Vertium Equity Income Fund

Fund Update | 31 December 2024

Key Facts

Awards

Money magazine's Best of the Best Awards—Australian Equity Income 2024

Financial Standard Leadership Award—Australian Equity Income Focused 2023

Investment objective

Higher level of income than the Index

Lower volatility and drawdown than Index

Potential for capital growth over the medium to long term (net of all fees)

Benchmark Index

S&P/ASX 300 Accumulation Index

Inception date

April 2017

Number of stocks

20 - 40

Distribution

Quarterly

Management fee

0.97 p.a.

Buy/Sell spread

+0.25 /-0.25

Minimum investment

$20,000

APIR

OPS1827AU

Suitable investors

1. Low-risk or low-tax investors
2. Pre-retirees and retirees
3. Endowments and charities

Key Platforms

Asgard | BT Panorama | CFS | HUB24
IOOF | Linear | MLC | Netwealth
Oneview | Praemium | MyNorth
Macquarie | Mason Stevens

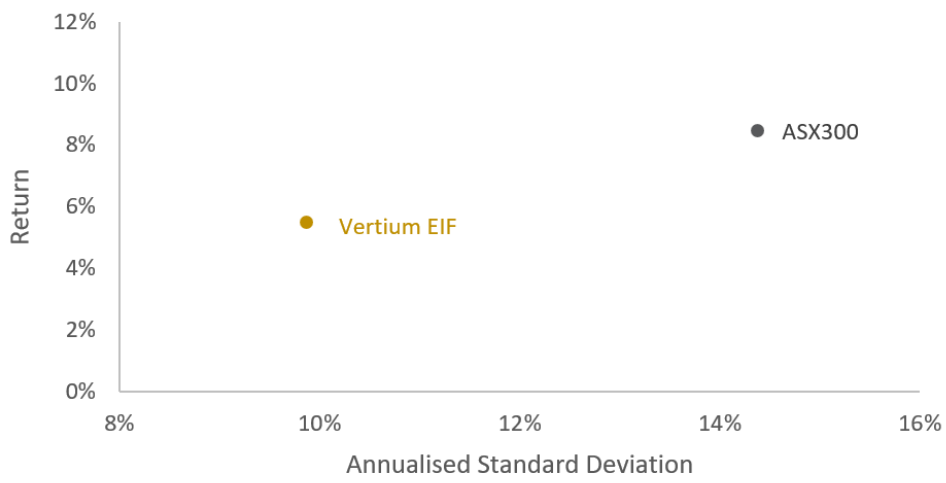
Capital preservation metrics (since inception) ^

	Fund	ASX300
Outperformance frequency in down markets	80%	N/A
Down market capture ratio	63%	1
Beta	0.65	1
Maximum Monthly Drawdown	-13.8%	-20.8%

Performance (%)

	1 Mth	3 Mth	6 Mth	1 Yr	3 Yr pa	5 Yr pa	Since Inc. pa
Income	1.0	1.0	2.0	5.4	5.5	5.5	5.8
Growth	-4.1	-4.1	0.2	-1.6	-0.7	0.2	-0.3
Fund total net return *(excludes franking)*	**-3.1**	**-3.1**	**2.2**	**3.8**	**4.9**	**5.7**	**5.5**
Income	0.1	0.5	1.9	3.9	4.2	3.9	4.2
Growth	-3.2	-1.3	5.1	7.5	2.8	4.0	4.3
Index total return	**-3.1**	**-0.8**	**6.9**	**11.4**	**7.0**	**8.0**	**8.4**
Fund beta	**N/A**	**N/A**	**N/A**	**0.67**	**0.62**	**0.64**	**0.64**
Franking credits	**0.6**	**0.6**	**1.0**	**1.4**	**1.6**	**1.3**	**1.4**
Grossed-up income	**1.5**	**1.5**	**3.0**	**6.9**	**7.1**	**6.7**	**7.1**
Grossed-up total return	**-2.6**	**-2.6**	**3.2**	**5.3**	**6.4**	**6.9**	**6.8**

Return versus risk (since inception)



Portfolio Dashboard

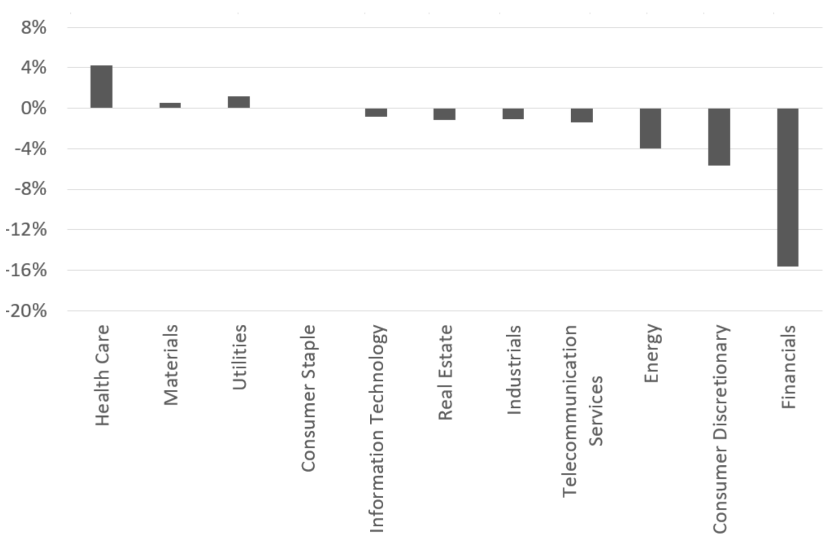
Top 10 holdings	ASX Code
CSL	CSL
BHP Group	BHP
Westpac Banking Corporation	WBC
Brambles	BXB
Fisher & Paykel Healthcare Corporation	FPH
Orica	ORI
National Australia Bank	NAB
Xero	XRO
ANZ Group	ANZ
Mirvac Group	MGR
AGL Energy	AGL

Number of stocks	34

Size exposure	%
Large Cap	57
Mid Cap	19
Small Cap	0
Effective Cash	24

Option exposure	%
Shares	90
Call Options	-3
Put Options	-11
Effective Cash	24

Sector Weightings



"Our equity income fund is designed with conservative investors in mind. We seek to deliver the benefits of equity exposure including attractive, tax effective income - with a commitment and focus on capital preservation."

