Vertium Equity Income Fund

Fund Update | Quarter to 30 June 2018

VERTIUM ASSET MANAGEMENT

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 mth %	3 mths %	6 mths %	1 yr %	Incep. %
Vertium Equity Income Fund					
Distribution[1]	2.64	2.64	3.67	5.70	4.98
Growth	0.22	2.70	-3.86	-0.67	-0.74
Total return	**2.86**	**5.34**	**-0.19**	**5.03**	**4.24**
S&P/ASX 300 Accumulation Index					
Distribution	0.23	0.85	2.07	4.33	4.44
Growth	2.96	7.51	2.20	8.91	4.39
Total return	**3.19**	**8.36**	**4.27**	**13.24**	**8.83**

[1] Based on quarterly distributions

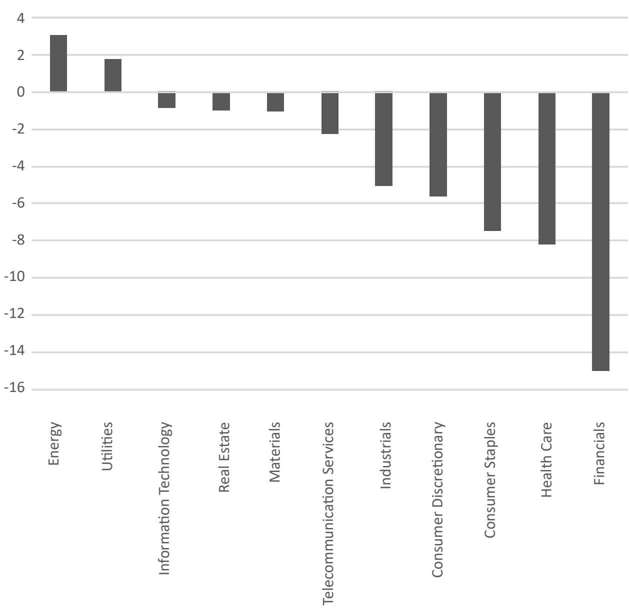
Volatility

	1 yr %	Incep. %
Vertium Equity Income Fund	5.14	4.77
S&P/ASX 300 Accumulation Index	7.35	7.63

Month-end unit prices^

Application	NAV	Redemption
$1.0207	$1.0181	$1.0156

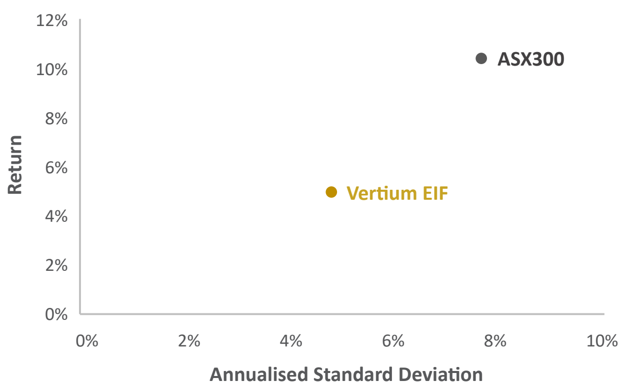
GICS active exposure



Top 10 holdings#

Company	ASX code
Commonwealth Bank of Australia	CBA
Caltex Australia Limited	CTX
Amcor Limited	AMC
BHP Billiton Limited	BHP
Vicinity Centres	VCX
Westpac Banking Corp	WBC
Spark Infrastructure	SKI
Link Administration Holdings	LNK
ANZ Banking Group Limited	ANZ
Sydney Airport	SYD
Number of stocks	21

Return vs risk (since inception)



Exposure

Size exposure	%	Option exposure	%
Large cap	42.40	**Shares**	63.33
Mid cap	10.28	**Call options**	(4.93)
Small cap	5.71	**Put options**	0.00
Effective cash	41.61	**Effective cash**	41.61

Quarterly commentary

The Vertium Equity Income Fund delivered a total net return of 5.0% for FY18, which lagged the benchmark's return of 13.2%. Our conservative investment style of being underweight the volatile resource sector and momentum driven, growth stocks predominantly led to the underperformance. However, our conservatism also meant that we delivered the returns with significantly less risk than the market (the standard deviation of the Fund's returns and the benchmark were 5.1% and 7.3% respectively).

