

With mobile now the preferred route for users, Facebook has become dependent on the mobile operating systems of Apple and Google – iOS and Android. While application developers are required to pay 30% of revenue to the mobile operators, Facebook's advertising model evades this charge. However, Apple and Google are able to collect any data that Facebook users generate on the platform which is an increasingly valuable asset. While the revenue sharing model is unlikely to change, it does highlight an inherent vulnerability of Facebook.

The company has a clear pathway to further monetise user engagement in the next few years; albeit beyond that we are wary of new, competing social platforms and question whether their future ventures will be successful.

Google (Alphabet)

In a close battle with Amazon for the world's most disruptive company, Google have ventured far beyond their initial success. Superseding Yahoo with a more advanced search engine, the company set on its mission to organise the world's information and make it universally accessible and useful.

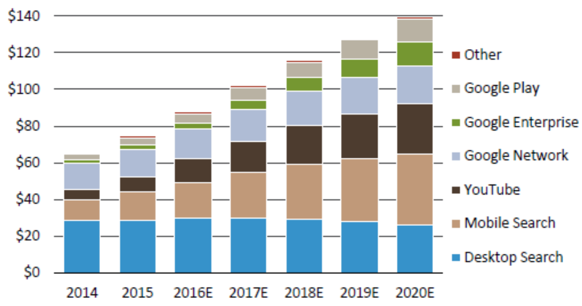
As with Facebook, Google needed to transition its search engine from desktop to mobile. Their business model was under threat from two distinct areas. Firstly, and more obviously, the user experience of typing in a tiny box on a small mobile device presented a product development challenge. Secondly, whilst the internet remains open architecture (meaning users are able to navigate to google.com for their search needs), mobile operating systems control an app ecosystem. As such, they could potentially stymie Google from being the universal search engine, or more likely, charge Google a large distribution fee to be the search engine on their system. Whilst the product development hurdle was easily overcome, the mobile operating system presented a complex challenge.

Google acquired Android in 2005 and subsequently launched the Open Handset Alliance, a consortium of handset makers, technology companies and wireless carriers with a goal of developing open standards for mobile devices. Today, Android is the dominant mobile operating system with well over 1 billion users. The Android system is free and open source, but on actual devices the software is bundled with Google and vendor installed applications. The clever operating system has maintained Google's dominance in Search in the mobile world.

Importantly, Android not only protected the core search business, but it also spawned a new highly valuable asset for the company – Google Play. An amalgamation of Android Market, Google Music and Google eBooks, Play is a digital distribution service delivering anything from apps to television programs. With over 1.4 billion Android users, Play serves as the portal for digital delivery, taking a small clip of each purchase. By 2020, Play is expected to generate roughly 15% of group revenue (**Fig 7**), and potentially far more of profit.

Google's revenue split and forecasts

FIG 7



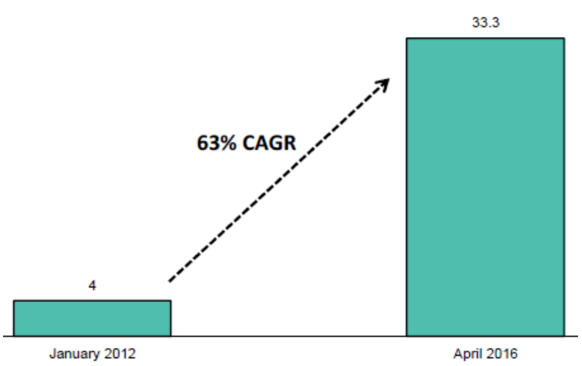
Source: UBS

Another of Google's largest value creators has also been one of their most disruptive businesses. Google acquired YouTube in 2006 for $1.6 billion, creating the dominant portal for online videos. It is among the main drivers of the migration of brand advertising dollars from TV to the web. The company is remarkably guarded on its financial performance revealing neither revenues nor earnings, but some simple analysis shows the extent of the value creation over the last decade.

It is estimated that there are over 30 billion daily video views on YouTube (Fig 8), up significantly from January 2012 when the company disclosed it generated 4 billion daily views. Last year YouTube disclosed that "*on mobile, the average viewing session is now more than 40 minutes, up more than 50% year on year*" and that "*more than half of YouTube views come from mobile devices.*"

YouTube daily views (billions)

FIG 8



Source: YouTube, Bernstein analysis

Facebook has an enterprise value of roughly $320 billion. They have 1.65 billion users who on average, spend 50 minutes per day on Facebook, Instagram and Messenger. The total hours spent each month on Facebook is roughly 60% greater than YouTube. Thus if we use time spent as a proxy for monetisation, we can normalise $320bn by dividing by 1.6. However we must also consider YouTube's lower margin as they pay for content (a future risk for Facebook). Assuming YouTube's margins are in line with traditional media models, YouTube is probably worth close to $70 billion.

