WATERSHED

FUNDS MANAGEMENT

Quarterly Update March 2021

Watershed Income Portfolio

Investment Profile

The Watershed Income SMA is a concentrated portfolio of listed debt, hybrid securities and ETF's or LIT's aiming to generate an income return of 2% above the UBS Bank Bill Index net of fees.

A separately managed account, or SMA, is a professionally managed portfolio whereby the investor receives beneficial ownership of the underlying securities.

The Watershed Income portfolio has a bias towards floating or variable rate fixed interest securities to minimise interest rate risk.

The portfolio should be viewed as defensive with minimal capital volatility and is not expected to generate any long term capital growth.

Key Portfolio Features	
Inception	30 Aug 2010
Benchmark	UBS Bank Bill Index
Authorised Investments	Listed Bonds Hybrid Securities Listed Debt
Number of Securities	10-20
Cash Allocation	2-20%
Investment Horizon	At least 2 years

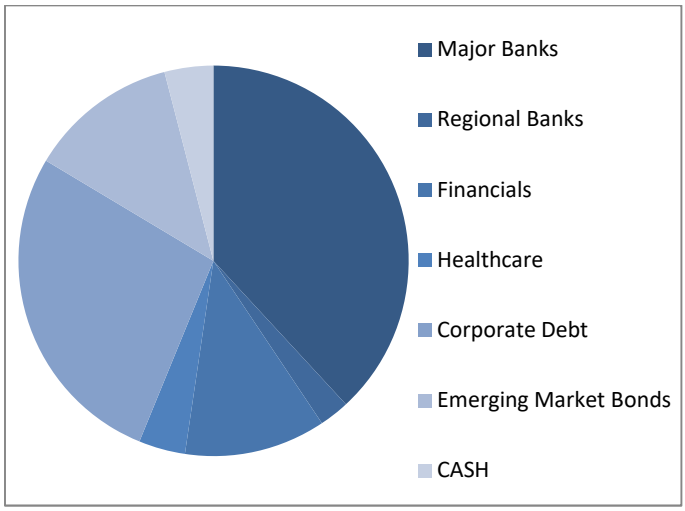
The Portfolio is designed for investors who…

- Seek higher than market, stable, tax-efficient income returns
- Have a medium-term investment horizon and are not expecting any capital gains from their investment

Portfolio Structure

No.	Company Name	ASX Code
1	MCP Master Income Trust	MXT
2	Vaneck Emerging Income Fund	EBND
3	KKR Credit Income Fund	KKC
4	Nab Capital Note 3	NABPH
5	ANZ Capital Note 6	ANZPE

GICS Sector by Issuer	
Major Banks	38.13%
Regional Banks	2.50%
Financials	11.71%
Healthcare	3.85%
Corporate Debt	27.38%
Emerging Market Bonds	12.39%
CASH	4.04%
TOTAL	100%



Performance

Gross Performance (%)	1m	3m	6m	1yr	3yr	5yr	7yr	9yr	Inception *
WFM Income Portfolio	-0.57%	-0.78%	2.67%	15.44%	4.10%	5.53%	4.17%	4.90%	5.37%
WFM Including Franking	-	-	-	16.43%	5.35%	6.89%	5.52%	6.25%	6.72%
UBS Bank Bill Index	0.00%	0.01%	0.04%	0.14%	1.12%	1.41%	1.71%	2.03%	2.50%
Relative Performance	**-0.57%**	**-0.79%**	**2.63%**	**16.29%**	**4.23%**	**5.49%**	**3.81%**	**4.22%**	**4.22%**

*Inception - August 2010

Performance Fee Disclosure All figures & tables stating investment performance returns (BEFORE administration fees and taxes) for the Portfolio. 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.

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Quarter in Review

The Watershed Income SMA had weak quarter as the spike in bond yields caused some uncertainty in fixed interest markets. The Income SMA returned -0.78% for the March quarter.

We have now had a full 12 months since the depths of the market lows and while the drawdown of the portfolio was unwelcome (driven by a liquidity issue), the portfolio took advantage of the mis-pricing to buy the dips. The portfolio has returned 15.44% for the 12 months (16.43% including franking credit estimates) with the underlying holdings trading back within normal ranges.

Portfolio Adjustments

Trimmed: ANZPE, ANZPD, CBAPD, NABPH, WBCPH

Topped Up: EBND

Quarterly Performance Attribution

Top Contributors	Key Detractors
MQGPD	**KKC**
RHCPA	**EBND**

Market View

The March quarter began ticking along nicely, until inflation expectations overshot on the upside and bond yields soared in response. Central banks have tried to calm markets and maintain their rhetoric on keeping official interest rates on hold for at least three years. However markets remain of the view that the huge wave of global stimulus will cause inflation to start to overshoot initial expectations which has put some near term pressure on yields. Australian and US 10-year Treasury yields are fast approaching 2% which is closing in on pre-Covid levels.

The Reserve Bank of Australia (RBA) is still artificially manipulating the 3-year government bond yield through its Quantitative Easing program and has been unequivocal in its guidance that it will not raise rates until actual inflation is between the 2-3% range on a sustainable basis. They are currently not expecting to do so until at least 2024.

We still believe it is too early to position for a sustained rise in inflation that would cause Central Banks to tighten monetary policy and expect there is further upside to bond yields given the inflationary backdrop. We prefer credit and are overweight relative to bonds on this basis. Credit spreads have continued to return to normal levels after their spike last year, and are paying a much more attractive yield.

Emerging Market debt is still set to be big a beneficiary of the global economic growth backdrop and is also helped by higher commodity prices. Once the market digests the US Treasury selloff, the improving global growth outlook should again support emerging market debt and we remain bullish on this position, having again increased the position over the quarter (details below).

Portfolio Positioning

The Income portfolio has made some minor changes to lighten some of the larger hybrid positions which are trading back above par value and with current margins below 3% (historically a good indicator they are at the more expensive end), and re-allocate funds to both cash and Emerging Market debt.

The listed Hybrid sector has not just recovered from the selloff in Feb/March last year, but has pushed to higher levels than pre-crisis with credit spreads across the financials now well under 3% and prices in most cases trading above the issue/maturity price. We still remain positively disposed to the sector, with floating rate margins in what will become a rising rate environment, but have slightly reduced exposure to the sector within the portfolio by around 3% by trimming positions in ANZPE, ANZPD, CBAPD, NABPH and WBCPH on valuation grounds.

Proceeds have been used to increase cash to 4%. But also to add to the VanEck Income Opportunities ETF (EBND) which is focused on Emerging Market debt paying over a 5% yield. EBND sold off on the back of global bond yields rising, ultimately from strong growth prospects and inflation which is inevitably positive for Emerging Markets and EM debt. We added this position to the portfolio in April last year and have increased the weight 3 times as we have become more confident in the economic recovery.

The portfolio is almost fully invested, albeit having a bit of a rotation during the quarter to restructure its positioning. The gross running yield remains over 4% which is still very attractive in an environment of close to zero interest rates.