Vertium Equity Income Fund

Fund Update | Quarter to 30 September 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

Month-end unit prices^

Application	NAV	Redemption
$0.9959	$0.9935	$0.9910

Total returns*

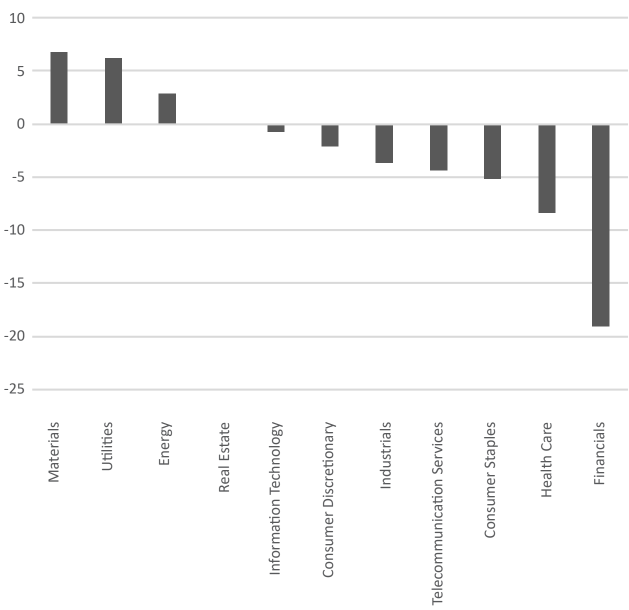
	1 mth %	3 mths %	6 mths %	1 yr %	Incep. %
Vertium Equity Income Fund					
Distribution[1]	1.00	1.00	3.67	5.72	4.81
Growth	-1.42	-0.85	1.90	-2.74	-1.19
Total return	**-0.42**	**0.15**	**5.57**	**2.98**	**3.63**
S&P/ASX 300 Accumulation Index					
Distribution	0.52	1.30	2.16	4.26	4.59
Growth	-1.71	0.20	7.83	9.77	3.75
Total return	**-1.19**	**1.50**	**9.99**	**14.03**	**8.34**

[1] Based on quarterly distributions

Volatility

	1 yr %	Incep. %
Vertium Equity Income Fund	5.39	4.55
S&P/ASX 300 Accumulation Index	7.56	7.12

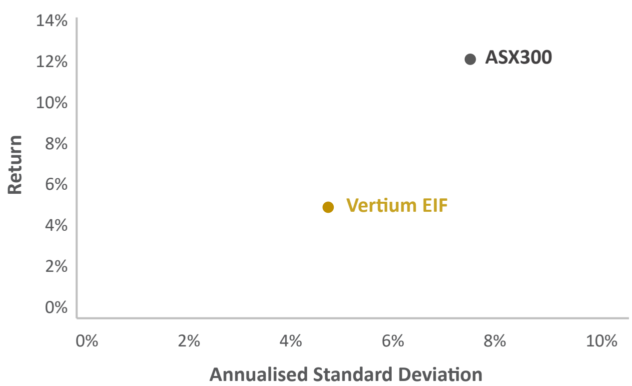
GICS active exposure



Top 10 holdings#

Company	ASX code
Commonwealth Bank of Australia	CBA
Amcor Limited	AMC
Vicinity Centres	VCX
Caltex Australia Limited	CTX
Rio Tinto Limited	RIO
BHP Billiton Limited	BHP
AusNet Services Limited	AST
Spark Infrastructure Group	SKI
Westpac Banking Corporation	WBC
Transurban Group	TCL
Number of stocks	**25**

Return vs risk (since inception)



Exposure

Size exposure	%	Option exposure	%
Large cap	48.72	**Shares**	83.11
Mid cap	18.34	**Call options**	(9.62)
Small cap	5.10	**Put options**	(1.32)
Effective cash	27.83	**Effective cash**	27.83

Quarterly commentary

During the September 2018 quarter, the Fund delivered a total return of 0.1% versus 1.5% for the S&P/ASX300 Accumulation Index. The Fund also paid one cent per unit distribution for the quarter.

The Fund underperformed during the quarter because of our risk aware, value investment style shunning many growth/momentum stocks. Like every bubble, when stocks are in favour they dominate index weights, hence have an outsized influence on index returns. For example, CSL, Australia's favourite growth company, is currently about 5% of the ASX300 while its PE multiple is at record levels not seen in the last 15 years. History has shown that bubbles can persist in the short term, much to the chagrin of value investors. However, in the long term they pop under the heavy weight of their lofty valuations.

