VERTiUM ASSET MANAGEMENT

Vertium Equity Income Fund

Fund Update | Financial Year to 30 June 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

Total returns*

	1 mth %	3 mths %	6 mths %	1 yr %	Incept. (p.a.)%
Vertium Equity Income Fund					
Distribution[1]	5.54	5.54	6.62	8.83	6.74
Growth	-5.74	-1.26	2.53	-4.20	-2.29
Total return	**-0.20**	**4.28**	**9.15**	**4.63**	**4.45**
S&P/ASX 300 Accumulation Index					
Distribution	0.23	0.83	2.17	4.39	4.42
Growth	3.41	7.22	17.67	7.03	5.60
Total return	**3.64**	**8.05**	**19.84**	**11.42**	**10.02**

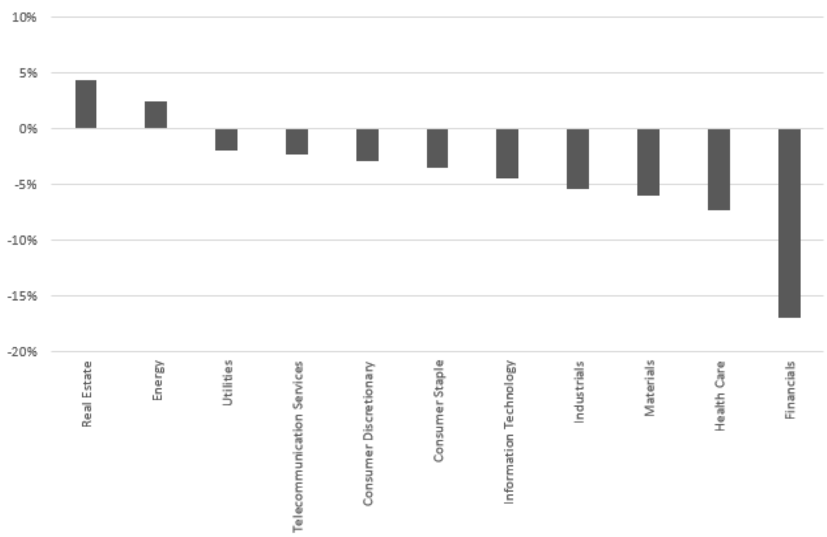
[1] Based on quarterly distributions

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 year. 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.

Risk

	1 yr	Incept.
Std deviation ratio to ASX300	55%	58%
Beta	0.46	0.47
VEIF max drawdown		-5.4%
ASX300 max drawdown		-9.5%

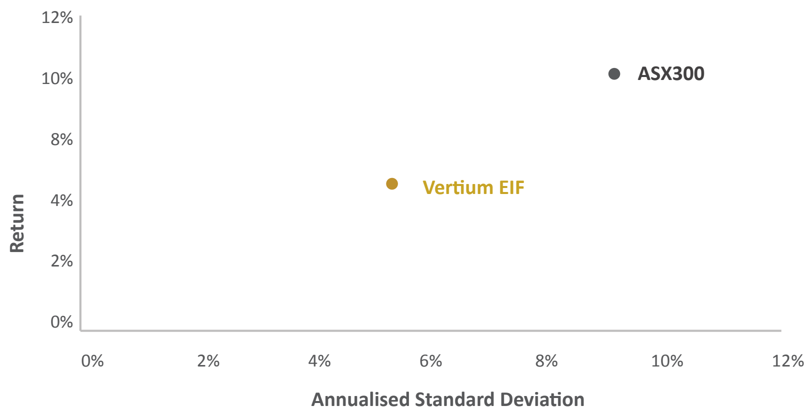
GICS active exposure



Top 10 holdings#

Company	ASX code
Lendlease Group	LLC
Vicinity Centres	VCX
Star Entertainment Group	SGR
National Australia Bank	NAB
Westpac Banking Corp	WBC
Caltex Australia Limited	CTX
Worleyparsons Limited	WOR
Challenger Ltd	CGF
James Hardie Industries plc	JHX
SEEK Limited	SEK
Number of stocks	**29**

Return vs risk (since inception)



Exposure

Size exp.	%	Option exp.	%
Large cap	32	Shares	62
Mid cap	21	Call options	-6
Small cap	3	Put options	0
Effective cash	44	Effective cash	44

Month-end unit prices^

Application	NAV	Redemption
$1.0086	$1.0060	$1.0035

Quarterly commentary

The Vertium Equity Income Fund delivered a total net return of 4.6% for FY19, which lagged the benchmark's return of 11.4%. Our defensive investment approach predominantly led to the underperformance when the market was in risk seeking mode for most of the year. The same conservatism also led to the Fund's risk profile being substantially below the market with a beta of 0.5 and about 45% lower standard deviation than the market. Importantly, the strategy preserved capital very well during the market correction in the fourth quarter of 2018.

