Vertium Equity Income Fund

Fund Update | 30 June 2021

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 "Recommended"

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
Oneview | Praemium | MyNorth
Macquarie | MLC

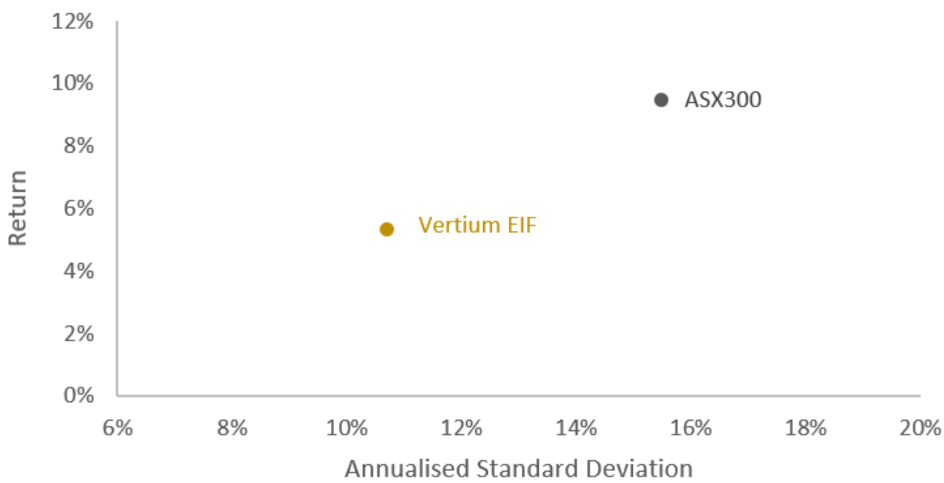
Capital preservation metrics (since inception) ^

	Fund	ASX300
Outperformance frequency in down markets	77%	N/A
Down market capture ratio	56%	N/A
Beta	0.65	1
Maximum Monthly Drawdown	-13.8%	-20.8%

Performance (%)

	1 Mth	3 Mth	6 Mth	1 Yr	2 Yr pa	3 Yr pa	Since Inc. pa
Income	1.6	1.6	2.7	5.1	5.0	6.3	5.9
Growth	-0.5	3.7	6.0	17.0	1.2	-0.6	-0.6
Fund Total Return	**1.1**	**5.3**	**8.8**	**22.0**	**6.3**	**5.7**	**5.3**
Income	0.1	0.6	1.7	3.1	3.2	3.6	3.8
Growth	2.1	7.9	11.3	25.4	5.7	6.1	5.7
Index Total Return	**2.3**	**8.5**	**13.0**	**28.5**	**8.9**	**9.8**	**9.5**
Fund beta	N/A	N/A	N/A	0.65	0.69	0.66	0.65

Return versus risk (since inception)



Portfolio Dashboard

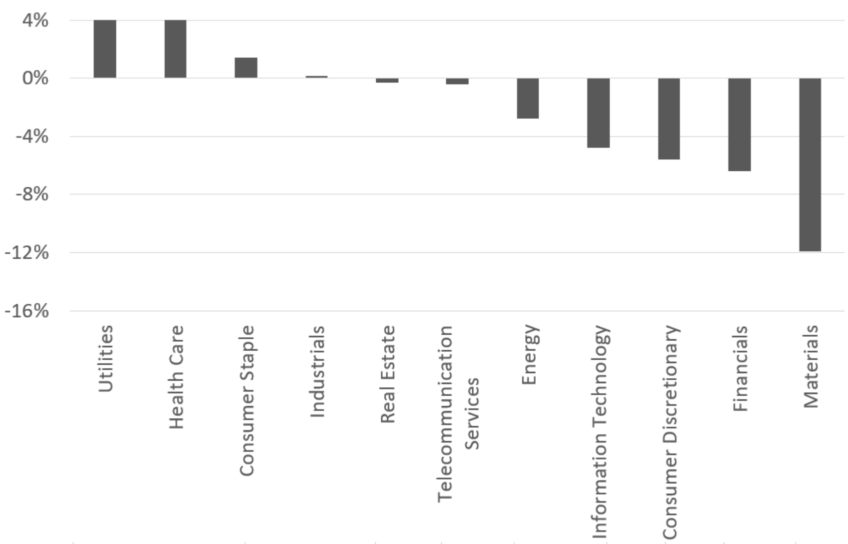
Top 10 holdings	ASX Code
CSL Limited	CSL
Commonwealth Bank	CBA
Aurizon Holdings	AZJ
APA Group	APA
BHP Group Limited	BHP
Westpac Banking Corporation	WBC
Insurance Australia Group	IAG
Resmed	RMD
Coles Group	COL
Charter Hall Group	CHC