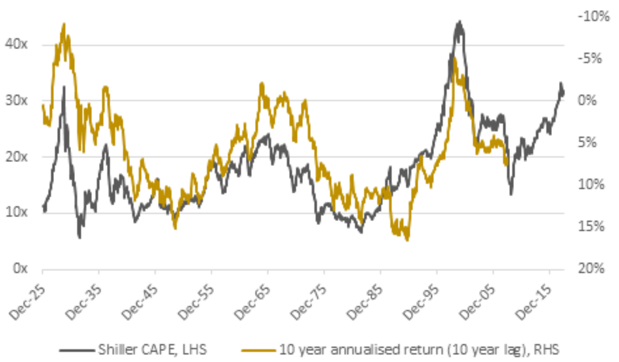
The Fund also paid a June quarter distribution of 2.6 cpu taking the total distribution for FY18 to 5.6 cpu in line with our objective of paying consistent distribution greater than the market (the distribution return of the Fund and benchmark were 5.7% and 4.7% respectively). Including franking, the grossed up distribution return for the Fund was 6.2%.

Danger flags are waving

There are moments in life where unnecessary risk is taken despite the warnings signs. For example, swimming outside the flags at the beach when the surf looks exciting. The flags are there for a reason, it protects you from turbulent currents that could suck you out to sea. For the stock market, the warning flags are overvaluation and slowing growth and investors should take heed when they are waving.

The overvaluation flag has been flapping for some time. For example, the Shiller Cyclically Adjusted Price Earnings index (S&P500 price dividend by its trailing 10-year average EPS) has been flashing extreme valuation levels for the US stock market.

Chart 1. Shiller Cyclically Adjusted Price Earnings index is pointing to low long-term returns



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

Despite the high likelihood of low long-term returns, valuations are overlooked because the only game in town right now is growth and momentum. However, over the long-term valuations cannot be ignored because growth is cyclical. When growth slows, share prices fall when there is no valuation support.

And recently the other warning flag is fluttering. Global growth has peaked and is expected to decelerate further. Signs of a slowdown have been evident since the beginning of 2018. For example, the OECD composite leading indicator (CLI), which precedes global growth peaked in December 2017 and has been contracting since then. Over the last decade every global slowdown has been marked by a crisis.

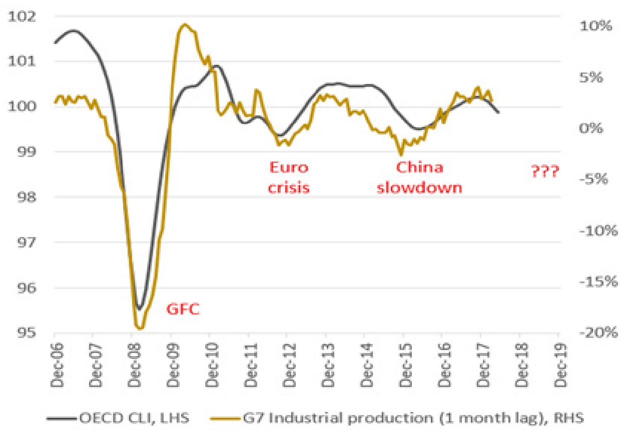
2008 was the Global Financial Crisis.

2012 was the Euro crisis.

2015 was the China/emerging markets slowdown.

If the OECD CLI continues its slide then another crisis is looming on the horizon.

Chart 2. OECD composite leading indicator is guiding to slower global growth



Source: OECD Vertium

Even before tariffs dominated news headlines, global trade as proxied by South Korean exports hit negative year on year growth from the beginning of 2018.

Chart 3. South Korean exports is the canary in the coal mine and is gasping for air

Source: CEIC, Factset, Vertium

Given the precarious state of global trade, a tariff war could create a Wiley Coyote moment where global growth could fall off a cliff.

Moreover, global growth is not expected to improve in the near term because global liquidity is evaporating. Cash, as represented by real M1 money supply, is being withdrawn from the global banking system.