The Fund also paid a June quarter distribution of 5.9 cpu taking the total distribution for FY19 to 8.9 cpu in line with our objective of paying consistent distribution greater than the market. The income and franking was high this year because the Fund participated in three off-market buybacks. The distribution return of the Fund and benchmark were 8.8% (12.1% grossed-up yield) and 4.4% respectively for FY19.

The mini correction and recovery over the last nine months is one of the strangest we have witnessed in history. Never have we observed this level of extreme risk taking when economic growth is slowing. The following are our thoughts highlighting the historic behaviour of bear markets during economic slowdowns.

The Anatomy of Bear Markets

The usual definition of a bear market is based on an arbitrary level of negative returns, such as -20%. While there can be flash crashes during bull markets (for example, 1987 or 2010), in our opinion, proper bear markets occur when global growth slows. Over the last thirty years, there have been eight global slowdowns, which have coincided with significant share market corrections. The anatomy of these bear markets and recovery (peak to trough return, peak to trough duration, trough to peak duration, peak to peak duration) are displayed in the table below:

Bear Market Anatomy - All Ords Price Index

Global slowdown periods	Peak to trough return	Peak to trough duration (mths)	Trough to peak duration (mths)	Peak to peak duration (mths)
1990	-27%	16	31	47
1994	-21%	12	21	33
1997	-11%	11	5	16
2002	-19%	20	15	35
2008	-51%	16	124*	140*
2011	-17%	6	17	23
2015	-16%	12	13	25
Average (excl 2008 GFC)	-19%	13	17	30
2018 / 2019	-11% ?	4 ?	5 ?	9 ?

Source: Iress

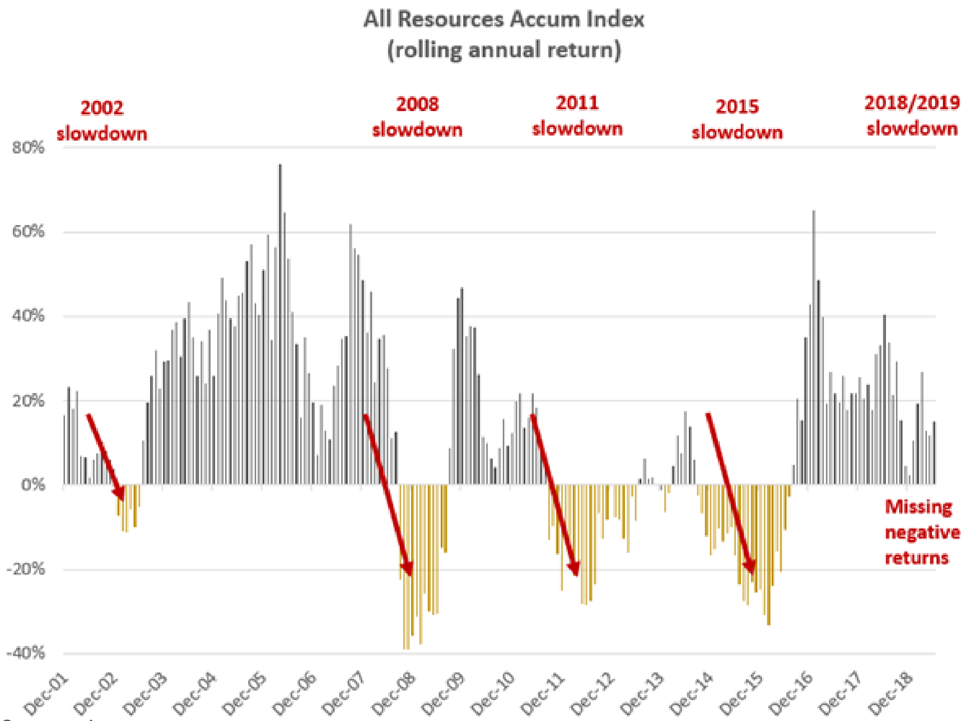
During an economic slowdown, the average peak to trough return was about -19% and the average bear market and recovery duration (peak to peak) was about 30 months (excluding the 2008 GFC period which is yet to complete).

Bear markets do not end abruptly. They tend to be drawn out processes with lots of volatility. Hence, something is very peculiar about the recent share market correction. The All Ords index collapsed in the fourth quarter of 2018 which reflected global growth concerns. Despite no sign of a global recovery, the market formed a V-shaped recovery and recorded its strongest half year return (20%) since 1991. If December 2018 was the market low, then this correction would be one of the most benign in terms of magnitude (-11%) and peak to peak duration (9 months). The correction to date happened so fast that there are not many wounds to lick, unlike previous global slowdowns.

