VERTIUM ASSET MANAGEMENT

Vertium Equity Income Fund

Fund Update | Quarter to 30 September 2017

Fund objectives vs S&P/ASX 300 Acc Index

1. Greater income yearly
2. Lower absolute risk yearly
3. Greater returns over 5 years

Suitable investors

- Low-risk or low-tax investors
- Pre-retirees and retirees
- Endowments and charities

Investment universe

- ASX-listed securities

Investment approach

- Quality companies at attractive valuations

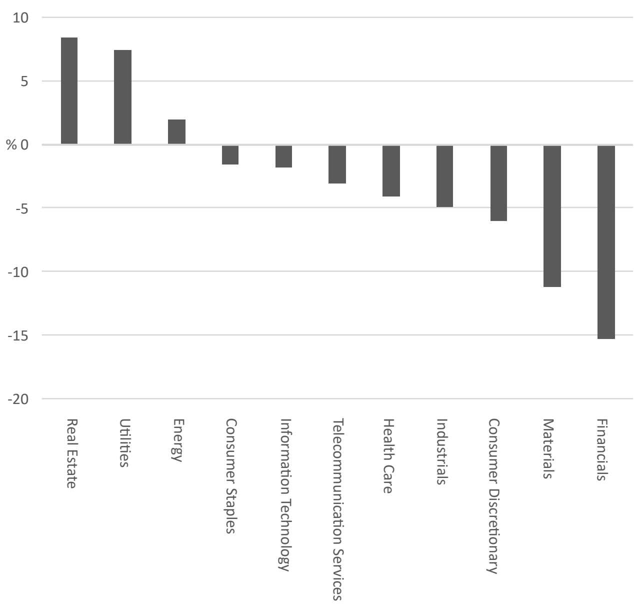
Total returns*

	1 month %	3 months %	Inception %
Vertium Equity Income Fund			
Income	*0.99*	*0.99*	*1.11*
Growth	*-0.37*	*1.23*	*1.04*
Total return	**0.61**	**2.22**	**2.15**
S&P/ASX 300 Accumulation Index			
Total return	**0.04**	**0.80**	**-1.75**

Month-end unit prices^

Application	NAV	Redemption
$1.0280	$1.0254	$1.0229

GICS active exposure



Top 10 holdings#

Company	ASX code
Commonwealth Bank of Australia	CBA
Vicinity Centres	VCX
Wesfarmers Limited	WES
AGL Energy Ltd	AGL
National Australia Bank Limited	NAB
CYBG Plc	CYB
Lendlease Group	LLC
Caltex Australia Limited	CTX
Spark Infrastructure Group	SKI
Transurban Group	TCL
Number of stocks	25

Exposure

Size exposure	%	Option exposure	%
Large cap	51.01	**Shares**	71.88
Mid cap	8.91	**Call options**	-2.77
Small cap	9.75	**Put options**	0.57
Effective cash	30.33	**Effective cash**	30.33

Fund information

Manager
Vertium Asset Management

Inception date
1 May 2017

Responsible entity
Copia Investment Partners

APIR code
OPS1827AU

Management fee
0.97% p.a.

Distributions
Quarterly

Buy/Sell spread
+0.25%/–0.25%

Investment time frame
At least 5 years

Quarterly commentary

Dear investors,

Welcome to the inaugural Vertium Equity Income Fund quarterly report. During the September 2017 quarter, the Fund delivered a total return of 2.1% versus 0.8% for the S&P/ASX 300 Accumulation Index (market). The Fund also paid a 1 cent per unit distribution for the quarter.

Market performance over the quarter was lacklustre. The Industrials sector fell 1.2% driven mainly by the poor performance of high profile stocks such as Telstra and Commonwealth Bank. However, the Resource sector performed well, rising 8.8% despite the Australian dollar iron ore price falling 5.0% over the quarter.

Is the stock market in a bubble?

