WATERSHED

FUNDS MANAGEMENT

Heavy Hitting but Keeping It Smooth

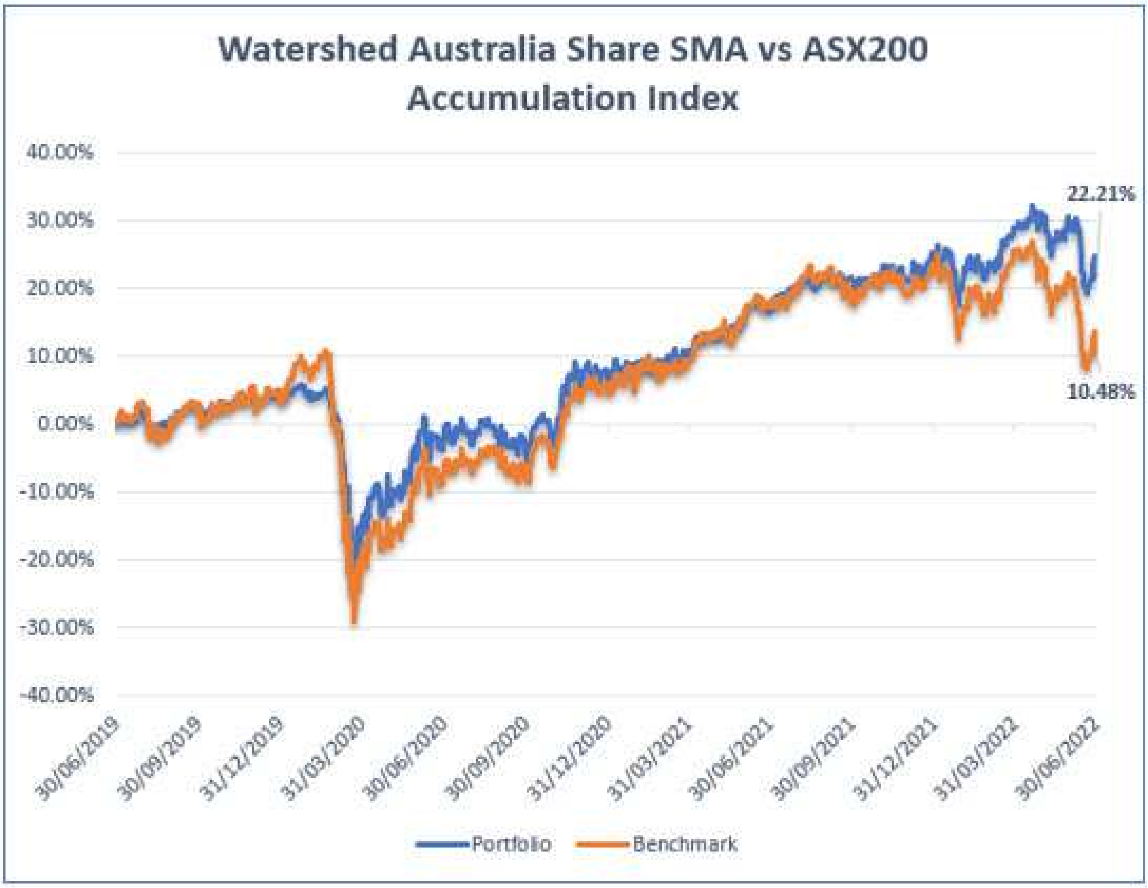
In what has been an exceedingly difficult three-year period to negotiate, the Watershed Australian SMA has been able to deliver industry-leading performance with significantly lower portfolio volatility.

Key Messages

- For the three years to June 30, 2022, the Watershed Australia Share SMA delivered a total return of **22.21%** compared to the ASX200 Accumulation Index that returned **10.48%.**
- Use of leveraged Long and Short market ETF's (actively trading the volatility) added **650bps** of performance over the 3-year period with cash adding a further **63bps**.
- Use of market short ETF's and actively managing the cash weight saw significantly smaller drawdowns during market falls with **Downside Capture** only **65%** of the benchmark.
- Our **Style Neutral** approach has provided a far smoother ride over the decade than factor/style or thematic based portfolio's (i.e. Value or Growth mandates) which can have periods of significant underperformance.