Resource stocks are sometimes grouped with growth stocks because they act as good proxies for global growth. Unlike growth stocks, which are mostly trading at high valuation multiples, most resource stocks are trading on more reasonable multiples. The following commentary outlines our thoughts on the resource sector.

The phantom resource bear market of 2018

What a difference a year makes. This time last year, the stock market was cheering the global synchronised growth story. Now, it is downbeat, fixated on tariff wars that could derail global growth, especially China. In our view, the tariff war is a side show to what is happening in China. The Chinese economy peaked in mid-2017 and since then has been slowing. Global synchronised growth was a false narrative.

Slowing Chinese activity

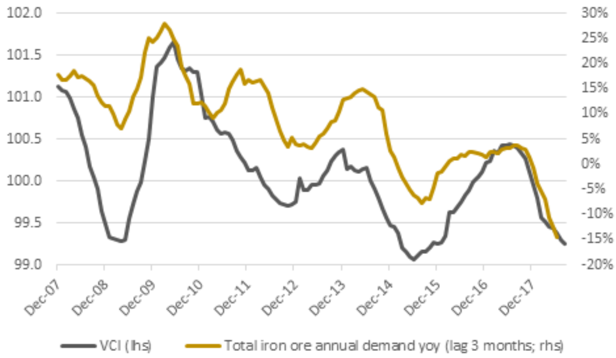
At Vertium, we track more than one hundred data series to get a better pulse of Chinese economic activity. Like the Li Keqiang Index created by The Economist to measure economic activity in China, we have created the Vertium China Index (VCI). Specifically, VCI is a composite index that captures changes in currency and demand deposits, domestic loans, electricity production, rail and water freight, property sales, automobile sales and mobile phone production.

Figure 1. VCI tracks the Chinese economic cycle, including the downturn of 2018

Source: Vertium

There have been four distinct economic downturns (2009, 2012, 2015 and 2018) in China over the last decade, which had significant impact on the demand for commodities. For example, VCI precedes China's total iron ore demand (proxied by domestic production and imports) by about 3 months. Currently, the downturn in Chinese activity has resulted in the lowest iron ore demand growth for over a decade.

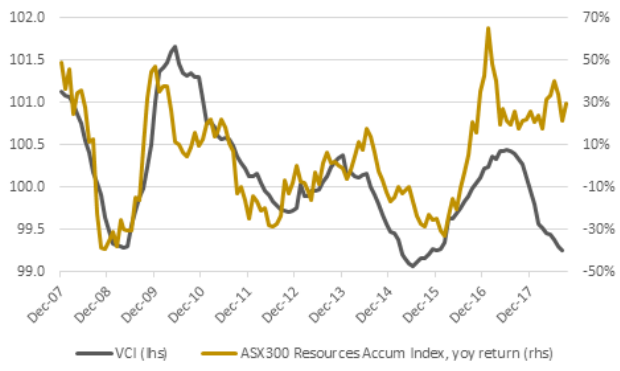
Figure 2. Chinese iron ore demand is extremely weak in 2018



Source: National Bureau of Statistics, General Administration of Customs, Vertium

One would expect that when Chinese commodity demand is weak resource stocks perform poorly. However, the behaviour of resource stocks in the current downturn is very different to previous cycles. When Chinese activity was close to its lows in 2009, 2012 and 2015 the Australian Resource sector's rolling annual performances were -31%, -28% and -33% respectively. Contrast those periods to the current slowdown when the resource sector's annual performance has delivered a perplexing +29%.

Figure 3. Resource sector performance historically followed Chinese economic activity



Source: Iress, Vertium

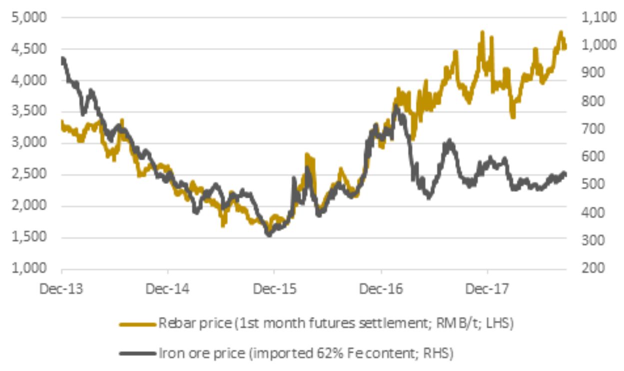
Is the resource sector about to collapse and catch-up with weak underling Chinese demand? Or is there something else that is driving its performance?

