WATERSHED

FUNDS MANAGEMENT

IMAP MANAGED ACCOUNT AWARD FINALIST AUSTRALIAN FIXED INTEREST

Quarterly Update September 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

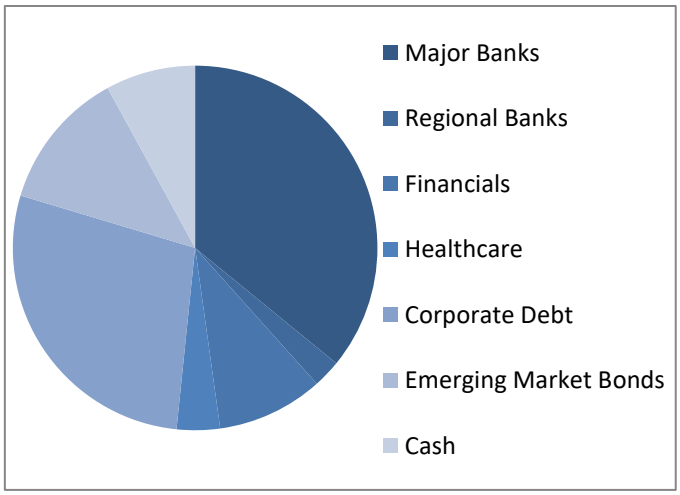
The Portfolio is designed for investors who…

- 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	KKR Credit Income Fund	KKC
3	Vaneck Emerging Income Fund	EBND
4	ANZ Capital Note 6	ANZPE
5	ANZ Capital Note 2	ANZPI

GICS Sector by Issuer	
Major Banks	35.90%
Regional Banks	2.47%
Financials	9.43%
Healthcare	3.83%
Corporate Debt	28.01%
Emerging Market Bonds	12.39%
CASH	7.97%
TOTAL	100%



Performance

Net Performance (%)	1m	3m	6m	1yr	3yr	5yr	7yr	9yr	Inception *
WFM Income Portfolio	0.33%	0.37%	3.29%	5.81%	3.43%	4.38%	4.15%	4.50%	4.98%
WFM Including Franking	-	-	-	6.80%	4.68%	5.74%	5.50%	5.85%	6.33%
UBS Bank Bill Index	0.00%	0.00%	0.00%	0.04%	0.78%	1.19%	1.52%	1.81%	2.38%
Relative Performance	**0.33%**	**0.37%**	**3.29%**	**6.76%**	**3.89%**	**4.54%**	**3.99%**	**4.04%**	**3.95%**

*Inception - August 2010

Performance Fee Disclosure The table above sets out the investment performance returns (AFTER investment management fees, but 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 a solid quarter as bond yields surged higher on progressing talks of Central Banks slowly unwinding their stimulus measures.

The portfolio has delivered positive returns in a month/quarter when most fixed interest managers would have struggled with developed market bonds falling as yields take off.

Portfolio Adjustments

Changes to the portfolio during the quarter:

Trimmed: NABPH, MQGPC, MQGPD

Quarterly Performance Attribution

Top Contributors	Key Detractors
ANZPI	**EBND**
WBCPH	**MQGPD**

Market View

Global fixed interest investors have been watching Central Bank commentary and reactions in bond markets closely as the narrative to tapering gets closer and closer. Inflation remains the canary in the coal mine as Reserve Banks walk a fine line between managing pricing pressures and supporting their respective economic recoveries. Decisions made at this level will have wide-reaching implications across all asset classes and global growth rates.

Domestically, the RBA announced at the September meeting that it would maintain the previous decision to lower weekly bond purchases from $5 billion to $4 billion but extended the purchases to February 2022. The RBAs base case is a return to pre lockdown conditions in the second half of FY22 in line with the vaccination rollout targets and reopening schedule, and it has doubled down on the prospect of no rate hike before 2024, opting to maintain highly accommodative funding conditions to stimulate economic growth.

In the US, the Federal Reserve narrative is moving more hawkish as talks about a start to tapering its massive QE program progress. While the expectations are this will be very gradual, and actual cash rates are not expected to rise until the end of 2022 at the earliest, bond markets have begun to price a rising rate environment earlier than initial expectations. The discussion about whether inflation remains transitory or may indeed be more permanent remains a key consideration for global central banks as they make these important decisions.

10-year bond yields in both Australian and the US rose significantly in September, ending a 6-month run of lower yields, as concerns grew around the prospect of inflation and Central Banks guided to the gradual unwind of the very accommodative monetary policy.

Portfolio Positioning

The Income Portfolio is positioned for the early to mid-part of the economic and interest rate cycle where interest rates/bond yields rise from extreme lows, and traditional fixed income assets (developed market Government Bonds) will likely perform poorly. This has certainly started to play out over September with the Fed talking about starting to taper it's QE programme and likely move off zero rates late next year or early 2023.

As mentioned above, September saw the US 10 year bond yield move up from 1.30% to 1.48%, which in turn saw negative returns from most global bond funds, with most of the European complex still near or even below zero. We expect it to head to 2% over the next 6 months (and potentially to 3% before the end of this cycle) and note it has pushed higher again so far in October to 1.61% and the Aussie 10 year is now 1.72% at the time of writing.

The current positioning is circa 52% floating rate hybrids that hold up relatively well in a rising rate environment, with 28% in high yielding credit securities (also floating rate) and 12% in actively managed Emerging Market Bonds (with far higher yield and far shorter duration than Developed Market bonds) that are expected to hold up well in a rising rate environment. The remaining 8% sits in cash after taking profits in several longer dated hybrids as yields to maturity fall close to record lows. The funds will temporarily sit in cash until the risk/return profile become more attractive to reinvest.