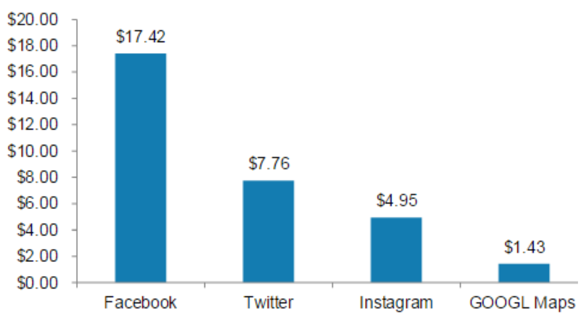
Despite the incredibly diverse business segments in which Google operate, their revenues and profits remain dependent on their core Search business. As shown earlier, this is expected to continue out for the next five years, with Search maintaining its disproportionate share of revenue. While Chrome, Android, Gmail and Maps all have over one billion users, they generate modest revenues (but deliver copious amounts of data for analysis and more targeted advertising). However we believe we are on the cusp of growth for one of Google's most under-monetised assets – Maps.

Maps has become ubiquitous with navigation. At the Google Performance Summit in May, Google introduced new local search ads where advertisers will now be able to show improved ads of businesses nearby that include promotional text, a customisable business page highlighting features of promoted locations, and the ability to search through store inventory. Potential monetisation is significant given 1 billion users. Google has also noted that total searches with local intent are growing more than 50% faster than all mobile searches and currently account for one third of all mobile searches.

In 2017, we expect Maps to generate revenue of $1.5 billion. Importantly, this is a conservative figure with upside over time. To get there, average revenue per user only needs to be $1.43, compared to much higher and more commercialised platforms such as Facebook and Twitter.

Average annual advertising revenue per user ($)

FIG 9

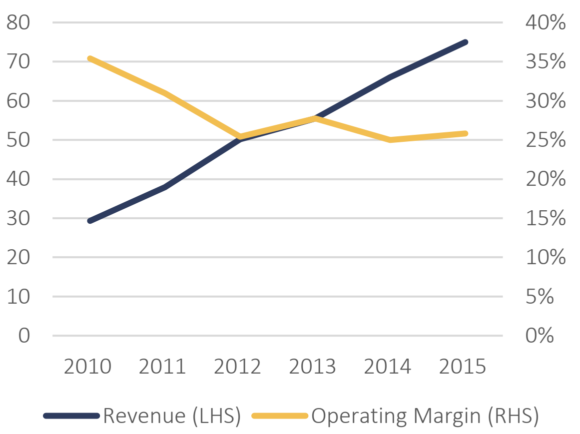


Source: Morgan Stanley estimates

Advancements in Artificial Intelligence, or AI, are occurring at a rapid rate. Tech companies are all racing to become the leader in this field, betting that whoever wins will have the advantage in a technology that is imbedded in more and more software programs and built into hardware. Amazon has an early lead in product development through its home assistant 'Echo', while Facebook is quickly enabling 'chatbots' through its Messenger platform. With very little effort, users will be able to book flights or movie tickets, send flowers to friends or be warned of changing traffic conditions. Google is well positioned to dominate the AI environment. Their depth of data is leagues ahead of the competition, organically built through decades of dominant user engagement. This transition to a richer experience was exemplified when the company changed the naming of internal roles from "SVP of Search" to "SVP of Knowledge". While the commercialisation pathway will differ for different industries, this is a potentially large value creator for the company.

Google has made many less than successful ventures as well, such as their large investment in Social, Google+. Failures are par for the course in any tech company's development. As a company run by engineers and controlled by its founders, shareholders began asking questions on capital management. Despite incredible revenue growth, margins had been declining at the company for five years (**Fig 10**).

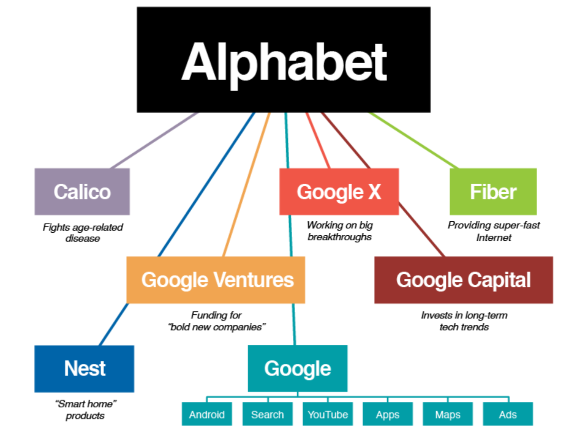
Google's large investments ($bn) FIG 10



Source: Morgan Stanley estimates

The appointment of Ruth Porat as CFO in 2015 signalled an important change for investors. Shortly after, the company changed its operating structure and was renamed Alphabet (**Fig 11**). This was a clever play on the investment jargon '*alpha*' meaning excess return and the colloquial term '*bet*'. With this came disclosure for the first time on the level of investment outside core Google websites. In 2015, the 'Other Bets' segment generated only $450 million in revenue and lost $3.6 billion. Investments in areas as far reaching as drones, self-driving cars and surgical robots drained resources for no short term financial benefit. Ruth Porat has a clear mandate to monitor these early-stage investments and cut programs with no identifiable prospects.