Number of stocks	32

Size exposure	%
Large Cap	66
Mid Cap	15
Small Cap	1
Effective Cash	18

Option exposure	%
Shares	89
Call Options	-8
Put Options	1
Effective Cash	18

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

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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**

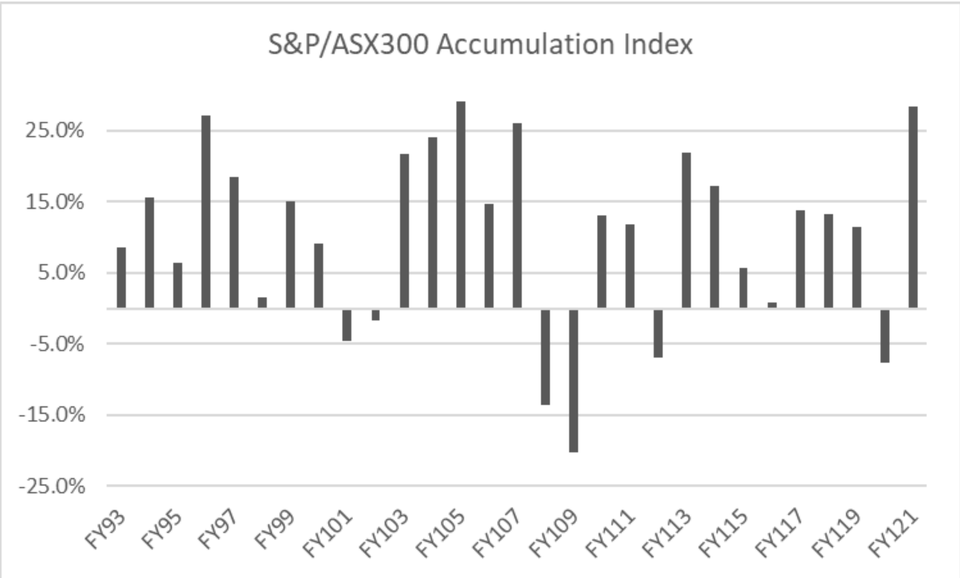
The &P/ASX 300 Accumulation Index delivered an +8.5% return for the June quarter. The best performing sector was Information Technology (+12.1%) led by Altium (+38.6%), which received a takeover offer from US peer, Autodesk. The worst performing sector was Utilities (-4.5%) led by AGL Energy (-15.0%).

Australia's GDP quarterly growth rate slowed from the previous quarter to 1.8%. The unemployment rate has fallen further to pre-pandemic levels of 5.1%. The annual inflation rate was relatively subdued and increased to 1.1% for the quarter.

Commodity prices were robust during the quarter. The Brent oil price (+18.2%) and copper price (+6.0%) continued to be strong, coinciding with a global economic recovery. The iron ore price (+30.3%) surged, fuelled by strength in Chinese steel production. The gold price (+3.7%) was relatively lacklustre as inflation expectations eased.

Year in Review

It has been an exceptional couple of years. The COVID crisis began in late February 2020 which led to a dramatic 36% drawdown in the market over two months. The market bounced off its March lows and then delivered an exceptional 28.5% return for FY21. It was the fastest share market recovery in history with FY21 representing the second-best performing year since 1992.



Source: IRESS

The strongest performing sectors in FY21 were Consumer Discretionary, Financials, and Information Technology. The worst performing sectors were Consumer Staples, Healthcare and Utilities.

Quarterly perspective | the Markets

ASX Sector Return

	FY20	FY21
Consumer Discretionary	2.2%	48.6%
Financials	-21.2%	41.1%
Information Technology	19.7%	39.6%
Materials	-0.6%	35.7%
REITs	-20.7%	33.9%
Telecomunications	-9.0%	33.1%
ASX300 Accum Index	-7.6%	28.5%
Industrials	-13.6%	10.8%
Energy	-29.4%	10.2%
Consumer Staples	12.0%	7.6%
Healthcare	27.3%	6.2%
Utilities	0.0%	-18.6%

Source: IRESS

When compared to previous recessions, the COVID crisis has seen some highly distorted sector performance. Three sectors (Consumer Discretionary, Healthcare and REITs) performed abnormally in the FY20 downturn and the subsequent FY21 recovery.