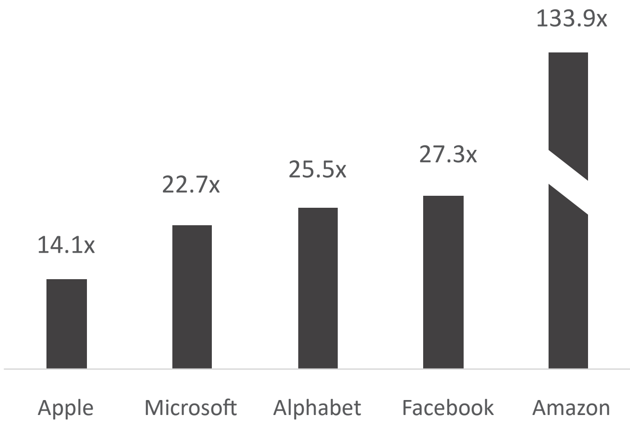
It has been about 10 years since the Global Financial Crisis (GFC) began to unfold. Very few were prepared for the financial damage that ensued. And it has permanently impacted the psyche of many market pundits. Since then, there has been no shortage of bear market predictions and lately there has been a lot of fearmongering in the media.

Several commentators have pointed to some well-known US fund managers struggling to match the performance of the US market. If they are finding it difficult, why wouldn't you think a bear market is imminent? For example, the US stock market has well and truly surpassed its pre-GFC highs and it continues to break all-time highs nearly every single quarter. Plus, most of the market gains in the US have been driven by technology stocks and much has been written about the rise of the FANG stocks – Facebook, Amazon, Netflix and Google.

However, the acronym should really be FAAAM (although it does not have the same ring) to represent the five largest stocks in the S&P500 – Facebook, Apple, Alphabet (aka Google), Amazon and Microsoft. Their combined market capitalisation is about $3 trillion and given their lofty prices, some observers are pointing to similarities with the technology bubble in 1999/2000.

Prices are one thing, but value is another. Typically, rich valuations are a precursor to bubbles bursting. The following chart displays the current price earnings multiples of the technology juggernauts.

Chart 1. PE multiples (next 12 months) of the largest US Tech stocks



Source: Factset

Apart from Amazon, their current PE multiples look a little expensive but do not suggest a bubble. Moreover, the global MSCI tech sector is trading at around 20x, which is a far cry from the tech bubble peak of 50x. During the technology bubble, not only were technology stocks dangerously expensive, but they were also cash hungry. Fast forward to today, the FAAAM stocks in the coming year are expected to hold more cash (about $444 billion combined) than the GDP of some countries.

How about valuations in the Australian stock market? Like in the US, some Australian fund managers have found it difficult to outperform this year. Is their performance also signalling an imminent bear market? To get a sense of valuations, the following table highlights the PE multiples of the ten largest stocks in the Australian market at the end of the September quarter compared to their pre-GFC peak.

Table 1. PE multiples (next 12 months) of the ten largest Australian stocks

	Pre-GFC peak	Sep-17	Difference
Wesfarmers	20.7x	16.2x	-22%
Woolworths	24.7x	19.5x	-21%
Commonwealth Bank	15.7x	12.8x	-18%
Westpac Bank	15.0x	13.0x	-13%
National Australia Bank	14.1x	12.7x	-10%
Macquarie Bank	14.8x	13.3x	-10%
ANZ Bank	13.3x	12.4x	-7%
Telstra	16.0x	15.9*	-1%
BHP Billiton	15.9x	16.5x	4%
CSL	28.0x	29.0x	4%

* Telstra's core EPS post NBN migration is around 22 cps
Source: Factset, Vertium

Compared to 10 years ago, with a couple of exceptions, most stocks have valuation multiples trading well below their pre-GFC highs. Sure, earnings growth in the post-GFC world is lower for some companies which may justify lower valuation multiples. However, interest rates have also halved over the same time frame which should raise valuations. Overall, lower valuation multiples indicate that euphoria, a necessary condition for market bubbles, is lacking.

Bubble or bear market predictions often get a lot of attention, but the canary in the coal mine - valuation multiples - are not yet signalling that we should worry. While we do not know where market prices will be in a years time, we do know that the starting point helps determine the future outcome: the lower the valuation multiple, the lower the chances of a market correction.

Stock commentary

The performance of the Fund is the result of not only the stocks we own but what we don't own. Importantly, minimising risk in the Fund is mostly about avoiding volatile stocks such as 'value traps' and 'expensive stocks'. In this quarter, we avoided a value / yield trap (Telstra) and an expensive stock (Commonwealth Bank) that dragged on market performance. On the flip side, our position in Clydesdale Bank helped drive our portfolio higher. Finally, not all positions performed as expected and we added to our AGL Energy position as the stock price drifted lower.