Jason Teh

Chief Investment Officer

FOR MORE INFORMATION, VISIT VERTIUM.COM.AU

Notes: As of 31.08.2021 the calculation of Income and Growth return series has been updated in line with FSC Standard NO. 6. ^Based on monthly data. Past performance is not a reliable indicator of future performance.

Quarterly perspective | **the Markets**

The S&P/ASX 300 Accumulation Index delivered a -0.8% return for the December quarter. The best performing sector was Financials (+5.9%) led by Commonwealth Bank's +13.2% return. The worst performing sector was Metal and Mining (-12.2%), with Mineral Resources bearing the brunt of the losses at -34.2%.

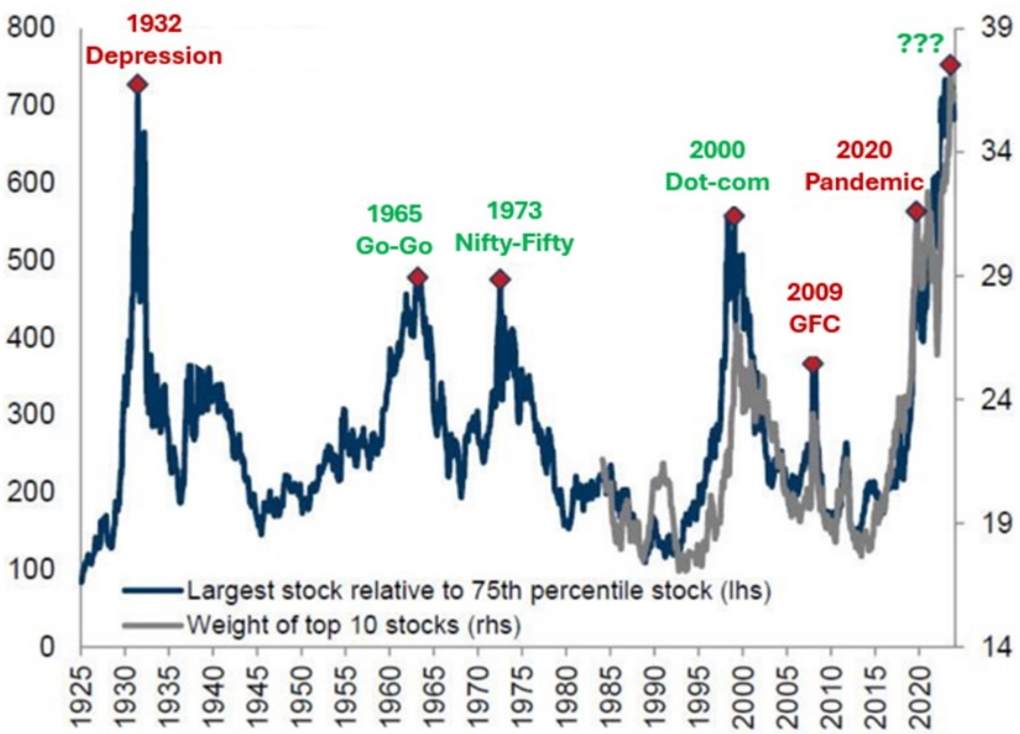
Australia's GDP annual growth rate in Q3 of CY2024 was 0.8%. The unemployment dipped to 3.9% in November 2024 from 4.1% in the prior three months. The annual inflation eased to 2.8% in Q3 of CY2024, with goods inflation sharply slowing mainly due to declines in electricity and fuel prices.

Commodity prices presented a mixed picture during the quarter with several divergences. The iron ore price (+10.4%) was a standout performer while the copper price (-10.9%) was weak. The Brent oil price (+4.3%) and Newcastle thermal coal price (-14.5%) faltered. Conversely, the gold price (-0.4%) was lacklustre after its rally in the previous quarter.

The Anatomy of Boom-Bust Cycles in a Passive Dominated Market

Stock market history is punctuated by dramatic periods of exuberant optimism (booms) and deep pessimism (busts). These cycles are characterized by a departure from rational valuations, often driven by herd mentality and speculative fervour. A hallmark of both booms and busts is the escalating concentration of a few dominant companies.

Market cap of the largest stock relative to 75th percentile stock (left side)
Weight of top ten stocks in S&P 500 (right side)



Consists of U.S. stocks with price, shares, and revenue data listed on the NYSE, AMEX, or NADAQ. Series prior to 1985 estimated based on data from Kenneth French data library reflecting the market cap distribution of NYSE stocks.