Alphabet organisational chart FIG 11



Source: CNN News

Interestingly, investors seem to be giving little credit to the possibility that one or more of these 'other bets' could grow into a successful venture. If we ignore these losses, and back out YouTube which we value at $70 billion, the core Google websites are trading on a P/E multiple of just 13x. An attractive investment price for the strongest digital business was available to us.

Netflix

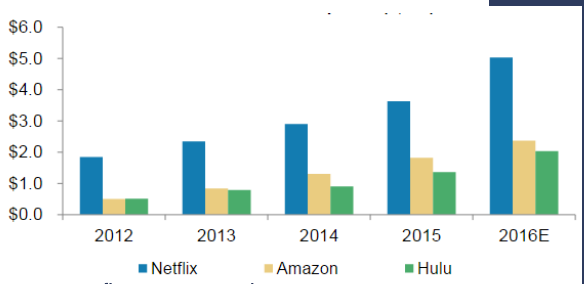
Netflix began in 1998 as a subscription DVD service. After a decade of growing subscribers, visionary founder and CEO Reed Hastings switched the distribution model from physical to digital, delivering subscription Internet Television and disrupting the linear TV model.

The rapid acceptance by US consumers was driven by the strong value proposition. For $10 per month, Netflix delivered a broad range of entertainment content that was available at any time. This cost was dwarfed by the roughly $80 per month that cable TV companies were (and still are) charging for their video offering. The attractive price point was boosted by unique and exclusive content. In 2011, Netflix outbid HBO in acquiring its first original TV series, *House of Cards*. The move was notably aggressive, committing to two seasons of 26 episodes without even a pilot. The show was a runaway success, helping to accelerate subscriber growth and amortise the investment over a larger base.

This was the beginning of Netflix Originals. Further success with *Orange is the New Black* and *Narcos* delivered distinctive viewing and were hugely important as Netflix launched offshore.

Internet Television is now globally accepted however, and competition is emerging. Amazon and Hulu are accelerating their investment in content, despite having relatively nascent international businesses. While Netflix is still the clear leader, the absolute quantum of investment by peers will make differentiation more difficult.

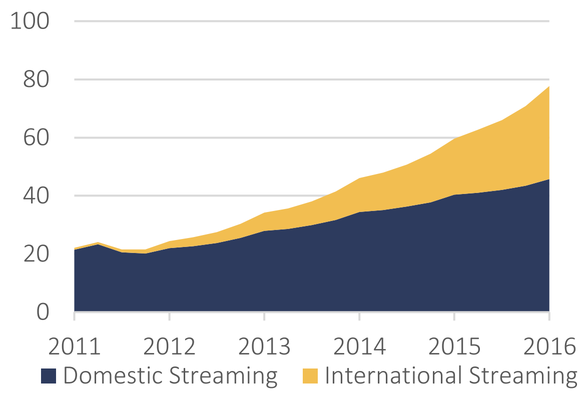
Global content costs (US$ billion) FIG 12



Source: Netflix, Morgan Stanley estimates

Netflix has 45 million US subscribers, approaching roughly 50% of US households. Incremental growth should be expected domestically, but for the company to grow significantly they must execute on their international ambitions. Brazil has been described as a "rocketship" by management suggesting a strong take up in the region. However countries within Europe have disparate performance. Sensing the urgency and benefits of a first mover advantage, Netflix surprised investors with a January 2016 launch into 130 new countries including India and Russia, but not China. The earlier than expected launch was a recognition of the increasing competition in these local markets.

Netflix's streaming subscriber base FIG 13



Source: Netflix

Netflix have a great product offering but we see two key investment risks. Firstly, margin may be squeezed as content rights are bid higher. To defray these costs, the company is targeting 50% original programming. Despite this, competitors such as Amazon, who use their video offering as a tool to sell more physical goods, will cap returns here. Secondly, international markets will likely face heightened local competition. Regional incumbents have seen the growth in Internet Television and are adapting their businesses as Netflix enters. Studios also prefer to partner with local distributors rather than Netflix who are inflicting pain in their profitable home market. In Australia, Stan's exclusive licensing deal with Showtime is a prescient example.

