Vertium Equity Income Fund

Fund Update | Quarter to 31 March 2018

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

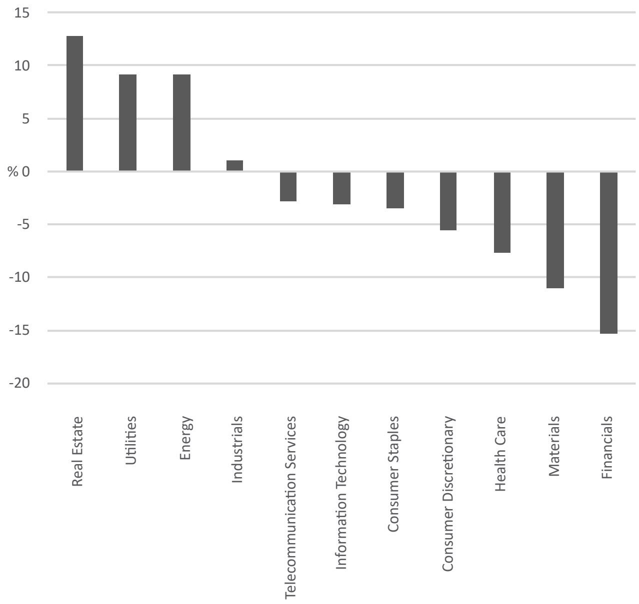
Total returns*

	1 month %	3 months %	Inception %
Vertium Equity Income Fund			
Income	*1.00*	*1.00*	*3.11*
Growth	*-3.23*	*-6.26*	*-3.48*
Total return	**-2.23**	**-5.26**	**-0.37**
S&P/ASX 300 Accumulation Index			
Total return	**-3.73**	**-3.78**	**1.86**

Month-end unit prices^

Application	NAV	Redemption
$0.9783	$0.9758	$0.9734

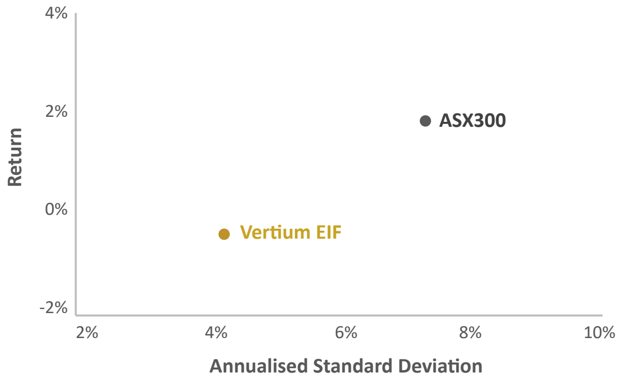
GICS active exposure



Top 10 holdings#

Company	ASX code
Sydney Airport	SYD
Vicinity Centres	VCX
Commonwealth Bank of Australia	CBA
AGL Limited	AGL
ANZ Banking Group Limited	ANZ
Caltex Australia Limited	CTX
Amcor Limited	AMC
Origin Energy Ltd	ORG
Westpac Banking Corp	WBC
Scentre Group	SCG
Number of stocks	23

Return vs risk (since inception)



Exposure

Size exposure	%	Option exposure	%
Large cap	65.74	**Shares**	87.56
Mid cap	8.15	**Call options**	-1.98
Small cap	9.33	**Put options**	-2.35
Effective cash	16.77	**Effective cash**	16.77

Quarterly commentary

During the March 2018 quarter, the Fund delivered a total return of -5.3% versus -3.8% for the S&P/ASX300 Accumulation Index (market). The Fund also paid one cent per unit distribution for the quarter and is on track to deliver a yield greater than the market by the end of the financial year.

While the Fund's risk profile is lower than the market the performance over the quarter was disappointing relative to the market. The sentiment around rising global interest rates negatively affected the performance of defensive stocks the Fund owned, especially during January and February.

To be clear on our strategy, the Fund does not hold defensives or yield stocks just for the sake of being defensive or chasing yield. Capital can be lost from owning expensive defensives or yield stocks that are value traps. The strategy also does not hunt the latest themes, even though we aim to understand the environment which our investments operate within.

To deliver long term sustainable returns our investment approach attempts to identify mispriced opportunities when there is a disconnect between perception and reality. Specifically, the strategy seeks out companies where the share price overreacts to negative fundamentals or underreacts to positive fundamentals.

In the current environment, we observe that the market is increasingly overreacting to positive fundamentals, that is, many stocks are becoming more expensive. On the other hand, with the perception of rising interest rates many defensive stocks are being overly punished when their business quality has not deteriorated.

The following commentary outlines our thoughts about interest rates, whether selected Australian defensive stocks offer good value, and current market risks.

Run for the Hills … Interest Rates are Rising

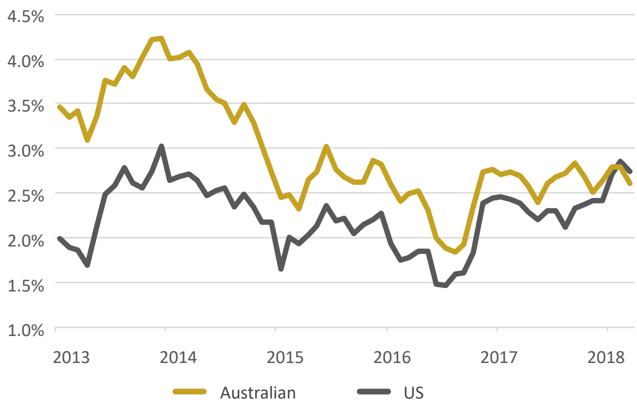
That is what some equity pundits masquerading as bond experts want you to believe. They predict that a 'bondcano' of rising interest rates will lead to collapsing prices for bonds and bond-like proxies.