This strange bear market behaviour is driven by a divergence from historical precedents in both the All Resources and the All Industrials indices.

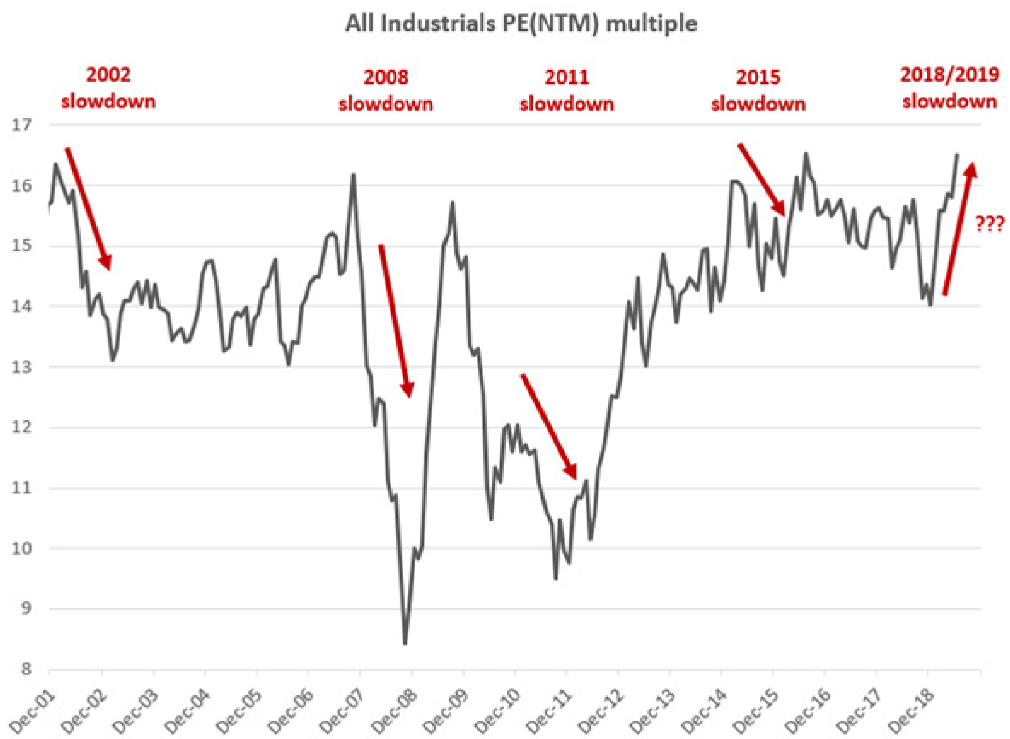
What is driving the resource divergence?

Resource stock earnings are highly sensitive to the global environment because of their operating leverage to commodity prices. Typically, during global slowdowns the earnings of resource stocks collapse and the All Resources index records negative annual returns. However, for the first time in twenty years the performance of the resource sector has diverged during a global slowdown. The rolling annual return for the All Resources Accumulation Index has amazingly remained positive (even prior to the Vale dam disaster in January 2019). This once in a lifetime divergence is due to the Chinese supply side reform implemented in 2016. By cutting supply for certain commodities, the Chinese have engineered high prices to help some of their heavily indebted industries pay off debt.