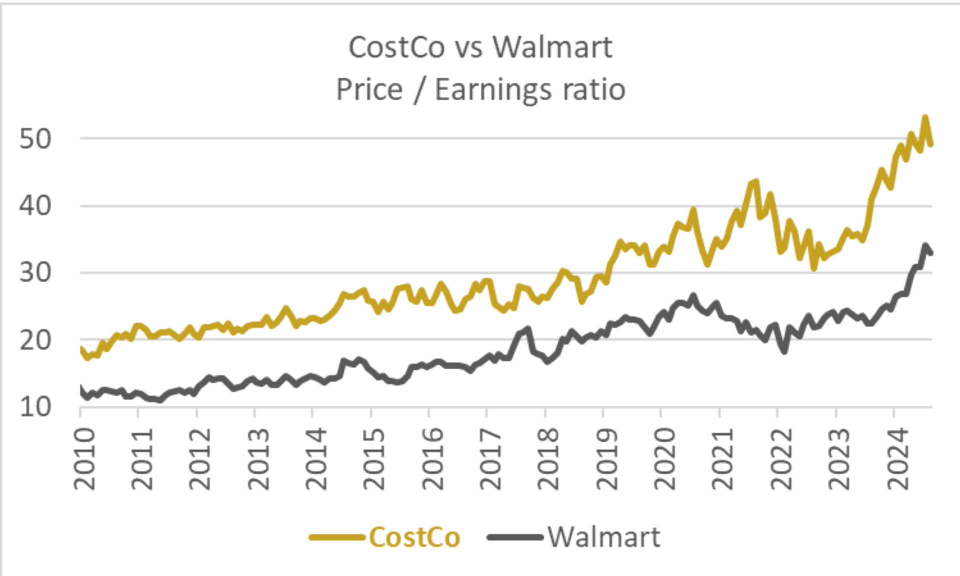
Source: Compustat, CRSP, Kenneth R French, Goldman Sachs GIR.

Quarterly perspective | the Markets

Major historical busts include the Great Depression of the 1930s, the Global Financial Crisis of 2008-2009, and the COVID-19 pandemic-induced market crash of 2020. During market downturns, investors seek perceived safety, gravitating to large, liquid stocks. This flight to safety exacerbates market concentration.

Notable booms encompass the "Go-Go Years" of the 1960s, the "Nifty Fifty" era of the 1970s, and the dot-com bubble of the late 1990s. Notably, the current market exhibits the highest concentration in US history, signaling a fourth major boom. The drivers of concentration vary across boom periods:

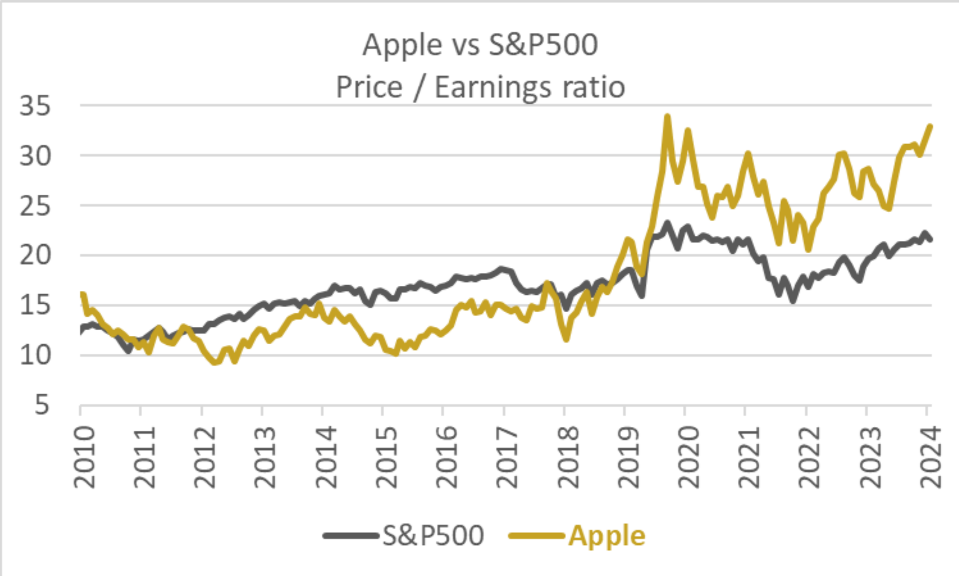
- Go-Go Years (1960s): Fueled by rapid growth in emerging sectors like technology and electronics, this era saw a surge in speculative companies.
- Nifty Fifty (1970s): Characterized by a focus on established, high-quality, large-cap companies with strong earnings growth and consistent dividends.
- Dot-com Bubble (late 1990s): Driven by optimism surrounding the internet revolution, leading to rampant speculation in "Dot-com" companies, many of which lacked sustainable business models.
- Current Boom (2018-Present): While artificial intelligence garner headlines, driven primarily by companies like NVIDIA, the extreme market concentration resembles the Nifty Fifty era where large established giants like Walmart and Costco are valued like market darlings.

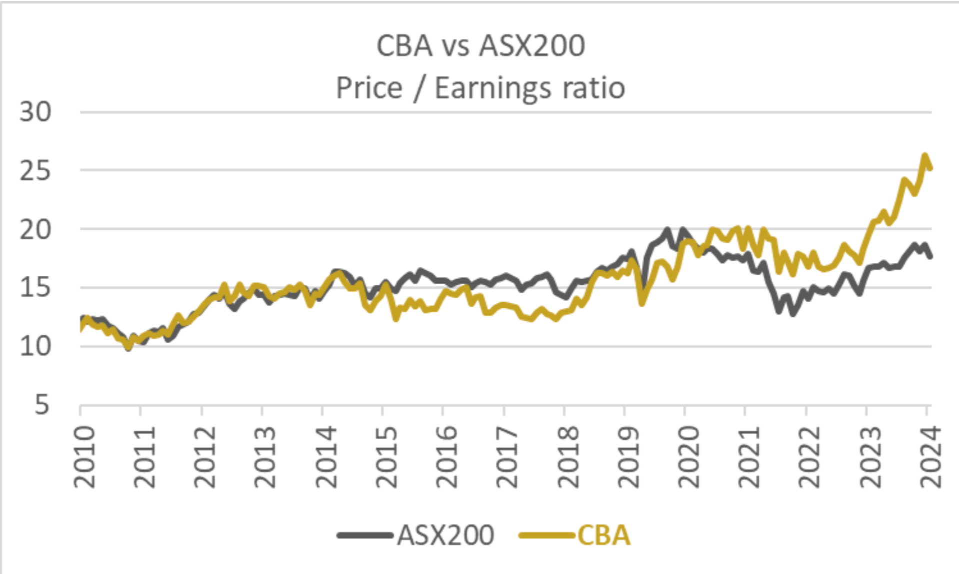


Source: FactSet

A universal characteristic of all boom periods is the emergence of excessive valuations for a few large companies. As speculation intensifies, these companies gain disproportionate weight within the market indices, exerting significant influence on overall market movements. Apple, the largest company in the US, and Commonwealth Bank, the largest in Australia, currently account for 7% and 10% of their respective indices. Their elevated price-to-earnings (P/E) ratios compared to their benchmarks highlight their significant valuation premium for the largest stock in each index.