Amazon

In the space of 20 years Amazon has become the most valuable retailer in the world, overtaking Walmart by market capitalisation. From humble beginnings in the 1990s as an online book store, the company has taken the consumer by storm and now offers everything from electronics to fresh food. Amazon is aggressively disrupting numerous industries and reducing the profit pool available to traditional competitors.

Amazon's philosophy is focused on the consumer. The company strives to improve price, delivery time and choice for consumers. Jeff Bezos convincingly makes the case – "when does a consumer ever complain that delivery was too fast, the price was too low, or that all their brands were available?" To provide a sense of Amazon's dominance, nearly every second dollar of e-commerce growth in the US is captured by Amazon (**Fig 14**). Amazon has only been able to achieve this dominance because they have a strategy of 'infinite shelf-space'. Essentially, Amazon has become an 'everything-store'.

Amazon US Gross Merchandise Value by product ($mn) FIG 14

Category	US eCommerce Spend	AMZN Share of US eCommerce	AMZN GMV By Category	AMZN Category Penetration vs. AMZN's eCommerce Share
Apparel & Accessories	$51,507	20%	$10,301	Under
Books & Magazines	9,850	70%	6,895	Over
Music, Movies & Videos	4,700	70%	3,290	Over
Computers / Peripherals / PDAs Computer Software Consumer Electronics Video Games, Consoles & Accessories	84,807	65%	55,125	Over
Consumer Packaged Goods	25,656	45%	11,545	Over
Event Tickets	18,510	0%	0	Under
Flowers, Greetings & Misc. Gifts	4,617	15%	693	Under
Furniture, Appliances & Equipment	12,293	10%	1,229	Under
Home & Garden	8,434	20%	1,687	Under
Jewelry & Watches	6,412	20%	1,282	Under
Office Supplies	12,560	15%	1,884	Under
Sports & Fitness	6,253	25%	1,563	Under
Toys & Hobbies	7,811	50%	3,905	Over
Other	51,888	29%	14,887	Under
Total	**$305,298**	**37%**	**$114,287**	

Source: JP Morgan estimates

Wherever Amazon competes, it hurts incumbents by taking share and driving price deflation. Amazon has spent over $20bn on its infrastructure. Its success is forcing incumbents like Walmart to announce that it will bring forward investments of $2bn in digital infrastructure, just to catch up.

Amazon's first mover advantage in digital sales has established barriers to entry that further cement their dominant position. Online search rankings are largely determined based on sales, which becomes a self-reinforcing cycle. With e-commerce becoming a large component of overall retail sales growth, Amazon's dominance is growing.

While Amazon presents an obvious threat to bricks and mortar retailers, it is also creating challenges for consumer goods companies. Companies such as Nestle and its global peers dominate shelf space in supermarkets, however as Amazon is not limited to stocking two or three brands in each category, smaller and emerging brands can now gain access. Furthermore, smaller suppliers can benefit from Amazon's Dragon Boat program whereby Amazon logistics takes product direct from factories in China all the way into the customer's home.

Amazon looks at the market in a completely different way to most retailers. A typical retailer is focused on gross profit margin, but Amazon focuses on 'per-unit basis cost' which accounts for shipping. Because Amazon is content with its strategy of building scale over immediate profitability, it willingly stocks items knowing it will book a loss. It has pools of profitability - such as books and electronics - while loss leaders such as fresh food are part of a broader strategy that will one day become profitable.

Amazon is not standing still. It is continuously investing to create more reasons for the consumer to shop with it. Its membership club 'Amazon Prime' is a unique hybrid of offline and online membership and has now penetrated one third of US households. Amazon has over 50 million Prime members paying $99 a year with the key benefit being free delivery. However Amazon refer to a '*flywheel*' approach and as more services are offered through Prime, customers' spend increases allowing for more service offerings. This has expanded Amazon into ventures such as subscription video on demand, music and digital storage.

Unpacking Amazon Prime value FIG 15

Amazon Prime	Select Competitive Offerings: Service	Select Competitive Offerings: Price	Estimated Value: Annual	Estimated Value: Monthly
1 2-Day & Same-Day Free Shipping	ShopRunner Google Express Wal-Mart ShippingPass	$79/year $95/year, $10/month $49/year	$100.00*	$8.33*
2 Prime Now	Postmates Plus Unlimited UBERRush	$9.99/month Per delivery charge	$119.88*	$9.99*
3 Prime Video	Netflix Hulu HBO Now	$7.99-$11.99/month $7.99-$11.99/month $14.99/month	$107.88	$8.99*
4 Prime Music	Spotify Apple Music Tidal Google Play Music Pandora	$9.99/month, 50% off each add'l family account $9.99/month, $14.99/month for family $9.99/month, $19.99/month for HiFi $9.99/month $4.99/month, $54.89/year	$107.88	$8.99
5 Prime Photos	iCloud Google Photos Dropbox Flickr	Free up to 5GB, $0.99/month for 50GB Free unlimited compressed storage Free up to 2GB, Pro $9.99/month Free up to 1000GB, Pro $5.99/month or $49.99/year	$11.99*	$1.00
6 Kindle Owners' Lending Library	Kindle Unlimited Scribd	$9.99/month $8.99/month	$95.88	$7.99
Estimated Prime Value			$543.51	$45.29
Actual Prime Cost			$99.99	$10.99
Discount			82%	76%