This cycle is different

In 2016, Chinese authorities pushed supply side reform as their main economic policy framework as they were concerned about zombie companies in overcapacity sectors such as coal and steel. The severity of the problem was highlighted by The Economist, which estimated that it would take the Chinese coal and steel industries 91 years and 74 years, respectively, to pay back total debt based on 2015 figures.

The heart of the supply side reform is reining in corporate debt and authorities aim to reduce State Owned Enterprises (SOEs) ratio of liabilities to assets by 2% over the next couple of years. Combining the supply side reform with China's 'war on pollution' that started a few years earlier, authorities have announced several measures to eliminate excess capacity and deleverage corporate balance sheets. Key industries targeted include steel, coal, coke and cement. For example, about 150 million tonnes of steel was eliminated in China, which reduced global steel supply by about 6%. The enormous cuts to steel supply, combined with environmental policies that encourage the use of scrap metal, has resulted in the steel price decoupling from the iron ore price.

Figure 4. Steel and iron ore prices have decoupled due to supply side reform



Source: Shanghai Futures Exchange, China Iron and Steel Association

Cutting overcapacity allows China to simultaneously achieve their twin objectives of reducing pollution and high levels of corporate debt. Engineering supply cuts in targeted industries, boost commodity prices and allows heavily indebted corporates to de-gear their balance sheets at a faster rate. The process roughly works like this:

- Government orders the entire industry to cut capacity, which reduces pollution
- Commodity price rises (offsetting falling volumes) lead to rising profits
- Profits are used to reduce debt.
- Once debt is manageable, the Government forces larger companies to swallow up smaller peers to drive greater operational efficiencies.

There is no other country in the world that can execute this type of strategy given the Chinese authorities iron grip on their SOEs. Under a free market in an industry with excess capacity, it may take years before supply cuts have a material impact. Under Government direction in China, it happens within months.

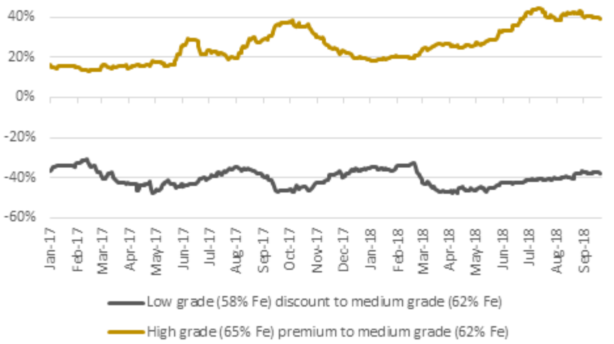
Chinese authorities also understand the very delicate balancing act required to reduce pollution and help SOEs deleverage. Changes in supply for one commodity has multiple consequences across the commodity supply chain. For example, supply cuts in coke (derived from coking coal), an essential ingredient for steel and a significant contributor to carbon emissions, has caused a price spike to record levels. Without supply cuts in steel to engineer high steel prices, profit margins would collapse from high coke costs. Thus, steel companies would be unable to deleverage.

Figure 5. Coke prices are high due to pollution controls

Source: Dalian Commodity Exchange

The high price of coke also indirectly affects the demand for different iron ore grades. Coke now makes up around 40% of a steel mill's costs compared to a typical range of 20-25%. To reduce the consumption of coke in blast furnaces, the demand for high grade iron ore has increased significantly because every 1% increase in iron ore grade reduces coke required by 2%. Hence, since the introduction of supply side reforms, the prices for different iron ore grades has diverged significantly. High grade iron ore (65% Fe content) trades at a significant premium to the benchmark medium grade iron ore (62% Fe content) while low grade iron ore (58% Fe content) trades at a significant discount.