Portfolio Performance:

For the three years to June 30 the Watershed Australia Share SMA delivered a total return of **22.21%** compared to the ASX200 Accumulation Index that returned **10.48%.**



Managing Overall Market Exposure

We have regularly referenced the importance of having flexibility to increase cash and or lower overall market exposure given our broader assessment of relative value, risk and expected short term return.

This provides a buffer in down markets and as per our recent trade updates also provides the ability to deploy capital into market weakness.

Equally we have continued to judiciously use leveraged ETFs (both long and short) as an efficient means to quickly and tax effectively dial up or dial down market exposure.

Our short positions have provided highly effective downside protection and enabled us to minimise capital losses, lower portfolio volatility and drive outperformance. Equally our long positions have enabled the portfolio to quickly increase market exposure after significant sell offs and fully capture market recoveries. The effectiveness of these trades is reflected in the three-year Refintiv Attribution Analysis for the Australia Share SMA where we see a contribution of **6.497%** (ETF's) and **0.629%** (Cash) to the **11.725%** overall excess return (pre fees) for the period.

Attribution Analysis vs Benchmark 30/06/2019 - 30/06/2022

Issue Name	Ave PF Weight	Ave Benchmark Weight	Ave Weight Difference	Portfolio Return	Benchmark Return	Return Difference	Allocation Effect	Selection Effect	Total Effect
Australia Share SMA	100.000%	100.000%	0.000%	22.207	10.482	11.725	6.991	4.734	11.725
Leveraged ETFs	4.588%		4.588%	20.272		20.272	6.497	0.000	6.497
Stapled Units	9.868%	11.025%	-1.158%	54.724	-0.543	55.267	-0.113	2.064	1.951
Ordinary Shares	68.158%	86.323%	-18.164%	12.637	12.026	0.611	-0.053	1.841	1.788
Depository Receipts	8.346%	2.651%	5.695%	32.063	16.784	15.278	0.031	0.829	0.859
Cash & Cash Equivalents	9.040%	0.001%	9.039%	1.178	1.177	0.001	0.629	0.000	0.629

*Source Refinitiv

Managing Downside Risk

- The Maximum Drawdown over the highly volatile last three years was -19.54% for the portfolio versus that of the benchmark of -26.78%
- The portfolio had more profitable periods and less losing periods than the benchmark
- The key metric for many advisers (and investors) of what sort of protection you provide in a market sell-off is reflected in the Downside Capture Ratio. This shows that the portfolio only absorbed 65% of the often-extreme market sell-offs, demonstrating that client capital was well protected.
- The Standard Deviation of the portfolio was less than the benchmark
- The Sharpe Ratio, reflecting the additional amount of return generated for incremental additional risk, was far superior
- The Upside Semi-Variance was lower, showing that the portfolio was less volatile during market upturns
- The Downside Semi-Variance is lower, showing that the Portfolio was less volatile during market upturns as well as absorbing less capital loss as previously mentioned.

Portfolio Risk Characteristics vs Benchmark 30/06/2019 - 30/06/2022			
	Portfolio	Benchmark	Difference
Maximum Drawdown	-19.54%	-26.78%	7.24%
Profitable Periods	66.67%	63.89%	2.78%
Losing Periods	33.33%	36.11%	-2.78%
Downside Capture Ratio	0.65	1	-0.35
Standard Deviation	14.59	18.52	-3.93
Realized Tracking Error	6.06%	0.00%	6.06%
Sharpe Ratio	0.44	0.16	0.28
Realized Alpha	4.00%	0.00%	4.00%
Upside Semi-Variance	10.12	14.81	-4.68
Downside Semi-Variance	31.71	53.44	-21.74

Despite this lowered risk our overall returns over this period are in the top echelon of Australian Share mandates as referenced in the table below.