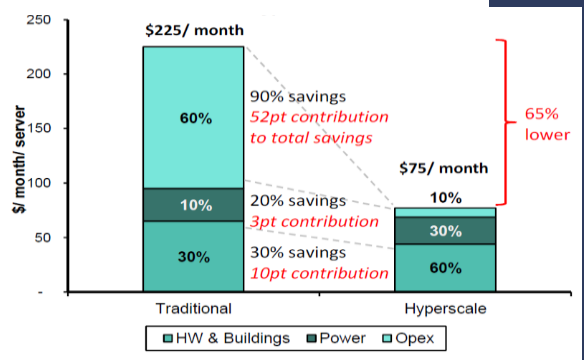
Source: JP Morgan estimates

Amazon is also disrupting the way businesses procure, develop and manage their Information Technology (IT) needs. Now 10 years old, Amazon Web Services (AWS) is the world's leading 'cloud computing' business and powers the IT workloads of over 1 million businesses in 190 countries. AWS is now bigger than Amazon.com was at 10 years old and is growing more rapidly with revenues expected to exceed US$10bn in 2016.

AWS is a 'public cloud' computing platform. Cloud computing may be difficult for some to conceptualise, but put simply it is any computing service that is provided over the internet. When you search for something in Google, the words you type are sent via the internet to a handful of Google's 4 million computers (servers) which do the work of finding the answers and sending them back to your screen. The computer executing your search request may be located in one of many locations across the globe, you'd never know and you don't need to!

Originally built to power Amazon's own online retail business, AWS has revolutionised the way IT infrastructure and needs are consumed by enterprises. Traditionally a business would purchase and reside all its computer hardware and software on premises (e.g. desktop computers, network servers), requiring up-front expenditure and specialised IT staff to maintain the systems. It is also highly unlikely that an enterprise would ever fully utilise the capacity of its technology infrastructure, with utilisation rates as low as 15%. Cloud computing platforms like AWS provide all the same functionality as a traditional setup but offer a 'pay as you go' service which can be accessed seamlessly over the Internet. Users of AWS platform effectively drive full utilisation for every dollar of spend, a far more efficient use of capital. The resulting efficiency gains and cost savings are profound. The analysis below considers the savings under a scenario of a larger scale enterprise database/data centre using AWS vs traditional (Fig 16).

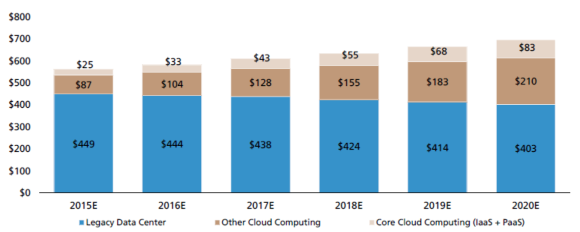
Hyperscale is 65% cheaper than traditional data centres FIG 16



Source: Bernstein analysis, Gartner

The core cloud computing market relevant to AWS was estimated at $25 billion in 2015 and is expected to grow to $83 billion by 2020. To put this in context, total IT spending was estimated to be $2.2 trillion in 2014, of which a third is related to enterprise IT infrastructure. While cloud computing is currently a small fraction of the massive IT spend, as AWS develops more functionality across more IT verticals, it will continue to grow its total addressable market, a market that is expected to be nearly $300 billion by 2020 according to UBS estimates (Fig 17).

US data centre & cloud computing market size (US$bn) FIG 17



Source: UBS

Over the last two decades Amazon have created three remarkable businesses; the retail marketplace, Prime and AWS. All three have significant runways for growth as they rollout out globally. Their engrained customer focus and infrastructure network create palpable barriers to entry.

Performance Review

The June quarter was another difficult one for investors in shares, with gains enjoyed early in the quarter pared back as the implications of the 'Brexit' referendum were digested by global markets. ALF began the quarter with a net short exposure to the market of almost 30%, reflecting our view that the relief rally which began in February would be short-lived. This positioning worked against the Fund in April and May as the share market extended its gains. Volatility returned in June as markets struggled to price the likelihood of a 'Brexit' and our positioning was ultimately validated when markets sold-off heavily in response to the referendum result.

The All Ordinaries Accumulation index increased by 3.9% in the quarter outperforming ALF (given its net short positioning), which delivered 2.5% after all fees. Being largely insulated from macroeconomic events, the market neutral funds fared better delivering 3.3% on average with substantially less volatility that the share market.

