VERTiUM
ASSET MANAGEMENT

Vertium Equity Income Fund

Fund Update | Month to 31 December 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 mth %	3 mths %	6 mths %	1 yr %	Incept. %
Vertium Equity Income Fund					
Distribution[1]	1.06	1.06	2.07	5.82	4.73
Growth	-1.41	-5.35	-6.22	-10.09	-4.33
Total return	**-0.35**	**-4.29**	**-4.14**	**-4.27**	**0.40**
S&P/ASX 300 Accumulation Index					
Distribution	0.25	0.86	2.17	4.28	4.41
Growth	-0.48	-9.26	-9.20	-7.35	-2.85
Total return	**-0.23**	**-8.41**	**-7.03**	**-3.06**	**1.56**

[1] Based on quarterly distributions

During the quarter the Fund participated in RIO and BHP's off-market buyback. Based on reporting standards, the Fund's performance numbers were impacted negatively by 0.9% and do not include the 2.0% imputation credit return generated from the buyback during the quarter. Hence, the overall net performance benefit on a before tax basis was 1.1%. A tax statement will be issued at the end of the Financial year.

Month-end unit prices^

Application	NAV	Redemption
$0.9436	$0.9413	$0.9389

Volatility

	1 yr %	Incept. %
Vertium EIF	5.92	4.94
S&P/ASX 300 Accum. Index	9.75	8.63

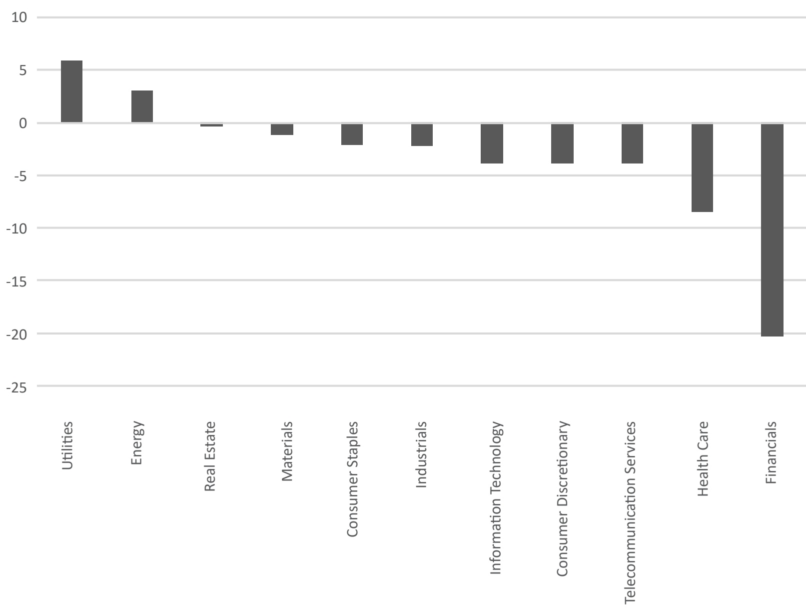
Top 10 holdings#

Company	ASX code
Amcor Limited	AMC
Transurban Group	TCL
Vicinity Centres	VCX
Caltex Australia Limited	CTX
Commonwealth Bank of Australia	CBA
Westpac Banking Corporation	WBC
AusNet Services Limited	AST
Spark Infrastructure Group	SKI
Woolworths Group Ltd	WOW
Newcrest Mining	NCM
Number of stocks	**23**

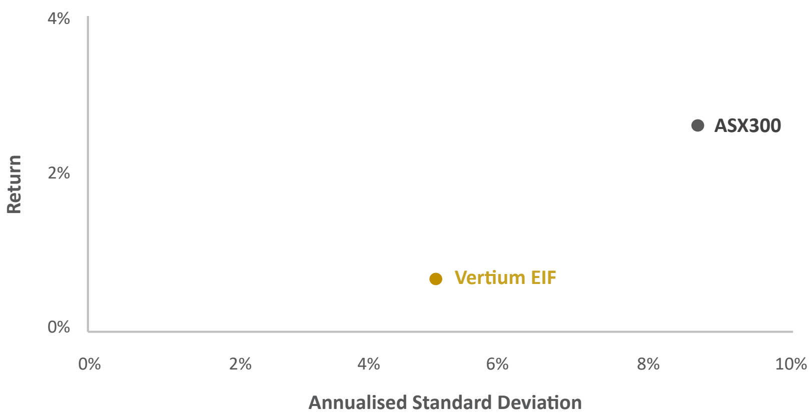
Exposure

Size exp.	%	Option exp.	%
Large cap	42.17	**Shares**	76.12
Mid cap	14.63	**Call options**	(8.84)
Small cap	5.76	**Put options**	(4.72)
Effective cash	37.44	**Effective cash**	37.44