Chart 4. Shrinking money supply precedes global growth slowdown

Source: Absolute Strategy, Allianz Global Investors

And more liquidity is expected to be drained from the markets as the US Federal Reserve is accelerating its balance sheet reduction (quantitative tightening). Last quarter, the Fed reduced their balance sheet by $30 million a month, this quarter it's $40 million a month, and in Q4 it will increase to $50 million a month.

While there are strong signs of slowing global growth, there is little doubt inflationary pressures are building in the United States.

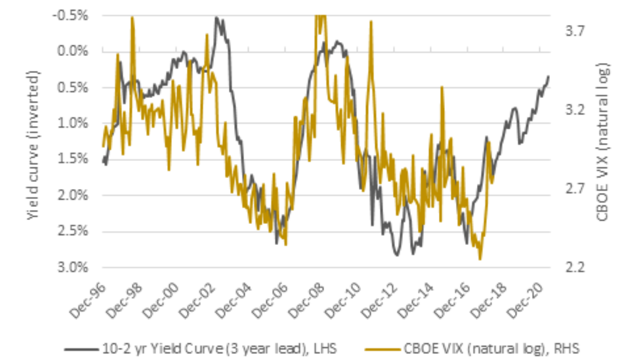
Chart 5. US inflation is expected to rise over the coming quarters

Source: FRED, Vertium

Naturally, rising inflation expectations may make investors think about rising interest rates. However, the prospect of slowing economic activity is disinflationary, which offsets inflation concerns. As a result, US bond yields have fallen in recent months.

With a benign US 10-year bond yield, the yield curve is fast approaching zero highlighting that the end of the economic cycle is nearer. When market valuations are high and growth disappoints the natural consequence is increased volatility: share prices fall when high expectations are revised down.

Chart 6. Flattening yield curve points to greater volatility ahead

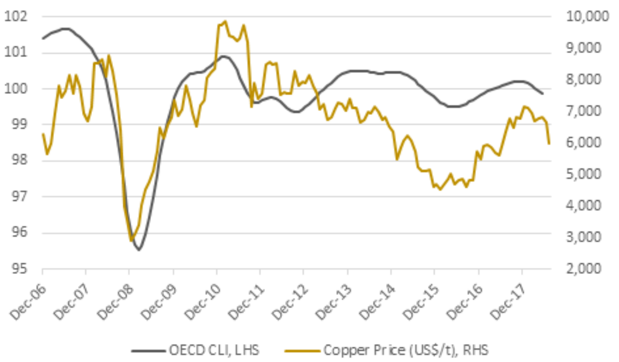


Source: FRED

So, what does slower global growth mean for Australian stocks? Most Australian companies are linked to the global industrial cycle in varying degrees. Resource stocks are highly leveraged to the global cycle while defensive stocks such as real estate investment trusts and utilities have the least correlation.

While resource stocks are not trading on excessive valuation multiples their earnings are at risk when the global industrial cycle turns down. Copper, the global economic bellwether, has already confirmed the weakness in global growth.

Chart 7. Dr Copper looks sick



Source: OECD, Iress

You may think it is safer to invest in high growth industrial companies that can grow through economic uncertainty. Think again – many high growth stocks are priced for perfection.

For example, the healthcare sector, led by growth kings such as Cochlear, Resmed, and CSL has historically delivered robust earnings growth and will no doubt continue to deliver consistent earnings going forward. However, their valuations are at decade-highs yet forecast growth rates are lower than they were a decade ago.

Chart 8. The average PE multiple of Cochlear, ResMed and CSL are in nosebleed territory

Source: Factset

Another area of the market where investors seek out growth is from small companies. Like the healthcare stocks, the sector is trading at extreme valuations.

Chart 9. Small Ords PE multiple is at extreme levels

Source: Morgan Stanley

High valuation multiples mean one thing – expectations are very high. Any disappointment from lofty heights would result in stock prices falling. Investors in recent fallen angels such as Ramsay Healthcare or A2 Milk (profit expectations have been revised down twice in the last 2 months!) are surely reassessing whether they are paying too much for their underlying growth.

