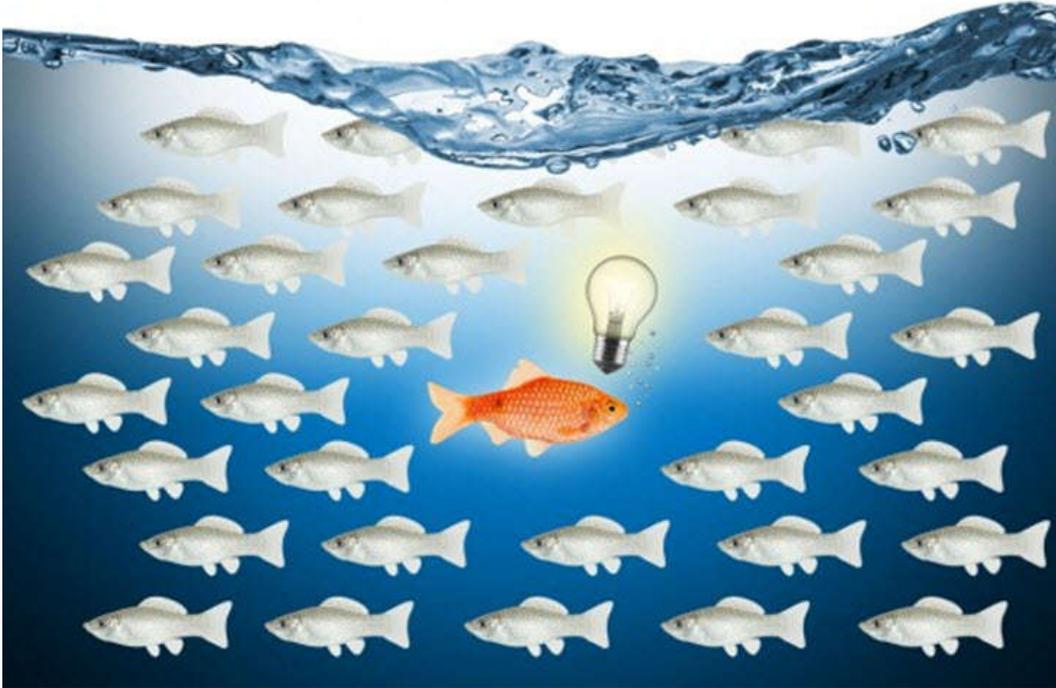




WATERSHED

FUNDS MANAGEMENT



Swimming Against The Stream

Advisers that read our market commentaries will know that for some time now we have been increasingly cautious on the outlook for equities both domestically and abroad (See mailout 'Is a Bubble About to Burst?'). As share markets have soared to record highs, investors have remained unperturbed by the fact that market valuations have also ballooned against a backdrop of negligible earnings growth. Equally they have been happy to ignore the massive global central bank stimulus that has principally driven this market appreciation, and the unsustainable current fiscal deficits in the US and elsewhere that is engineering only marginal rates of productivity growth. We have in fact witnessed the trademark collective rationalisation of a share market bubble where warnings have been discounted and tenuous key assumptions have remained unchallenged. The extreme market pricing has been justified by the fact we are in a new, unprecedented economic environment where interest rates will be lower for perpetuity and earnings growth is an eventual, convenient inevitability. And this "new

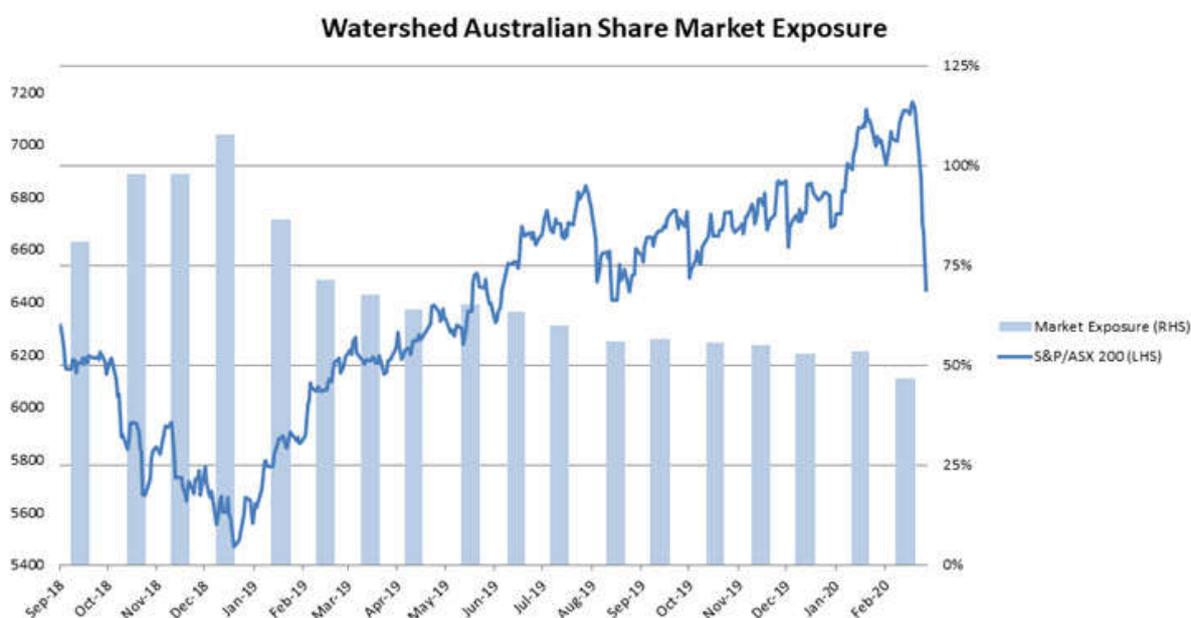
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normal” apparently requires a greater leniency when evaluating a share market’s worth. This flimsy justification of heightened valuations conjures memories of famed investor Sir John Templeton who once famously opined that “the four most stupid words in investing are: “this time it’s different”.