GICS active exposure



Return vs risk (since inception)



Quarterly commentary

During the December 2018 quarter, the Fund delivered a total return of -4.2% versus -8.4% for the benchmark. The Fund also paid a one cent per unit distribution for the quarter, which is in line with the Fund's objective of delivering higher levels of income.

The Fund's quarterly performance was dragged down due to its participation in RIO and BHP's off-market buybacks. Based on reporting standards, the Fund's performance numbers were impacted negatively by about 0.9% and do not include the 2.0% imputation credit return generated from the buyback. Hence, the overall net performance benefit from the off-market buybacks on a before tax basis was 1.1%. More detail on the off-market buyback is provided later in the commentary.

Over the calendar year, the Fund underperformed by 1% (but matched the market excluding the impact of the off-market buybacks). Our risk aware, value investment style underperformed the market for 9 months to September 2018 when the stock market was in bubble territory. When the bubble burst, the same conservative investment style outperformed for the last three months of the year. Importantly, the Fund achieved its performance with about 40% less risk (standard deviation) than the market, which is in line with the Fund's objectives.

The following commentary outlines what happened during the calendar year and our outlook.

The Year of Investing Dangerously

2018 was the year of living dangerously as far as the stock market was concerned. The year began with a bang, cheered on by the global growth squad. However, unbridled risk taking eventually led to negative returns later in the year.

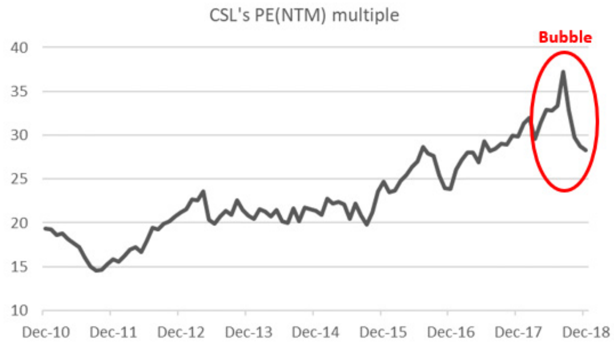
Most equity indices around the globe delivered negative returns for the 2018 calendar year. Chinese and European stocks peaked early in the year and were heavily sold off with the Shanghai Composite Index down 25% and the Euro Stoxx 50 Index down 14%. The US and Australian markets delivered less taxing returns (-6% for the S&P500 and -7% for the ASX300 Price Index) as bubble conditions peaked around September.

Chasing stocks in the name of quality and growth became a sport for most of 2018. For a while it seemed like the momentum trade was the only way to make money despite our numerous warnings: 'One of the most dangerous things investors can do', 'Witching hour for Cinderella stocks', 'Danger flags are waving', 'The bubble in quality', and 'The real danger lurking in the shadows'.

The bubble in quality and growth stocks was exceptionally clear when observing the PE multiple of the world's first trillion-dollar company, Apple. For most of 2017, the company was trading around 15x PE multiple (the top end of its historical range). Then in early 2018, a rocket was lit under Apple's share price. With the share price gathering pace at a faster rate than earnings, its PE multiple expanded exponentially.

Source: FactSet

The growth bubble was ubiquitous. For example, Australia's growth bellwether, CSL, also experienced a bubble moment when its PE multiple reached stratospheric heights at 37x (highest multiple in 15 years).



Source: FactSet

The 2018 bubble occurred because narrative traps on global growth and rising interest rates led the market astray. For a while, risks were ignored despite economic fundamentals not improving. However, stock prices always mean revert to reflect fundamentals in the long term. Nothing escapes economic gravity.

Global Growth Narrative Trap

Investors chased growth companies because they believed that growth was becoming scarce. China first led the economic slowdown from late 2017 followed by Europe from early 2018. US economic conditions continued to look robust boosted by a late-cycle fiscal stimulus program.

However, the US economy is not an economic island. Problems with the rest of the world will sooner or later affect its economy because of its interdependence. History shows that the US economic cycle cannot diverge from other major economies for too long. In this cycle, the US economy was late to the exit party. Over the next few months, US economic data will confirm a slowdown and from then the world will be in a synchronised slowdown.

