

26 February 2019

A MESSAGE FROM THE CHIEF INVESTMENT OFFICER

Dear fellow Shareholders,

While it has been a difficult few years for Watermark funds, capital losses were largely mitigated until the final quarter of last year, when Long/Short managers the world over experienced material draw downs. The financial results for Australian Leaders Fund Ltd (ALF, the Company) announced today while unsatisfactory, do not reflect the positive developments occurring at Watermark which I would like to share with you.

We have made the difficult decision to exit international shares, returning to our roots as an investor in the Australian market. While we will be a stronger manager in the longer run for our experience in international shares, it diminished our ability to outperform in the local share market.

We have strengthened our Australian team and today we have more resources and experience dedicated to the local share market than at any time in the past. We have started the new-year well, with the team having successfully navigated through the recent profit results. The portfolio is full of good ideas and is fully hedged, providing considerable protection against the volatile markets that lie ahead.

We have reset the business and are back doing what we do best. I am confident we can return to the performance of old in the year ahead.

This has been a difficult period for the Company in many respects. Our cautious portfolio settings have not yet been vindicated, and the portfolio has lagged its benchmark for some time. The Board has also had the unenviable task of re-setting Shareholders' expectations in respect of the dividend that the Company can sustain, putting further pressure on the ALF share price. These factors have all combined to leave the Company's shares trading well below the Net Tangible Asset Backing.

At times when we feel higher levels of protection are warranted, exposure to the underlying share market will be fully hedged. This places greater reliance on stock selection as the primary driver of Fund returns. The cost of this protection is twofold: While the Fund is fully protected from a falling market, it derives no benefit from a rising market; nor does it receive a dividend yield or 'carry' on its portfolio, given dividends received on the Company's investments are paid away to the beneficial owners of the shorts (part of the cost of the hedge).

During periods where the portfolio is fully hedged, the Company derives its return exclusively from capital profits; dividends are not retained. ALF's portfolio will track sideways unless we can create capital returns or 'alpha' through our security selection. Historically, we have been very successful in doing this. This can be seen clearly in *Figure 1*: ALF's Pre-Tax NTA (before dividends paid to shareholders) has performed in line with the All Ordinaries Index over the last 4 years. The Fund has underperformed the *Accumulation Index* (ALF's benchmark) however, by the amount of the dividends which we don't receive. We would have hoped to bridge the gap by creating 'alpha' but have fallen short in recent years.

For personal use only

Figure 1: ALF NTA Performance versus All Ordinaries Price & Accumulation Indices



Economic Outlook & Market Update

Shares fell sharply in the closing stages of 2018 and bottomed on Christmas Eve, before recovering most of their December losses in January. Many share markets around the world have moved decisively into bear territory as investors contemplate a confluence of slowing growth, rising inflation and restrictive monetary policy.

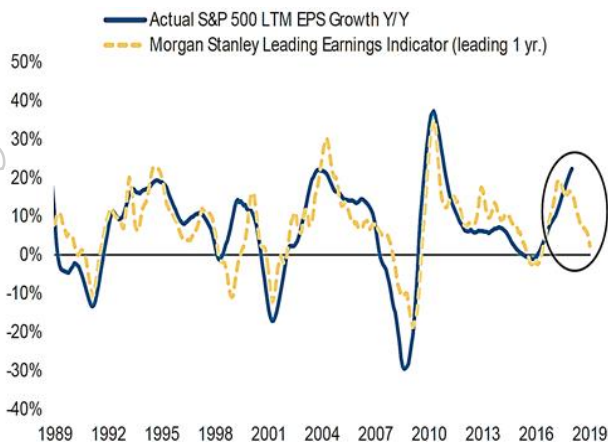
Activity indicators have slowed, particularly in Europe, which had a very weak final quarter to 2018. Activity in China is also slowing faster than expected, while leading indicators in the US are holding steady. While we may end up seeing a small contraction in global industrial production in the quarters ahead, a broader economic downturn is not on the immediate horizon.

Shares were oversold going into Christmas. With the US Federal Reserve softening its stance on interest rates and trade tensions with China easing, shares have staged a strong recovery early in 2019. The key question now is whether this is simply a throw-back rally in a new bear market or a correction with the market yet to advance to new highs in the year ahead.

I suspect the answer lies somewhere in between, with 2019 looking much like 2018 where shares move sideways to down as the year progresses. We are running out of runway in this cycle, the prospect of another final rally diminishes as time slips by. With activity slowing, profit forecasts are too high and will have to be lowered, ensuring profit downgrades in the medium term (Fig 2).