Telstra (TLS)

TLS's share price fell 19% during the quarter. Just prior to TLS's FY17 results, the forward-looking fully franked dividend yield was a mouth-watering 7%. But, yield chasers were sorely disappointed when TLS significantly rebased the dividend. The 7% yield turned out to be an illusion as the dividend was slashed from the expected 31 cents per share to 22 cents per share for the 2018 financial year. The dividend cut reflects the structural impact of losing much of their fixed-line earnings when the NBN migration completes in 2022 (read our article "The yield trap of 2017" for further discussion).

Looking ahead, TLS's new dividend set at 22 cents per share may look like it is sustainable. We do not think so. When the NBN migration is complete, we believe TLS's earnings per share will be very close to its dividend per share. By 2022, it may be déjà vu for TLS, again faced with a 100% payout ratio scenario.

One string TLS had in its bow was the possibility of securitising its NBN infrastructure cash flows. By selling these cash flows at a higher multiple than the rest of the business, TLS would have the firepower to embark on a share buy-back program. This would reduce the share count of the company to offset weaker earnings in the future and hence support its dividend per share. This plan is now off the table given NBN Co blocked TLS's securitisation proposal.

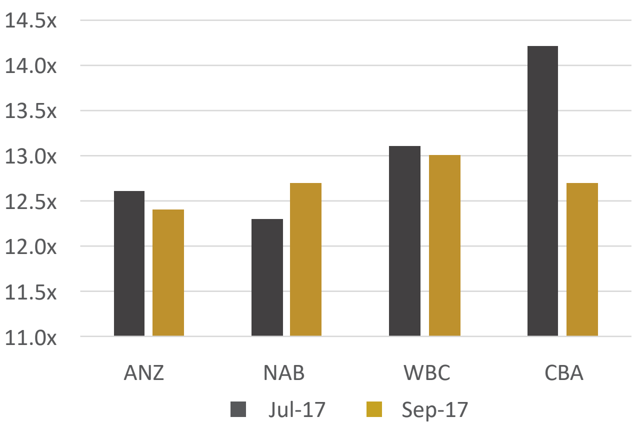
At the end of September, TLS is trading on a PE multiple of 16x based on our EPS estimate of 22 cents per share when the NBN migration is complete. Without the flexibility to buy back shares, we consider the current stock price to be expensive.

Commonwealth Bank (CBA)

During the quarter, CBA's share price fell 9% as the market digested news that the financial intelligence agency AUSTRAC was investigating criminal activity occurring through CBA's automatic teller machines.

The market is clearly afraid of potential AUSTRAC penalties and has de-rated CBA's PE multiple accordingly. Before the AUSTRAC incident, CBA traded at about an 11% PE premium to the other three major banks, but now it trades roughly in-line.

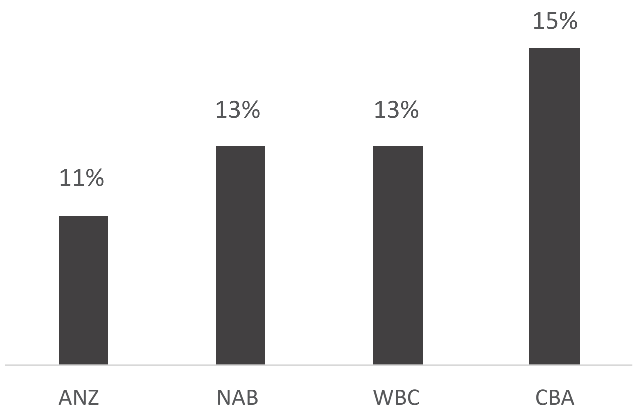
Chart 2. PE multiples (next 12 months) of the four major banks pre- and post-AUSTRAC news



Source: Factset

The de-rating implies that the market is expecting a net present value of about $15 billion in penalties. The incident was very unfortunate. But, at current prices, value is emerging given CBA has superior return on equity compared to the other three major banks.

