Vertium Equity Income Fund

Fund Update | March Quarter 2020

Key Facts

Investment objective vs benchmark

1. Greater income yearly
2. Lower absolute risk yearly
3. Greater returns over 5 years

Benchmark index

S&P/ASX 300 Accumulation Index

Inception date

April 2017

Number of stocks

20 - 40

Distribution

Quarterly

Management fee

0.97 p.a.

Buy/Sell spread

+0.25 /-0.25

Minimum investment

$20,000

APIR

OPS1827AU

External ratings

Lonsec "Recommended"
Zenith "Approved"

Suitable investors

1. Low-risk or low-tax investors
2. Pre-retirees and retirees
3. Endowments and charities

Key Platforms

Asgard | BT Wrap | BT Panorama
CFS | HUB24 | IOOF | Netwealth
Praemium | MyNorth
Macquarie | MLC

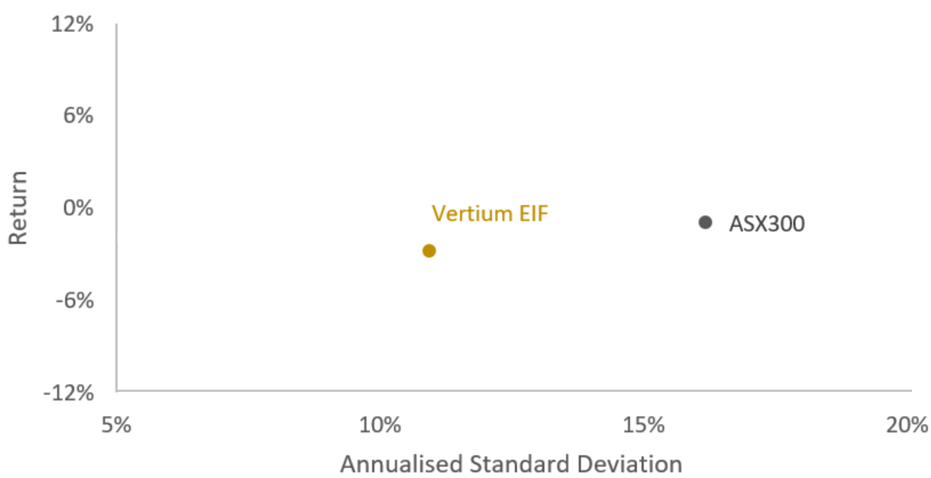
Capital preservation metrics (since inception) ^

	Fund	ASX300
Outperformance frequency in down markets	75%	N/A
Down market capture ratio	58%	N/A
Beta	0.63	1
Maximum Monthly Drawdown	-13.8%	-20.8%

Performance (%)

	1 Mth	3 Mth	6 Mth	1 Yr	2 Yr pa	Since Inc. pa
Income	1.1	1.1	2.1	8.9	7.4	6.1
Growth	-14.9	-20.6	-20.5	-21.6	-11.3	-8.9
Fund Total Return	**-13.8**	**-19.5**	**-18.3**	**-12.7**	**-3.9**	**-2.8**
Income	0.5	1.0	1.8	4.0	4.2	4.3
Growth	-21.4	-24.5	-24.7	-18.5	-6.4	-5.3
Index Total Return	**-20.8**	**-23.4**	**-22.9**	**-14.5**	**-2.3**	**-0.9**
Average market exposure	65.0	71.7	68.1	63.4	67.2	68.6
Fund beta	N/A	0.61	0.67	0.68	0.65	0.64

Return versus risk (since inception)