Over the last few months, this hype about rising global interest rates reached fever pitch due to:

1. US fiscal deficit: The late cycle US fiscal stimulus will result in ballooning Government budget, which will be funded from selling more Government bonds.
2. Globalised synchronised growth: The US economy leading the way with robust economic growth and fears of rising inflation around the world.
3. Central Bank quantitative tapering: Central Banks reversing their quantitative easing programs by selling bonds from their bloated balance sheets.

With the backdrop of rising US bond yields, you may be thinking that Australian bond yields should also rise given their historic correlation.

Chart 1. US and Australian 10-year bond yield



Source: Iress

Since mid-2017 US bonds indeed experienced a 'bondcano' moment. But Australian bond yields have been benign. For the first time in 20 years the US 10-year bond yield is now higher than the equivalent Australian bond yield. US 10-year rates have mean reverted to 2014 levels while Australian rates are well below the peak in early 2014.

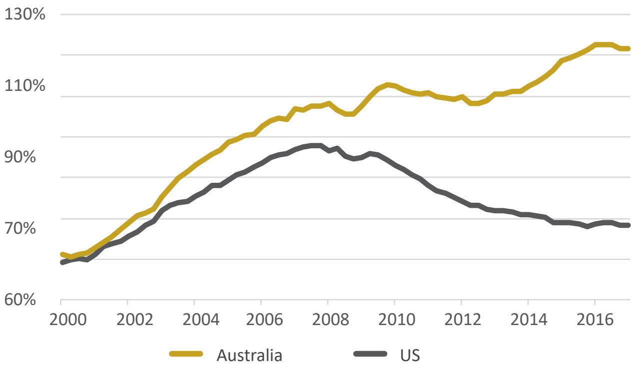
Why are Australian interest rates out of sync with the US?

One word … debt. Specifically, household and government debt.

Interest rates are highly linked to GDP growth. However, they are bounded – the lower limit is close to zero and the upper limit is a function of the indebtedness of an economy. The more debt an economy holds the closer it approaches a 'Minsky moment' of economic collapse when interest rates rise.

Given that household consumption represents about 60-70% of total GDP for developed economies, household debt matters. Prior to the global financial crisis (GFC) the trend of household debt to GDP was correlated for both US and Australia.

Chart 2. Household debt to GDP ratio

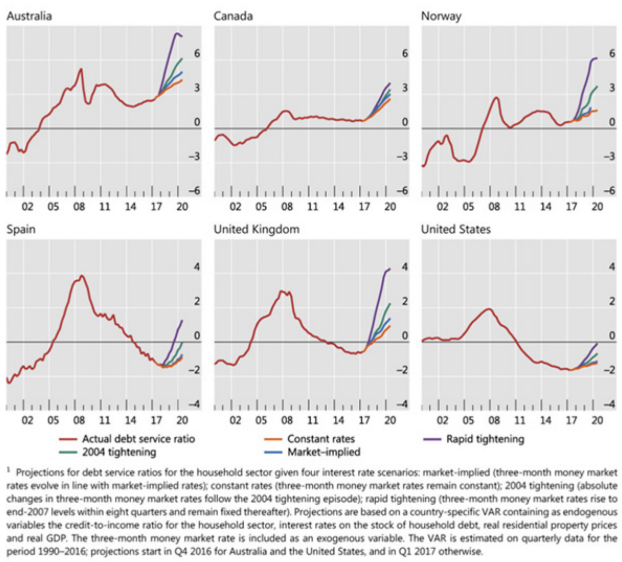


Source: Bank of International Settlements

However, post GFC the debt paths have differed. The US went through a tumultuous period of purging some of their household debt. On the other hand, Australia's household debt to GDP continued to soar.

High debt levels are a problem when interest rates rise because debt serviceability (debt payments to income ratio) will eventually become unsustainable. This was recently highlighted by the Bank of International Settlements when they analysed the debt serviceability of various countries under different interest rate scenarios.

Chart 3. Household debt servicing burdens under different interest rate scenarios



Source: Zabai. A., [Household Debt: Recent Developments and Challenges](), Bank of International Settlements, December 2017

Deleveraged countries (like the US) can withstand higher interest rates, hence the impact on household consumption will be lower. On the other hand, indebted countries (like Australia) cannot tolerate higher interest rates otherwise household consumption may collapse.

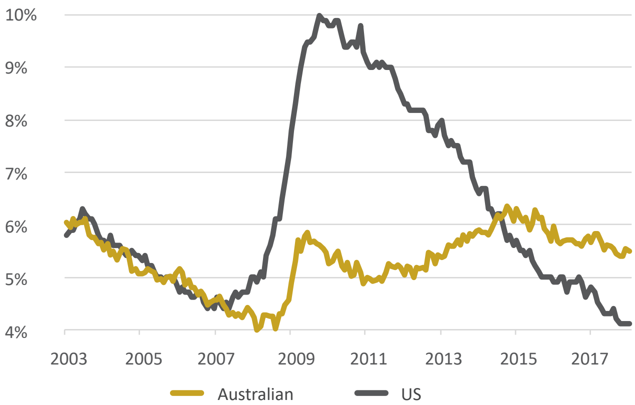
To be clear, we are not saying bond yields cannot rise in Australia. Currently, the Australian 10-year bond yield is 2.6% and it could mean revert to early 2014 levels of 4%. But if it does our economy will increasingly become fragile because Australian household debt is about 20% higher than four years ago. Over the same period, average weekly earnings have only increased by about 7%. Wages need to significantly catch up to de-risk Australia's large household debt.

