VERTiUM ASSET MANAGEMENT

Vertium Equity Income Fund

Fund Update | Quarter to 31 March 2019

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
$0.9772	$0.9748	$0.9723

Volatility

	1 yr %	Incept. %
Vertium EIF	6.09	5.25
S&P/ASX 300 Accum. Index	11.14	9.39

Top 10 holdings#

Company	ASX code
Westpac Banking Corporation	WBC
National Australia Bank Ltd	NAB
Vicinity Centres	VCX
Lendlease Group	LLC
Caltex Australia Limited	CTX
Amcor Limited	AMC
James Hardie Industries plc	JHX
Stockland Corporation Ltd	SGP
Whitehaven Coal Ltd	WHC
Worleyparsons Limited	WOR
Number of stocks	**34**

Exposure

Size exp.	%	Option exp.	%
Large cap	47.83	**Shares**	83.48
Mid cap	23.53	**Call options**	(4.43)
Small cap	8.91	**Put options**	1.22
Effective cash	19.73	**Effective cash**	19.73

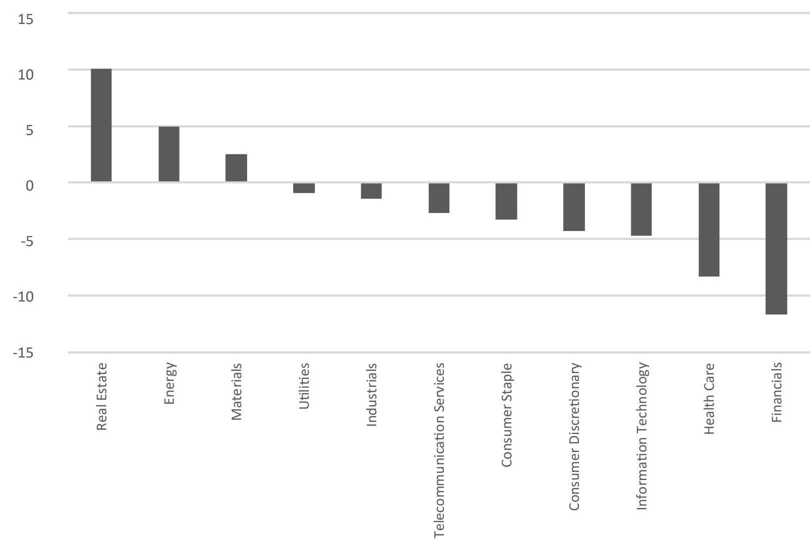
Total returns*

	1 mth %	3 mths %	6 mths %	1 yr %	Incept. (p.a.)%
Vertium Equity Income Fund					
Distribution[1]	1.02	1.02	2.09	5.84	4.66
Growth	-1.40	3.65	-1.91	-0.08	-1.90
Total return	**-0.38**	**4.67**	**0.18**	**5.76**	**2.77**
S&P/ASX 300 Accumulation Index					
Distribution	0.55	1.33	2.20	4.41	4.55
Growth	0.18	9.59	-0.61	7.33	2.43
Total return	**0.73**	**10.92**	**1.59**	**11.74**	**6.98**

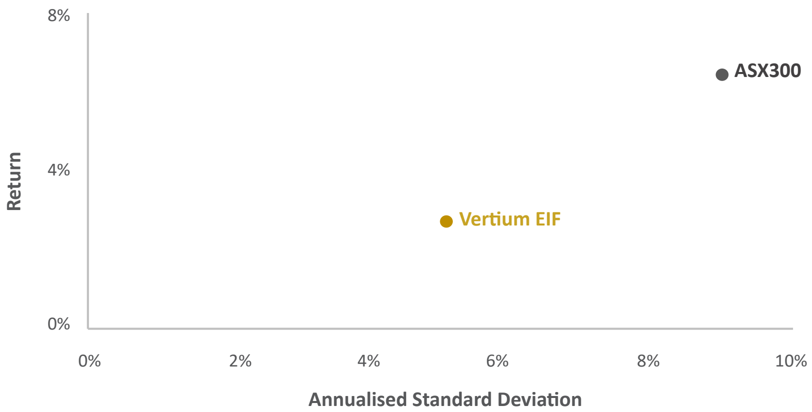
[1] Based on quarterly distributions

During the year 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.