Quarterly perspective | **the Markets**



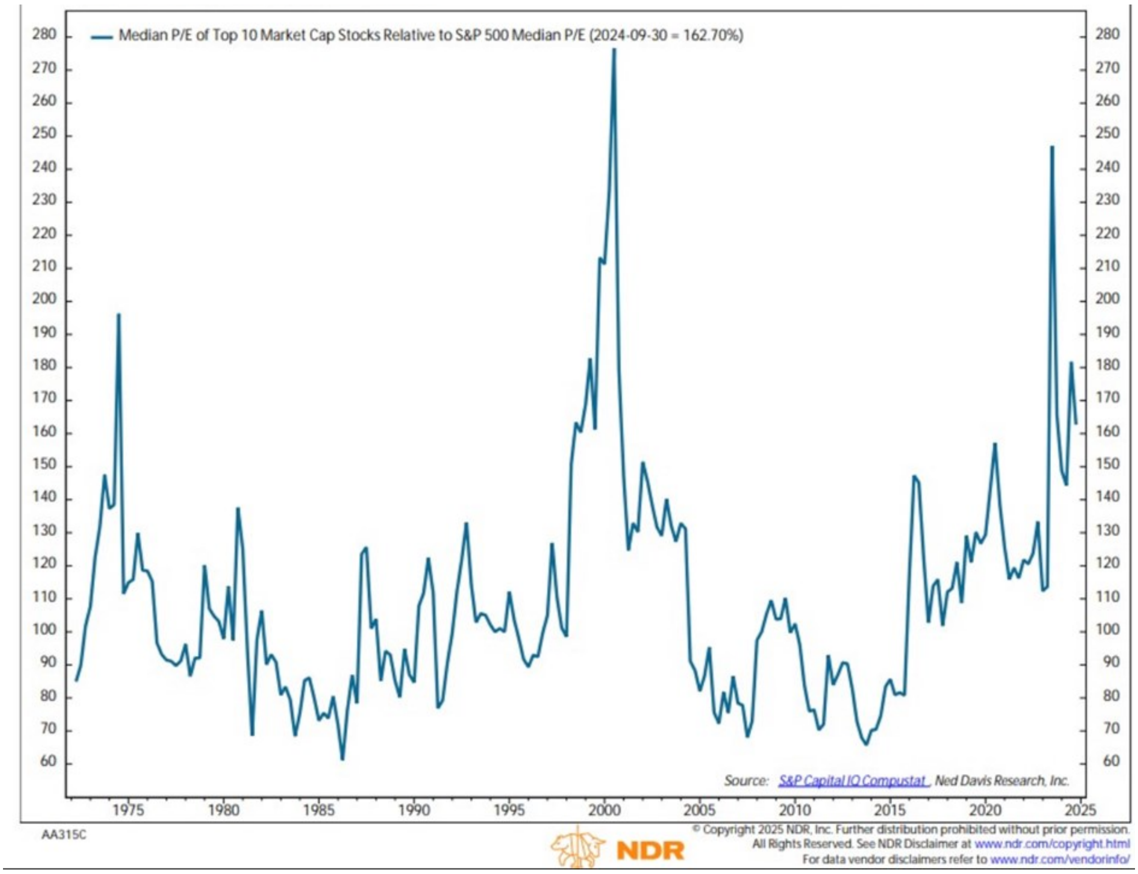


Source: FactSet

This trend of elevated valuations extends beyond these individual examples. The P/E ratios of the top 10 S&P 500 companies currently rival those observed during the Nifty Fifty bubble and are approaching the peak levels witnessed during the dot-com era.

Quarterly perspective | the Markets

S&P 500 Concentration Median P/E—Quarterly Data 1972 – 2024

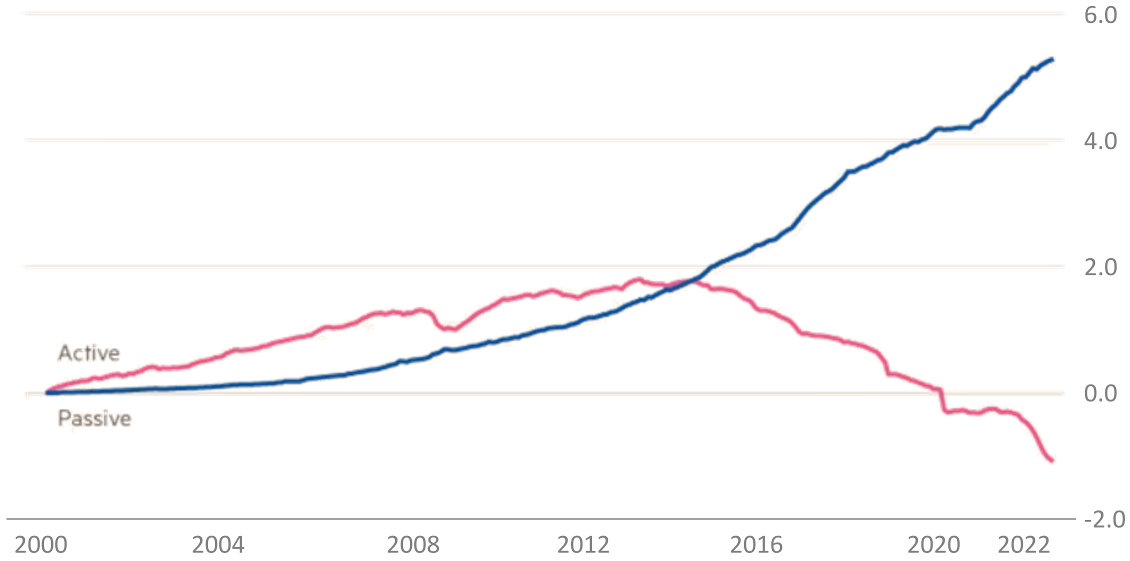


Historically, boom-bust periods are short-lived and span several years between them. However, the current period of elevated market concentration is unprecedented in its duration. Prior to the current boom (Go-Go Years, Nifty Fifty, Dot-com), the period of increasing market concentration leading up to the peak typically lasted around 3-5 years. The current extreme market concentration that commenced in 2018, has now persisted for over 7 years.