In summary, the warning flags of overvaluation and slowing growth are clearly waving. Ignoring them will be like swimming against the tide in choppy waters. In the current environment, where the potential for disappointments are high capital preservation should be paramount in investors' minds.

Stock Commentary

Bullish undercurrents propelled the benchmark to deliver a 13.2% total return for FY18. The best performing groups of stocks were small companies and the resource sector.

Industrial stocks produced lacklustre returns, but there was huge performance divergence across the spectrum. The worst performing stock was Telstra (-33.7%) as it significantly downgraded its earnings outlook due to the impact of the National Broadband Network (NBN) and increased mobile competition. The best performing stock was A2 Milk (+179.8%) as it reported exceptional earnings growth from selling infant formula in China.

The Fund's underperformance was predominantly driven by the stocks we did not own in the benchmark rather than the stocks we owned in the portfolio. The conservative strategy of owning high quality companies at reasonable valuations meant that the Fund had limited exposure to the fast-rising sectors of expensive, growth stocks and the volatile resource sector. Our strategy is not averse to buying high growth companies, however, we are unwilling to own them if valuations become extremely stretched. For example, the Fund owned CSL and Fisher and Paykel in the first half of FY18 but sold them when their share prices rose to elevated valuations.

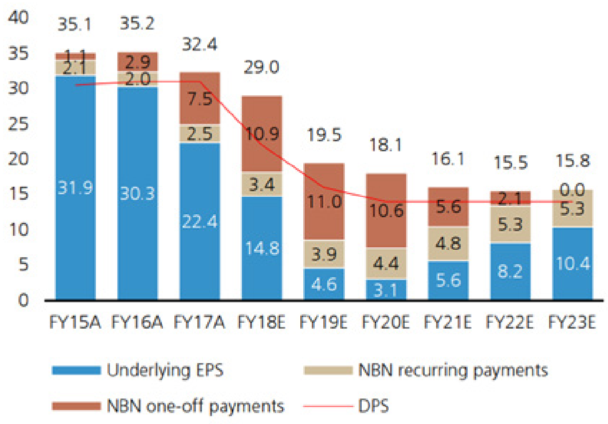
The Fund's worst performance drag in FY18 came from AGL Energy which fell -7% for the year. Like all stocks that performed poorly in the portfolio it underwent a detailed review to understand whether the original investment thesis had changed. After the review, we concluded that industry dynamics are worsening due to increased electricity supply. Also, the politically motivated Australian Competition and Consumer Commission (ACCC) report of recommending the Australian Government to underwrite power generation has the potential to add more fuel to the fire. While AGL Energy exhibits a reasonable PE multiple in the near term, post the shutdown of its Liddell power station, its valuation does not look compelling in the long term. Without a reasonable margin of safety, we sold out of AGL Energy.

Regulation and Government Intervention

AGL Energy is not alone in being impacted from increased Government intervention. The entire utility sector is under scrutiny by regulatory bodies such as the ACCC and the Australian Energy Market Operator to bring down electricity prices. The financial services industry's reputation has been tarnished by the Financial Services Royal Commission claiming AMP as its biggest scalp to date. Aurizon Holdings has an uphill battle against the Queensland Competition Authority regarding the profitability of its regulated rail network. And finally, Link Administration was unexpectedly side swiped when the FY18 Federal budget proposed changes to superannuation accounts with low balances.

The market has good reason to fear Government intervention. Telstra highlights how politically motivated Government actions can severely damage a company's profitability. Based on UBS estimates, Telstra's profits will be a shadow of its former self when the NBN migration is completed by 2022.

Chart 1. Telstra EPS Breakdown



Source: UBS

While regulation may become a nightmare for existing shareholders it also creates potential opportunities for new shareholders if the share price overreacts to the earnings risk. We are closely monitoring these negative developments to work out when to buy these fallen companies.