GICS active exposure



Return vs risk (since inception)



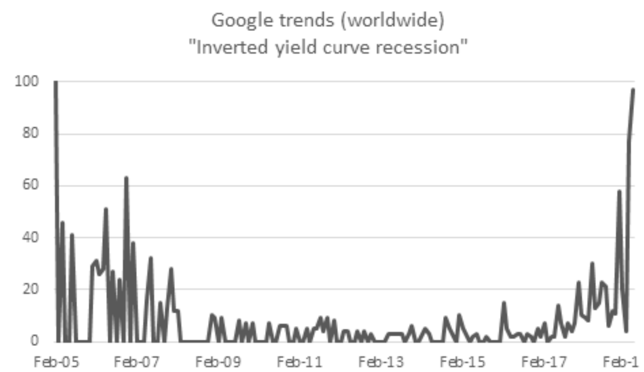
Quarterly commentary

During the March 2019 quarter, the Fund delivered a total return of 4.7% versus 10.9% 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 than the benchmark.

Under exuberant market conditions, the Fund naturally lags given its risk aware, conservative, value investment style. The driver of the underperformance during the quarter was the Fund's underweight position in banks and iron ore stocks. Banks rallied from oversold positions when the Royal Commission came out with benign final recommendations. Iron ore stocks rallied when the Vale tailings dam disaster occurred causing the iron ore price (in Australian dollars) to rise 23% over the quarter. BHP Billiton, RIO (a Fund holding) and Fortescue Metals rallied 12%, 25%, 70% respectively over the quarter. Given that these stocks make up a large portion of the index they had an outsized influence on the benchmark. Investors should not extrapolate Q1 market returns for the rest of the calendar year, as its drivers were one-off in nature. Furthermore, a quarterly return of more than 10% has historically occurred just 11% of the time over the last thirty years.

Are equities safe when there are growth worries?

The most talked about harbinger of a recession is the inverted yield curve. Google trends show recent internet searches on "inverted yield curve recession" have reached a fever pitch.



Source: https://trends.google.com/trends/explore?q=inverted%20yield%20curve%20recession&date=all

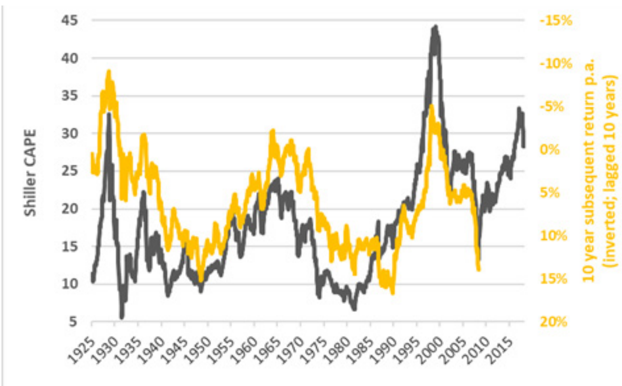
It is interesting to note that in August 2005 the same search terms also reached extreme levels. Yes, a global recession did occur three years later in 2008. However, from August 2005 the MSCI world index rallied more than 40% to its peak in late 2007.

Understanding how consensus thinks is important for identifying mispriced stocks. When everybody is on the same side of the boat it doesn't take much for it to sway the other way when the consensus shifts. Think about the Aussie banks before and after the Royal Commission final report was released. Before the report was released, banks were priced for a negative outcome. When the final recommendations were revealed to be benign their share prices significantly rebounded. Similarly, when everybody is bearish about stocks because of an inverted yield curve, it may prove to be bullish because valuations are already priced for a slowdown.

Consensus views can be canvassed through various means such as google trend searches, sentiment surveys, or short positions. At Vertium we rely heavily on valuations – when valuation multiples are high (low) we aim to understand why consensus views are positive (negative) and work out whether they are sustainable.