Though it is difficult to reduce exposure to an equity market posting new all-time highs almost daily, we have maintained conviction in our fundamental assessment of market value and conviction that this contrarian approach would reap longer-term benefits. The chart below details our gradual reduction to share market exposure (within the Australian Share SMA) as the Australian bourse has surged to record highs.



The above chart illustrates that we have moved from having a small leveraged position early last year when the ASX 200 hit a low of 5,400, to now being net long only 48% today. This provides a lot of firepower to buy the current correction.

The market’s complacency with valuation has been sorely shaken this week with a new headwind emerging that poses significant risks to markets domestically and abroad - the coronavirus. Initially fears of a meaningful global growth disruption were brushed aside, with the virus thought likely to only impact the first quarter. But in the last few days of February, containment looks to have failed as multiple cases have emerged outside of China. Substantial anecdotal evidence of supply chain issues and collapsing Chinese demand that were previously ignored or dismissed as temporary in scope are now forefront of mind. China is obviously one of the two most important economies in the world and any challenges to its economic growth has global ramifications. And the economic data out of China, though sometimes questionable in terms of its veracity, is

currently abysmal and suggests activity has ground to a halt during the virus. Even though reported new cases fell overnight, the country is still facing the challenge of getting their people back to work quickly without flare-ups of the virus causing further substantive health and economic challenges. Equally, as the virus spreads to other countries there will undoubtedly be further adverse knock-on effects to the global economy and subsequently investor confidence. In this scenario, the extended late market cycle is likely over with the inevitable growth expectation of the “new normal” proven a fallacy, and investors still long the equities market will learn a harsh lesson in market valuation and its reversion to its historical mean.

At Watershed, our Portfolios have been positioned for a sell off with elevated cash levels at the asset allocation level (having taken equity exposure off the table in December 2019 and put into alternatives – See ‘Trade Update – Diversified Model Rebalance’), and higher cash and market short positions at the direct investment level. This provides the portfolios with plenty of downside protection, but also the ability to deploy the cash quickly and come out of this volatility in a strong position. The net equity exposure for the Watershed Balanced Portfolio is 40.5% compared to its neutral target of 60%. The remaining allocation is split between cash, alternatives and fixed interest/income securities. This conservative positioning has been in place across our suite of products for some time now as we have communicated in our recent updates and webinars.

During this period of elevated valuations, and given the complacency of markets given the backdrop of limited earnings growth (especially in Australia) and the state of the virus (until this week), the portfolios have been positioned with a focus on capital protection. This has hurt relative performance in the last few months, albeit producing strong absolute returns, but the positioning has provided invaluable protection in the recent selloff.

All our SMAs are currently available for investment on the HUB24, OneVue, Mason Stevens, Fiducian, Praemium and Netwealth Platforms.

If you would like to discuss how any of these strategies can add value to your client portfolios please contact our Business Development Manager, Shantelle Lay on (03) 9614-8899.

Performance Fee Disclosure

The performance returns have been calculated on a daily basis taking into account brokerage costs, and are accumulated for the period shown. Returns are shown as annualised if the period is over 1 year, or as total returns otherwise.

Watershed Funds Management

Watershed Funds Management is a specialist Managed Account (MDA & SMA) Provider and has been a pioneer in the delivery of these portfolio solutions to financial advisers. Watershed leverages the expertise of a highly credentialed investment team to form a global thematic view that determines asset class and sector allocations. Our investment committee structure differs for each SMA and is chaired by an individual with niche expertise and a proven track record for managing portfolios within that asset class. With a research process that is both rigorous and thorough we have been able to deliver strong historical returns across our full suite of Managed Accounts.

An investment in a Watershed Managed Account provides professional and active investment management with full transparency of holdings, transactions and structure. Watershed seeks to form a collaborative relationship with advisers, actively communicating portfolio strategy in the current market environment so that advisers are better equipped to communicate with their clients..