Typically, discretionary retail spend collapses in recessions and takes time to recover. However, Discretionary Retail performed exceptionally well as work from home orders significantly boosted profits during the COVID crisis. For example, JB Hi-Fi's profit after tax is expected to double from FY19 to FY21.

On the other hand, healthcare stocks are generally insulated from recessions. However, the COVID crisis negatively impacted the sector. CSL, the largest stock in the sector, was significantly affected as blood collections fell due to the stay-at-home orders and stimulus cheques handed out by the US Government. CSL is expected to deliver a relatively flat profit profile from FY19 to FY21, which is quite rare in its 30-year listed history of growing earnings.

Another peculiarity was exhibited by the REITs sector. They typically outperform in a recession and then underperform in a market recovery. The opposite occurred in the COVID crisis as there were initial fears of lost rent for the entire sector due to the lockdowns. REITs with large exposures to shopping centres were the most impacted while REITs with industrial property were resilient. As fear subsided, their discounts to valuations (due to the FY20 crash) were unwound leading to a significant rally in FY21.

Most other sectors performed in-line with expectations. For example, the low beta Consumer Staples and Utilities sectors outperformed in the FY20 market crash and subsequently underperformed in the FY21 market recovery. The magnitude of the Utilities underperformance in FY21 was amplified by the poor performance of AGL Energy (AGL).

High beta sectors with economically sensitive earnings such as Mining (within the Materials sector), Energy and Financials collapsed in the crisis and rebounded in FY21. However, the magnitude of the recovery in energy stocks has been underwhelming despite the oil price recovering to pre-pandemic levels. Iron-ore stocks performed exceptionally well as that the iron ore price reached an all-time high due to a combination of supply disruption from Brazil and strong Chinese steel demand.

Quarterly perspective | **the Markets**

While Mining was not the best performing sector it had some of the best performing stocks. Six of the top ten best performing stocks in the ASX100 were mining related. For example, Mineral Resources (MIN) and Fortescue Metals (FMG) benefited the most from the 113% surge in the iron ore price. Only one technology stock, Afterpay (APT) made it into the top 10. The outperformance of cyclical stocks relative to APT is phenomenal given that APT grew revenues by about 100%.

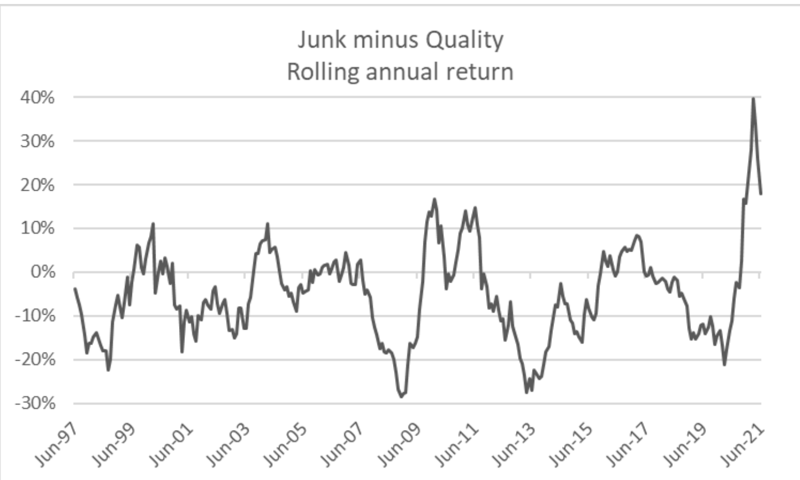
Best and Worst ASX100 Stocks (1 year return to June 2021)

Top 10		Bottom 10	
Lynas Rare Earth	199%	A2 Milk	-68%
Mineral Resources	168%	AGL Energy	-48%
Reece	159%	AMP	-35%
Nine Entertainment	117%	Nortern Star	-25%
Oz Mineral	108%	Aurizon	-19%
ALS	103%	Origin Energy	-19%
Boral	94%	Orica	-19%
AfterPay	94%	Newcrest	-19%
Fortescue Metal	90%	Evolution	-18%
Bluescope Steel	90%	Beach Petroleum	-17%

Source: IRESS

The worst performing stocks were plagued with stock specific issues. For example, A2 Milk experienced a significant decline in earnings from the lack of demand in the Daigou market. AGL has been plagued by a litany of issues such as a Government intent on oversupplying the wholesale electricity market, the unexpected departure of its CEO, and cutting its dividend to preserve its balance sheet before structural separation. AMP is still suffering significant issues that seem insurmountable following the Financial Services Royal Commission in 2019.