Starting valuation matters

It is easy to prove why starting valuations matter for long term returns. Just plot the Shiller CAPE index for the S&P500 against its subsequent ten-year return (inverted).



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

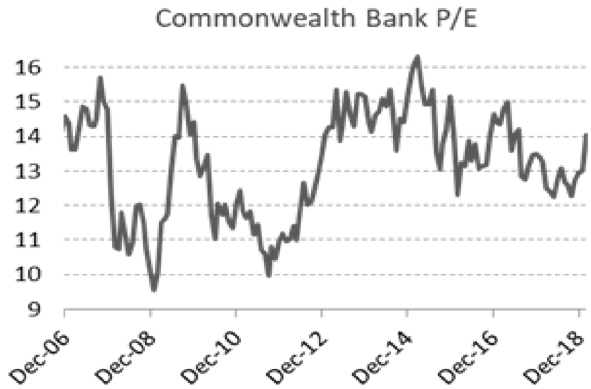
The chart highlights a near mirror image between the Shiller CAPE index and future returns. When valuations are low future returns are likely to be high and vice versa. Specifically, if stock prices are priced for negative outcomes then neutral or positive events are likely to lead to substantial re-ratings. Naturally, the reverse applies when the market is priced for perfection. Given the high valuation level for the S&P500, its next ten-year returns are likely to be very low.

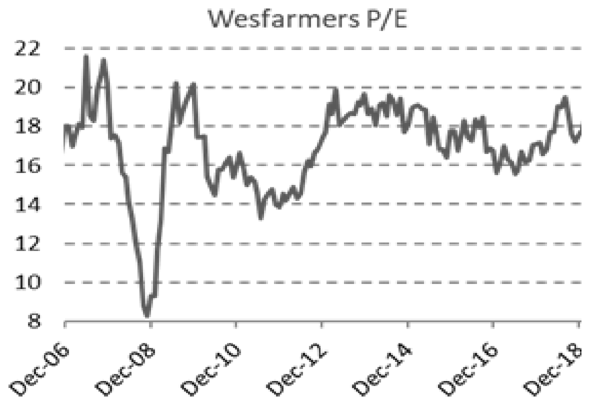
While the market multiple may be high, the current economic slowdown has lowered the valuation of many stocks. Investors currently fretting about a slowing growth environment should view it as a gift from the investment Gods. The key for investors is whether valuations are priced for a slowdown.

In Australia, the economy is slowing. Credit growth is decelerating, and its economic tentacles have dragged many parts of the economy down such as lower house prices, falling car sales, and subdued retail sales. And there is increasing commentary about the Reserve Bank of Australia needing to cut interest rates to prevent a rising unemployment rate.

Are stocks priced for a sombre economic backdrop? Yes and no. On our analysis, there is a large disparity among economically sensitive stocks.

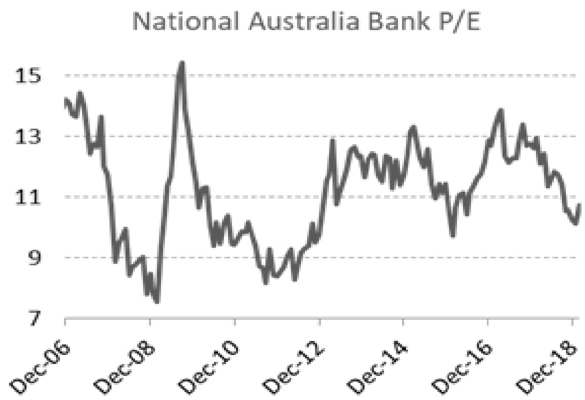
Stocks priced for no slowdown – valuation multiples are priced in the middle to upper end of their long-term range.