Expected yield over next 12 months, including franking **6-8%**

Portfolio Dashboard

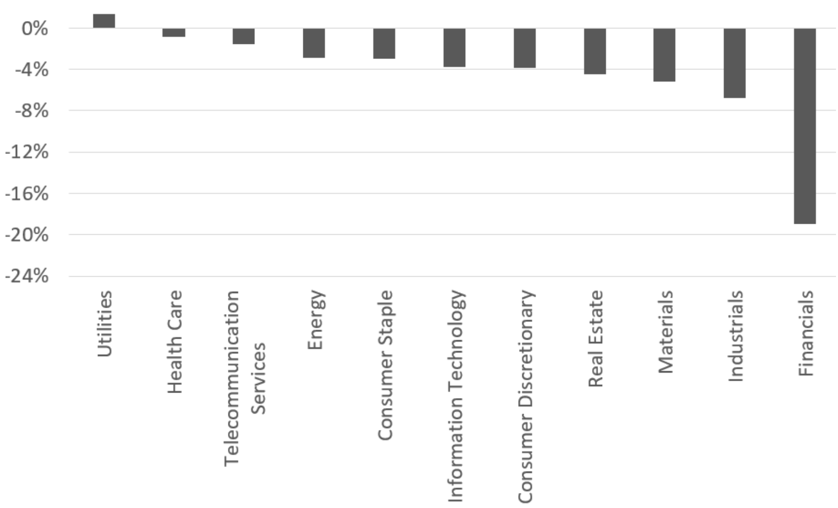
Top 10 holdings	ASX Code
CSL Limited	CSL
BHP Group Limited	BHP
Coles Group	COL
Ausnet Services	AST
Westpac Banking Corp	WBC
Aristocrat Leisure	ALL
REA Group	REA
Rio Tinto	RIO
Lendlease Group	LLC
James Hardie Industries	JHX

Number of stocks	22

Size exposure	%
Large Cap	43
Mid Cap	8
Small Cap	0
Effective Cash	50

Option exposure	%
Shares	51
Call Options	0
Put Options	0
Effective Cash	50

Sector Weightings



"Our equity income fund is designed with conservative investors in mind. We seek to deliver the benefits of equity exposure including attractive, tax effective income - with a commitment and focus on capital preservation."

Jason Teh
Chief Investment Officer
Vertium Asset Management

Notes of Performance: Due to participation in various off market buybacks, the headline performance was negatively impacted. On a tax-exempt basis, these buybacks contributed positively due to imputation credits. The following shows the negative impact on performance and the imputation benefit in brackets: Nov 2018 RIO -0.33 (+0.87); Dec 2018 BHP -0.63 (+1.25); Apr 2019 CTX -0.01 (+0.21) . ^Based on monthly data.