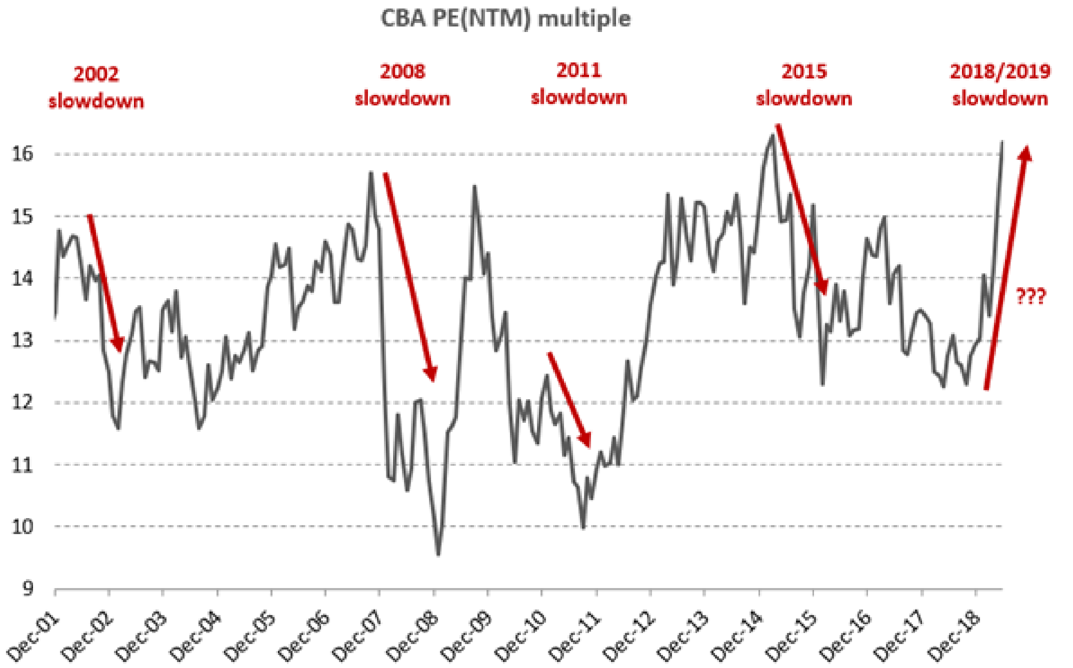


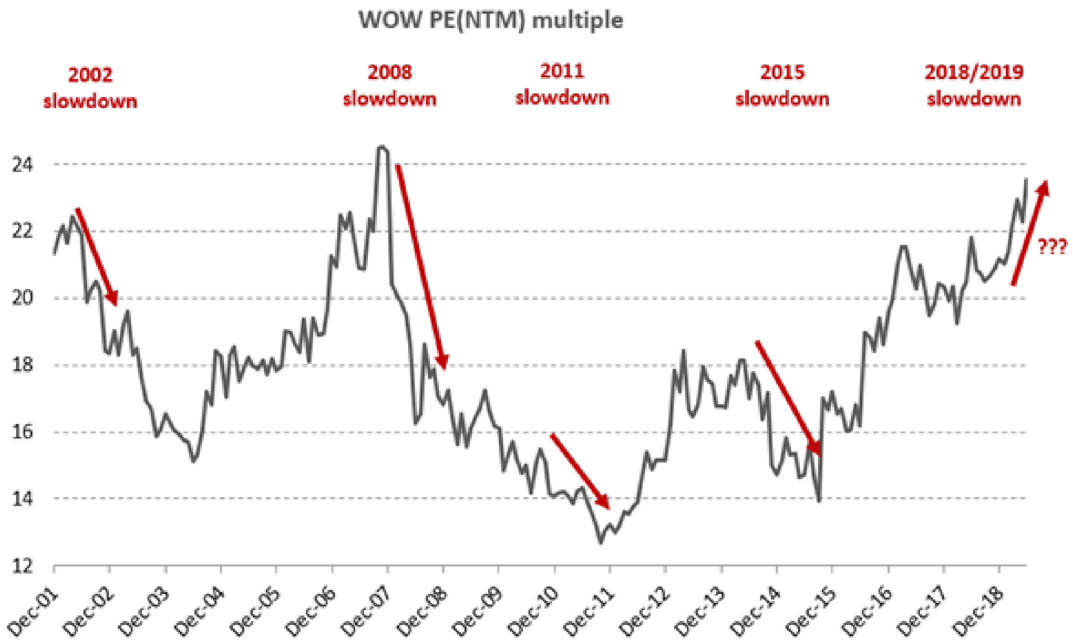
Source: Iress

However, resource stocks account for about 20% of the market. The majority of the All Ords is driven by industrial stocks, which have rallied so hard that current market valuations are on par with the technology boom peak. This is the fourth time in the last twenty years that the All Industrials has hit its 16.5x PE multiple ceiling. The high valuation multiple is more akin to market tops, which is in direct contrast to previous global slowdowns where PE multiples contract.



While the WAAAX (Wisetech, Appen, Altium, Afterpay, Xero) stocks get a lot of attention about their exhilarating growth, it is the large companies with slower growth prospects that have pushed the market to its highs. For example, Commonwealth Bank (CBA) and Woolworths' (WOW) PE multiples have expanded despite their earnings being revised down over the last few months. Like the market, their PE multiples have also hit their historical extreme PE ceilings. In contrast, during previous global slowdowns both CBA and WOW had contracting PE multiples. Contrary to popular opinion, WOW was not so defensive in the past.