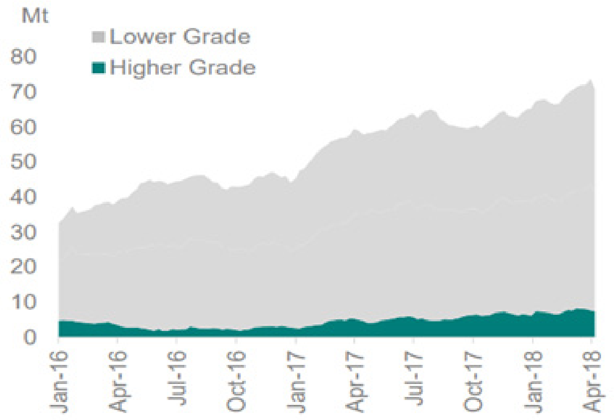
Figure 6. Demand for low grade iron ore is weak due to supply side reform



Source: SteelHome

Weak demand for low grade iron ore is also evident in other Chinese data. For example, iron ore port inventories are at record levels because they are predominantly comprised of low-grade iron ore imports.

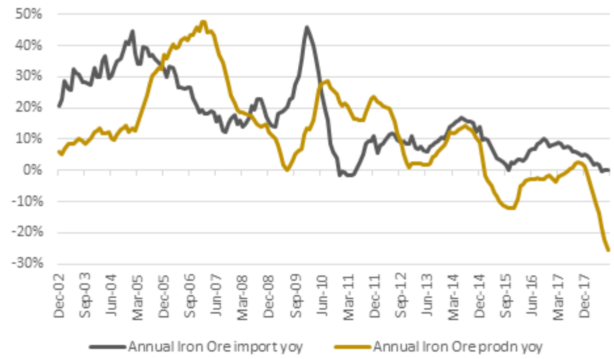
Figure 7. Chinese iron ore port inventories are at record levels



Source: Vale

Furthermore, Chinese iron ore is low grade in nature and its annualised production has collapsed 26% to 1.03 billion tonnes. In comparison, iron ore imports, which has a combination of all grades of iron ore, has plateaued at an annualised rate of 1.07 billion tonnes.

Figure 8. Demand for domestic Chinese iron ore has collapsed



Source: National Bureau of Statistics, General Administration of Customs, Vertium

Given that Chinese iron ore accounts for a large portion of global iron ore production and the price of low-grade iron ore is weak, a volume weighted iron ore price on global production highlights a very clear bear market.

Fortescue Metals, a producer of low grade iron ore, has borne the brunt of the iron ore bear market and was one of the worst performing stocks on the ASX over the last year. However, the profits of resource giants, BHP Billiton and Rio Tinto, were saved because the demand for high- and medium-grade iron ore has been more resilient.

Conclusion

There is no doubt that Chinese economic activity is waning, and commodities were due for a bear market in 2018. But with China's supply side reform starting a couple of years ago, this turned out to be a phantom bear market for some commodities. If China maintains their supply side reform, it might pull off the most beautiful deleveraging process in history but with profound ramifications across the commodity spectrum.

Stock commentary

Resource Stocks

During previous downturns in China, investors focussing on the slowing demand would have avoided the carnage in resource stocks. However, for the first time in history the supply side reforms have changed the dynamics within the commodity landscape. Hence, the current Chinese downturn has been difficult to navigate, which resulted in us underestimating the effects of supply cuts offsetting waning commodity demand on certain commodities. In the last few months we have selectively invested in resource companies (including BHP and RIO) that will continue to benefit from China's supply side reform.

BHP and RIO are indirect beneficiaries when low grade iron ore demand is weak. On valuation metrics both stocks trade on a reasonable 7% free cash flow yield. Furthermore, their balance sheets are in excellent shape, which means shareholders are likely to receive extra cash returns via capital management initiatives when asset sales are completed.

In addition, both BHP and RIO sit on a mountain of franking credits which could be released to Australian shareholders when they initiate capital management programs.

Figure 1. BHP and RIO have enormous franking credit balances

	Franking credits (USD billion)	% of Australian market capitalisation
BHP	11.4	14%
RIO	8.5	37%

Source: Company accounts, Vertium

Rio Tinto (RIO):

In September, RIO announced a US$3.2bn buyback program, split between US$1.9bn off-market buyback on the Australian Stock Exchange and a US$1.3 billion increase to the current on-market buyback on the London Stock Exchange to US$3 billion. The off-market buyback releases substantial franking credits and significantly lifts after tax returns for low tax paying Australian shareholders.

Using a $75 share price as a guide and assuming the maximum 14% buyback discount, it would equate to a $64.50 buyback price. With the capital component of the buyback price set at $9.44, the other component represents a $55.06 fully franked dividend. Hence, a significant amount of franking credits of $23.60 per share is released to shareholders. Based on these calculations, tax exempt shareholders would earn a substantial return of 17%.