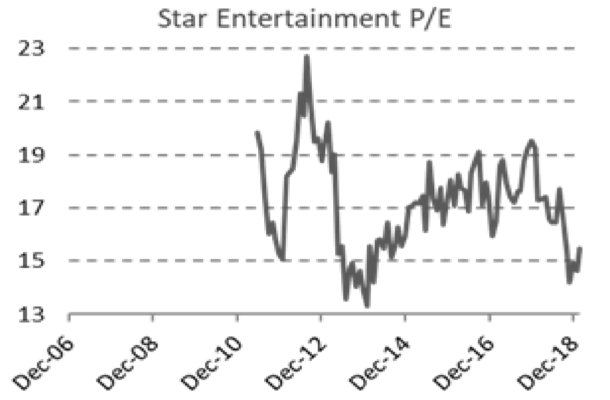




Source: Factset

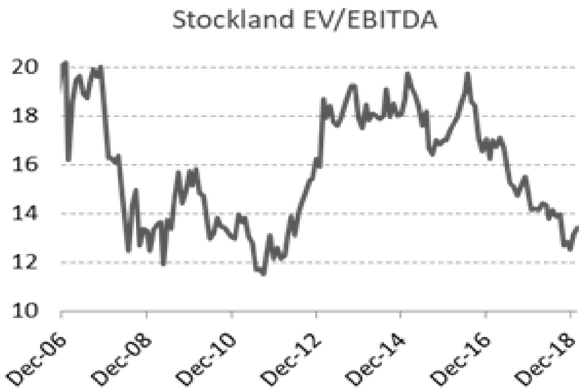
Stocks priced for shallow slowdown – valuation multiples are priced at the low end of their short-term range.

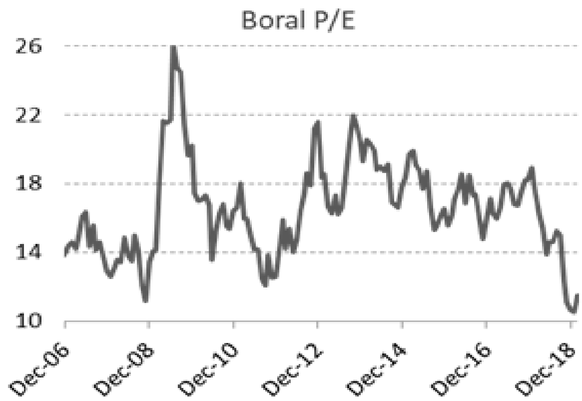




Source: Factset

Stocks priced for deep slowdown – valuation multiples are priced at the low end of their long-term range.



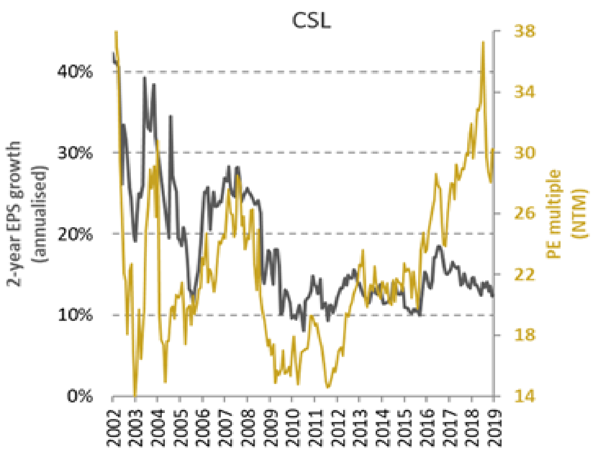


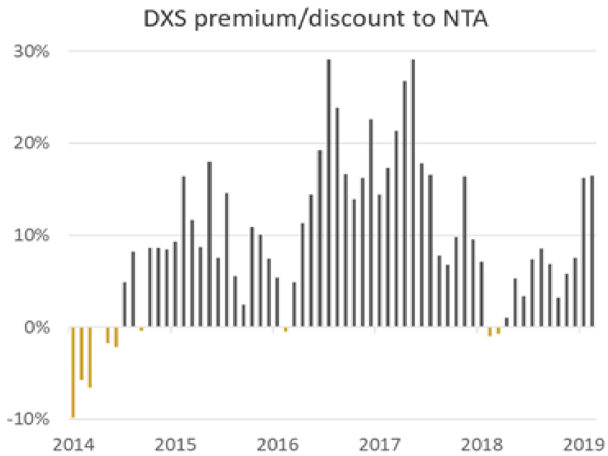
Source: Factset

Unfortunately, we do not have a crystal ball to exactly pinpoint where the economy is headed but based on valuations we have an idea of how the consensus is positioned. If you believe Australia is going to suffer a deep slowdown, Boral and Stockland's share prices are not likely to rise. But every other stock on the market will likely collapse to catch up to their depressed valuations. For example, the Commonwealth Bank's share price could collapse by about 40% if it de-rated to 10x PE multiple (a deep slowdown scenario).