China | Europe | United States

Late in the slowdown | Middle of slowdown | Start of slowdown

Source: FactSet, Vertium

Rising Interest Rate Narrative Trap

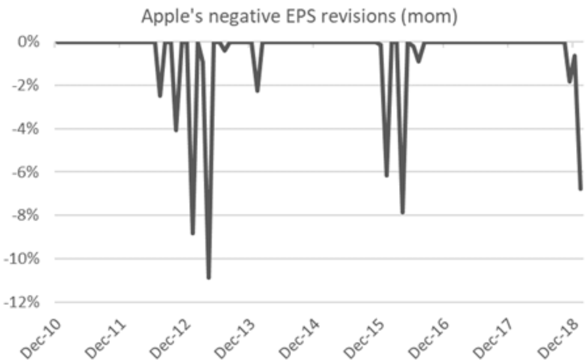
Another popular narrative in 2018 was to sell bond proxies because of the prospect of rising interest rates. Contrary to popular opinion, rising interest rates affect all securities, not just defensive stocks. While rising interest rates reduce valuations, more importantly, they increase the risk of an economic slowdown. Economic cycles end when rising interest rates eventually push economic growth over the edge. When growth expectations are revised down, growth stocks perform poorly while defensives outperform.

Economic law also dictates that slowing economic growth is disinflationary. Commodities exposed to lower demand and rising supply will be in a world of pain. Oil is currently caught in this perfect storm as the Brent price has fallen close to 40% from its peak in October. Consequently, a declining oil price drags down headline inflation.

Buy the Dips?

Now that valuations are cheaper, maybe it is a good time to buy the dips.

While the first phase of the correction has largely played out (the valuation multiple has de-rated), the second phase of earnings downgrades is yet to display its full force. In the coming months, economic data will confirm a slowdown. Signs of a global slowdown are beginning to appear in company earnings. For example, Apple first warned of slowing iPhone sales in November 2018 and it seemed to be at the beginning of an earnings downgrade cycle.



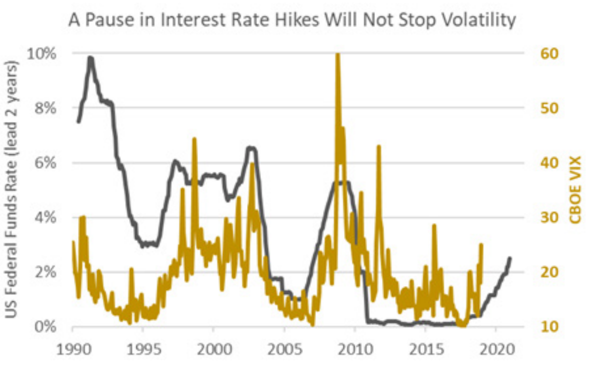
Source: FactSet, Vertium

After the price correction in late 2018, Apple looked cheap trading around 12x PE multiple with net cash representing about 15% of its market capitalisation. However, buyers of the dip got punched in the face shortly after. In early January 2019, earnings were revised down again, and its stock price fell 10% after the announcement. What looks cheap can get cheaper in a global slowdown.

Apple will not be an isolated case. If the world's largest consumer company cannot escape the global vortex then it's a sure bet that other companies will have a similar experience. Cyclical companies are likely to report negative earnings growth and have their PE multiples expand. Growth companies' PE multiples will de-rate as their rate of growth slows. Defensive stocks have little earnings risk and typically outperform in this environment.

Furthermore, the European Central Bank and the US Federal Reserve (Fed) could add more fuel to the fire of a deteriorating macro environment. Both central banks intend to further raise interest rates via open market operations and quantitative tightening. The Growth Bulls rallying cry of 'fundamentals are robust' has now changed to shrieks of 'stop raising interest rates!'.

While the Bulls may rejoice if the Fed stops raising rates, it will not be enough to stop the macroeconomic snowball gathering pace. History shows that share market volatility remains high when the Fed pauses rate hikes. Market rallies will be fleeting.