Quarterly perspective | **the Markets**

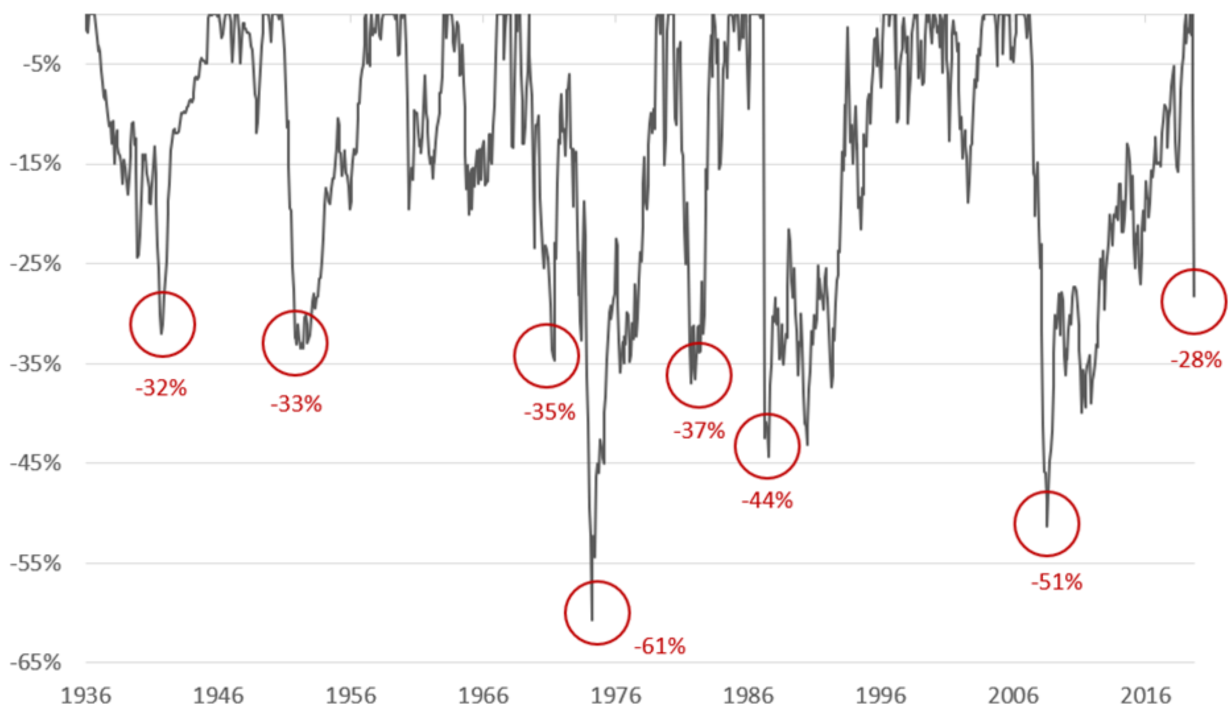
The S&P/ASX 300 Accumulation Index fell 23.4% for the March quarter. The best performing sector was Healthcare (+1.5%) driven by Australia's largest company by market capitalisation, CSL (+8.1%). The worst performing sector was Energy (-48.2%) as the oil price collapsed to 18-year lows.

Australia's GDP annual growth rate grew 2.2% in the fourth quarter of 2019, accelerating from its previous quarters. The unemployment rate edged down to 5.1% and the annual inflation rate was relatively stable at 1.8%. While the statistics showed an improving economy at the end of 2019, the world completely changed in March 2020. The Coronavirus pandemic brought global economies to a standstill. In response, the Reserve Bank of Australia (RBA) aggressively cut the cash rate by 50 basis points to a record low of 0.25%. The RBA also embarked on a quantitative easing (QE) program for the first time. Furthermore, the Australian Government announced the biggest fiscal stimulus in history by spending $213.7 billion (10.9% of annual GDP).

Commodity prices in general were weak during the quarter. The Brent oil price (-60.8%) collapsed as Saudi Arabia and Russia started an oil price war at the worst possible time when as the virus was spreading globally. Copper and iron ore prices (-22.6% and -8.7% respectively) also fell due to fears of a global slowdown. The gold price (+4.0%) was resilient as yields collapsed globally.

In our view, the Coronavirus pandemic is the biggest exogenous shock the world has experienced since World War II. When the pandemic began to spread outside China, equity markets fell in late February and it accelerated in the following month. The crash had similar hallmarks to the 2008 Global Financial Crisis (GFC) and the 1987 market crash. This is the 8th significant correction for the All Ordinaries Price Index spanning 84 years. It's rare to witness a stock market crash of this velocity and magnitude.

All Ords Price Index Peak to Trough Drawdown (July 1936 – March 2020)