With a greater debt load in Australia it now takes a much smaller increase in interest rates to slow economic growth. Several studies including the IMF Global Financial Stability Report (October 2017) highlight that while increased debt supports higher economic growth in the short term it eventually hampers growth in the medium term. If the studies are correct, given that Australian household debt peaked in 2016, lower household consumption should drag on real economic activity in the coming years and also on interest rates.

However, astute readers may point out that nominal bond yields can still rise if inflationary expectations rise. In this regard, economists categorise inflation into tradable inflation (price of goods and services from international trade) and domestic inflation (price of domestic goods and services). Australian tradable inflation is heavily influenced by commodity prices and the Australian currency, which in turn is significantly influenced by China. We made our views clear about China. But we'll let you decide on whether China is in an expansionary or contractionary phase.

Domestic inflation is mostly anchored to wage growth. It requires the combination of strong economic activity and full employment for wage growth to become noticeable (which is typically represented by the Phillips curve). To highlight how much labour slack is in the economy the chart below shows the unemployment rate for US and Australia.

Chart 4. US and Australian unemployment rate



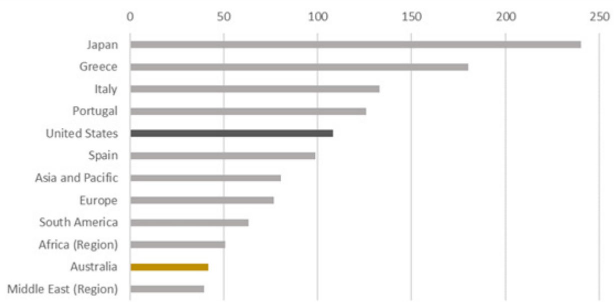
Source: Australian Bureau of Statistics and US Bureau of Labor Statistics

Prior to the GFC, like the household debt chart, the trend in unemployment was very similar for both countries. However, post GFC, the differences are stark. The US unemployment rate is now below its pre-GFC lows. On the other hand, Australia's unemployment rate is still elevated and is closer to its 2014 peak than its pre-GFC low. With a tight US labour market, there is little doubt that wage pressure will underpin US inflation expectations. However, US wage inflation has no bearing on Australian wage inflation because their labour market conditions are very different.

If Australia's interest rates remain benign from sluggish economic growth (due to indebted households) and subdued inflation (due to labour slack), why is there so much fear? Some commentators point to the famous 'banana republic' quote by treasurer Paul Keating in 1986. Global bond vigilantes demand higher interest rates when public finances are in disarray.

Contrary to popular belief Australia's government indebtedness compared to the rest of the world looks great. On the other hand, the US government is one of the most indebted countries in the world. The level of US debt is flying high with the PIGS (Portugal, Italy, Greece and Spain – countries that suffered a sovereign debt crisis during the GFC).

Chart 5. 2017 government gross debt (per cent of GDP)



Source: International Monetary Fund

And it will get worse for the US. The tax cuts and the late cycle fiscal program is estimated to blow out the US government debt to GDP to more than 130% by 2025. Global bond holders may now be demanding higher interest rates to reflect higher sovereign default risk. Currently, the US may be experiencing a 'banana republic' moment where the demand for US currency is weak even though US interest rates are rising relative to the rest of the world. In contrast, a healthier Australian government balance sheet has attracted strong global demand for Australian bonds, hence keeping our interest rates lower.

In summary, while Australian and US interest rates have historically been correlated their paths can differ. Given that Australia's debt situation and economic environment are currently very different to the US our interest rate path will likely be very different. A US 'bondcano' moment is simply not translating to Australia.

Defensives: Perception versus Reality

Are Australian bond-like proxies going to suffer a bondcano moment? Certainly, stocks that have defensive characteristics have been sold down in recent months. And bond bears would have it that they are collateral damage from rising US yields.

However, we believe this is a false narrative. Hence, we need to go back to first principles to sort out perception and reality.

1. The valuation of domestic cashflows are not based on overseas interest rates

In recent months, the aggressive sell-off in Australian bond-like stocks looks like they are more correlated with the rising US bond yields rather than Australian bond yields. Fundamentally, this should never happen.

No rational investor would buy an Australian asset and fund it with US debt. Otherwise, there is a huge basis risk in terms of the cash flows generated from an asset in one country and the finance cost associated with another country.

US interest rates drive US asset valuations.

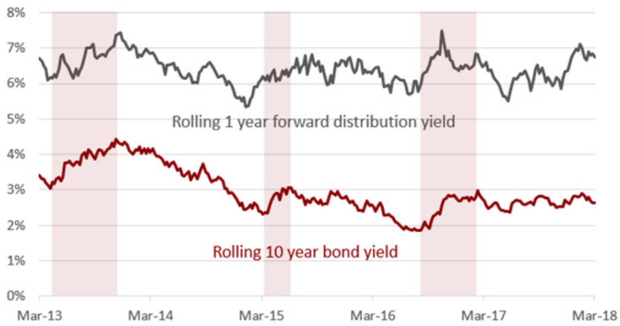
Australian interest rates drive Australian asset valuations.

Zimbabwean interest rates drive Zimbabwean asset valuations.

You get the idea.

To illustrate how Australian interest rates affect the pricing of Australian bond-like stocks we use Spark Infrastructure (SKI) as an example. The chart below plots the rolling 1-year distribution yield of SKI against the Australian 10-year bond yield over the last five years. Given the heightened fear of an Australian bondcano event in recent months, we have also shaded historical bond sell-off periods (light red) to provide perspective.