Alternatively, if the economy is headed for a shallow slowdown then stocks priced for a deep slowdown will likely re-rate. On the other hand, stocks priced for no slowdown will likely de-rate and stocks priced for a shallow slowdown will likely trade sideways.

Are stocks with business models not sensitive to the economy more resilient investments? Again, their starting valuations will provide a clue about their future returns. Let's use CSL (healthcare company) and Dexus (office REIT) as two examples.





Source: IRESS and Factset

For industrial companies, valuation multiples should reflect the level of earnings growth. Since 2017, CSL's PE multiple has diverged from its underlying growth rate. To bring it back to equilibrium, either its earnings growth must be revised up or its PE multiple must de-rate. To highlight why sometimes short-termism prevails, a recent broker report highlighted that CSL is trading at fair value because its trading in-line with its 70% premium to the market (ex-banks) over the last two years. Does anybody question why the 70% premium is justified and why use the last two years as a comparative period? What about comparing its valuation over the last seventeen years? The last time CSL traded around 30x PE multiple was in the early 2000s when its forecast earnings growth was twice the rate compared to today.

While REITs have low earnings growth, they offer more defensive earnings compared to industrial companies. A simple investment rule, that the market often forgets, is to buy REITs below their net tangible assets (NTA) and sell when they trade at a premium to NTA (the caveat is that their balance sheet is not over-geared). Hence, the best time to buy DXS was a year ago when it traded at a discount to NTA. Back then, the consensus narrative was global synchronised growth driving up interest rates, which could lead to NTA downgrades. Clearly, the opposite has occurred, and the consensus narrative now is that the global slowdown is driving down interest rates. DXS is currently trading at a substantial premium to NTA and is priced for perfection.

Mispricings occur when the market extrapolates

The examples above highlight that the market often prices the dominant narrative at that time. In other words, the consensus has the propensity to focus on the short term and extrapolate the prevailing good or bad conditions.

Challenger (CGF) is another example of the market extrapolating short term issues.

Source: Factset

About two years ago, the company was priced for perfection trading at 18x PE multiple. At the time, there were no short-term issues and a high valuation multiple was justified by the burgeoning cohort of retirees buying CGF's annuity products. After its recent earnings downgrade in late January 2019, the stock collapsed more than 20%. The consensus earnings growth rate was revised down substantially, and the company is currently trading at 13x PE multiple. What happened to the bullish narrative on annuity sales?

Conclusion

An inverting yield curve may scare investors away from equities. While it is prudent to prepare for an economic slowdown it should be done by reference to valuations. Valuations should be used as the yardstick to buy or sell equities not prevailing market narratives. When the world looked rosy last year, investors threw caution to the wind by ignoring valuations and extrapolated good times forever. Now in the foggy mist of an economic slowdown the same mistake may be occurring but in the opposite direction.

Like bond proxies that were shunned last year, when expectations are very low for some stocks it sets the foundation for lower risk equity returns in following periods.

Stock commentary

While the benchmark has risen substantially off its December lows, it was largely driven by a few large companies that dominate the index. In other words, there were many stocks that did not participate in the rally to the same degree.

The current environment is very different to last year when the momentum craze rewarded investors who chased the latest themes. The universe of cheaper stocks has grown significantly compared to last year. It is now a stock pickers market where there is more opportunity to sift out mispriced opportunities.

When searching for mispriced opportunities we are looking for stocks that offer asymmetric return payoffs – low downside risk with reasonable upside returns. The following are a few examples of stocks that the Fund has recently bought.