Source: Iress, Vertium

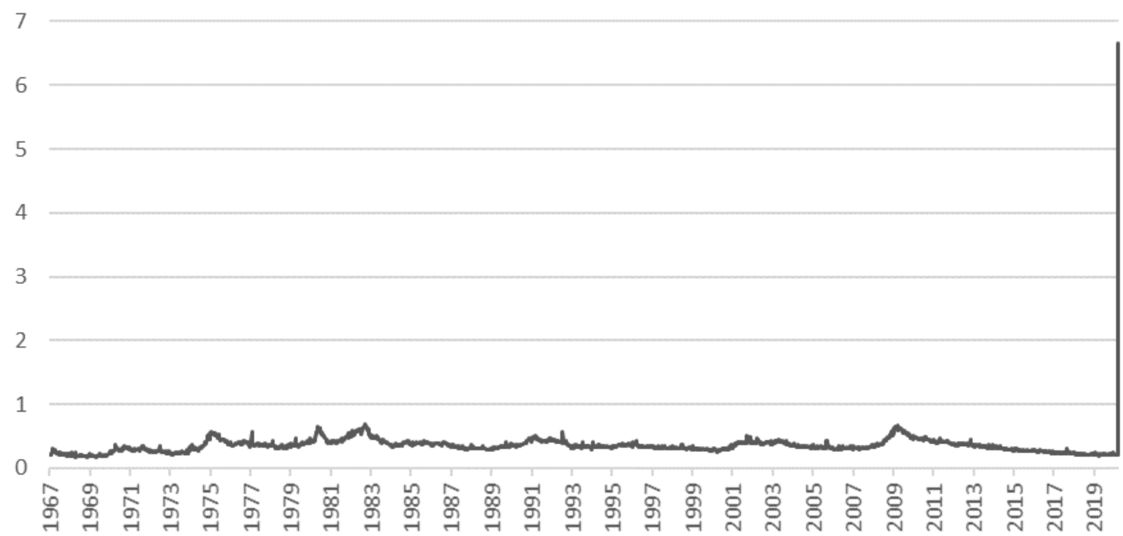
Quarterly perspective | **the Markets**

From Health Crisis to Credit Crisis

Never in modern history have we witnessed entire countries stay at home and practice social distancing. About a third of the world's population are currently in lockdown to prevent a complete breakdown of the healthcare system. The trade-off between saving lives and saving livelihoods has resulted in the collapse of travel and leisure industries and small and medium enterprises (SMEs).

SMEs are particularly important because they drive about 60% of the economy. Unfortunately, they are highly sensitive to a temporary shutdown of the economy and many will be in dire circumstances. The first sign of employment stress appeared in the third week of March when US unemployment initial claims surged to about 3.3 million. This was followed by another surge of 6.6 million the following week, by far the largest number in history. The magnitude of this shock is about tenfold higher than previous peaks during the 1982 and 2009 US recessions. It is astonishing that Americans have filed for jobless claims in the last two weeks representing roughly 6% of work force.

US Unemployment Initial Claims (million)