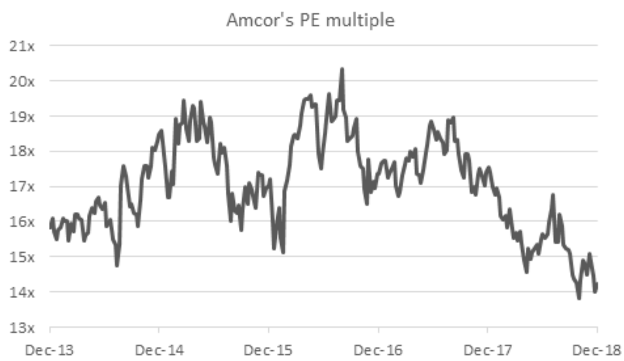
Source: FactSet, Vertium

In summary, the global growth narrative trap resulted in poor stock returns for 2018. More volatility is expected in 2019 when the world moves to a synchronised slowdown. At this stage we do not know if the current slowdown is shallow or deep. Unlike the two previous global slowdowns in 2012 and 2015, the current slowdown is occurring when the US yield curve is fast approaching zero (like it did before the Global Financial Crisis).

Stock commentary

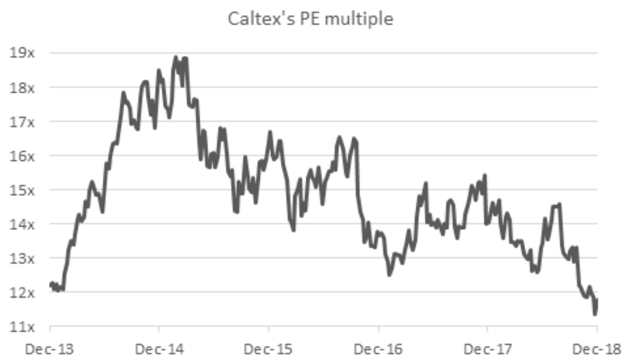
As expected, our conservative investment style outperformed the market during the market correction. However, for some stocks in the portfolio we have underestimated the severity of the sell-off.

Defensive industrials, such as Amcor, were aggressively sold off during the year. Amcor's current PE multiple is trading at 5-year lows.



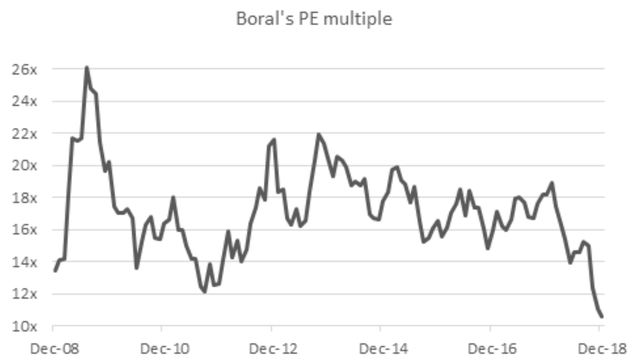
Source: FactSet

Asset-rich companies, such as Caltex, have not been spared. Caltex's PE multiple is also trading at 5-year lows.



Source: FactSet

Cyclical industrials, such as Boral, have been severely sold off. Boral's PE multiple at 10x multiple is the lowest in 10 years.

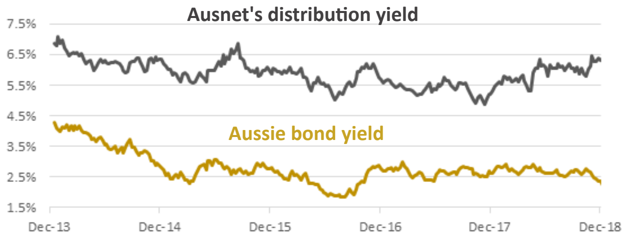


Source: FactSet

In the current market environment, any negative news is punished irrespective of valuation multiples. Examples of stocks (not in the portfolio) that have recently been chastised:

- In November 2018, Lendlease's (LLC) share price collapsed 27% when it reported continued problems with its construction division. LLC was trading on an 11x PE multiple before its earnings were downgraded by 29%. The company now trades on a 10x PE multiple on lower earnings.
- In November 2018, Clydesdale's (CYB) share price collapsed 22% when it reported disappointing FY18 results. CYB was trading on an 8x PE multiple before its earnings were downgraded by 9%. The company now trades on a 7x PE multiple on lower earnings.
- In January 2019, Costa's (CGC) share price collapsed 32% when it revised earnings guidance to flat growth for FY19. CGC was trading on a 24x PE before its earnings were downgraded by 8%. The company now trades on a 18x PE multiple on lower earnings.