The performance of Cyclicals and Resources stocks in FY21 highlights the underbelly of the stock market rally – the rise of lower quality stocks (aka junk stocks). These stocks typically have lower return on equity, more volatile earnings and/or weaker balance sheets. The outperformance of junk stocks in Australia is the most extreme since records began in 1997.

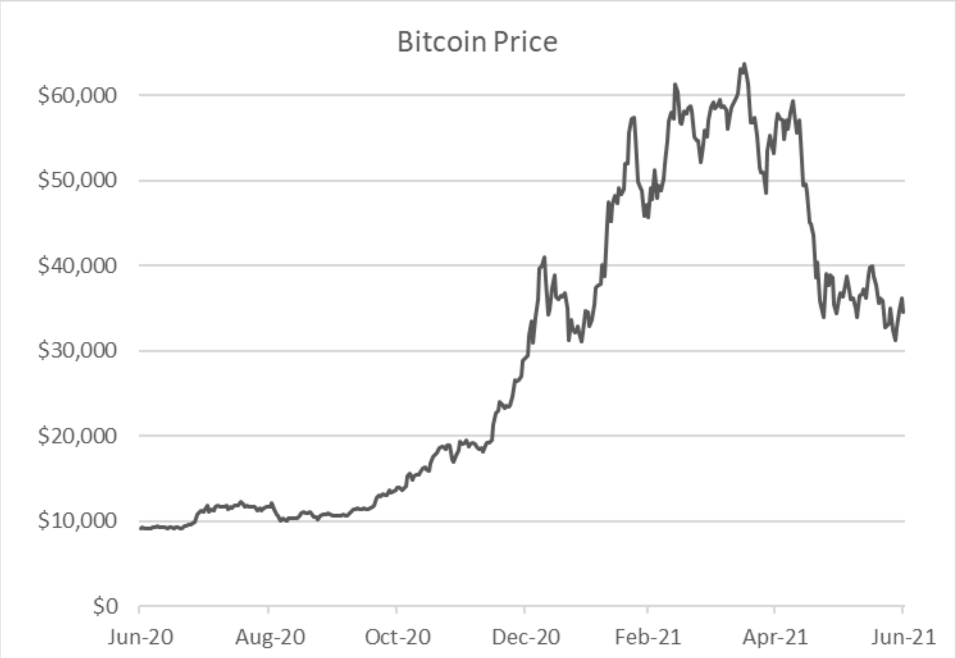


Source: AQR, Vertium

Quarterly perspective | **the Markets**

The junk rally is a symptom of the unprecedented amount of money injected into the financial system. The excess amount of liquidity has spilled into asset markets and has led to some unbelievable price movements. Since the COVID crisis began we have witnessed a negative oil futures price, the rise of meme stocks fuelled by social media platforms, and what we believe takes the cake – invisible art sold for A$23,500.

While invisible art may not be for you, Bitcoin has been promoted to the masses. It seems so easy to speculate on Bitcoin. In the 5 months from June 2020, its price doubled. It doubled again in the next 2 months. And it then rose another 50% in about 3 months to its $63,400 peak in April 2021. Since then, Bitcoin has halved in price and is currently at the same level it was six months ago. Sometimes speculation crumbles under its own weight.