Chart 1. Spark Infrastructure 1-year forward distribution yield versus Australian 10-year bond yield



Source: Factset

Historically, when SKI's yield was rising (that is, share price was falling) it mirrored rising Australian bond yields. This implies that the stock market is not very good at forecasting, but is generally good at marking to market with interest rates in real time. This is a hallmark of an efficient market.

However, for the first time in five years SKI's yield has skyrocketed while there is no evidence of an Australian bond sell-off. Is this an example of an efficient market or a mispriced opportunity?

Our view is that SKI's valuation being priced off US interest rates is fundamentally incorrect.

On a technical note, the bond experts will recognise that SKI's cash flows resemble a variable interest rate security. If you believe interest rates are going to rise in the future then SKI future cashflows will also rise. Given that SKI owns monopoly assets, the regulator sets its cash flows based on a return on capital that is largely influenced by interest rates. The valuations of variable interest rate securities simply should not change that much from interest rate movements.

2. Valuations are not solely driven by the interest rate

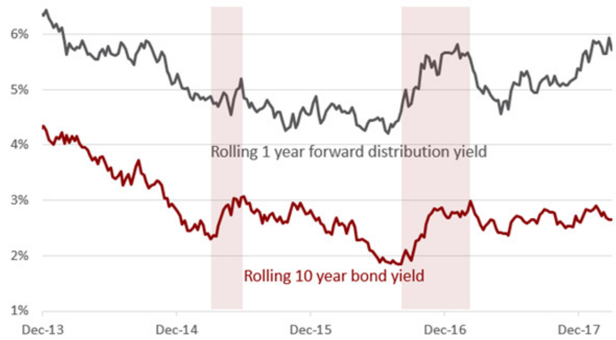
With so much media attention on interest rates (risk-free rates), many commentators are confusing risk-free rates with discount rates. Valuations are driven by an asset's discount rate which is comprised of two components: the risk-free rate and a risk premium, where the risk premium reflects the riskiness of cashflows given that assets are not riskless.

Changes in both interest rates and risk premium drive valuations, not just one of these in isolation. Sure, rising interest rates will put upward pressure on the discount rate but if it is countered by a wide and shrinking risk premium then valuations can be preserved.

Alternatively, if risk-free rates are benign and the underlying asset yield rises it implies the risk premium has expanded. The million-dollar question for investors is whether the wide risk premium represents a disconnect between perception and reality of greater risk.

Let's use another bond-like stock, Sydney Airport (SYD), as an example. The following chart plots the rolling 1-year distribution yield of SYD versus the Australian 10-year bond yield since its last corporate restructure in late 2013.

Chart 2. Sydney Airport 1-year forward distribution yield versus Australian 10-year bond yield



Source: Factset

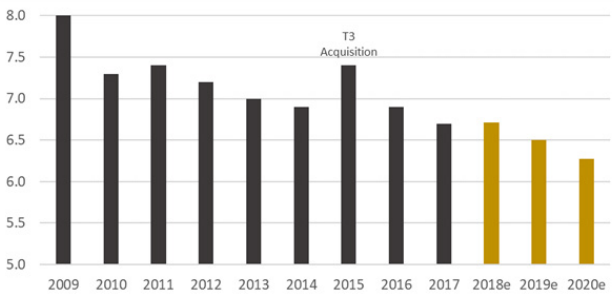
Like SKI, the recent rise in SYD's distribution yield also looks like SYD's share price has been priced off US interest rates, which we know is fundamentally incorrect. The recent sell-off has been so dramatic that the yield spread is at the highest level over the last five years.

Chart 3. Sydney Airport yield premium versus Australian 10-year bond yield

Source: Factset

The only feasible explanation for SYD's widening yield premium is that the business may be under stress. The first thing that came to our mind regarding risk was SYD's gearing levels given its historical relationship with Macquarie Bank. Maybe SYD's balance sheet under pressure?

Chart 4. Sydney Airport net debt / EBITDA ratio



Source: Factset

SYD used to be highly geared when it was owned by Macquarie Bank. Not any more. Over time its leverage ratio has been falling and is expected to continue in the future. The improved balance sheet has been confirmed over the last few months by Moody's and Standard and Poor's which upgraded SYD's credit rating to Baa2 and BBB+ respectively. If the deleveraging continues SYD will be on a path to receive an A credit rating by early 2020s.

Maybe debt funding costs have skyrocketed? Like Australian bond yields, Australian BBB corporate interest rates have fallen over time and has been relatively benign over the last few months.

Chart 5. S&P/ASX Corporate Bond BBB interest rate

Source: Factset

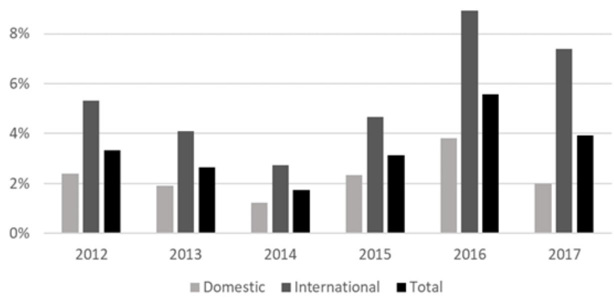
Further, SYD's debt refinancing risk is low because there is no significant debt maturity in the next couple of years. As a sign of conservative management, SYD is paranoid about managing its debt. To ensure that its average debt maturity is long dated (around 8 years) and most of the interest rate risk on their debt is hedged (about 93%) they overpay on their debt cost (5% interest rate versus the equivalent Australian BBB interest rate of 3.4%). Not many companies take an extremely long-term view on managing their debt.

In summary, when leverage ratios are falling with a benign debt funding environment, risk also reduces. Bond experts will recognise that securities which are deleveraging command a shrinking risk premium.