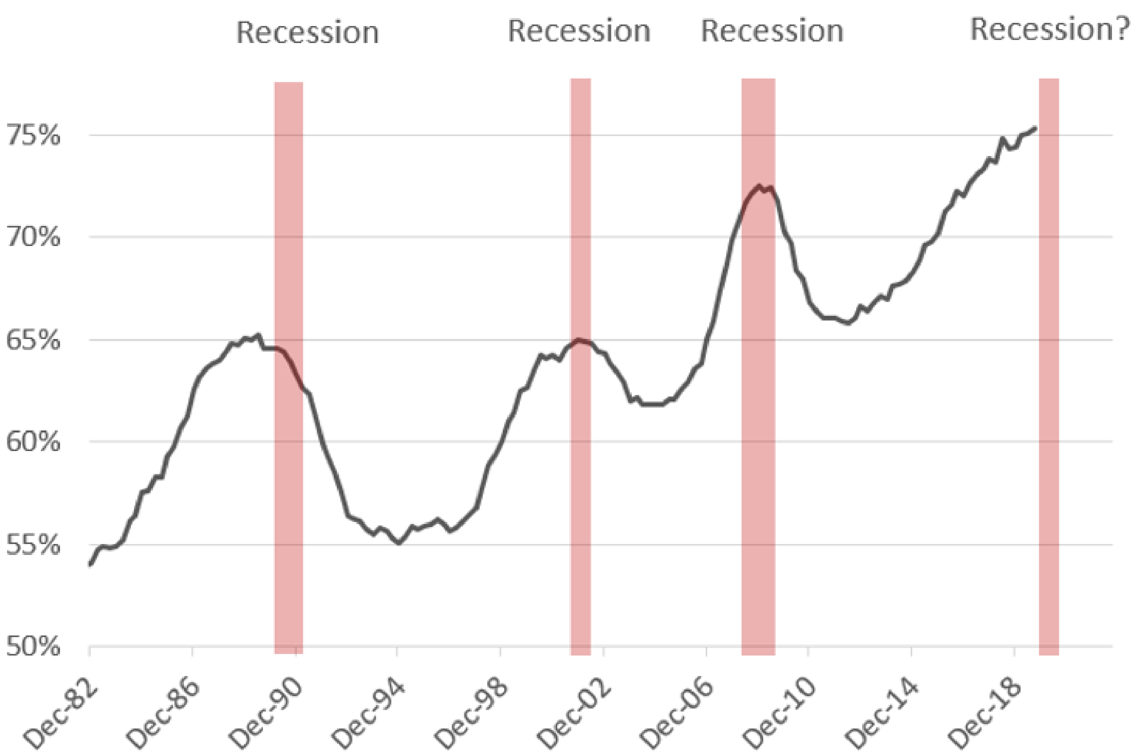


In Australia, we are likely to see similar trends in official statistics in the coming months. Anecdotally, the news of Centrelink's website crashing and 300,000 applications for 5,000 roles advertised at Coles highlight the magnitude of the crisis.

The exogenous shock from Coronavirus pandemic has morphed into a global credit crisis. It was the catalyst that exposed economic imbalances building up over time and has brought forward the inevitable in our view. While the GFC was due to the implosion of US household debt the epicenter of the current credit crisis is the corporate sector. For instance, United States corporate debt as a percentage of GDP has surpassed its GFC highs and is currently the highest in history.

Quarterly perspective | the Markets

US corporate debt to GDP



Source: Bank of International Settlements, Vertium

Debt payments must be paid irrespective of how revenue is lost whether it is due to low oil prices for energy companies or stringent social distancing measures. When corporates are having trouble paying their debt, equity markets are in turmoil. Further, debt problems are not confined to stocks only. The private equity bubble, worth $5 trillion globally, is set to burst as their business models heavily rely on debt versus their listed counterparts.

While Australian corporates are less indebted than their US peers, many are scrambling for cash, which is a clear sign of a credit crunch. In March, two companies (Cochlear and Ooh Media) raised equity at steep discounts to their share price. Five companies were in trading halts (Flight Centre, Webjet, IDP Education, Kathmandu and Southern Cross Media) as they work out the best way to raise capital. Many other companies have cut or suspended their dividends to preserve cash. We expect more companies raise equity and cut dividends and in the coming months.

Quarterly perspective | **the Portfolio**

The Vertium Equity Income Fund delivered -19.5% return during the quarter, outperforming the market. The quarter was a tale of two halves. In January and the first 3 weeks of February, the portfolio lagged the bullish market. However, when equity markets began to correct from late February the portfolio outperformed as expected. The Fund also paid a 1 cent per unit distribution for the March quarter. This is in line with the Fund's objective of delivering higher levels of income than the benchmark over the coming year.

When the Coronavirus hit news headlines in January, no one (including Vertium) could have predicted the severity of the global economic impact two months later. At first, our research was using the SARS pandemic as a benchmark to monitor Coronavirus. However, some signs appeared in late February that the current pandemic was unique. Various sources of high frequency data were showing an economic slowdown was increasingly likely. Before it snowballed out of control, the Fund implemented several measures to protect it from ongoing volatility:

1. Bought hedge protection via options on several stocks (e.g. Qantas, banks and resources)
2. Reduce overweight positions (e.g. James Hardie, Lendlease and REA Group)
3. Rebalance to selective defensive stocks (e.g. Coles, Ausnet Services and some gold stocks)

While buying hedge protection affected our performance in late February and early March it proved to be the correct strategy. Equity markets continued to collapse as the world rapidly transitioned from a global growth recovery phase to an impending global slowdown. As a result of the actions taken the cash levels of the Fund rose as events quickly unfolded.