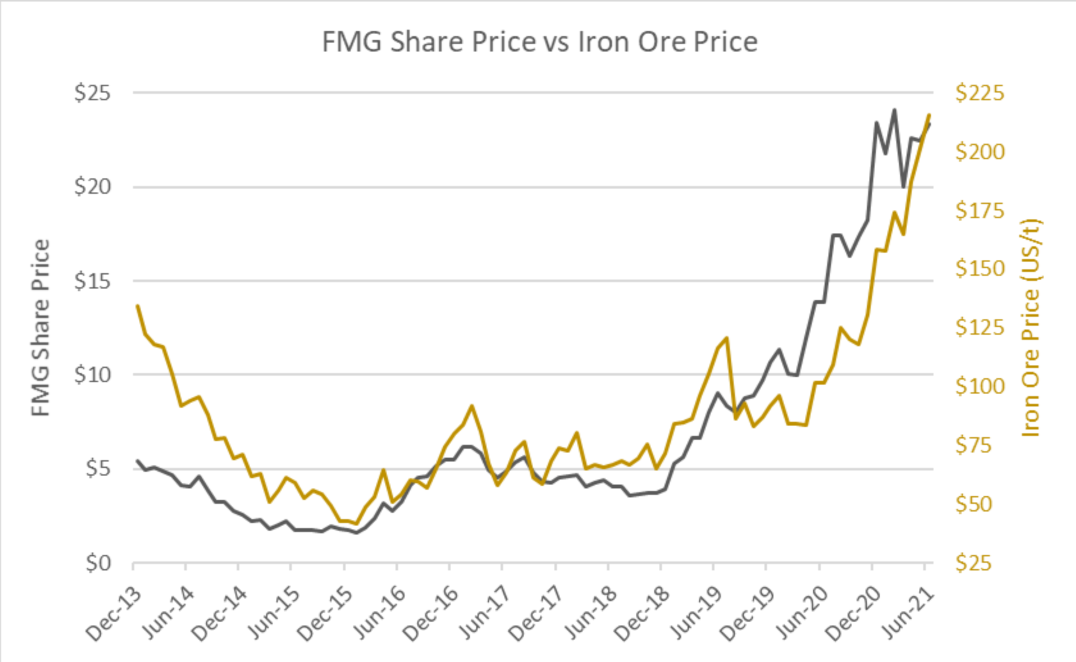
Source: IRESS

Even commodities that are hard to speculate on, such as US Lumber, have shown similar exponential price rises before collapsing. The Lumber price nearly tripled but then fell nearly 60% from its peak in April 2021.

Source: FactSet

Quarterly perspective | **the Markets**

Could other commodities be next? There are several commodities that have surged to all-time highs like lumber. Iron ore is one such example. Stocks such as FMG have been huge beneficiaries of the high iron ore price. At current iron ore price of around US$200/t, FMG's free cashflow generation is tremendous and it is currently offering a mouth-watering 13% dividend yield.



Source: IRESS

The sustainability of FMG's dividend yield is contingent on the iron ore price. If the iron ore price retraced to US$100/t it will still be at a significant premium to the long-term average of US$55/t. However, FMG's share price would most likely halve in value if that were to occur. Chasing dividend yields at peak commodity prices is like picking up pennies in front of a steam roller.

Quarterly perspective | the Portfolio

The Vertium Equity Income Fund delivered a total net return of +5.3% for the quarter and +22.0% for the year. The Fund paid a 1.4 cent per unit distribution for the June quarter resulting in a 5.1% income return, which is about 2% ahead of the market. The Fund's risk (volatility) profile was considerably lower than the market given that it exhibited a yearly portfolio beta of 0.65. The Fund's low risk profile led to it outperformance during the COVID crash but also led to the Fund underperforming the fast-rising market recovery. Losing less capital during the COVID crash meant that the Fund did not have to take on excessive risk to recoup lost capital when the market recovered.

The Fund's best and worst performers relative to the market in FY21 were as follows:

1 Year Performance Attribution

Top 5	Average Wt	Performance	Attribution
CHARTER HALL	3.0%	64%	1.1%
COCA-COLA AMATIL	2.2%	57%	0.8%
A2 MILK	0.0%	-68%	0.8%
REA GROUP	2.7%	58%	0.8%
TRANSURBAN	1.0%	3%	0.7%

Bottom 5	Average Wt	Performance	Attribution
EFFECTIVE CASH	22.8%	0%	-4.9%
AURIZON	4.8%	-19%	-2.9%
FORTESCUE METALS	0.0%	90%	-0.8%
LENDLEASE	3.2%	-6%	-0.7%
AFTERPAY	0.0%	94%	-0.7%