Defensive shares are very much back in vogue given the macroeconomic climate and provided some of the strongest contributors to performance during the quarter. In healthcare, the portfolio strategy has been to avoid or short-sell the most expensive domestic names while investing in stronger businesses offshore, which are trading on more reasonable multiples. *Merck & Co* and *Medtronic* were two notable long positions in the quarter, while a core short in a domestic biotechnology name also performed well.

Infrastructure and Utilities shares are also well-positioned to withstand the volatility being felt more starkly in other sectors of the share market. The Funds were well-positioned in respect of changing regulatory and competitive dynamics amongst Australian Utilities and a core positon in *Transurban* also continues to perform well. We still hold a negative view on the major Australian grocery retailers, with a preference for discount retail formats such as *Costco Wholesale Corp*.

Cyclical parts of the economy outside the property market continue to struggle. Mixed messages from central banks, political instability and weak income growth have all weighed on consumer and business sentiment, with little respite expected. The portfolios were net short in retailing and transport throughout the quarter. *Fairfax Media* has been a core position for many months and continues to perform well, led by the strength of its *Domain* real estate business.

Financial shares were hit hard towards the end of the quarter as the fallout from the 'Brexit' referendum rocked fragile asset markets around the world. While asset managers had enjoyed a tailwind as share markets rallied, they were hardest hit when markets fell and the portfolios benefitted from short positions in this sector. The major banks rallied from their lows in April but finished the quarter more or less where they started. We remain circumspect on the outlook for Australian banks and their expensive Canadian peers and have positioned the portfolios accordingly.

The Resources sector has been a bellwether for much of the volatility that has characterised recent months. Notwithstanding a modest recovery in the price of certain bulk commodities and the continued strength of popular sectors such as lithium and graphite, we are ultimately in a bear market for commodities. We retain a neutral exposure to mining and energy shares, with investments in Gold and Lithium producers amongst the best performers in the quarter.

Company at a Glance – June 2016

ASX Code	ALF
Fund Size	AU$363.9m
Fund Strategy	Variable Beta
Shares on Issue	269.9m
Dividend (FY16 Interim)	5 cents
Dividend Yield (annualised)	6.9%

Net Tangible Asset (NTA) Backing

	May 16	Jun 16
NTA Before Tax	$1.32	$1.33
NTA After Tax	$1.32	$1.33

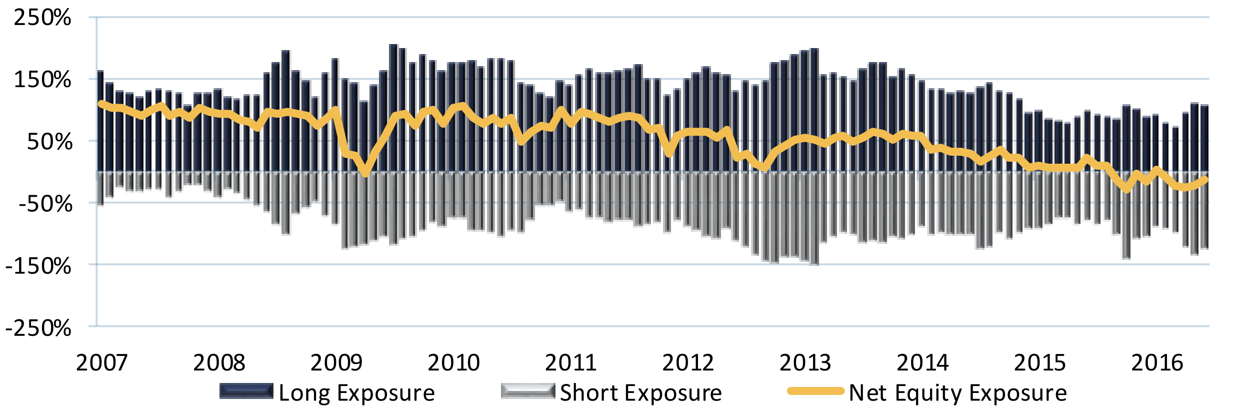
Gross Portfolio Structure

	May 16	Jun 16
Long Exposure	111.6%	107.9%
Short Exposure	-133.4%	-122.5%
Gross Exposure	245.0%	230.3%
Cash	121.9%	114.6%