While many stocks have de-rated, some defensive stocks continue to offer good value especially when interest rates are falling. Historically, periods of falling bond yields have coincided with yields compressing (stock price rising) for defensive stocks. This year, though, Australian bond yields have fallen but strangely the yields for some defensive stocks have risen. Ausnet Services (AST), a regulated utility, is one such defensive stock. It seems like the market is pricing AST on a 3.5% bond yield environment (like in 2014) even though current bond yields are falling due to a slowing economy.



Source: FactSet

While some defensive stocks continue to offer reasonable value, the stock market correction has increased the universe of cheaper stocks. Our current research activity is sifting through the fallen angels, the cyclicals, the resource sector and defensive laggards.

For cyclicals and resources, the view on a shallow or deep slowdown weighs heavily on our minds because for these stocks timing is important. Catching 'falling knives' is less dangerous if it is a shallow slowdown but will be painful if the slowdown is deep. The price behaviour of LLC, CYB and CGC highlights that earnings disappointments are severely punished and that the illusion of cheap or cheaper valuation multiples provides no protection.

Our research process has already identified a few companies highly likely to report earnings downgrades. We expect many other companies to disappoint earnings expectations in the coming months.

Energy stocks

At the beginning of the quarter the Fund sold out of Woodside Petroleum (WPL) and thus had no energy related exposure when the oil price collapsed. We have been concerned for some time about the global growth narrative trap compounded by troubling signs of rising supply.

Since early 2018, US oil inventories began to rise but the market ignored this issue as it was focussed on the global growth narrative.

Source: EIA

However, in the second half of 2018 when the market shifted its attention to a global slowdown it was inevitable that the oil price had to fall from its elevated heights. The combination of rising supply and a lower growth outlook resulted in oil being the worst performing commodity for the quarter (-40% from peak to trough).

Off-market Buybacks

Off-market buybacks are a bonanza for low-tax paying investors. During the quarter, both BHP and RIO did not disappoint when they announced off-market buybacks. However, to participate in off-market buybacks there is a catch. Shareholders must forego some capital because the stock is sold back to the company at a discount to the market price in return for a large, fully-franked dividend. Both RIO and BHP's share discounts were 14% but were more than offset by the imputation credits returned to shareholders.

The following highlights the capital loss and the imputation credit benefit for zero-tax investors of each share sold into both BHP and RIO's off-market buyback:

		RIO		BHP	
		Per share	Return impact	Per share	Return impact
(a)	Share price	$81.03		$32.14	
	Capital loss from discount	-$11.34	-14%	-$4.50	-14%
	Buyback price	$69.69		$27.64	
(b)	Capital component of BB price	$9.44		$4.92	
	Fully franked dividend component of BB price	$60.25		$22.72	
	Imputation credit	$25.82	32%	$9.74	12%
(a+b)	**Total profit for zero tax investor**	**$14.48**	**18%**	**$5.24**	**6%**

Source: Vertium

There is no doubt that the pre-tax returns are extremely lucrative (especially when no extra risk is taken) if a large portion of the buyback price is a fully franked dividend. Hence, there is generally very strong demand by Australian investors when off-market buybacks are announced. Typically, the scale back is more than 90% when there is a large fully franked dividend component as a percentage of the buyback price. However, both RIO and BHP scale backs were strangely only around 60%. The lower than expected participation rate meant that greater returns were captured by investors who did participate in the buyback process.

In other words, rather than expecting less than 10% of the Fund's position in BHP and RIO to disappear it ended up being 40%. Consequently, the return impact from RIO and BHP's off-market buybacks were greater than anticipated – a greater capital loss but offset by a greater imputation return.

A low participation rate in BHP and RIO's off-market buyback is extremely unusual. We can only speculate that those who decided not to participate did not want to lower their headline performance by selling shares at a discount to the market price. The capital loss is reported in performance tables but the imputation return is not.

Concluding Remarks

September 2018 marks the turning point for when the growth bubble burst. The market has finally recognised that the world has moved towards a synchronised slowdown. When earnings expectations are revised down because of a global slowdown, valuation multiples tend to compress.

The good news is that many stocks are now considerably cheaper than a year ago, thus expanding the investible universe. However, blindly catching falling knives in the current environment may amputate a few fingers when company earnings disappoint expectations. Patience is required to carefully sift through this volatile minefield. When valuations are lower on cyclically lower earnings the Fund will prudently deploy capital.

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

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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 hard-close and cum-distribution.

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