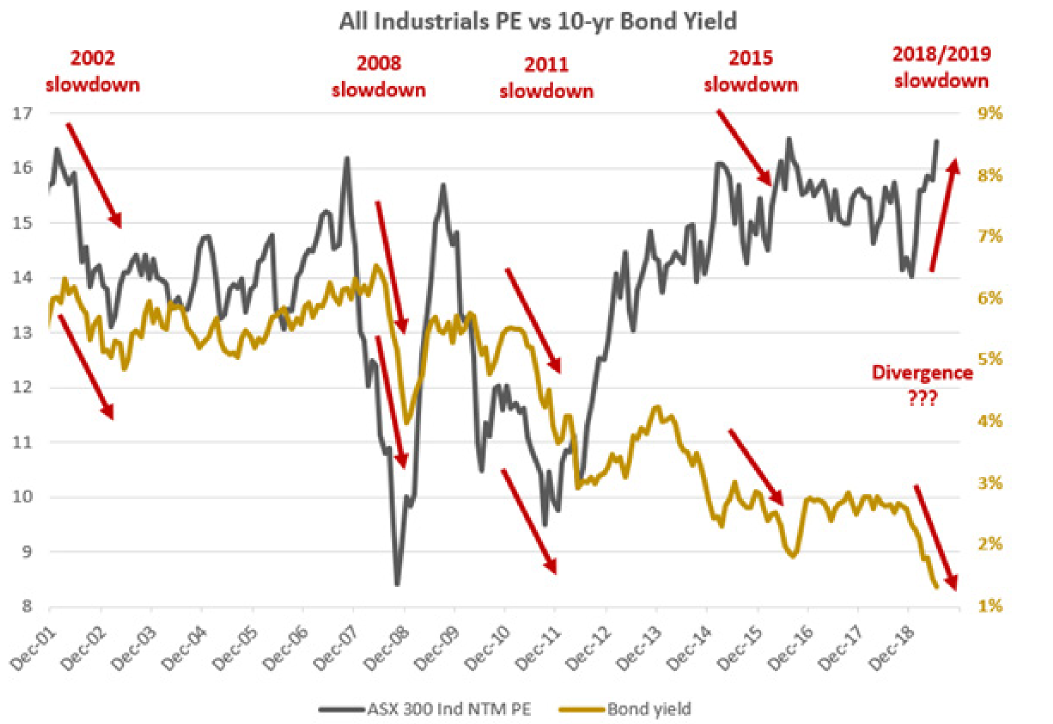




Source: Factset

During economic slowdowns, interest rates fall and valuations compress

Many pundits attempt to justify rising stock valuations by pointing to falling interest rates. This is only partially correct because valuations are not a one factor model based on interest rates – growth is a more important factor. In periods of economic slowdowns, valuation multiples typically compress because the impact of lower growth expectations outweigh the impact of lower interest rates. This is the same reason why PE multiples generally expand when economic growth is robust.

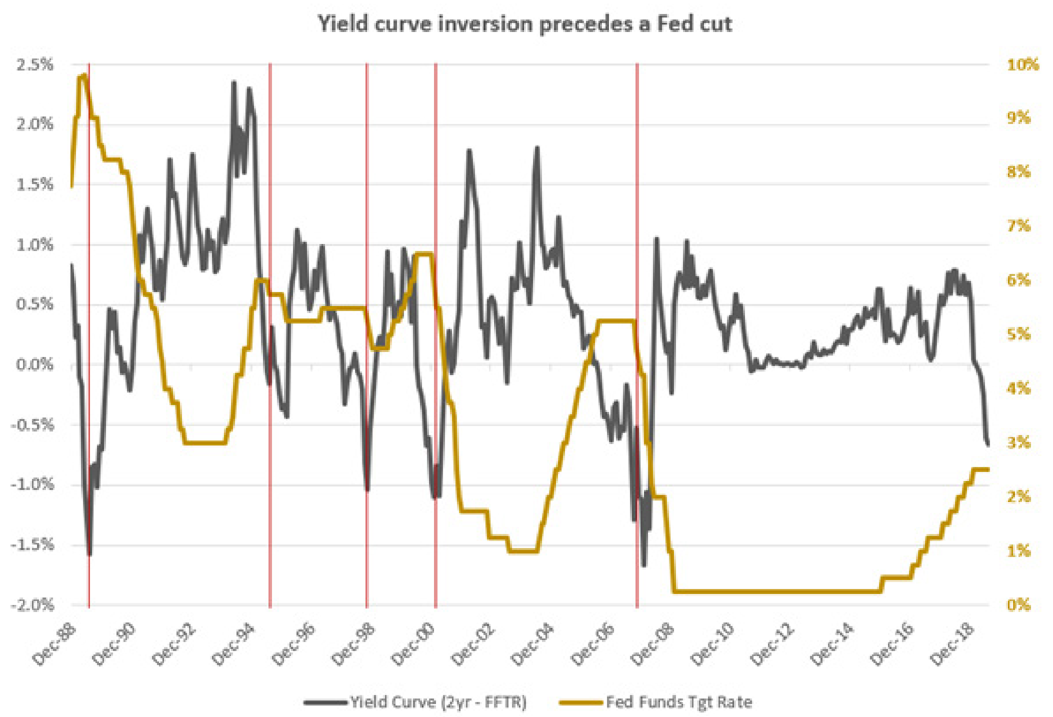


Source: UBS, Iress

Can Central Banks engineer a shallow slowdown?