A crucial factor contributing to this prolonged period of elevated concentration is the dramatic rise of passive investing, such as those into index funds and ETFs. The market share gain of passive investments at the expense of active managers has fundamentally altered market dynamics.

Quarterly perspective | the Markets

Money is pouring out of active funds into passive
US domiciled cumulative fund flows, $tn (to August 2022)



Source: JPMorgan

Two significant implications arise from the dominance of passive flows in markets:

1. Elevated market concentration and valuation

Passive flows, by design, do not discriminate between overvalued and undervalued stocks. This valuation indifference can perpetuate elevated market concentration and contribute to the persistence of overvalued conditions. This is evident in the highest market concentration and the longest-lasting boom in history.

2. Rolling booms and busts

While passive flows create consistent demand for stocks, prices are still determined by changes in marginal demand and supply dynamics for stocks by active managers. With fewer active managers, prices become more susceptible to self-reinforcing, rather than self-correcting, tendencies. An efficient market relies on the "wisdom of crowds" – the collective judgment of a diverse group often surpasses the insights of individuals. This phenomenon is akin to accurately estimating jelly beans in a jar through crowd sourcing. However, this wisdom erodes when the crowd lacks diversity. In the current market, the convergence of active manager perspectives diminishes the “wisdom of crowds” effect and increases the likelihood of extreme market swings. Essentially, when all managers are "on one side of the boat," it's easier to inflate a boom, but it also increases the risk of a sudden and dramatic market correction. This is evident in more frequent mini boom-bust cycles in recent years: the boom that started in 2018, the 2020 COVID-19 bust, the 2021 speculative boom, the 2022 correction, and the current market boom. Active managers adhering to buy-and-hold strategies may struggle to navigate these rapid shifts in market sentiment. This is exemplified by the stark underperformance of growth managers in 2022 and value managers in 2024.

Quarterly perspective | **the Markets**

Conclusion

Historically, stock market booms and busts are quite rare, typically occurring over many years. However, the current market, dominated by passive investing, has fundamentally altered this dynamic. While passive investing offers the allure of simplicity and low costs, it has inadvertently fuelled a dangerous cycle of market instability. By indiscriminately allocating capital, passive strategies can contribute to the persistence of overvalued conditions during market booms.

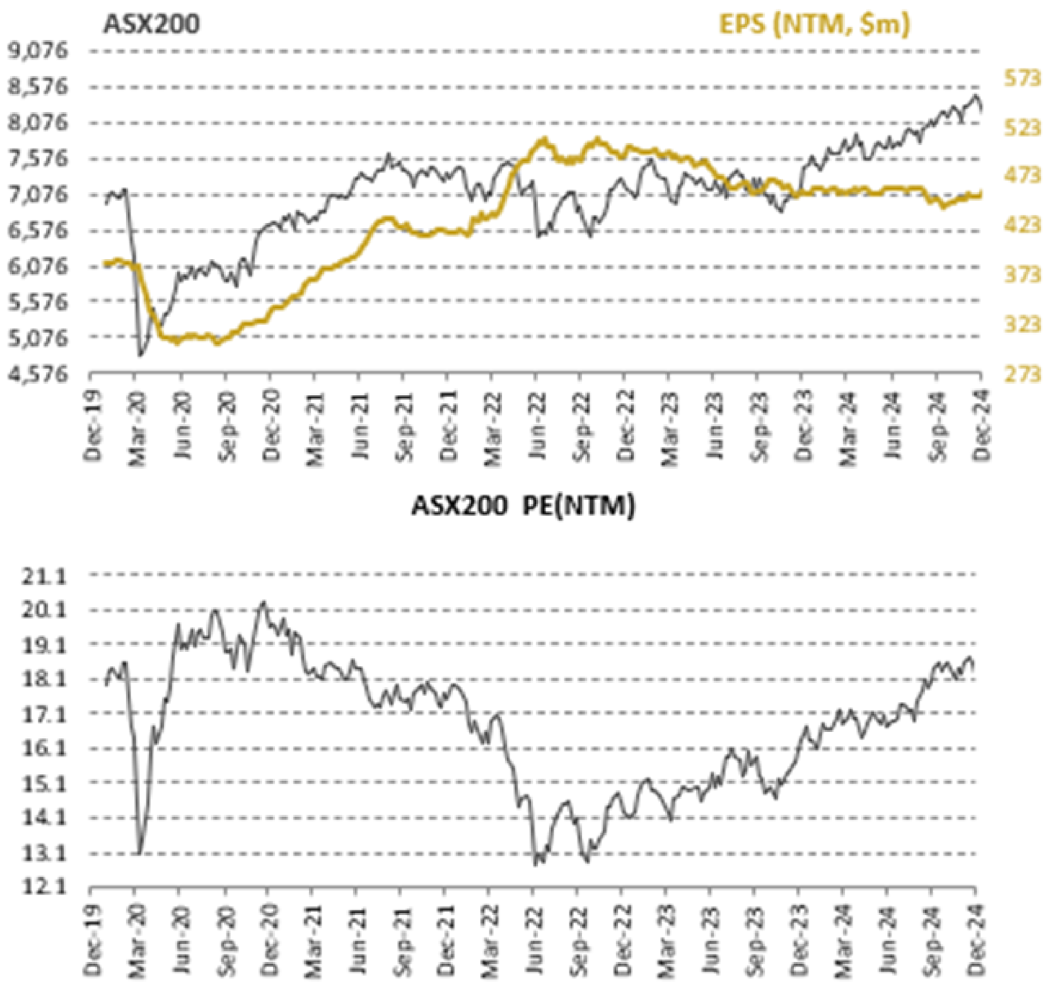
Concurrently, the decline of active management increases the vulnerability of the market to experience booms and busts. The recent years have witnessed a disturbing trend of ‘rolling mini boom-bust cycles’, which serves as a stark warning. Just as night inevitably follows day, the current market exuberance is likely to be followed by a painful market correction.