If the balance sheet is not under stress, maybe the high yield premium is due to the growth outlook deteriorating?

SYD's profitability is directly linked to the number of passengers traveling through the airport.

Chart 6. Sydney Airport passenger growth



Source: Sydney Airport

Prior to 2016, total passenger growth was growing around 3% per annum. From 2016, total passenger growth was +4% per annum. The step change in growth has predominantly been driven by international passengers. The elevated passenger growth over the last couple of years have driven EBITDA growth by 9% per annum.

There is a lot to like from SYD's exposure to future passenger growth. And the outlook has become clearer and better since 2015 for four main reasons.

1. China

China's recent five-year (2016-2020) plan highlights 50 new airports to be built including Beijing's new mega airport, which is due to open in 2019. More airports will allow the growing Chinese middle class a greater opportunity to travel. With 10% of Chinese nationals holding a passport it highlights significant untapped travel demand.

Over the past five years, Chinese visitors have consistently grown by more than 15% per annum and now represent about 8% of SYD's total international passengers. Importantly, China and Australia signed an open skies agreement in 2016, which means that current passenger growth from China is likely to be sustained.

2. Terminal 3 (T3) optimisation

SYD has three terminals where terminal 1 (T1) is dedicated to international travel and terminal 2 (T2) and 3 (T3) are dedicated to domestic travel. In 2015, when SYD bought Qantas' T3 lease it was processing about 10 million passengers versus 15 million passengers travelling through T2. In our view, there is enormous scope to increase T3's asset utilisation.

3. Terminal 4 (T4)
SYD has proposed a new terminal, T4, which is expected to be built around mid-2020s. Qantas is expected to operate both its international and domestic services from T4. Hence, the new terminal will free up valuable capacity in T1 for more international passengers.

4. Western Sydney Airport (WSA)
WSA is expected to be built by the mid-2020s and serve around 3 million passengers (in comparison SYD served 16 million international and 27 million domestic passengers in 2017). Notably, around 80 percent of WSA passenger demand would be for domestic use.

On the surface, it may seem like a competing airport would crimp SYD's profits. However, SYD suffers capacity constraints during peak periods. Hence, by diverting domestic passengers to WSA, SYD can free up valuable capacity during peak times for more international flights.

With a growing mix shift to international passengers, SYD's operating outlook is brighter than ever. In the long term, it is foreseeable that SYD could process more international passengers than domestic passengers. It's not hard to do the maths on SYD's future profitability when international passengers deliver 4x more revenue than domestic passengers on a largely fixed cost base. Given the leverage to international passengers, by the time WSA is built SYD's future profits could be double last year's profit.

With a stronger operating outlook, SYD's yield premium over bonds should at the very least narrow not expand.

To sum up, in early 2014 when Australian bond yields were around 4%, SYD had a 6% distribution yield but had a weaker balance sheet and tepid growth expectations. Currently, Australian bond yields are under 3% compared to SYD offering a similar yield of 6%, but with a strengthening credit and operating outlook.

Can you spot the disconnect between the perception of fear and the business reality?

The Real Danger Lurking in the Shadows

While many investors fret about bonds or bond-like proxies from rising interest rates, the real danger lurking in the shadows is the prospect of rising risk premiums.

Interest rates globally have already normalised and maybe there is a little more to go. And today bond-like stocks already have wide risk premiums. But risk premiums for other stocks are extremely low and have yet to normalise!

A bondcano moment looms large for many non-bond-like securities. Many of these stocks have low risk premiums or in Benjamin Graham's language 'little margin of safety'. This means that any bad news including rising interest rates, could pop their valuation bubble.

Over the last few months, the fear of missing out has driven many investors into highly cyclical or high PE stocks irrespective of low risk premiums. The number of highly priced growth stocks have been increasing in recent years. As they become more prevalent and expensive they become a bigger part of the index.

Unfortunately, there is no long term valuation data on the Australian stock market to make a proper assessment on long term performance. In the US, the Shiller cyclically adjusted PE (CAPE) index has tracked the valuation of the S&P500 over the last century. Ominously, the CAPE index has recently surpassed the 1929 peak and is fast approaching the technology boom peak.

Chart 1. US S&P500 Shiller cyclically adjusted PE

Source: www.econ.yale.edu/~shiller/data

If you thought the Global Financial Crisis (GFC) was tough for equity markets, at least future returns were somewhat preserved because valuations in 2007 were not extremely stretched. The subsequent 10-year return from the S&P500 peak prior to the GFC still delivered a modest 5% per annum. If history is a guide, the current high CAPE index indicates that the next 10-year annualised return is likely to be close to 0%. In other words, the next decade of returns from the US stock market will likely be worse than the 10-year period post the GFC.

Chart 2. Shiller cyclically adjusted PE and subsequent 10-year annualised return for S&P500

Source: www.econ.yale.edu/~shiller/data, Vertium

And if momentum pushes the CAPE index even higher into the danger zone, long term expected returns could be negative. There is little margin of safety and the flash crash in early February provided a small taste of what is to come when low risk premiums suddenly mean revert.

Those who ignore risk premiums do so at their own peril because it is an important anchor for long term returns. When valuations are very high (from low risk premiums) prices will eventually collapse under their own weight.

So how can investors generate decent results in a low return environment?

Invest in securities with wide risk premiums that can absorb negative fundamentals. In other words, invest in securities when fear drives a large gap between perception and reality.

Three years ago, there was extreme fear with commodity-related stocks when China was on the brink of a recession. Fortunately, China kick started their economy through large fiscal and monetary measures. When China put a floor under commodity prices mining stocks performed well thereafter. As fear subsided their risk premiums shrunk, forcing up their valuations.