The divergence between rising PE multiples and negative earnings revisions (which coincide with falling bond yields) stems from excessive risk seeking sentiment – more so than in previous global downturns. Alternatively, maybe the worst is over, and an economic recovery is shortly underway as Central banks will save the day.

Indeed, the Reserve Bank of Australia has consecutively cut rates twice in June and July 2019. And the US treasury market is expecting the Federal Reserve to cut rates at the end of July 2019. Over the last forty years, when the short-term yield curve (2-year treasury yield minus Federal Funds target rate) inverted, it preceded the Federal Reserve cutting interest rates.

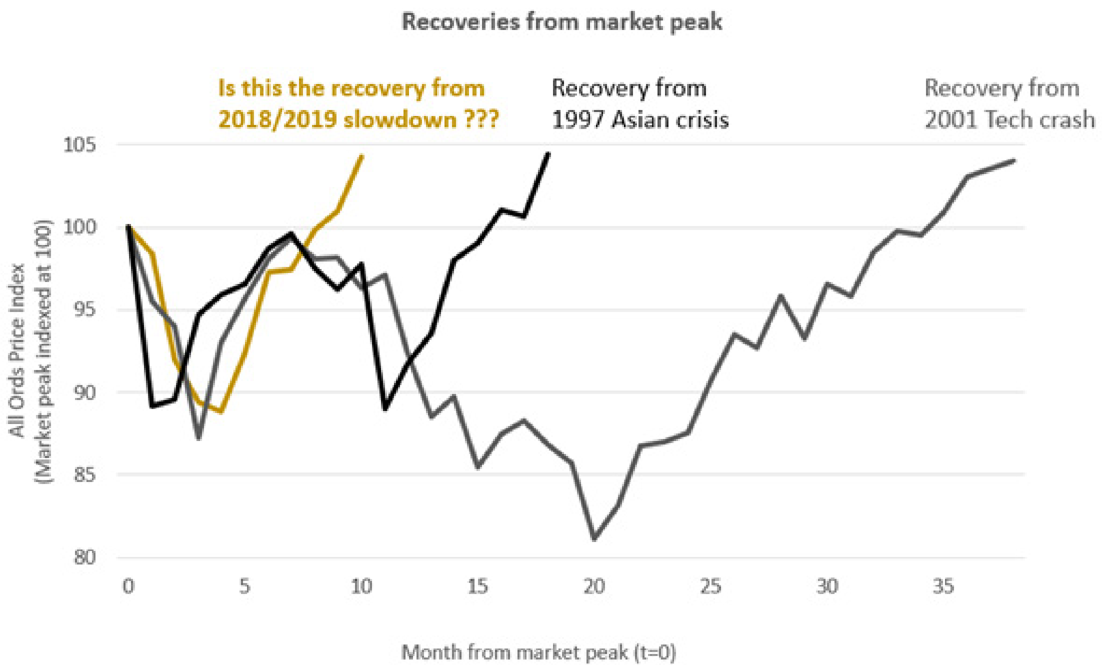


Source: Refinitiv

Before the current inversion, there were five instances since the late 1980s when the short-term yield curve inverted. Two of them coincided with shallow market corrections (1994 and 1997) and the other three (1990, 2002, and 2008) were deeper corrections that coincided with US recessions. From a pure statistical basis, two versus three is not favourable odds for the Federal Reserve to engineer a shallow slowdown. Putting one's faith in a recovery based on the first rate cut by the Federal Reserve is not a great strategy to aggressively buy stocks.

V-shaped recoveries occur infrequently

Historically, V-shaped recoveries are infrequent, occurring twice (1997 Asian crisis and 2001 Technology crash) out of seven prior slowdowns. They also tend to be fleeting as the initial market optimism eventually deflates and morphs into a W-shaped recovery. Volatility prevails when investor expectations are too out of sync with economic reality.



Source: Iress

The 1997 Asian crisis ended up being a shallow correction while the 2001 Tech crash was a deeper correction which coincided with a US recession. If the current market recovery maintains its course, it would set a record. Is this time different or will history rhyme?

Conclusion

If corrections are the market's winter season, then the fourth quarter of 2018 saw a quick hail storm before becoming balmy with sunny skies. It saw half the average bear market return, one third the duration and the sharpest V-shaped recovery in history – all extraordinary.