Quarterly perspective | the Portfolio

The Vertium Equity Income Fund delivered a total net return of -3.1% for the quarter and +3.8% for the calendar year. The Fund paid a 1 cent per unit distribution for the December quarter, in line with its commitment to providing investors with a higher income return than the market.

The Fund's low beta hindered relative performance in a bullish market environment. Market valuations soared to new highs driven by exuberant sentiment as the PE ratio approached its 2021 speculative levels. However, unlike 2021, the earnings environment was lacklustre throughout the year.

ASX200 Price, EPS and PE

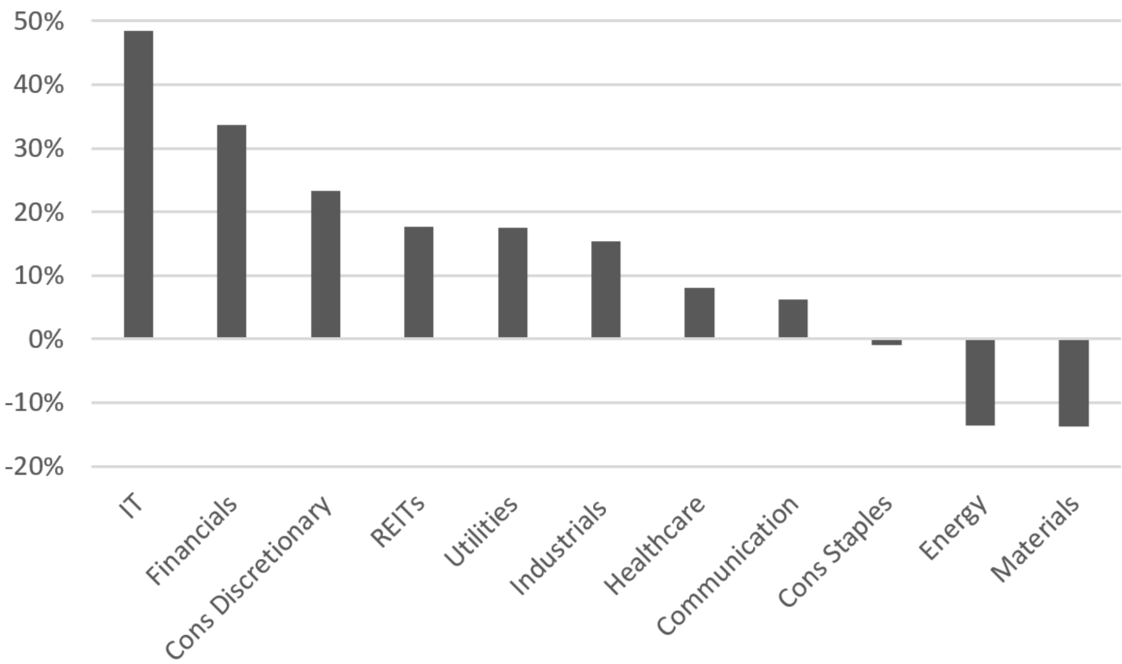


Source: FactSet

Quarterly perspective | the Portfolio

At the sector level, the IT and Financials sectors propelled the market, while commodity related stocks weighed down the Energy and Materials sector, leading to negative returns.

ASX Sector 2024 Return

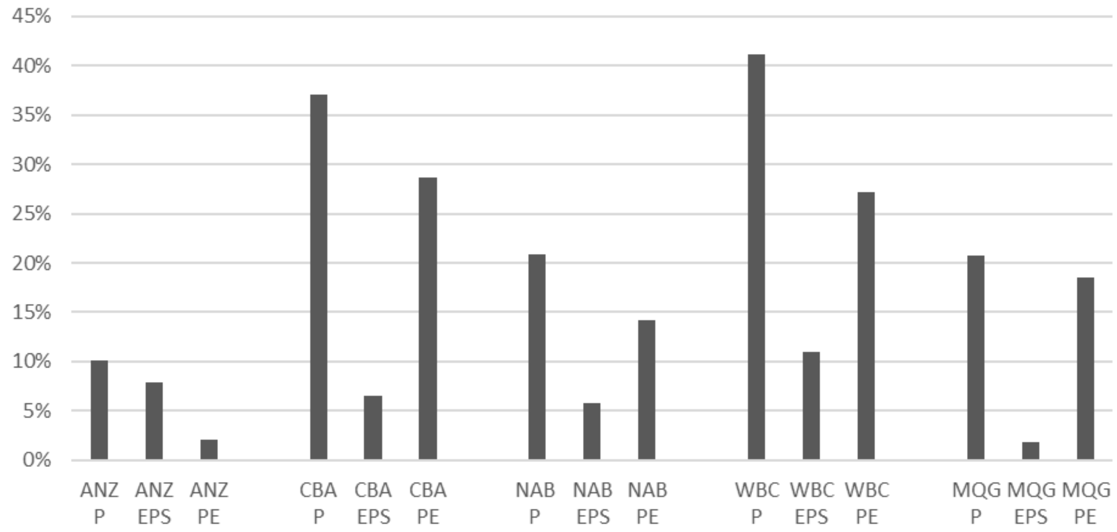


Source: FactSet

The Financials sector was the biggest contributor to the benchmark's return, constituting 27% of the index. Excluding ANZ, most of the major banks had significant PE re-ratings that were disproportionate to their earnings growth. This multiple expansion was the primary driver of their substantial stock returns.