Mandate	1m	3m	6m	1yr	3yr
WFM Australian Share	-5.97%	-5.47%	-2.63%	3.12%	6.31%
Hyperion Australian Growth Companies	-8.43%	-20.04%	-30.91%	-26.81%	6.25%
Greencape High Conviction	-7.96%	-12.53%	-12.22%	-7.67%	6.06%
Australian Ethical Australian Shares	-10.59%	-18.16%	-21.65%	-17.75%	6.00%
Macquarie Australian Equities	-8.21%	-12.02%	-10.08%	-5.14%	5.59%
Fidelity Australian Equities	-9.85%	-12.96%	-12.98%	-6.57%	4.88%
Pendal Wholesale Plus Australian Share	-8.90%	-11.71%	-10.20%	-6.78%	4.57%
Invesco Wholesale Australian Share	-9.36%	-12.91%	-9.75%	-7.50%	4.21%
iShares Australian Equity Index	-8.97%	-12.24%	-10.47%	-6.94%	3.27%
Maple-Brown Abbott Australian Share	-7.02%	-8.54%	-0.91%	4.15%	3.27%
Allan Gray Australia Equity	-8.58%	-12.70%	-0.77%	5.67%	3.11%
UBS Australian Share Fund	-8.43%	-12.31%	-10.06%	-7.36%	2.48%
Russell Australian Opportunities	-8.18%	-11.86%	-10.03%	-6.49%	2.26%
Morningstar Australian Shares	-9.02%	-14.79%	-16.45%	-16.67%	1.43%

*Source FEAnalytics

A Style Neutral Approach makes sense as the Core Share Exposure for Portfolio's

Another key contributor to our outperformance and lower volatility has been our neutral style bias. In working with lots of advisers we have noticed that many have a style bias in terms of either value or growth. History however shows time and again that both value and growth will outperform at varying stages of an economic cycle and therefor holding one solely for the longer-term (or having a strong bias to one) significantly increases short-term risk and will most likely limit overall performance. For the past decade, buoyed by the era of free money and anaemic interest rates, growth managers enjoyed significant outperformance in comparison to their value peers. However, as the Macroeconomic pendulum has recently swung to a more restrictive environment value stocks have begun to significantly outperform growth stocks on a relative basis and many growth managers have swiftly given back years of relative outperformance. This differential is referenced in the ASX200 Growth Index vs ASX200 Value Index for the past twelve months below:

As a long-term manager whose investment process centres around a thorough appraisal of the macroeconomic environment, we believe style neutrality is pivotal to achieving optimal portfolio performance. The simple fact of the matter is there are economic climates that will be conducive to the performance of both investment styles as evidenced by the historical fluctuations between the two.

It's important to be aware of the economic drivers of market sentiment towards growth and value stocks and position portfolios accordingly. And it is equally important to remember that these respective conducive climates usually aren't short-lived and so holding firm on an investment bias for the longer-term can be highly destructive to client portfolio returns in the short term (2-3 years). Value may be enjoying its time in the sun currently but had been a laggard for 8 of the past 10 years.

This performance differential demands that a manager be adaptive to the macro environment and apportion capital to growth and value assets accordingly if they hope to consistently deliver outperformance irrespective of the economic cycle. In doing so they will also reduce the volatility of investment returns.   Consistent with this rationale we are also not advocates for combining value and growth managers at the same time, as whilst it might mitigate risk, there is a high probability that their non-correlated returns will simply negate each other's alpha over time and leave you holding what is tantamount to an expensive index-tracking portfolio.

We believe that the Core Share exposure should be style neutral and that this can then be complemented with a satellite: i.e. a Small Cap portfolio as we do in our Multi Asset Portfolio's or a high quality value, growth or thematic tilt for the longer term portfolio preference.

Watershed Funds Management

Our JUNE 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 provider and has been a pioneer in the delivery of Managed Account (MDA & SMA) 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 Managed Account (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 SMA's.

An investment in a Watershed SMA 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.

Performance Fee Disclosure

All figures & tables stating 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.

FE Analytics Index

The FE Peer Group Multi-Index Indices offer average returns across circa 150 funds with a similar risk mandate, i.e Balanced.