Figure 2. RIO's off-market buyback metrics

Share price	75.00
Buyback discount	14%
Buyback price	64.50
Capital component	9.44
FF dividend component	55.06
Grossed-up dividend component	78.66
Imputation credit	23.60
Grossed-up exit price	88.10
Total Return (assume 0% tax rate)	**17%**

Source: Vertium

RIO's buyback program came from the sale proceeds of various coal assets, which were sold for a combined pre-tax value of US$4.15 billion. With a balance sheet that is close to net cash we expect any proceeds from future asset sales to be returned to shareholders. In early October, another asset was sold, RIO's stake in Grasberg, for US$3.2 billion (post tax). Further, there is media speculation that RIO's stake in Iron Ore of Canada is for sale, which could be valued at approximately US$2 billion (post tax).

The current capital management program of US$4.9 billion and future capital initiatives estimated to be US$5.2 billion represents about 11% of RIO's current market capitalisation. Hence, shareholders are likely to earn an 18% return (7% free cash flow yield + 11% capital return) over the next year based on the current share price. The addition of franking credits will boost after tax returns further.

BHP Billiton (BHP):

Given that BHP's current net debt sits at bottom of its target net debt range of US$10-15 billion, the proceeds from the recent sale of its US shale assets are expected to be returned to shareholders. The after-tax proceeds of about A$11 billion represents about 6% of BHP's current market capitalisation. BHP is likely to execute an off-market buyback given its under geared balance sheet and its large franking credit balance.

Hence, shareholders are likely to earn 13% return (7% free cash flow yield + 6% capital return) over the next year based on current prices. The after-tax returns will be further boosted with the release of franking credits.

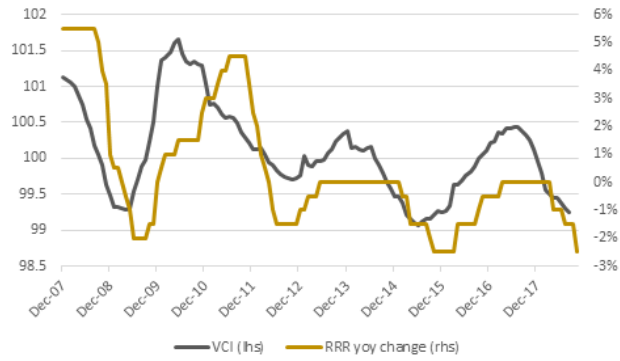
Commodity outlook:
While the earnings multiples for BHP and RIO look reasonable, their share prices can still fall if underlying commodity prices are weak. In the short to medium term, we believe that the chances of medium grade iron ore prices collapsing are low due to winter production cuts and recent stimulus measures.

Following the success of reducing pollution last winter, when heavy industries were ordered to cut production, China has implemented a similar scheme for the upcoming winter. Coke production, which contributes about 15% of carbon emissions in China, is expected to be cut again. Elevated coke prices will ensure that demand for high and medium grade iron ore remains resilient in the short term.

Beyond the Chinese winter, there are two reasons to be more positive on Chinese economic activity finding a base over the coming months:

1. Monetary stimulus
China has several key monetary tools, including managing banks' reserve ratio and adjusting interest rates. Currently, Chinese monetary policy is loosening to respond to lower economic activity. Like previous downturns, the banks' required reserve ratio (RRR) has been cut to inject more liquidity into the economy. The RRR has been cut three times this year.

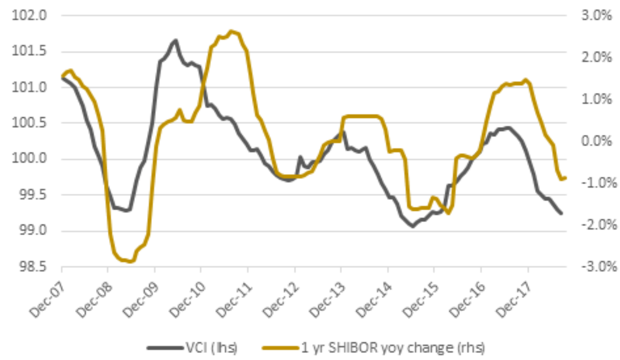
Figure 3. When the economy slows, the RRR is cut to encourage bank lending



Source: PBOC, Vertium

While the benchmark lending rate has yet to be cut, the Shanghai interbank offered rate (SHIBOR), the interest rate Chinese banks lend to each other, has decreased over the last few months. The SHIBOR is now about 90 basis points lower than a year ago.