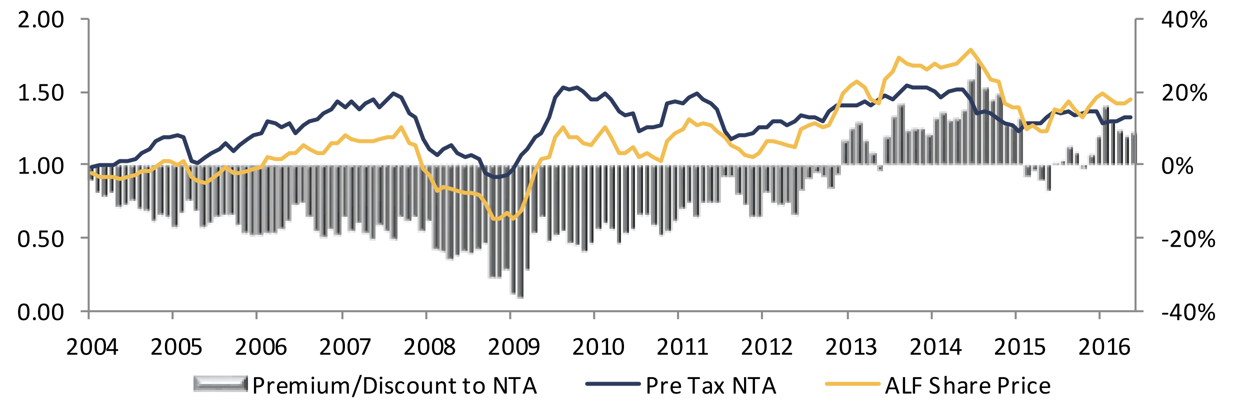
ALF Performance

	1 Mth	6 Mths	1 Yr	3 Yrs (pa)	5 Yrs (pa)	7 yrs (pa)	S.I. (pa)
Portfolio Return (net)	1.0%	1.8%	11.2%	9.3%	11.3%	14.1%	13.9%
All Ords Accum Index	-2.3%	1.6%	2.0%	8.2%	7.3%	8.9%	8.5%
Outperformance (net)	3.3%	0.2%	9.2%	1.1%	4.0%	5.2%	5.5%

Net Equity Exposure (% of Capital)



Historical Premium/Discount to NTA History



WATERMARK FUNDS MANAGEMENT

Market Neutral Trust

APIR: WMF0001AU

Fund at a Glance – June 2016

Fund Size	AU$59.7m
Strategy FUM	AU$153m
Fund Inception Date	August 2012
Fund Strategy	Equity Market Neutral
Application/Redemption	Daily
Management Fee	1.5%
Performance Fee	20%
Benchmark	RBA Cash Rate

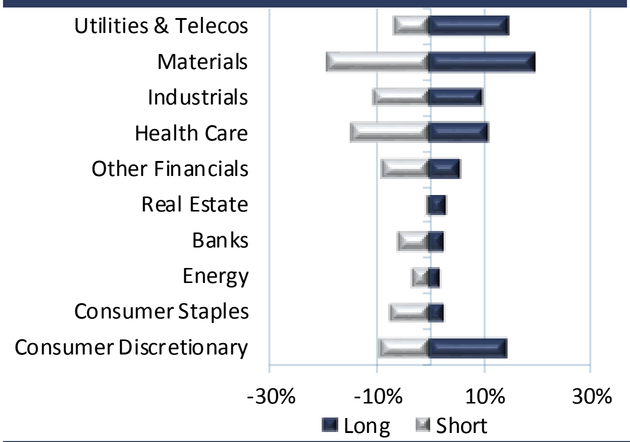
Return Characteristics[1]

Positive Months	70%
Portfolio Beta	-0.22
Sharpe Ratio	1.7
Sortino Ratio	4.9
Standard Deviation	7.5%
No. Long Positions	55
No. Short Positions	55
Gross Exposure	175.5%

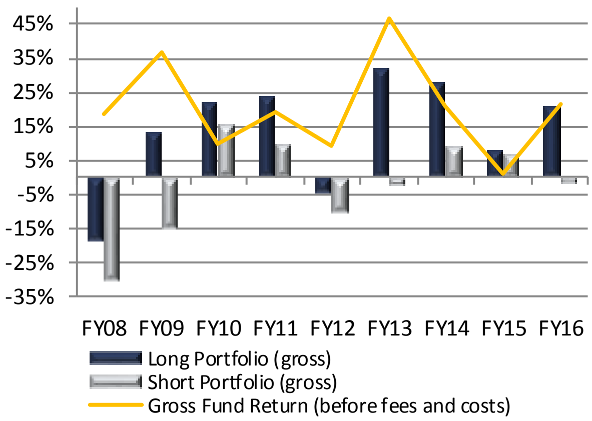
Performance[2]

	1 Mth	6 Mths	Fin. YTD	1 Yr	2 Yrs (pa)	S.I (pa)
WMNT (net return)	1.8%	2.4%	17.2%	17.2%	9.7%	15.2%
RBA Cash Rate	0.1%	1.0%	2.0%	2.0%	2.3%	2.5%
Outperformance	1.7%	1.4%	15.2%	15.2%	7.4%	12.7%