In today's environment, there is extreme fear and misinformation about rising interest rates even though Australian rates have been benign. Hence, some Australian bond-like stocks are priced with wide risk premiums. Even if interest rates do rise, their wide risk premiums have the potential to narrow and hence preserve value. On the other hand, if perceived fear subsides, a shrinking risk premium will deliver reasonable returns.

Stock Commentary

Defensive stocks

During the quarter the defensive stocks did not behave so defensively given the fear of potentially rising interest rates. However, this perception does not match the reality of the Australian economic environment or the business quality of many defensives.

The Fund used the share price weakness in selected defensives to:

i. Increase our position in Spark Infrastructure (SKI)

SKI is a stapled security that owns stakes in three regulated electricity network and distribution monopolies (49% interest in South Australia Power Network, 49% interest in CitiPower and Powercor Australia, and 15% interest in TransGrid). Regulated monopolies are the most defensive assets given that their cashflows are based on a prescribed return on assets by the regulator.

As highlighted earlier, SKI's cashflows resemble a variable interest rate security. Hence, its valuation is largely preserved because changes to its cash flows provide a hedge to changes in the valuation discount rate. The biggest risk to earnings is a change in the regulatory framework. We view this as a relatively low risk given that the weighted average cost of capital regulatory framework was reviewed only a few years ago.

SKI's 7% distribution yield is expected to grow by at least the inflation rate in the foreseeable future. With a healthy payout ratio of 61%, SKI is currently trading on an 11x PE ratio. At current prices we believe SKI is mispriced.

ii. Bought a new position (Sydney Airport, SYD)

Earlier, the investment case for SYD was highlighted. The company has the trifecta of stronger operating outlook, strengthening balance sheet and importantly cheaper valuation.

However, there was some negativity during their FY17 results when SYD announced an additional $500 million capex. There was confusion because SYD will not receive additional return on this spend in the current aeronautical agreement with the airlines that ends in 2020.

We met with management to clarify whether there is a risk that the spend will not be recovered. They highlighted that it is normal for the business to start spending capex if it is required to meet the anticipated demand. The $500 million capex is expected to start closer to the end of the current aeronautical agreement and will overlap into the following new agreement. Hence, there should be no issue getting a return on their additional capex.

SYD's business model is extremely strong. The more it spends on anticipated passenger demand, the greater its profit as it is derived from larger passenger volume and higher charges. The profit is also supercharged from capex related to international passengers because they generate 4x more revenue (aeronautical and retail) than domestic passengers. Hence, with an elevated capex program, SYD's profit growth looks bright. Further, the business model is so unique that SYD can continue to deleverage its balance sheet while having a strong capex program.

SYD's 6% distribution yield is expected to grow at high single digits in the foreseeable future. At current prices, we believe SYD is mispriced.

iii. Maintain our large position (Vicinity Centres, VCX)

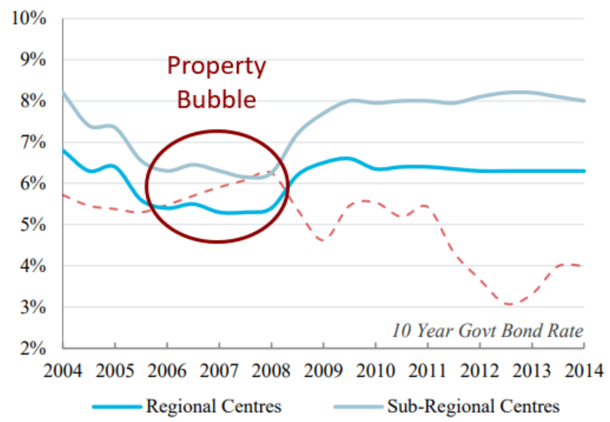
VCX has performed poorly over the quarter. It is Australia's second largest listed retail landlord and owns one of the most prestigious retail precincts in Australia, Chadstone shopping centre. VCX's corporate history is relatively short as it came from Federation Centres (FDC) taking over the higher quality REIT, Novion Property Group (NVN) in 2015.

In recent months, VCX's net tangible asset (NTA) increased to $2.93 while the share price languished. VCX is now trading at 18% below its NTA. Clearly, market sentiment is extremely bearish. This is in stark contrast to 2 years ago when VCX was trading at 41% premium to NTA.

Naturally, we ask ourselves why such a large disconnect in valuation exists between what the private market is willing to pay (NTA) and the public market (share price). The steep discount to NTA indicates that the stock market does not believe the NTA. In other words, the market does not believe the underlying capitalisation rate (cap rate) which drives the property valuation.

Maybe the NTA is overvalued? After all, a property bubble was witnessed in the years leading to the GFC. During that time, cap rates traded below the risk-free rate. The negative yield premium highlights the asset bubble.

Chart 1. Australian shopping centre cap rates

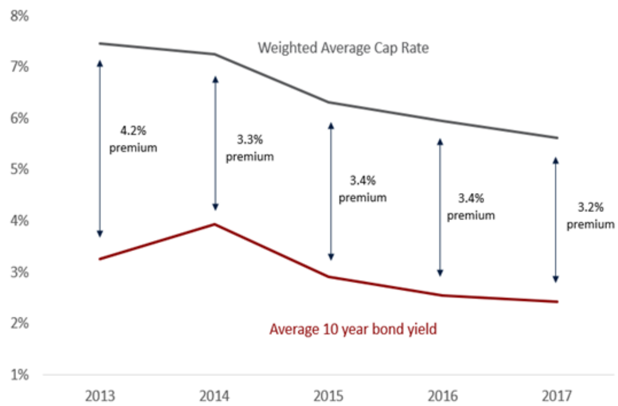


Source: Savills; RBA

Not only was there a property bubble, but the stock market joined the euphoria. At the time, market sentiment was extremely bullish because many REITs traded at significant premiums to NTA.