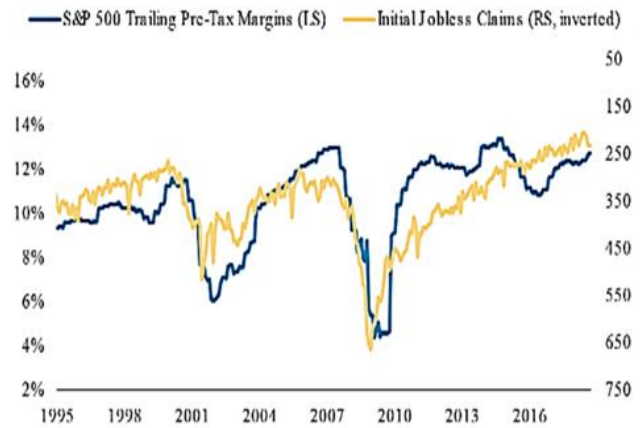
For personal use only

Figure 2: Slowing Profit Growth



Source: Morgan Stanley Research

Figure 3: Profit Margins have Peaked



Source: Morgan Stanley Research

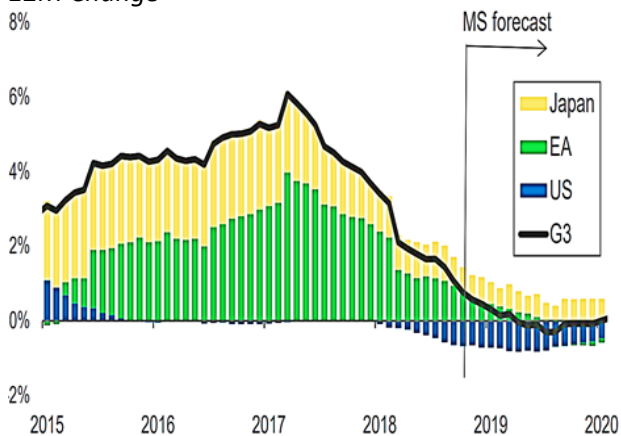
We could be in for an earnings hiatus not unlike the two years from 2014 through to 2016 when profit growth stalled on a stronger US dollar and falling oil prices. These cycles typically last a few years and don't resolve quickly. We have a similar matrix now of slowing activity and rising costs, squeezing margins which look to have peaked (Fig 3).

While we are not looking for a downturn on the immediate horizon, we may see an 'earnings recession' where profits fall for a quarter or two given the inflated level of corporate profits which have tripled from GFC lows a decade ago. It is hard to see how shares can sustain a rally with this backdrop.

Incorporating some modest downgrades to 2019 profit forecasts for the S&P 500 Index, at 2750 the US market is trading at 16.5 times (P/E) forecast earnings, this looks fully valued at this late stage of the cycle.

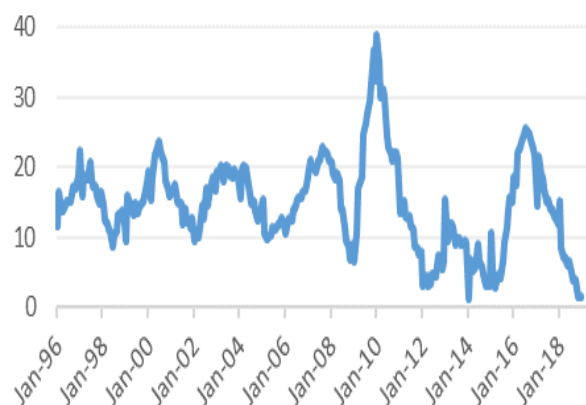
There is some good news however, in so far as interest rates will increase more slowly than many feared, as the US Federal Reserve steps back from the abyss. Share markets will still be challenged through 2019 however as all G4 Central Banks will either be raising interest rates or withdrawing liquidity through 'Quantitative Tightening' (unwinding QE), a first for this cycle (Fig 4).

Figure 4: Central Bank Balance Sheets (% of GDP) 12M Change



Source: Morgan Stanley Research & Haver Analytics

Figure 5: M1 Growth (Credit Growth Proxy)



Source: Bloomberg

No one fully understands the sensitivity of the economy to interest rates. There are many who believe policy in the US has already been tightened too far- while US interest rates are now at 'neutral' levels, because they have been below neutral for so long, market stresses are likely to emerge sooner.