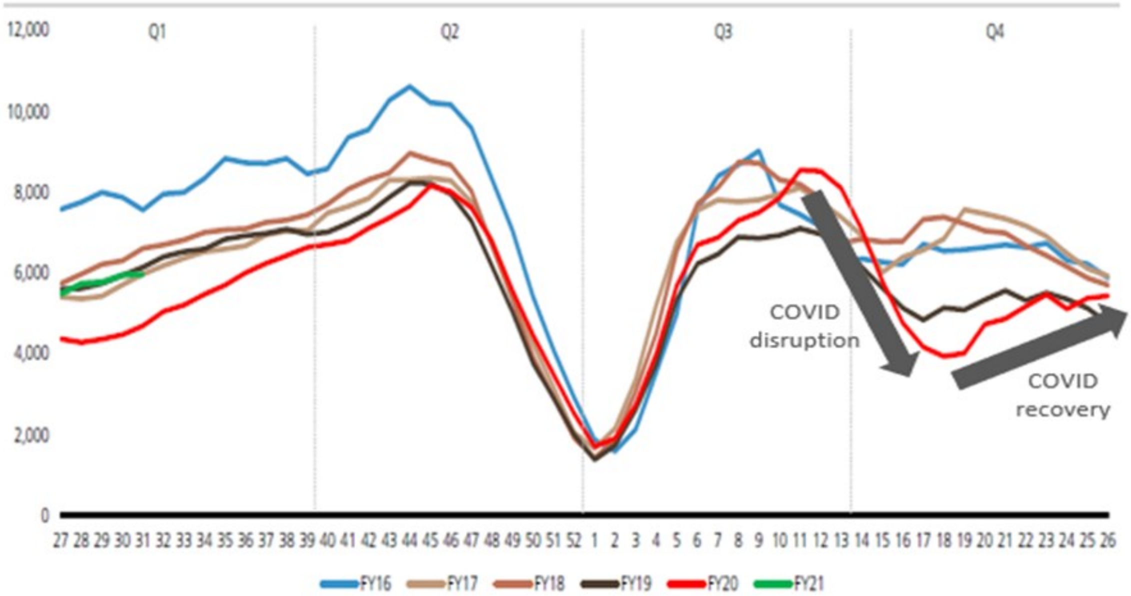
Source: NAS

REA was a strong performer over the year. REA is a stock we label as a "neglected orphan". These stocks are often considered growth stocks because they typically do not display a cheap valuation multiple on near term earnings. However, they generate good risk-adjusted returns because future earnings are underestimated by the market.

Despite the economic uncertainty around the lockdowns, our research highlighted that the recovery in residential listings was being underestimated by the market. Specifically, once the lockdowns were removed property listings surged, which is a significant driver of REA's profits.

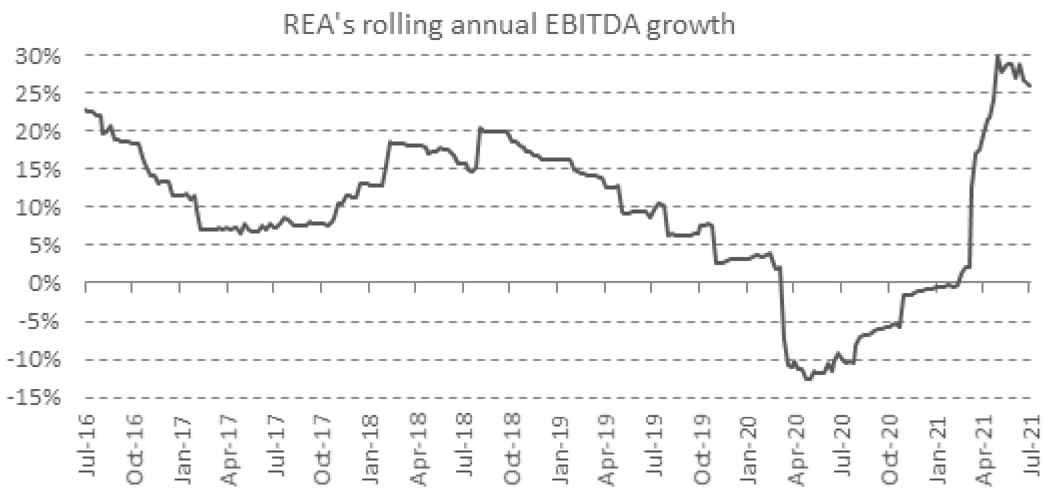
Quarterly perspective | **the Portfolio**

Sydney new residential listings volumes (4 week rolling) - as reported by CoreLogic



Source: Vertium, UBS

The market's underestimation of REA's earnings recovery created a disconnect between the share price at that time and REA's improving business fundamentals. Over FY21, REA's earnings growth has surpassed consensus expectations and its rolling annual EBITDA growth has increased to around 30%, the highest growth rate in the last five years.



Source: FactSet

The combination of REA's earnings growth and an expansion of its valuation multiple led to its strong performance over the year. Given REA's higher valuation the Fund has reduced its position.

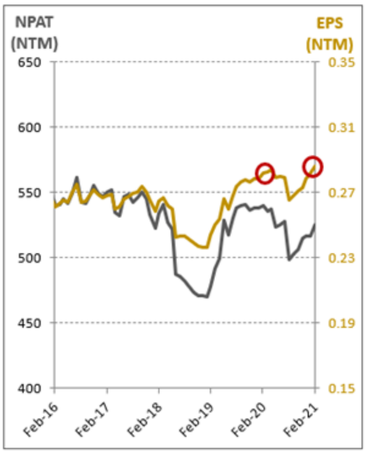
Aurizon (AZJ) was a poor performer over the year. AZJ is a stock we label as a "bathwater baby". These stocks typically are often called value stocks because of their cheap valuation multiple. Good risk-adjusted returns are generated in the future when their valuation multiple expands after the market realises the fundamentals are not as bad as they seem.