The Fund's higher cash level is warranted given that the world is moving towards a recession. The cash level will act as a shock absorber if there is ongoing equity market volatility. Cash also provides the Fund with optionality as it can be deployed into stocks that get dislocated from their fundamentals. In late March, Aristocrat was one such stock, which was bought.

On the surface, Aristocrat's share price collapse in March seems justified when 70% of its earnings disappear due to their casino customers closing operations as a result of the lockdowns. However, we believe the market has overreacted to Aristocrat's business disruption. First, the pandemic will pass and hence casinos will eventually open. The key question is the duration of the lockdowns. Based on our assessment, the company can survive for about two years without needing equity from shareholders, which is a huge buffer for the pandemic to pass. Furthermore, many of its competitors are highly indebted. If they become bankrupt, then Aristocrat has the scope to strengthen its market position when the industry recovers. Importantly, the stock was bought on a valuation multiple (pre-Coronavirus earnings downgrade) that was at the bottom end of its 20-year range.

Aristocrat PE Multiple History (March 2000 – March 2020)

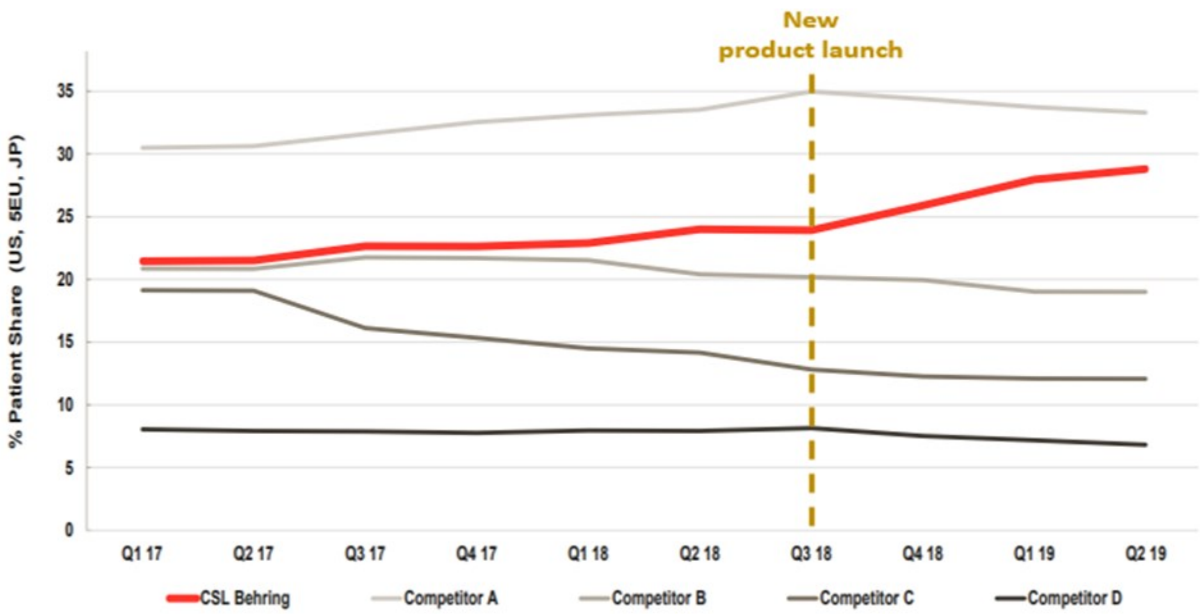
Source: FactSet, Vertium

Quarterly perspective | the Portfolio

A strong performer in the quarter was CSL (+8.1%). Based on our research the market is underestimating the strength of CSL's business relative to other growth stocks. First, CSL has a heart attack drug within its R&D portfolio that is in the final stages of approval. If approved this could increase group profits by about 30% in future years. Secondly, CSL's largest division, immunoglobulin (IG), is expected to deliver strong profit growth over the next few years due to robust demand in the primary immune deficiency (PID), secondary immune deficiency (SID) and the chronic inflammatory demyelinating polyneuropathy (CIDP) markets.