A real estate bubble simply does not exist today. Property cap rates have roughly followed the 10-year Australian government bond yield with a healthy positive risk premium. The following chart highlights FDC / VCX's portfolio cap rate over the last five years.

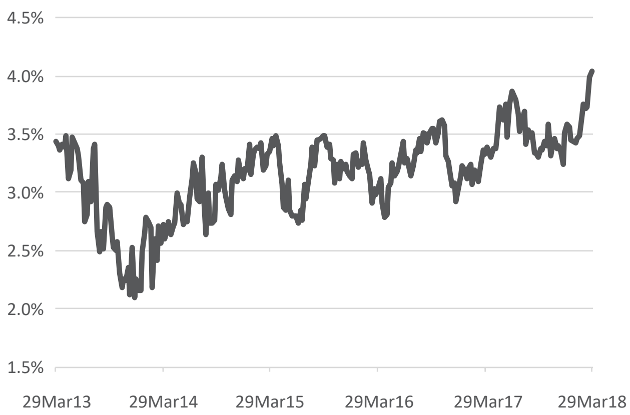
Chart 2. Weighted average cap rates of Federation Centres (2013, 2014) and Vicinity Centres (2015-2017)



Source: Federation Centres, Vicinity Centres, Iress

However, there are sceptics of NTA valuations. After all, REITs are incentivised to pay property valuers well to value their assets. To resolve this issue, we use the stock market as a measure of value. Specifically, we track the asset yields (EBITDA / enterprise value) of FDC and VCX relative to the Australian 10-year Government bond yield over time.

Chart 3. Asset yield spread of Federation Centres (2013, 2014) and Vicinity Centres (2015-March 2018)



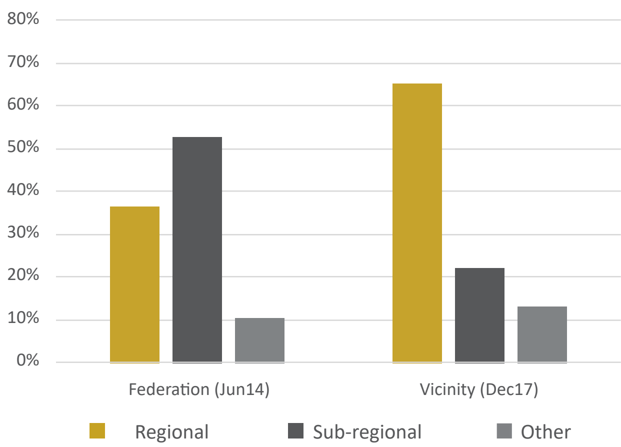
Source: Factset, Vertium

Over the last five years, VCX's yield premium relative to the risk-free rate was around 3%. In early 2014, when bond yields were around 4% the market was more bullish on FDC's prospects given that the yield spread dropped to under 2.5%. However, in the current environment when bond yields are under 3% the stock market is extremely bearish with a yield premium of 4%. The high premium leads to two questions:

Is the balance sheet under stress?
VCX has one of the lowest gearing ratios (A credit rating) in the sector, hence there is no balance sheet issue.

Is the operating earnings under pressure?
Rental health is linked to the strength of shopping centres creating an environment for retailers to thrive. Generally, regional centres generate more sales per square metre than sub-regional centres. Hence, regional centres are better equipped to maintain high rents during industry headwinds. The table below shows the retail centre exposure by type for FDC in 2014 and VCX today.

Chart 4. Property centre by type



Source: Federation Centres, Vicinity Centres

Prior to the 2015 merger, FDC was a much lower quality REIT with greater exposure to sub-regional centres. Given that NVN owned higher quality assets, the takeover substantially improved the quality of the merged entity. Further, VCX is expected to reduce exposure to subregional centres as they are focussing most of their capex efforts on their regional centres.

Some commentators would point to the tough retail environment as to why retail REITs should be valued less. To put this into context, the following chart highlights Australian retail sales growth over the last five years.

Chart 5. Australian retail sales growth

Source: ABS

Note that the current weak retail environment is like 2013 where there are more discounted rental deals. Importantly, while retail earnings may collapse in a tough retail environment, the shopping centres' earnings remain relatively steady. However, the stock market is now more bearish on VCX's higher quality portfolio versus FDC's lower quality portfolio in 2013/2014.

Another criticism about NTA valuations is that it excludes corporate overheads. This is true, but equally NTA also excludes operating earnings such as development or property management fees. In VCX's case, the management fees equal their corporate expenses. Hence, this argument is moot for VCX.

However, this may change significantly in the future. VCX's shopping centres sit on large land lots with unutilised land that is not valued in the NTA. VCX has recently announced plans to sell the unutilised land into special purpose vehicles and develop non-shopping centre assets (for example, residential, office, and hotels) to earn development profits and/or management fees. Management has identified that about half of their properties may have this type of development potential. The capital deployment for this venture could be up to $10 billion, which can be funded off-balance sheet. This strategy of developing other assets next to shopping centres has a dual purpose of ensuring captive foot traffic for their shopping centres and create extra non-rent earnings.

In summary, there is a huge disconnect between perception and reality for VCX. Today, VCX is at the same share price as the Federation Centres share price back in 2013/14. However, back then bond yields were higher and the portfolio quality was substantially lower. VCX is further mispriced especially when there is now a free option on potentially growing non-rent earnings. VCX's 7% distribution yield is expected to grow at 2-3% per annum for the foreseeable future.