Quarterly perspective | the Portfolio

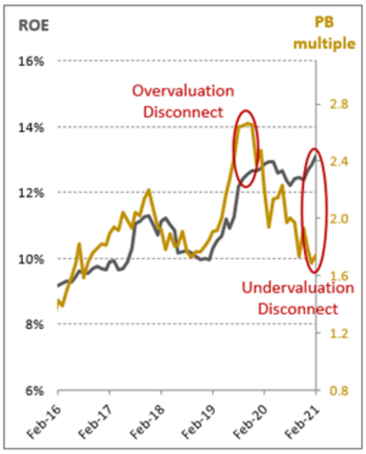
During the COVID crash, the Fund bought AZJ around 15x PE multiple. Despite our research highlighting its robust fundamentals, the stock was bought too early and continued to derate to about 13x PE multiple later in the year.

Pre-COVID: PE multiple at record high
Now: PE multiple is at all time low

Minimal COVID impact on earnings

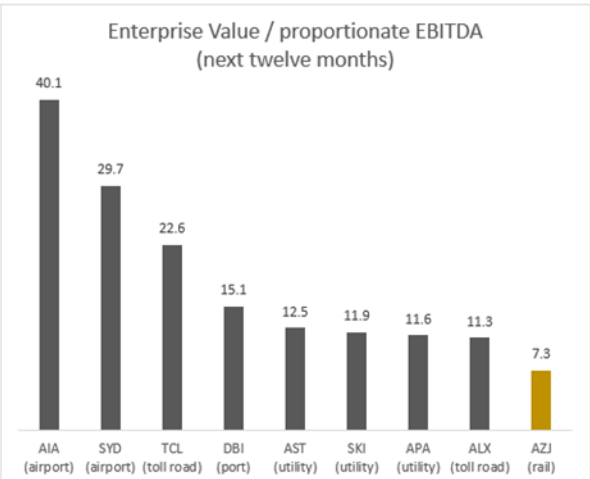


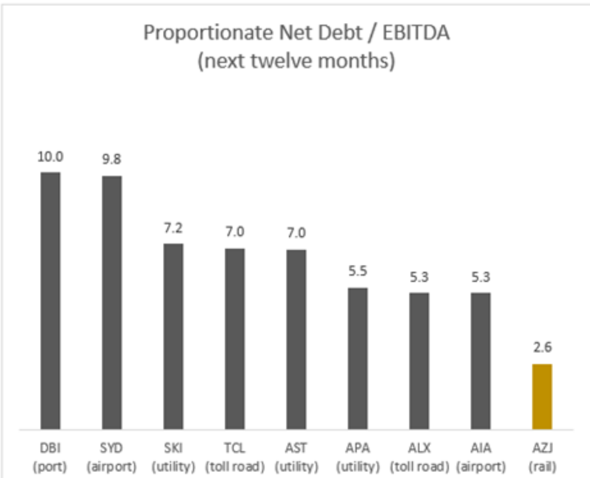
Large disconnect between quality and value



Source: Vertium, FactSet

Furthermore, there is growing activity in the infrastructure sector such as Telstra selling its mobile towers for 28x EV/EBITDA, and the takeover bids for Sydney Airport and Spark Infrastructure in recent weeks. Below are valuation multiples and gearing ratios of listed infrastructure stocks as at the end of June 2021. Note that airports look expensive on near term earnings because of current international border closures.





Source: Vertium, FactSet

Technically, AZJ is not a pure infrastructure stock, but it also seems the market has forgotten that about 60% of AZJ earnings are derived from monopoly rail assets. Relative to infrastructure peers, AZJ has the lowest valuation multiple and is the least geared.

Quarterly perspective | **the Portfolio**

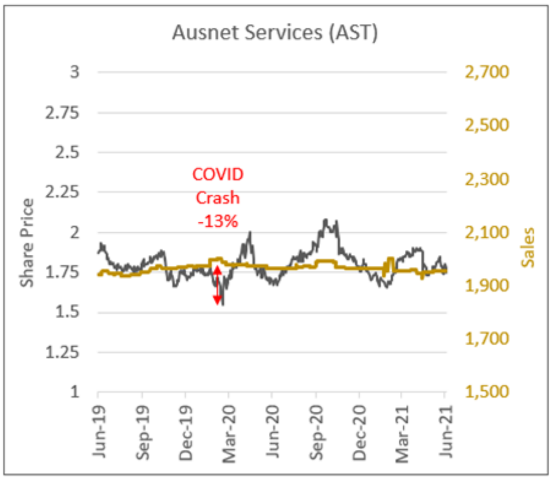
The low valuation of AZJ is a head scratcher if we compare it to its closest peer – Dalrymple Bay Infrastructure (DBI). AZJ's multiple trades at half that of DBI's multiple of 15x EV/EBITDA. More interesting is that AZJ's EV multiple of 7x is less than DBI's net debt to EBITDA of 10x. Considering that enterprise value is the sum of the value of debt and equity, the maths does not add up for AZJ. If monopoly assets can be geared to 10x net debt to EBITDA, it implies that AZJ would have negative equity value if its enterprise value remained at a 7x multiple.