Quarterly perspective | **the Portfolio**

Major Australian Banks change in stock price, EPS and PE (2024)



Source: FactSet

Commonwealth Bank's (CBA) performance was exceptional, with a calendar year return of 41%, the best in history outside the GFC period. This was remarkable considering its PE ratio was already near record levels at 19x last year and reached new highs this year. CBA's valuation exhibits characteristics of a bubble, with a rapidly rising PE ratio not supported by commensurate earnings growth. Its current valuation appears unsustainable.

CBA PE(NTM)

Source: FactSet

Quarterly perspective | **the Portfolio**

Given Commonwealth Bank (CBA) is the largest stock on the market (10% weight) with exceptional returns, it contributed to about one-third of the markets calendar year return. Unfortunately, the Fund did not hold CBA during the year. Furthermore, the Fund's significant underweight to the Financials sector negatively impacted its relative returns by about 8% over the year.

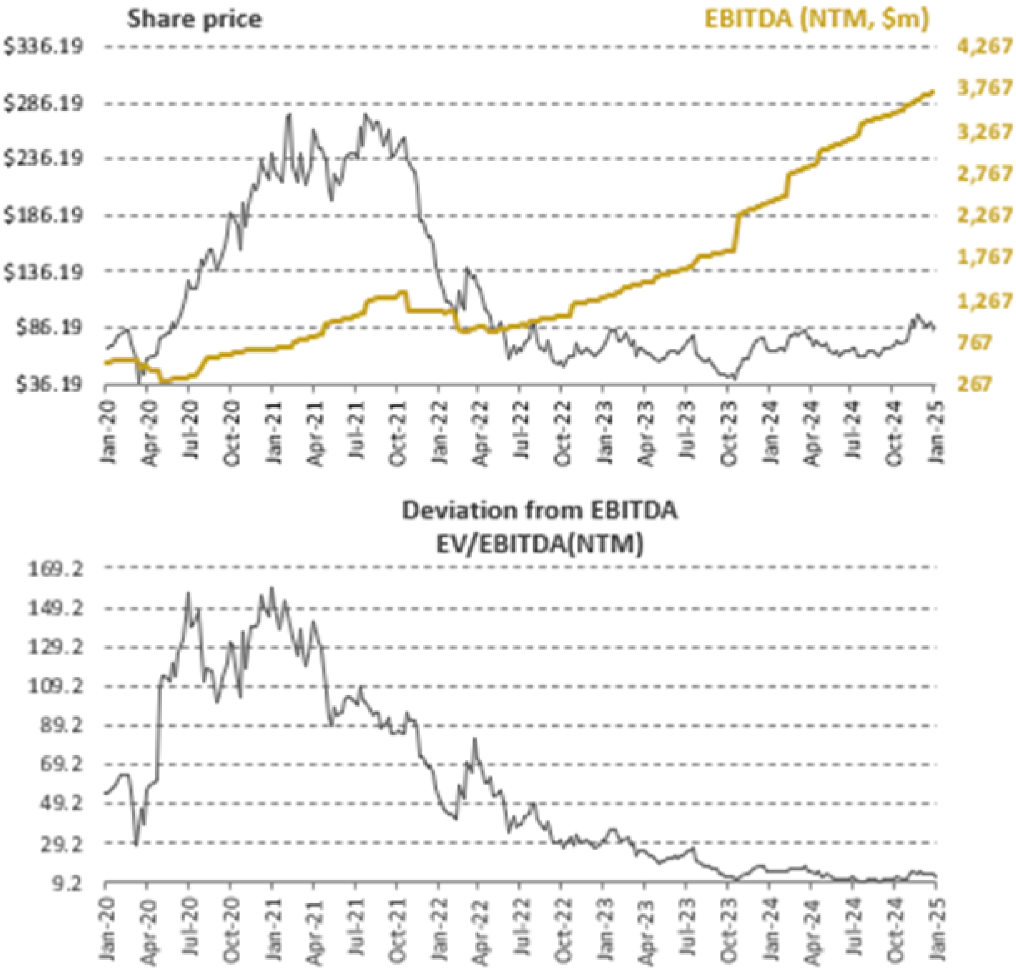
Within the IT sector, the Fund's investments in XRO and SQ2 performed reasonably well. Both XRO and SQ2 have been successful in increasing profitability in recent years. Unlike the Financials sector, their returns were primarily driven by earnings growth rather than inflated valuation multiples, which have not expanded significantly. Without euphoric valuation multiples, both stocks still offer good value.