Energy Stocks

Woodside Petroleum (WPL)
During the quarter WPL surprised the market by raising $2.5 billion to acquire the Scarborough gas field from Exxon Mobil. The weak share price reflected the confusion around WPL potentially raising too much equity given that the acquisition price was under A$1 billion. After speaking with management, it was clear that they raised more equity to fund the entire Scarborough development program while preserving their credit rating. Woodside has taken the conservative view of avoiding any further equity raise during the development phase when the prevailing oil price might be weak.

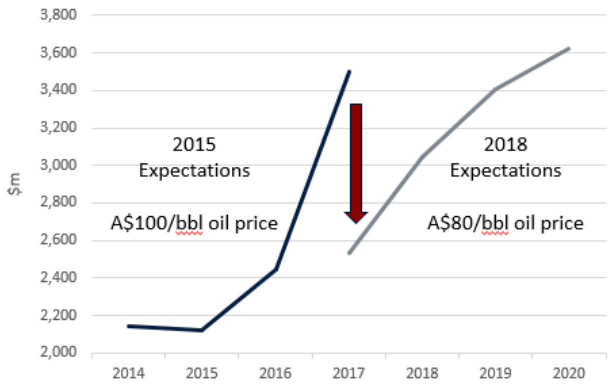
Scarborough adds value to WPL because it is a relatively low-cost LNG development that leverages off their Pluto LNG infrastructure. Moreover, Scarborough plugs WPLs' production gap from their mature and declining North West Shelf LNG production. In the long term, Scarborough will help it commercialise other stranded gas resources around that region.

At current prices, WPL is trading on a 6x EV/EBITDA multiple versus 8x prior to the equity raising. Given its cheaper valuation and that the Scarborough LNG development is fully funded we are comfortable with our holding.

Origin Energy (ORG)
ORG was bought during the quarter. We are attracted to ORG due to its self-help measures to improve the robustness of their business. It is the only large cap commodity related stock with a significant balance sheet repair and cost out program.

ORG's business is significantly linked to the oil price given that half of its EBITDA is derived from their 37.5% stake in the APLNG project. Oil price expectations prior to 2015 are significantly different from today. This has significant earnings implications for Origin Energy.

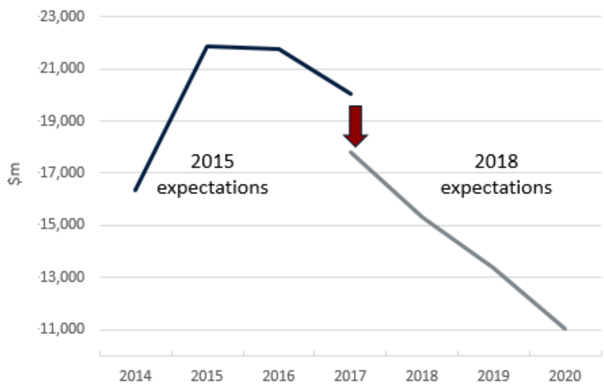
Chart 6. Origin Energy's proportionate EBITDA forecast in 2015 and 2018



Source: Vertium, Factset

Unfortunately, when the oil price collapsed in 2015, ORG was severely wounded from carrying too much debt from the APLNG development. Since then it has largely improved its balance sheet from raising equity and selling assets. Going forward, its debt position will improve largely from the APLNG cashflows.

Chart 7. Origin Energy's proportionate net debt forecast in 2015 and 2018



Source: Vertium, Factset

The recent strength in the oil price (currently at A$90/bbl) will help accelerate ORG's debt reduction program. Hence, with further reduction in costs and an improving balance sheet ORG's equity value should improve over time.

Caltex (CTX)
The Fund increased its holding in CTX during the quarter as the company confirmed that it is reviewing its asset ownership model. Spinning off property or infrastructure assets is not new. For example, Wesfarmers owns the Bunnings retailer and regularly spins-off its properties to BWP Trust (Bunnings REIT) or other property owners.

Given that CTX owns one of the largest petrol station networks in Australia it has the potential to realise substantial value from selling their petrol station properties. Petrol station REITs' NTAs are valued on 16.7x EV/EBITDA multiple (6% cap rate), while CTX trades on a lower multiple of 7.5x EV/EBITDA.

Further, the spinoff could be a catalyst for CTX to return its substantial franking credits to shareholders. Given that a REIT can support higher gearing levels, the restructure may leave CTX with less debt. An under-geared balance sheet will be the prerequisite for CTX to perform an off-market buyback and release the franking credits.

CTX offers compelling value as it is priced as a low growth business at 13x PE (or 7.5x EV/EBITDA). However, at current prices there is a free option on the valuation uplift if the corporate restructure occurs.

Concluding Remarks

The Fund did not behave defensively during the quarter predominantly due to our defensive stocks falling on the perception that Australian interest rates will skyrocket. While the quality of these companies has not changed significantly their pricing is now close to five-year lows. These stocks offer more value than a few months ago. Hence, the Fund used the share price weakness to build greater positions in selected stocks.

Unfortunately, when the Fund is building contrarian positions some share price volatility is expected in the short term. However, in the long term sustainable returns are generated when securities are bought cheap versus their fundamentals. This typically happens when perception and reality disconnects. Three years ago, when there was real fear with the collapse of commodity related stocks it provided good opportunities to generate decent future returns. Today, there is misperceived fear with defensive stocks which also sets up the foundation for robust future returns.

The Fund continues to aim to deliver on its triple investment objectives of more income, less risk and greater returns relative to the Australian share market over the long term. We are grateful for managing your capital and thank you for your support.

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

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

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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.