WATERSHED

FUNDS MANAGEMENT

REPORTING SEASON SUMMARY – Upcoming Webinar

The Australian market continued to grind higher through the August reporting season finishing up 2.2%. Once again however, this lagged US equities, with the S&P500 up 7% and the technology heavy NASDAQ up nearly 10% in the month. The Small Ordinaries on the other hand was up 7.1% and has continued its strong performance through the pandemic. A key driver of our Diversified portfolios performance this month was a healthy exposure to the Global Tech titans in our international share SMA and an overweight to mid cap companies and continued strong performance from our Emerging Leaders SMA.

Reporting season was mixed, with expectations tempered after analyst downgrades in the third quarter. The market rewarded those that beat expectations OR provided an earnings outlook for the current year, after many withdrew guidance during the peak of the pandemic.

Key themes through reporting season were the effect of **huge levels of fiscal stimulus** and the **outperformance of technology** stocks with an acceleration in the shift to online. The level and speed of the fiscal stimulus was unprecedented and has provided some level of relief, either directly or indirectly, to most sectors. **Strong balance sheets** have remained a focus with a few coming to market for funds and expectations of a few more to come. Costs have generally been managed diligently and debt has been relatively easily raised or refinanced where needed, thanks to the liquidity provided by very supportive central banks globally. The biggest concern noted was around the environment once the **fiscal stimulus starts to roll off**.

Diving into sector specific performance, which was very mixed:

- **Information Technology** (up 14.9% in August), was the best performing sector in the market. The pandemic has forced years of technology transition into months, but the weight to technology in Australia is too small to provide a material lift to the overall market, especially when compared to the US.

- **Consumer Discretionary** spending (+8.8%) was a major beneficiary of the fiscal stimulus, with government payments (Job Keeper/Seeker), Mortgage deferments and early access to super helping quell softer demand and shift discretionary spending away from travel and eating out, to home DIY (WES), home furniture (NCK, TPW) and tech (JBH, HVN), just to name a few, much of which was purchased online. We are slightly underweight in the large cap portfolio but saw strong results and performance from Baby Bunting and Collins Foods in the mid cap portfolio. We are reluctant to chase the large discretionary retailers here given risks around the length of recession and eventual stimulus roll off.

- The two worst performing sectors were **Utilities** (-6%) and **Communications** (-5%) which were dragged down by AGL and TLS both guiding to a decline in earnings in FY21. Travel and Leisure stocks actually had a relatively strong month reflecting investors desire to own vaccine beneficiaries, but still remain significantly down on the year. We currently do not have any exposure to Telcos or Utilities.

- **Materials** as a whole were largely flat (+0.3%) with strong commodity prices offset by falls in gold. Iron ore prices above US$100tonne will drive big earnings upgrades if spot prices are incorporated, so the longer it stays at these levels (currently >US$120mt) the better for the majors. Strength is driven by a global wave of stimulus that will cause an increase in commodity intensive infrastructure and construction work, especially in China. We remain overweight BHP and Rio Tinto, and saw very strong gains from Mineral Resources in the mid cap portfolio.

- **Financials** were largely flat (0.7%) after the banks 3Q earnings failed to instil confidence, and while those on mortgage deferrals did fall, net margins fell and provisioning for bad debts increased while the heavily sought after dividends were cut or removed. We remain significantly underweight financials.

- **Health Care** was strong (+4%) with the backlog from hospital closures and delays to elective surgeries coming through as restrictions around the world were eased. While Resmed (respiratory devices) was slightly weaker post reporting we saw strong performance from Sonic Healthcare which benefit from Covid testing globally.

- **REITs** rebounded 7.4% during the month with those providing guidance well received after significant underperformance leading into the results. Big questions still remain about the structural shift to online impacting retail landlords and whether the work from home thematic will see softer office demand in future. We remain underweight REITS but do own Goodman Group which not surprisingly delivered another very strong result from industrial property linked to supply chains.

With results now finished, Australian EPS fell 20% in FY20, the largest fall being the banks (-32%) with only a small fall in Resources (-2%). FY21 EPS is forecast to rise around 5% in Australia despite banks being forecast to deliver another year of falling earnings. Broader market performance from here will be heavily reliant on whether this is met.

Portfolio Positioning:

Underlying portfolios went into reporting season with a medium cash buffer given the uncertainty, with the view to deploy into any compelling investment opportunities. But with US markets back to record highs and the Australian market now trading on nearly 20x FY21 projected earnings we feel it prudent to maintain this cash buffer for the time being.

One of the very interesting thematics across August was a continuation of the valuation dispersion between value and growth companies, where already expensive growth companies generally traded to even higher levels while cyclical value stocks continued to underperform. There has been plenty of press regarding the loss of substantial mandates from a few well known value managers which we suspect is being transitioned to growth managers and being funnelled into the same small numbers of companies. This we believe will provide an interesting opportunity in time and will be an area of focus for us as we complete our full year results analysis.

If you would like to discuss how this investment can add value to your client portfolios please contact our Business Development Manager, Shantelle Lay on:

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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.

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