Commonwealth Bank (CBA)

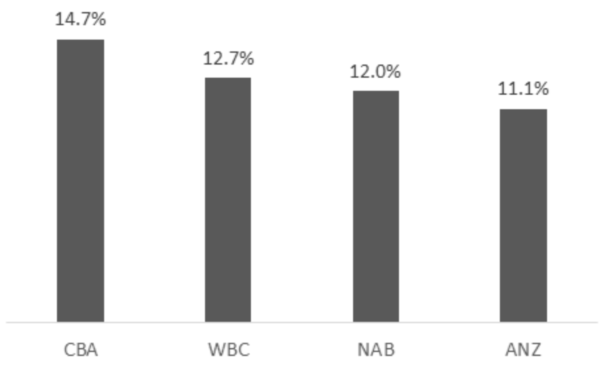
One fallen angel from regulatory pressure has been CBA. Its valuation multiple has significantly deflated following the AUSTRAC issue and the Financial Services Royal Commission.

Chart 2. CBA's PE (next twelve month) multiple history

Source: Factset

At the beginning of FY18, the Fund did not own CBA because it was too expensive. However, as the year progressed we used the share price weakness to buy and then increase our holding over time. CBA continues to be the highest quality bank in Australia given its superior return on equity versus its peers.

Chart 3. Major banks return on equity (next 12 months)



Source: Factset

Link Administration Holdings (LNK)
Another fallen angel due to Government intervention is Link Administration. In May 2018, the Australian Government announced that inactive superannuation accounts under $6,000 will be transferred to the Australian Taxation Office from July 2019. Superficially, this was a negative outcome for LNK given that the company earns a fee on a substantial number of inactive accounts under $6,000.

A week after the budget announcement, LNK estimated that the 'unmitigated' impact would be $55 million revenue per annum. However, the impact could be mitigated by super funds contacting their members or through volume protection clauses if there was material decrease in member numbers.

The confusion significantly de-rated the stock to its lowest PE multiple since its initial public offering in 2015.

Chart 4. LNK's PE (next twelve month) multiple history

Source: Factset

We used the share price weakness to increase our holding as the share price overreacted to the budget decision. Furthermore, in April 2018, LNK raised $300 million of equity to deploy on future acquisitions. Given their cashed-up balance sheet and low valuation, shareholders are getting a free option on any benefit associated with future acquisitions.

BHP Billiton (BHP)
During the quarter the Fund bought BHP. While we are cautious on the current negative macro environment associated with commodity prices we also cannot ignore the micro developments occurring with some resource companies. BHP is one such company where a stock specific driver offsets the uncertainty around the commodity price outlook.

BHP is in the process of selling their US shale assets that would create value for shareholders in multiple ways:

1. There is a very large valuation wedge between BHP's US shale assets and the remainder of its business, which is of higher quality. It's US shale assets generate about US$1 billion EBITDA (5% of group EBITDA) and the sale price is expected to be around US$10 billion. This implies a 10x EV/EBITDA multiple for the US shale division versus the entire company trading on 6x EV/EBITDA multiple.
2. The sale of the US shale assets will likely push BHP's balance sheet to net cash. Hence, BHP is likely to return the entire US shale proceeds back to shareholders. It is likely that the preferred capital management program will be an off-market buyback given the company has significant franking credits. Hence, the after-tax return to shareholders will likely be enhanced by the release of significant franking credits.
3. Whilst the shale division produces a positive EBITDA it is free cashflow negative given that it is a highly capital-intensive business. BHP will generate more free cash flow per share if the proceeds from the sale of shale assets are used to buy back its shares.

Concluding Remarks

FY18 was an unusual year where many companies got slapped by the heavy hand of the Government while risk-seeking was prevalent across many stocks that exhibited growth. For industrial stocks, PE multiples expanded more than earnings revisions and resource stocks rallied with volatile commodity prices. While we are disappointed with the short-term underperformance it is not unexpected given that the Fund invests with a conservative and risk aware approach. Regarding the Fund's other objectives, we have more than met them by delivering greater income and delivering returns with less risk than the benchmark.

Post FY18, many stock valuations are now higher than they were a year ago plus the tailwind of synchronised global growth has passed. High valuations and slowing growth is a dangerous cocktail for stocks because its sets the foundation for disappointment. We are patiently waiting for better opportunities to invest in industrial companies when investor expectations are revised down. We are also patiently waiting for the cyclical downturn in China to play out to prudently deploy capital in the resource sector.

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.