Xero's Share price, EPS and EV/EBITDA

Source: FactSet

Quarterly perspective | the Portfolio

SQ's Share price, EPS and EV/EBITDA



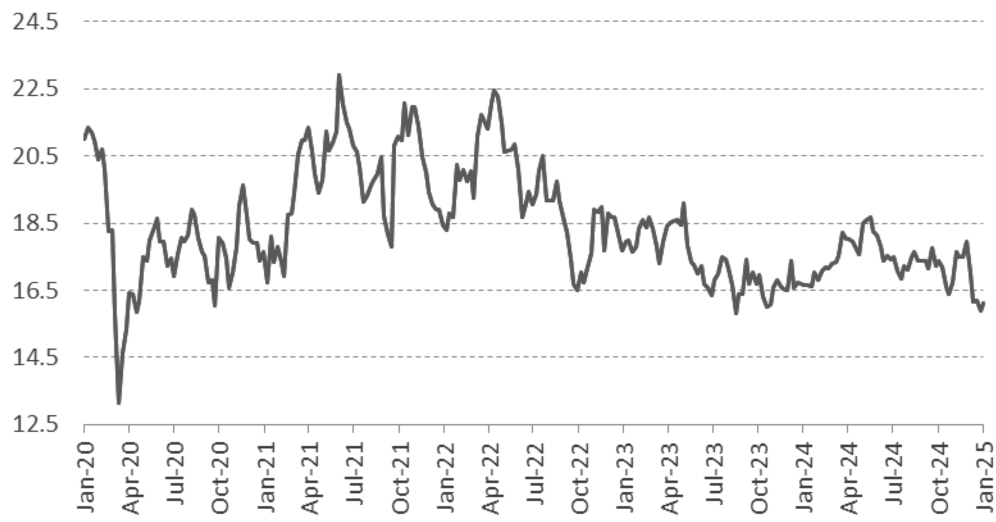
Source: FactSet

In an expensive market, value opportunities still exist. For example, the Fund has increased its position in Orica (ORI) and Mirvac (MGR) in recent months, both exhibiting improving fundamentals overlooked by the market.

ORI has undergone a significant transformation over the last couple of years through the acquisition of Terra Insights and Cyanco. Consolidating these acquisitions has enabled the company to raise its medium-term net asset return targets to 13-15%, an increase from the previous range of 12-14%, as outlined in its November full-year results. The company also announced a positive start to the new financial year at its December AGM. ORI's core businesses – blasting technology, specialty chemicals, and digital solutions – are poised for continued growth, with specialty chemicals and digital solutions expected to be key drivers in the future. Building on the success of its recent acquisitions, the company is currently reviewing its capital allocation framework, with further details expected in March 2025. Given their higher return targets and low leverage, there is potential for increased dividend payouts and/or share buybacks. ORI represents compelling value, particularly as its share price weakened towards the end of the year, resulting in its PE ratio currently trading near its five-year low.

Quarterly perspective | **the Portfolio**

Orica PE(NTM)



Source: FactSet

MGR's stock price also fell towards the end of the year as bond yields rose. From a fundamental perspective, the company's outlook is much brighter than the last couple of years. At its August results announcement, they rebased FY25 expectations, acknowledging that residential margins would be temporarily below their long-term targets due to elevated subcontractor costs and weather-related project delays. Importantly, the company does not anticipate these issues to recur as they have reset cost expectations to preserve margins if such events occur again. From a residential volume perspective, quarterly sales were patchy, averaging around 310 through the first three quarters of FY24. However, a key positive was that exchanges improved to 560 in 4Q24.

Mirvac's residential exchanges and leads

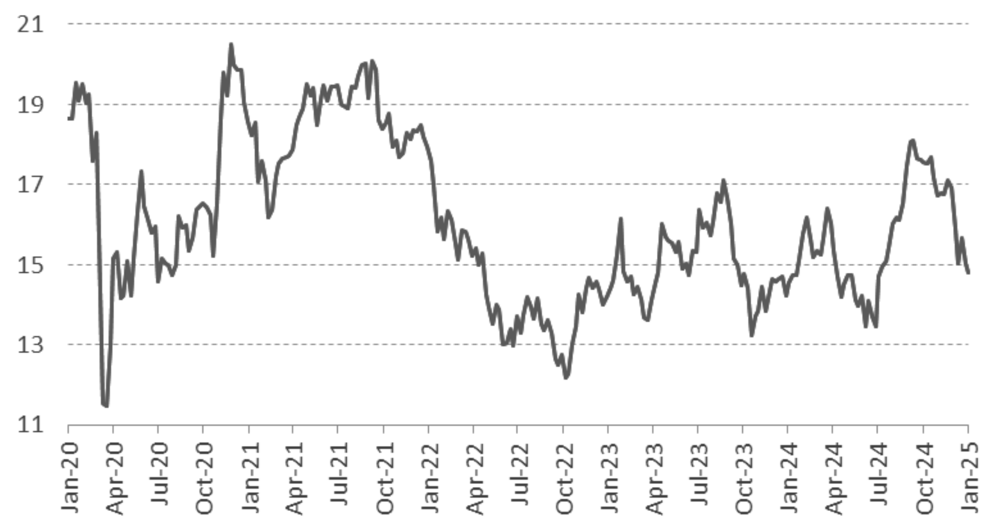
Source: Mirvac FY24 Results Presentation, August 2024.

Quarterly perspective | the Portfolio

The company continued to see good momentum on residential sales, as announced in November, when their Harbourside Residences in Sydney's iconic Darling Harbour were sold out within just 24 hours. They secured over $600 million of pre-sales, a record for the company. Over 140 apartments have been conditionally sold, ranging from just over $1.7 million to $25 million, highlighting that volume is not an issue if the right product is available. Another positive is that the Victorian State Government recently abolished stamp duty for anyone buying off the plan apartments and townhouses. This policy applies to all buyers, at every price point, for 12 months starting from October 21, 2024. We expect this to stimulate demand for Mirvac's Victorian apartments and townhouses. Approximately 25% of MGR's apartment pipeline is in Victoria, with the average price per unit around $1.4 million.

Currently, MGR is trading at a low PE multiple based on trough earnings, implying that the market has very low expectations for an earnings recovery for the company. The recovery in the MGR's residential business will be a key driver for the market to recognise its currently depressed valuation. MGR currently trades at a 20% discount to its Net Tangible Assets and offers a 5% dividend yield.

Mirvac PE(NTM)



Source: FactSet

Concluding Remarks

The current market environment presents a complex picture, with pockets of overvaluation alongside compelling opportunities. The Fund remains disciplined in its approach to identifying stock prices disconnected from their fundamentals to ensure investors benefit from both attractive income and sustainable risk adjusted returns.

We are grateful for the trust you place in managing your capital and appreciate your continued support.