Housing related stocks

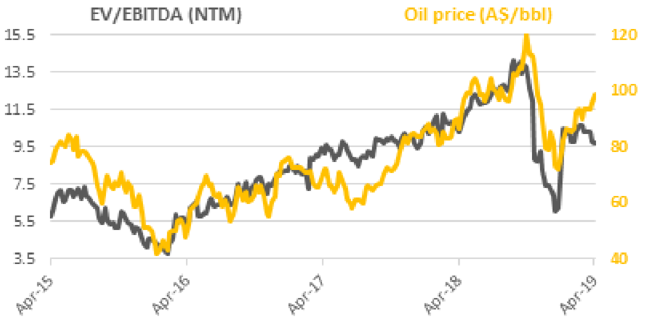
The demand for housing is highly linked to the demand for credit. And credit demand is linked to the affordability of credit, namely interest rates. Hence, as a general rule when economic conditions are strong (poor) housing stocks should be sold (bought) because of rising (falling) interest rates. In other words, buying or selling housing related stocks should be countercyclical.

In the current environment, when consensus is focussed on poor economic conditions (which results in low valuation multiples), the underpinnings for the next up cycle are about to be created, once interest rates are lowered. In the United States most mortgages are priced on long-term interest rates such as the 30-year mortgage rate, which has fallen significantly. In Australia, most mortgages are priced on short term interest rates. The RBA is expected to cut interest rates this year. Historically, when the RBA cuts interest rates house prices rebound. In subsequent periods, building approvals stabilise and then begin to improve.

The Fund owns four housing related stocks: James Hardie, Boral, Stockland, and Fletcher Building.

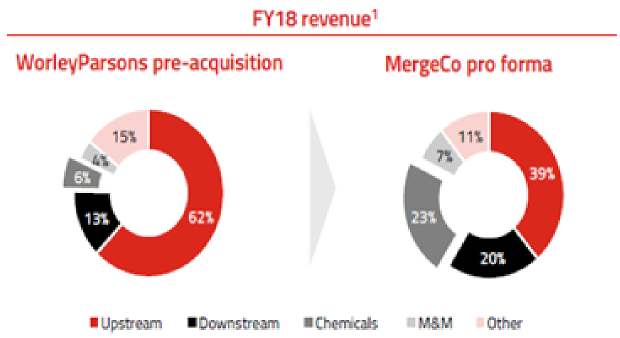
WorleyParsons (WOR)

WOR is a global oil and gas contractor. Hence, its valuation multiple tends to track the oil price because a higher oil price implies a growing workbook (hence profits) and vice versa.



Source: Factset

In October 2018, WOR announced a major acquisition (Jacobs ECR) that doubled the size of its business and diversified its revenue streams. Importantly, there are substantial synergies ($130m per annum over 2 years) from the integration of the two businesses. The synergies alone would drive EBITDA growth by 15% per annum over the next two years.



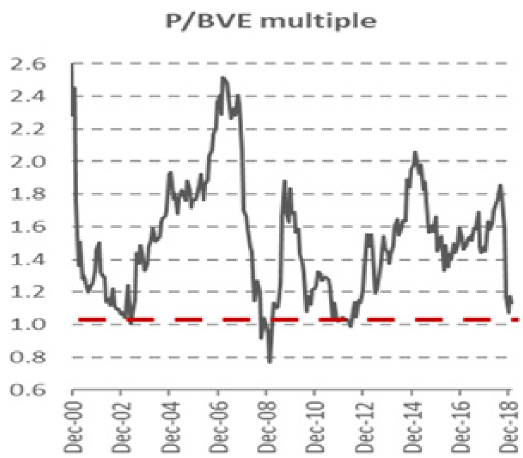
Source: WorleyParsons

WOR's current valuation multiple (10x EV/EBITDA) is trading substantially below its pre-acquisition announcement multiple (12x EV/EBITDA). Importantly, the business is now more diversified and will grow earnings substantially from its synergy targets (which are not linked to movements in commodity prices). Based on synergy targets alone, WOR could be trading on a 7x EV/EBITDA multiple in a couple of years based on its current share price. At that valuation multiple, the share price implies a US$50/bbl oil price environment versus the current oil price of US$70/bbl. WOR has the best margin of safety profile (asymmetric payoff) versus the other energy related companies.