Chart 3. Return on equity (next 12 months) of the four major banks



Source: Factset

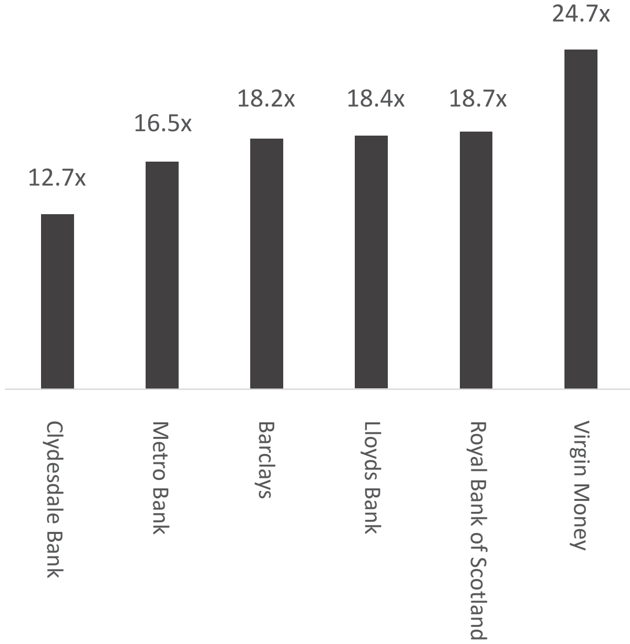
With value emerging from the share price weakness the Fund established a new position.

Clydesdale Bank (CYB)

CYB delivered a 10% return during the quarter. CYB is a UK domiciled bank that was spun off from National Australia Bank (NAB) in early 2016 and is listed on both the London and Australian stock exchanges.

Scarred from the near-total collapse of the banking system in 2008, regulators have forced banks to hold more balance sheet capital. Hence, in a post-GFC world, banks have constantly raised equity. But not CYB - it holds a tremendous amount of excess capital. Compared to its listed UK bank peers, whose average leverage ratio (assets / equity) is around 19x, CYB is an anomaly with a leverage ratio of about 13x. In fact, CYB also has a lower leverage ratio compared to any Australian bank.

Chart 4. Leverage ratio (next 12 months) for listed UK banks.



Source: Factset

Furthermore, spin-offs generally result in greater management engagement, which ultimately leads to stronger business performance. In CYB's case, there are strong signs the business is improving. At the 1H17 results, the company reported its return on tangible equity (ROTE) was 6.3%, a 40% increase from a woeful 4.5% in the previous period. Management has set a reasonable target to hit double-digit ROTE by 2019, by reducing legacy costs and through prudent lending.

As the business improves over time, we expect CYB's cheap valuation to disappear. At the end of September, CYB's price-to-book multiple was just 0.9x.

AGL Energy (AGL)

AGL Energy (AGL) delivered a -6% return during the quarter. The poor performance was the result of the Australian Government putting AGL between a 'rock and hard place'. In an extraordinary measure, the Australian Government asked AGL to extend the life of the 45-year old Liddell power plant for another five years beyond its planned retirement in 2022. The implication of such a request was that if AGL complied, it would cost shareholders several hundreds of millions of dollars or if it did not comply, the Government may indirectly open the doors for further industry regulation.

With the National Electricity Market sourcing about 75% of its electricity from coal power stations, it was never going to be an easy transition to adopt a greener energy mix. With Australia being a signatory to several global climate forums, it implicitly meant coal power was a dying industry. Hence, to replace aging coal power plants, green energy was the only alternative. However, the green policy came with a catch: higher electricity prices are required to provide the price signal for future green energy development. This was the essence of the defunct carbon price policy.

The unexpected policy backflip by the Government to extend existing coal-fired power stations has caught the industry flat-footed. Before the Government requested the Liddell life extension, AGL had the largest capital expenditure program in the industry to transition away from coal power. Although the carbon price was abolished in 2014, the fear of it coming back has stopped the private sector (including AGL) from building and extending coal power stations.

To put it mildly, the regulatory overhang is creating a lot of uncertainty for the energy industry. However, with uncertainty comes opportunity. Because of recent share price weakness, AGL is now trading at its lowest earnings multiple for several years.

Chart 5. Rolling enterprise value / EBIT multiple (next 12 months)

Source: Factset

Furthermore, AGL's balance sheet has de-geared considerably over the same time frame.