AZJ's investment metrics are the antithesis of junk stocks – respectable ROE of 12%, relatively stable earnings profile and a strong balance sheet. With the stock trading extremely cheap relative to its fundamentals the Fund continues to maintain its position.

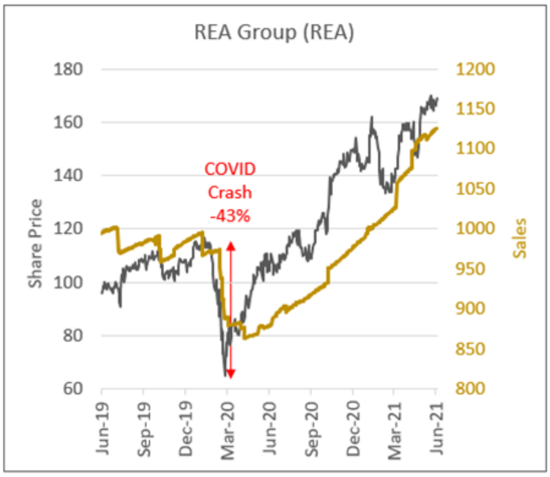
While the performance attribution is good at highlighting outperformers and underperformers, it only highlights one aspect of the Fund. The Fund's other objectives are just as important regarding delivering high levels of income and lower volatility. These two attributes are very important in managing sequencing risk for our retiree clients.

Higher levels of income are expected from the Fund through its core strategy of selling options. When call options are sold on existing stock positions, the effective cash position rises to take into account that the stock could be sold at a future date. The Fund's effective cash was certainly a drag on returns in FY21. In a fast-rising market there is a greater chance of sold call options being exercised and hence stock positions converting to cash. While effective cash dragged on overall returns in FY21 it is an outcome of an options strategy that delivered an income return that was far superior than the market.

While effective cash can be used to generate extra income for the portfolio via the options market, there are other stocks that are cash-like in nature because of their low volatility and high dividend yield. For example, Ausnet Services delivered a high dividend yield and lower volatility relative to the market over the last two years. However, the stock has underperformed the market because it lacked growth. On the other hand, over the same time frame REA outperformed the market because of its high growth profile but the stock has a lower dividend yield and is more volatile than the market.



Yield (June 2019) = 5.5% ✓
Beta = 0.32 ✓
Return = 1.9% p.a. ✗



Yield (June 2019)= 1.5% ✗
Beta = 1.25 ✗
Return = 33.6% p.a. ✓

Source: FactSet, Vertium

Quarterly perspective | **the Portfolio**

A Fund heavily weighted to stocks like REA would certainly perform extremely well in terms of its total return but would fail to deliver high income and low volatility. Alternatively, if the Fund went to the other extreme and invested in lots of stocks like AST it would significantly underperform the market from a return perspective but would deliver high levels of income and exhibit extremely low volatility.

The key to achieving sustainable results based on the Fund's triple objectives is the portfolio construction process. The process aims to prudently combine different stock attributes and create a balanced portfolio. That is, find the optimal blend between stocks like AST and REA and combine their qualities to provide a more holistic outcome to deliver the Fund's triple objectives.

Concluding remarks

The financial impact from Fiscal and Monetary stimulus during the COVID crisis has led to some speculative financial bubbles such as Bitcoin. Cyclical and commodity stocks have also benefitted. But without a constant supply of sugar hits from the Government and Central Banks the sustainability of the returns from these stocks are highly questionable. The challenging environment of an economic recovery mixed with high levels of speculation in certain areas of the stock market is best navigated with a capital preservation mindset.

The Fund remains disciplined in its approach to identifying mispriced investment opportunities and avoiding investment traps. The Fund is well positioned to deliver on its objectives of higher income than the market, a reasonable total return through time and preserving capital in falling markets.

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

Jason Teh
Chief Investment Officer
Vertium Asset Management