For personal use only

For personal use only

For shares to rally to new highs, we would need to see a return to synchronised growth as occurred in 2016/2017. This is unlikely as the world's second-largest economy China is decelerating quickly as credit to the shadow banking sector was removed last year (Fig 5).

Consumer spending and trade in China have contracted in recent months, and while the property sector has held up surprisingly well, it is likely to fall later this year given weaker orders held by major developers. The central government is well progressed in re-stimulating the economy by cutting interest rates and taxes while lifting infrastructure spending. This is unlikely to boost activity until later in the year.

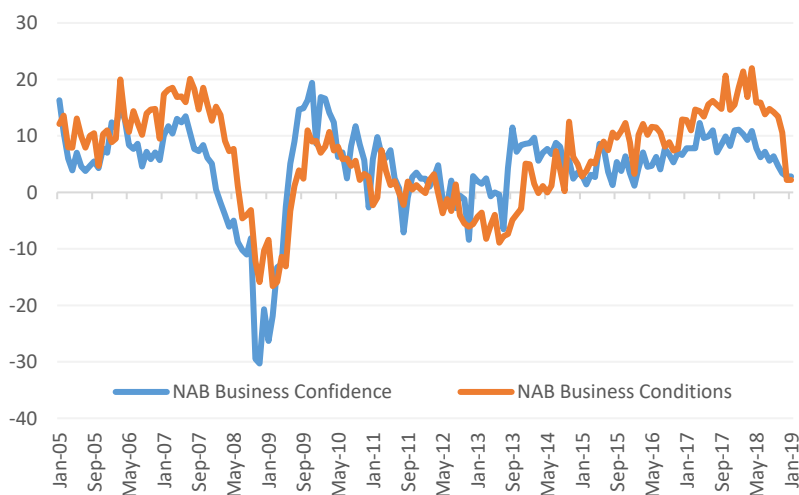
Turning to Australia, a slowing Chinese economy will be pivotal given the importance of the trade relationship. Growth in export volumes and commodity prices have been a tailwind for our economy in recent years but this is now waning. The outlook for domestic demand is mixed, although on a positive note, we are finally seeing some modest growth in household income which has been absent in recent years.

The positive impulse from public spending and the recovery in the mining sector is peaking, while a contraction in credit is deflating an overvalued housing sector, creating stresses in some indebted sections of the economy. Consumption, the dominant force in the economy, has been supported in recent years by a reduction in the savings rate as income growth has been anaemic. The savings rate is now low and unlikely to fall further, so an increase in wages is crucial to sustain growth in spending from here.

Australian household indebtedness is high for a developed economy and credit will no longer be a source of support, particularly as banks tighten unsecured lending. Consumer confidence is the critical swing factor and falling house prices don't help. Recent weakness in retail sales and discretionary spending would suggest households are becoming more cautious. State and federal elections this year are likely to dampen spending further and disrupt business continuity.

For the optimists on the economic outlook, who have pointed to a recovery in business investment, a cursory look at the latest NAB business survey of business confidence would be alarming (Fig 6).

Figure 6: NAB Business Survey



Source: Bloomberg & CLSA

On balance we suspect the economy will lose momentum this year, absent an external shock or disorderly deflation of the housing bubble, we are unlikely to see an outright contraction in activity any time soon as a new Federal Labour Government is likely to boost spending and wages, buttressing domestic demand.

As for the share market - I am firmly in the Bear camp. I cannot see shares making a new high any time soon; we could however see the market test new lows later this year or early next year. Key sections of the market are challenged - profits are unlikely to grow for the major banks in the medium term; this is also true for

defensive sectors such as telecom and utilities. Mining companies have held up remarkably well given the slowdown in China and will most likely trade sideways from here. This leaves the broader industrial market where growth is still overvalued despite the recent pullback, and profit expectations are likely to be paired back as the economy slows.

The funds are overweight the defensive segments of the market: infrastructure, regulated utilities, property, general insurance and staples; while maintaining shorts in housing and retail. The portfolio is neutral in mining, with shorts in the bulk commodity producers and longs in base metals and gold. We are in a bear market for oil, given the weaker demand backdrop and are defensively positioned in this sector.