Lendlease (LLC)

In periods of global stock market sell-offs there are rare opportunities where some companies are extremely oversold versus their business fundamentals. LLC is one such rare opportunity.

After reporting continued problems with its engineering construction division in late 2018, LLC's share price collapsed to 1x P/B multiple. This is the fourth time in the last twenty years that it has traded at such distressed multiple (2003: US problem, 2008: GFC, 2012: Euro crisis, and now: engineering construction problem).



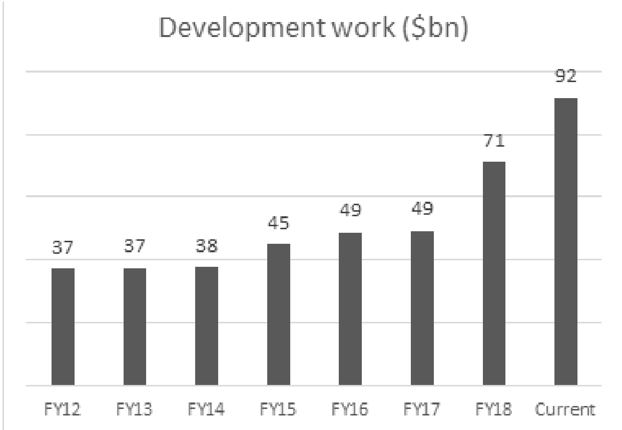
Source: Factset

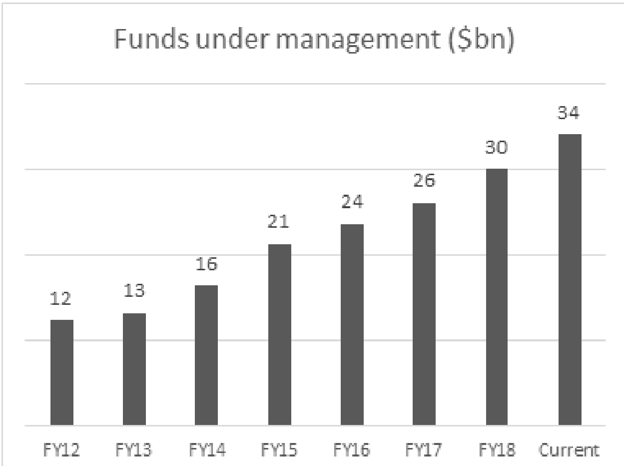
At its February 2019 results, LLC announced that it was planning to sell its engineering division (part of its Construction segment). Hence, the restructured company will have a greater focus on its core Development and Investment segments.

Business model	Prev. Target	Revised Target
Target EBITDA mix:		
• Development	35-45%	40-50%
• Construction	20-30%	10-20%
• Investments	30-40%	35-45%

Source: Lendlease

In effect, the problems in the engineering construction division hide the strength of LLC's other divisions. To highlight LLC's huge value discrepancy, one must observe its development work and funds under management over time.





Source: Lendlease

In 2012, the outlook for its Development and Investment divisions were relatively benign. Today, both divisions are growing from strength to strength. Specifically, its development work has nearly doubled over the last two years, which will substantially raise profits over the next five years.

In 2012, buying LLC could easily be justified based purely on a cheap valuation multiple despite a benign earnings outlook. Now, the investment case is even more compelling given that it is trading on a similar 2012 valuation multiple, but its core divisions are growing strongly.

Concluding remarks

There is no doubt economic growth is slowing across many countries including Australia. In the current environment it's a stock pickers market because so many are priced for a slowdown while many are not.

The Fund has prudently deployed capital where we believe certain stocks provide the best risk-reward payoff. Low valuations on the stocks we have invested in provide some margin of safety to minimise downside risk. When the depressed expectations change we expect upside returns to be delivered.

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** 30 April 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.