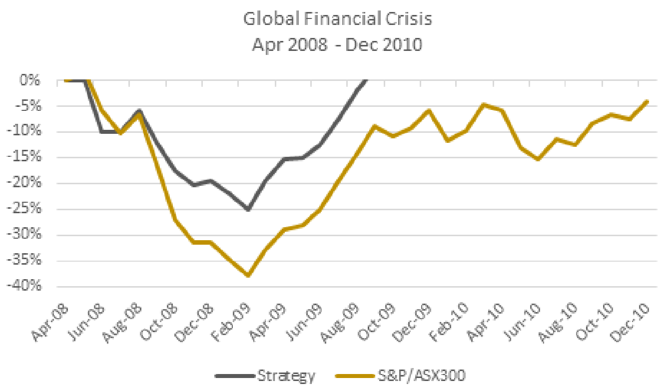
Excessive optimism has pushed PE multiples to their historic highs. This is despite negative earnings revisions within the current global slowdown. Investors who adopted the same risk seeking behaviour in prior slowdowns would have been caught in a blizzard with no clothes.

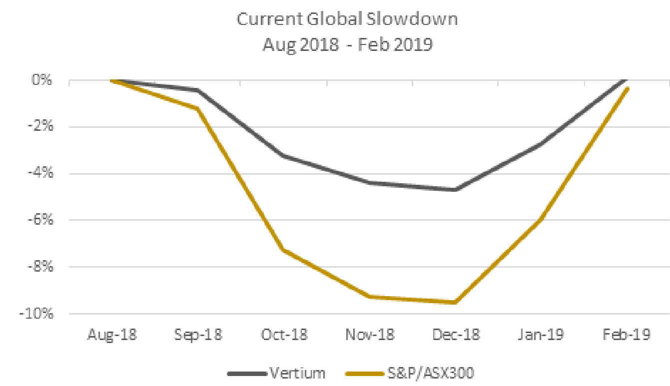
While the current market recovery appears to have seen many firsts, perhaps there is another explanation. Maybe the correction process is still underway. With expectations extremely high, this sets the foundation for risk rather than the fantastic returns that is on offer at the bottom of bear markets.

Fund commentary

The true test of any strategy that promises capital preservation is how it performs during market corrections. This strategy has been running for more than a decade (about two years under Vertium) when there were four significant market corrections. The most recent was in the fourth quarter of 2018 when the capital preservation strategy was tested again. The drawdown profile for the strategy and the market is displayed in the following charts.

Drawdown profile during market corrections





While the current correction feels like a walk in the park, we suspect it is not over yet because valuations are highlighting extreme optimism. Equities will always be the riskiest asset class and hence our approach is to invest capital with prudence and care. Being conservative does result in the strategy lagging the market when excessive optimism prevails. Avoiding undue risk is the predominant reason for the underperformance, especially during the last 6 months of FY19.

Another contributor to the underperformance during the year was the Fund participating in three off-market buybacks (BHP Billiton, RIO Tinto, and Caltex). It removed about 1% from the performance. Selling stock back to the company at a 14% discount to market price to participate in an off-market buyback guarantees a decrease in headline performance (which is why many funds do not participate). So why did we participate? What the performance numbers do not capture is the extremely large franking credit that is returned to unit holders by participating in the off-market buyback process.

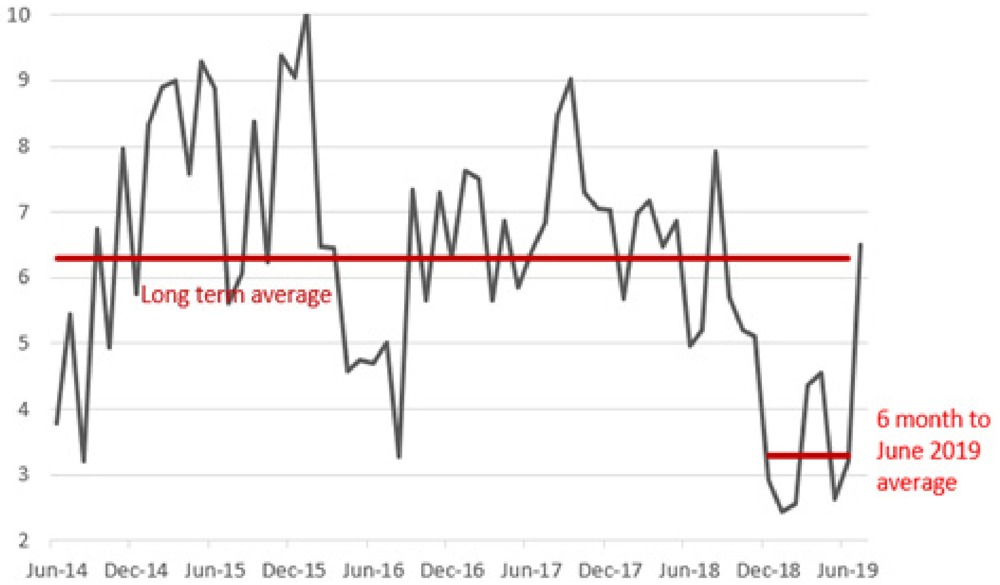
We have also made mistakes during the year and our biggest one was Caltex. Our core investment thesis on the stock centred around a demerger. Last year, management was contemplating an asset ownership restructure, vending the retail properties into a property trust. In August 2018, the company announced it would not go ahead with the plan.