Managing ALF’s Net Equity Exposure

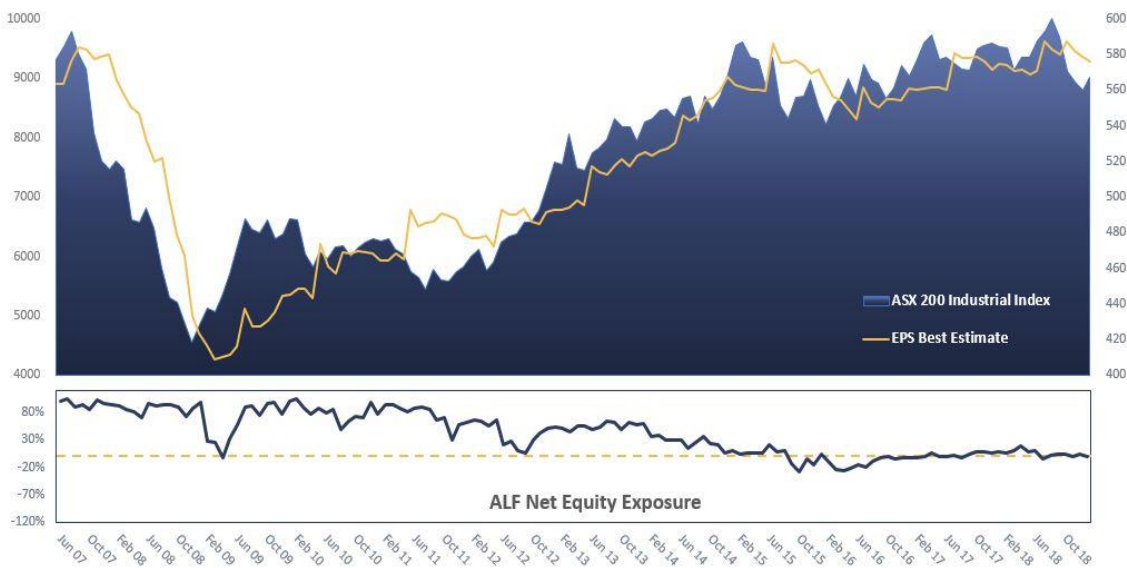
When shares are cheap and earnings momentum is supportive, ALF will retain an exposure to a rising market. Conversely, at times such as now when shares are fully valued and risks are elevated, ALF’s net equity exposure is likely to be low, in order to hedge against the risk of a major setback for shares.

This can be seen clearly in *Figure 7* which shows ALF’s net equity exposure as compared with the performance of the Australian share market, as led by consensus estimates for corporate earnings.

There are several key lessons that arise from the chart:

- ALF’s net equity exposure was too high in the lead up to the GFC and the Fund suffered a major draw-down when the Australian market crashed
- We responded quickly as markets recovered, setting the fund to benefit fully from the rising market while adding additional value through security selection
- We were active in adjusting ALF’s net exposure through the middle phase of this cycle, in response to major events such as the European Sovereign Debt Crisis and in consideration of market valuations and earnings trends
- As market valuations pushed higher, we reduced ALF’s net equity exposure. A reflection of the increased risk of an expensive market
- The Australian share market peaked in 2015 and corporate earnings began to deteriorate. ALF was fully hedged and significantly outperformed the Australian share market
- We did not increase ALF’s net exposure as markets rallied in 2016/17 and underperformed as a result.

Figure 7: ALF Net Equity Exposure through the Market Cycle



For personal use only

The lessons learned through the GFC have been front of mind as we have moved through the final phase of what has been one of the longest bull markets in modern history. With markets only recently having recovered (in price terms) the losses suffered in 2008, our caution has been informed by an overarching objective to protect our investors' capital from another major setback. We justify this caution with the knowledge that we have historically been able to create enough value through our security selection, to sustain an adequate return without any exposure to the market. Unfortunately, we have not delivered in this regard in the last 3 years.

While it may seem that ALF has been stuck in a market neutral setting for some time, this is a function of the market backdrop and the risks that we see, rather than a shift in the Company's investment strategy. For so long as the outlook for shares remains highly uncertain and valuations are stretched, we will retain our defensive portfolio settings, in order to protect investors from the risk of a major draw-down, which will inevitably come as this cycle completes.

However, if the share market was to move lower and value was restored, which we fully expect to occur in the next year or so, we would look to significantly increase ALF's exposure. As seen in *Figure 7*, we did this successfully in 2009 when markets rebounded after the Financial Crisis and will look to do so again when the opportunity presents itself.

Yours Sincerely



Justin Braitling