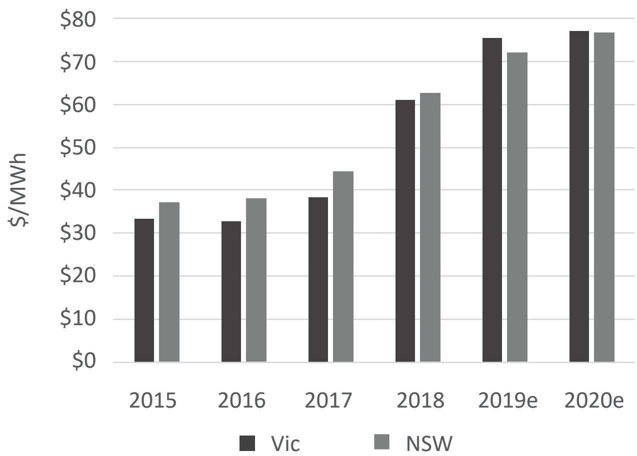
Chart 6. Rolling net debt / EBIT (next 12 months)

Source: Factset

As a result, the stock is now cheaper and has more balance sheet capacity than when AGL announced its $600 million share buy-back program in September 2016.

Sure, AGL looks cheap, but are its earnings sustainable? Given AGL hedges most of its future electricity sales on the forward curve, it is important to monitor base-load electricity forward prices. The following chart highlights the three-year average forward price of each contract year for both Victoria and New South Wales.

Chart 7. Average 3-year forward base-load electricity price (Victoria and New South Wales)



Source: Iress, Vertium

When the industry was oversupplied, the 2015/16 electricity forward prices averaged around $35/MWh. Between 2016 and 2018, the average forward price increased by about $25/MWh. Beyond 2018 there is another $15/MWh increase in the average forward price.

The increase in the average forward price between FY18 and FY20 is the embedded profit uplift for AGL. With greater profits, the company will be able to de-gear even further or invest significantly in future projects IF energy policy is clear. Of course, electricity prices can mean revert but there are long lead times for significant changes to occur with industry supply.

Offsetting potential future profits from higher electricity prices is the threat of extra regulation, which may crimp profits. However, at current valuation multiples, the market is effectively assuming any future profit growth will be eliminated by regulation.

Concluding remarks

While the stock market in general may not look expensive, we nonetheless take a cautious approach to investing your capital. Our focus is on avoiding unnecessary risk and this has allowed us to avoid several fallen angels. Where the risk is worth taking, we have prudently added to some existing positions (for example, AGL) and bought new positions (for example, CBA).

We believe being patient and waiting for the right opportunity is the best way the Fund can deliver on its triple investment objectives of more income, less risk and greater returns relative to the Australian share market.

We are grateful for managing your capital and thank you for your support.

Respectfully yours,
Vertium Team

Investment team

Jason Teh
Chief Investment Officer
MFin, BSc

- Founded Vertium in 2017, responsible for managing the firm and its investment team.
- Oversees portfolio management and responsible for the firm's investment philosophy and strategy.
- Prior to Vertium, Jason was a Senior Portfolio Manager at Investors Mutual where he was the architect of the Investors Mutual Equity Income Fund.

Daniel Mueller
Portfolio Manager / Equity Analyst
BCom, GDipAppFin, CA, CFA

- Joined Vertium in 2017 as a Portfolio Manager / Equity Analyst.
- Assists the CIO and responsible for researching and analysing Australian companies.
- Prior to Vertium, Daniel was a Portfolio Manager / Senior Equities Analyst at Forager Funds where he assisted managing the Forager Australian Shares Fund.

Sam Dyson
Portfolio Manager / Equity Analyst
MEng, CFA

- Joined Vertium in 2017 as a Portfolio Manager / Equity Analyst.
- Assists the CIO and responsible for researching and analysing Australian companies.
- Prior to Vertium, Sam was a Portfolio Manager at Maple-Brown Abbott where he managed its Australian large and small-cap portfolios.

Trent Crawley
Equity Analyst
BCom, CAIA, CFA

- Joined Vertium in 2017 as an Equity Analyst.
- Responsible for researching and analysing Australian companies.
- Before joining Vertium, Trent was a Trader at Franklin Templeton Investments Australia and an Investment Analyst at Mercer.

Ratings

Recommended
Lonsec Research

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*The total return performance figures quoted are historical, calculated using soft close, end-of-month mid-prices and do not allow for the effects of income tax or inflation. Total returns assume the reinvestment of all distributions. The performance is quoted net of all fees and expenses. The index does not incur these costs. This information is provided for general comparative purposes. Soft close unit prices are interim unit prices struck at month end before all transactions for the month have been completed. Performance data available on the Vertium website, vertium.com.au, however, is based on hard close unit prices which are struck after all transactions for the month have been completed.

^Month-end unit prices are soft-close and ex-distribution.

#In order of highest to lowest weighting at the end of the reported month.

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