While significant asset value is hidden within the company (property spun out of the company could be valued at an 18x EV/EBITDA multiple versus CTX valued at 7x) it doesn't matter when a demerger is not approved. Think about Yahoo's

15% stake in Ali Baba or News Corp's 62% stake in REA Group. When investing in businesses with management teams that have an aversion to selling assets to unlock value, hidden asset values do not count for much when earnings are revised.

Over the course of the year, Caltex earnings was revised down by more than 20%. The drivers of the negative earnings revisions were due to unusually low refining margin (47% lower than long term average) and retail fuel margin (15% lower than long term average).

Dubai crack Singapore refining margin (US$/bbl)



Source: Refinitiv

Australian average retail diesel margin

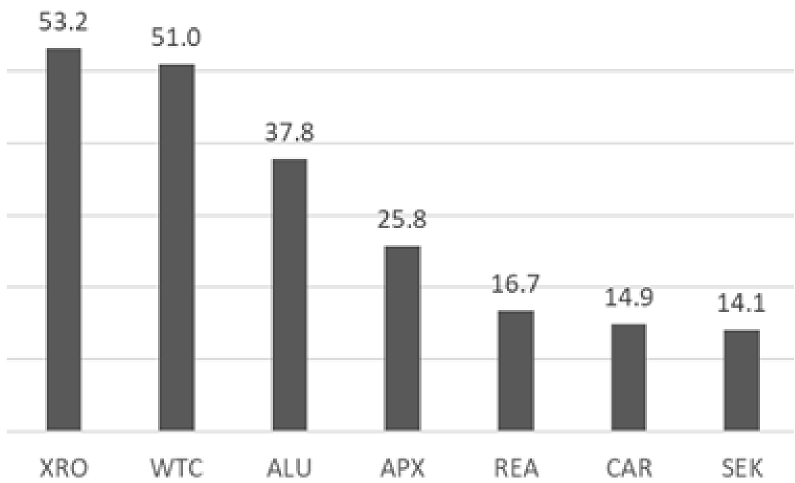
Source: Australian Institute of Petroleum

Since late June 2019, both the refining margin and retail fuel margin have mean reverted to their long-term averages. The Fund still owns CTX and is closely monitoring further developments.

While capital preservation is paramount and avoiding mistakes such as CTX is imperative to achieve this objective, our defensive strategy doesn't mean that risk is shunned altogether. When we believe a stock offers an asymmetric outcome to the upside, risk is embraced. One such stock is Seek (SEK).

SEK is Australia's largest on-line employment platform and operates in 18 countries. When the stock was bought in March 2019, SEK was the cheapest stock in the technology sector.

Aussie technology stocks as at March 2019 (1 year forecast PE multiple)



Source: Factset

Importantly, we believe the market is underestimating the quality of the company's earnings. SEK is undergoing a positive mix-shift where employers are transitioning to more expensive premium ads, which helps to lift profits by offsetting weakening job ads. Currently, premium ads account for 25% of total job ads versus 10% five years ago. We believe there is a long runway for this mix-shift to continue in SEK's mature ANZ business and eventually its overseas businesses.

The market is also not valuing SEK's early stage ventures properly. Over the last five years, SEK has invested in start-up businesses looking for the next 'unicorn'. These ventures currently generate losses and represent about 6% of group EBITDA. Hypothetically, if SEK stopped investing in these businesses group profit would rise instantly. Either these businesses are worth a lot (which management think so) or worth zero. The losses should be stripped out from EBITDA to value the company otherwise losses are capitalised forever at the group valuation multiple.

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 companies 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.

Tomas Vasquez
Portfolio Manager / Equity Analyst
BEng, MAppFin, CFA

- Tomas joined Vertium in 2019 as a Portfolio Manager / Equity Analyst.
- Responsible for researching and analysing Australian companies.
- Before joining Vertium, Tomas was an Equities Analyst at Investors Mutual and held similar positions at CBA, ABN AMRO and Aspect Huntley.

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+

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.