Of special note is CSL's Hizentra product that has received orphan drug status by authorities for the CIDP market. This means CSL has exclusive rights to sell their higher margin product to the second largest IG market in the world. Since launching their new products into the CIDP market, CSL has experienced a step change in market share gains.

CSL's CIDP Market Share



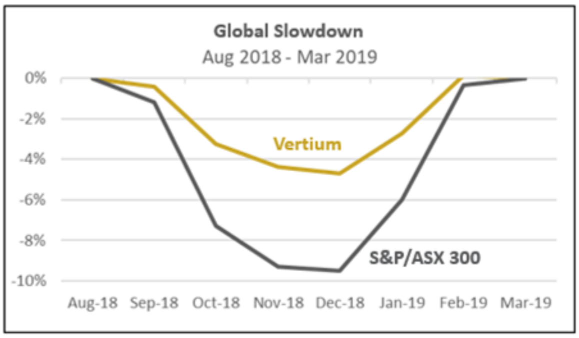
Source: JP Morgan Healthcare Conference, January 2020, Vertium

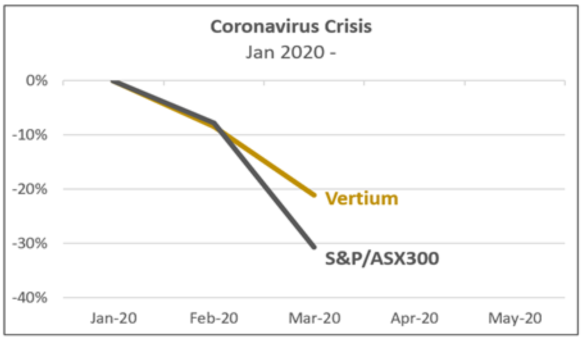
CSL is not 100% immune from the flow on impact of the Coronavirus pandemic. Social distancing measures will likely cause a decrease in blood collection, but it may also cause hoarding of CSL's higher margin Hizentra product which is administered at home. A medium-term issue is whether there is a sustained increase in unemployment which may lead to an increase in blood collection and potentially increase the supply of IG. We are keeping a close eye on the risks and opportunities for CSL like with all stocks in the portfolio.

Despite the portfolio outperforming the market, the Fund had a few disappointing underperformers, namely Qantas (-52.7%). The fund no longer holds Qantas after the hedge protection removed the stock at higher prices than it is currently trading. The original investment thesis was based on the industry becoming more rational due to supply (capacity) reductions. However, positive developments on supply became irrelevant when the pandemic obliterated demand for air travel. The situation is now very fluid with both Qantas and Virgin Australia asking for Government bailouts. We are monitoring industry developments closely and whether supply discipline is still present when demand returns.

Quarterly perspective | the Portfolio

Notwithstanding the Coronavirus pandemic being unique compared to other crisis periods, market dislocation is not a new phenomenon. The peak to trough drawdown charts below highlights the strategy consistently preserving capital better than the market during these turbulent times. This is the fifth time in history where the strategy has been tested in chaotic markets.





Source: Vertium

The strategy's shallower drawdown profile help mitigate one of the biggest hazards for retirees called sequencing risk. Furthermore, higher levels of capital preservation help the capital base recover faster in a bear market.

On a final note, we have entered a period of elevated uncertainty. The pandemic will pass but whether this takes a several weeks or months is unknown. And once the health crisis passes, there is still much uncertainty regarding the length and depth of the economic downturn or how the associated credit crisis gets resolved. The good news is that Governments and Central Banks are responding with large fiscal programs and liquidity to support the financial system. In this complex environment we believe the portfolio is well positioned to protect capital for investors.

We are grateful for managing your capital and thank you for your support. Please keep safe and healthy.