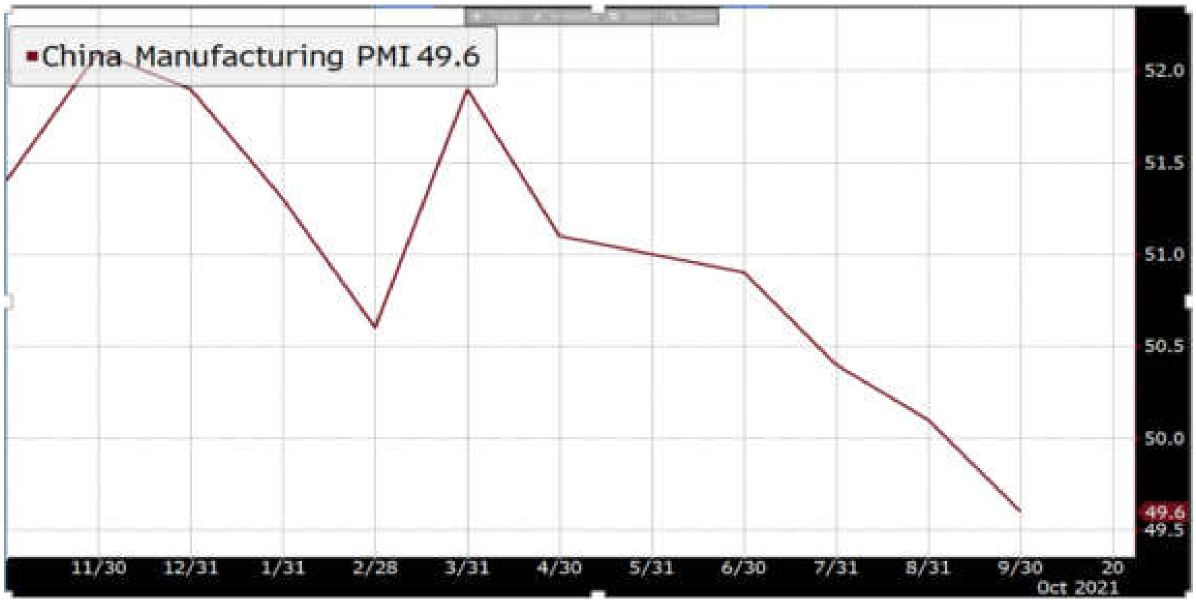
WATERSHED

FUNDS MANAGEMENT

Rethinking Defence in Volatile Markets – September Quarter

Markets fell into negative territory in September, with two emerging risks impacting investor sentiment:

1. **Slowing Growth in China** – the near-collapse of property developer Evergrande sparked fears that it would trigger a broader economic slowdown. In addition, the Chinese government intensified its regulatory crackdown on the education and technology sectors as part of its 'common prosperity' initiative. Investors sold Chinese equities, fearing that societal/national objectives will take precedence to shareholder returns. Slowing economic growth in China more broadly is a theme that we have spoken often about over the course of 2021 as the world opens and consumer spending shifts from durables to services. This is evidenced by China's September Manufacturing PMI which has declined for 5 months in a row now, to below 50.



China's credit impulse also turned negative earlier this year which coupled with the troubled (Evergrande) property sector will see a continued decline in Infrastructure and Property investment and construction. There is also an energy shortage developing which may see supply to industrial sectors cut this winter. We consequently retain a negative view on the Chinese stock market and cautious view towards Emerging Market equities.

2. Rising inflation and bond yields – with the US recovery remaining on track and inflation at elevated levels, the US Federal Reserve indicated that it would start to taper, slowing the pace of asset purchases. We expect to see the end of the Feds QE programme around mid 2022 with futures markets now pricing in 2 rate hikes in late 2022. This is again a key market thematic that we have discussed and positioned for.

Over the quarter, the net result was that developed markets were flat, with the decline in September erasing prior gains. Emerging Markets underperformed due to the sell-off in China. Japan however rose on expectations that another major stimulus package will be announced ahead of upcoming general elections.

Our Positioning: Providing Outperformance in down markets

Pleasingly, our portfolios were well positioned for the increase in volatility in September, delivering strong outperformance against their benchmarks and providing downside protection from falling markets. The Watershed Balanced Portfolio outperformed its benchmark by 1.23% over the quarter, with positive contributions from our single-sector portfolio strategies.

There were several drivers of our outperformance over the quarter:

1 – Defensive positioning within the Income SMA.

Rising bond yields have led to negative returns from most global bond funds. We expect the Income SMA to hold up reasonably well in such an environment due to our high allocation (~50%) to floating rate hybrids and the portfolio having a much shorter duration profile (therefore lower sensitivity to yield changes).

2 – Defensive positioning within the Australian and International Equity SMAs

Over recent months, as markets rallied to new highs, we progressively took profits and increased our defensive exposure. Within our Australian Equity portfolio we have maintained overweight positions to Energy and Healthcare, while our International ETF portfolio has a large allocation to Japan.

In addition, both our Australian and International Equity portfolios have direct short positions (against ASX200 and NASDAQ).

3 – Use of ‘defensive alternatives’ – During the quarter we added the PIMCO Trends Managed Futures strategy as an alternative allocation. We previously used this strategy prior to the last major market downturn, during which it provided a valuable source of downside protection to our multi-asset portfolios.

Outlook

Although volatility may increase over the next few months, on balance, we remain positive on markets over the remainder of 2021. The combination of covid-era monetary and fiscal stimulus, elevated consumer spending as we emerge from lockdowns and businesses expanding production to meet supply shortages, should ensure that economic growth remains strong.

However, the current cycle is particularly challenging for investors, as starting valuations are high and interest rates are extremely low. This increases the likelihood of both bonds and equities falling in tandem during periods of market volatility, as we witnessed during September.

We therefore remain of the view that a flexible approach to asset allocation is required, which involves being able to make timely and meaningful changes to the portfolio as we move through the economic cycle.

Over the next 3-6 months, on the back of strong growth we expect bond yields to push higher, and as such traditional fixed income assets are likely to underperform. We are positioned for this trend, as part of our overall view that we are in the early to mid-part of the economic and interest rate cycle.

Watershed Funds Management

Our September Quarterly reports can be viewed here.

If you would like to speak to us and how Watershed can help drive your client's investment returns please contact our BDM Shantelle Lay:

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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.

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.