Sector Exposures



Long/Short Spread[3]



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**
2016	-0.14	-1.92	1.13	0.53	1.08	1.76							**2.44**

[1] Return Characteristics are in relation to the market neutral strategy using long/short return series recorded from April 2008
[2] Performance data is net of all fees and expenses. The Fund's inception date is August 2012
[3] 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

Watermark Market Neutral Fund Ltd

WATERMARK FUNDS MANAGEMENT

Company at a Glance – June 2016

ASX Code	WMK
Fund Size	AU$93.4m
Fund Strategy	Equity Market Neutral
Shares on Issue	87.1m
Dividend (FY16 Interim)	2.5 cents
Dividend (FY16 Special)	1.0 cents
Dividend Yield (annualised)	5.9%

Net Tangible Asset (NTA) Backing

	May 16	Jun 16
NTA Before Tax	$1.07	$1.06
NTA After Tax	$1.06	$1.07

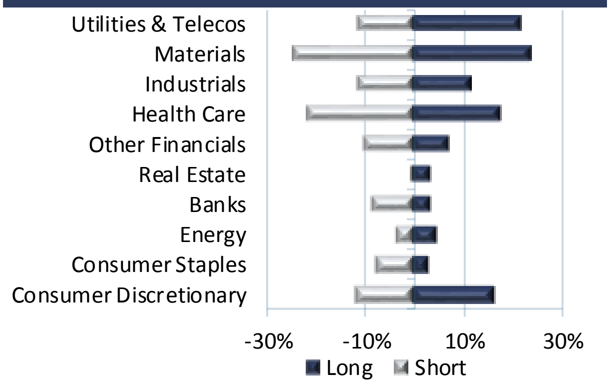
Gross Portfolio Structure

	May 16	Jun 16
Long Exposure	117.9%	111.9%
Short Exposure	-121.1%	-114.1%
Gross Exposure	239.0%	226.1%
Cash	103.3%	102.2%

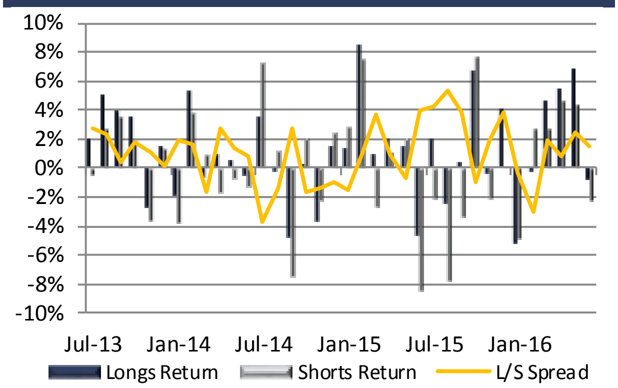
WMK Performance

	1 Mth	6 Mths	1 Yr	S.I. (pa)
Portfolio Return (net)	1.4%	2.2%	16.2%	8.5%
RBA Cash Rate	0.1%	1.0%	2.0%	2.3%
Outperformance (net)	1.3%	1.2%	14.2%	6.2%

Sector Exposures

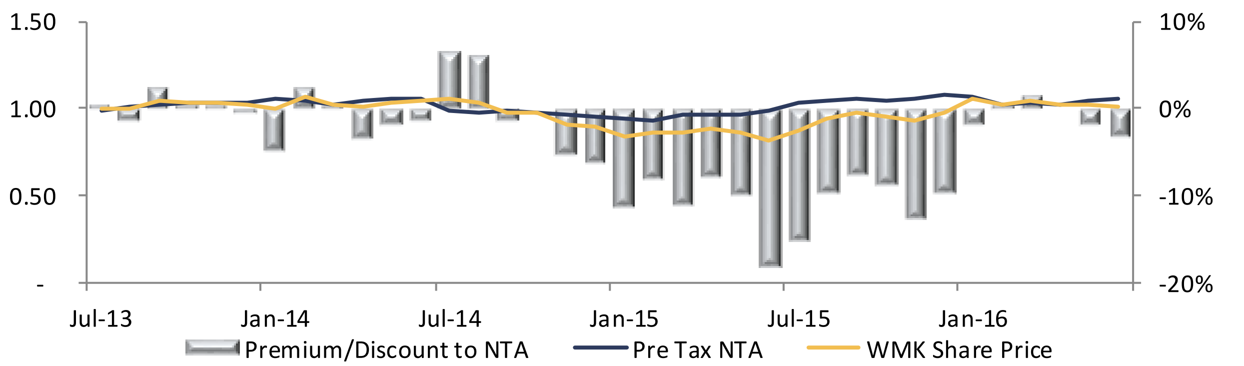


Long Short Spread*



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

Historical Premium/Discount to NTA



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WATERMARK
FUNDS MANAGEMENT

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