Figure 4. When the economy slows, SHIBOR decreases to improve liquidity between banks



Source: Shanghai interbank offered rate, Vertium

2. Infrastructure stimulus
Since early 2018, infrastructure spending has slowed dramatically when the Chinese Government reduced the fiscal budget deficit from 3% to 2.7%. However, in July 2018, in response to slowing economic activity Chinese authorities indicated they would adopt a more proactive fiscal policy. Amongst further stimulatory measures announced, the most important was allowing local governments to issue 1.35 trillion yuan (~US$200 billion) of bonds for infrastructure projects. Assuming the infrastructure projects are geared at 60%, the total infrastructure spend could be about US$330 billion. To provide context, this amount of spend represents about 40% of Chinese fiscal spend during the Global Financial Crisis in 2009.

With the backdrop of continued supply cuts and looser credit and fiscal conditions on the horizon in China, 2019 is expected to be a safer year to invest in resource companies. To be clear, we do not expect the extreme levels of stimulus that occurred in 2009 or 2015 because China still has the long-term goal to deleverage their economy.

Amcor (AMC)

AMC performed poorly during the quarter when management announced it would acquire its US competitor, Bemis. The announcement rattled the market, raising questions over its acquisition discipline.

While we don't necessarily like companies lowering their return hurdles for acquisitions, it is somewhat offset by the acquisition being funded with 100% equity. Importantly, from an investment point of view, Amcor's share price is well below its preannouncement price, yet the acquisition improves its profit outlook due to US$180 million of cost synergies. Furthermore, the balance sheet will rapidly de-gear when the businesses are merged.

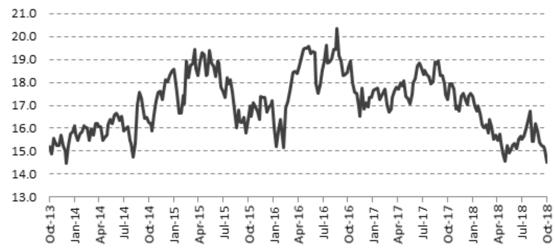
Figure 5. Amcor's earnings and gearing pre- and post-merger with Bemis

	Jun '19E	Jun '20E	Jun'21E
AMC EPS (USD)	0.64	0.71	0.73
growth		9.6%	3.6%
AMC + BMS EPS (USD)	0.64	0.73	0.78
growth		13.5%	7.9%
EPS accretion	**-0.6%**	**2.9%**	**7.2%**
AMC ND/EBITDA	2.5	2.3	2.1
AMC + BMS ND/EBITDA	2.4	2.1	1.4
Balance sheet accretion	**261**	**366**	**1,691**
% of current market cap	2%	2%	11%

Source: Vertium

A lower share price with greater earnings growth and a stronger balance sheet clearly makes the company cheaper. The uncertainty has created an outstanding value opportunity with AMC's PE multiple at its lowest level over the last five years.

Figure 7. Amcor's PE (next twelve months) multiple



Source: Factset

Amcor represents the classic 'baby thrown out with the bathwater' value stock.

Concluding Remarks

There has been a lot of financial commentary about growth investing outperforming value investing in recent months. However, over the long term empirical studies have shown that value investing outperforms. We are confident that common sense will prevail eventually, and we will only deploy capital prudently.

While we are not resource bulls, some resource stocks offer reasonable risk-reward payoffs especially if one considers their capital management initiatives. The cash return (free cash flow yield plus capital return) from BHP and RIO offer some margin of safety while we wait for recent Chinese stimulus to take effect and stabilise the Chinese economy.

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

Zenith Investment Partners
Approved

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

CONTACT COPIA

1800 442 129 | clientservices@copiapartners.com.au | copiapartners.com.au

John Clothier	General Manager, Distribution	0408 488 549 | jclothier@copiapartners.com.au
Sean Paul McGoldrick	Account Manager, Northern Region	0421 050 370 | spmcgoldrick@copiapartners.com.au
Iain Mason	Director, Institutional Business	0412 137 424 | imason@copiapartners.com.au

[*]The total return performance figures quoted are historical, calculated using hard 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 hard-close and cum-distribution.

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

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